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A. INTRODUCTION

1. Preface

The European Council in Feira in June 2000 confirmed that

“its objective remains the fullest possible integration of the countries of the Western Balkans region into the political and economic mainstream of Europe through the Stabilisation and Association process, political dialogue, liberalisation of trade and cooperation in Justice and Home Affairs. All the countries concerned are potential candidates for EU membership”.

In view of the EU-Western Balkan Thessaloniki Summit in June 2003, the General Affairs and External Relations Council adopted “The Thessaloniki agenda for the Western Balkans: moving towards European integration”¹. The Thessaloniki agenda strengthened the Stabilisation and Association process by introducing new instruments to support the countries’ reform and European integration efforts, including European Partnerships. This agenda was endorsed by the European Council and by the countries of the Western Balkans in June 2003.

In June 2005, the European Council reiterated that:

“... each country’s progress towards European integration, taking account of the evolution of the acquis, depends on its efforts to comply with the Copenhagen criteria and the conditionality of the Stabilisation and Association process. Moreover, in this process, regional cooperation and good neighbourly relations will remain essential elements of EU policy.”

The structure of the report is largely the same as that used in previous years and assesses the implementation of the Stabilisation and Association process. The report:

- describes the relations between Serbia and Montenegro² and the Union;
- analyses the political situation in Serbia and Montenegro in terms of democracy, the rule of law, respect for human rights and the protection of minorities;
- assesses the economic situation in Serbia and Montenegro in terms of economic developments and progress towards economic stability and competitiveness;
- reviews Serbia and Montenegro’s capacity to implement European standards, that is, to gradually make legislation in key policy areas more compatible with European legislation and standards;
- examines the extent to which Serbia and Montenegro’s has addressed the European Partnership priorities.

This report takes into consideration progress since the Feasibility Report published in April 2005. It covers therefore the rather short period from April 2005 to 30 September 2005, which should be taken into account when reading this report. It looks at whether planned reforms

¹ Conclusions of the General Affairs and External Relations Council, 16 June 2003.

² The State Union on of Serbia and Montenegro comprises two member states: the Republic of Serbia and the Republic of Montenegro. Throughout this Report the terms “Republic(s)” and ‘republican’ refer to the Republic of Serbia and/ or the Republic of Montenegro as member states of the State Union of Serbia and Montenegro. The two Republics represent two separate customs territories and pursue distinct customs policies. They apply duty free access to goods originating in the customs territory of each other under specific rules of origin.

referred to in the Feasibility Report have been carried out and examines new initiatives, as well as assessing the overall level of implementation.

Progress has been measured on the basis of decisions *actually* taken, legislation *actually* adopted and the degree of implementation. As a rule, legislation or measures which are in various stages of either preparation or Parliamentary approval have not been taken into account. This approach ensures equal treatment for all countries and permits an objective assessment of each country in terms of their concrete progress implementing the Stabilisation and Association Process.

The report draws on numerous sources of information. Serbia and Montenegro has been invited to provide information on progress made since the publication of the Feasibility Report. Council deliberations and European Parliament reports and resolutions have been taken into account in drafting the report.³ The Commission has also drawn on assessments made by various international organisations, in particular the contributions of the Council of Europe, the OSCE, the international financial institutions, and non-governmental organisations.

This report does not cover Kosovo, as defined by the UN Security Council Resolution 1244, which is dealt with in a separate Progress Report.

2. Relations between the EU and Serbia and Montenegro

Recent developments in bilateral relations

Serbia and Montenegro is participating in the Stabilisation and Association Process (SAP). Currently, there is no contractual framework between the EU and Serbia and Montenegro. Political and technical dialogue is carried out through the Enhanced Permanent Dialogue (EPD), where meetings take place regularly several times a year. Formal contractual relations between the EU and Serbia and Montenegro should be established through the conclusion of a Stabilisation and Association Agreement (SAA). Parts of the SAA would be implemented through an Interim Agreement until ratification of the SAA is completed.

The Feasibility Report on Serbia and Montenegro's preparedness to negotiate an SAA was adopted by the Commission in April 2005. Based on the findings of this report, the Commission concluded that Serbia and Montenegro was sufficiently prepared to negotiate an SAA. The Commission therefore recommended to the Council that negotiations should be opened. At the same time, it urged Serbia and Montenegro to continue to prepare for the negotiations in a sustained way. In this respect, the Commission pointed out that over the coming months, in line with the European Partnership, the authorities should make further significant progress concerning a number of areas, notably cooperation with the UN International Criminal Tribunal for the former Yugoslavia (ICTY), constitutional issues, the functioning of democratic institutions, public administration reform and the development of administrative capacity, judicial reform and the fight against organised crime and corruption. Moreover, the Feasibility Report stressed that should the Commission note at any time that the State Union and republican authorities have not lived up to their commitments and have not satisfactorily addressed the issues highlighted in this Feasibility Report, it will propose to the Council that the negotiations be suspended.

³ For the European Parliament the rapporteur during the reporting period was Mrs. Doris Pack, MEP. Recently, Mr. Kacin, MEP, has been appointed as rapporteur for Serbia and Montenegro.

The Council endorsed the Feasibility Report and invited the Commission to present the draft negotiation directives, which the Commission did in July 2005. On 3 October 2005, the Council adopted the negotiation directives and authorised the start of negotiations. At the same time, it indicated that the pace and conclusions of the negotiations will depend in particular on the country's progress in developing its legislative framework and administrative capacity, the effective implementation of the Constitutional Charter and full co-operation with the ICTY. The SAA negotiations were officially opened on 10 October 2005 in Belgrade.

Meanwhile, the Commission has continued to monitor closely the progress made by Serbia and Montenegro, notably in the context of the Enhanced Permanent Dialogue, where several sectoral groups have been set up. As a result of the Thessaloniki agenda, the first political dialogue meeting at ministerial level between the EU and Serbia and Montenegro was held in June 2004. A second ministerial meeting took place in February 2005.

An EU-Serbia and Montenegro inter-parliamentary meeting, attended by delegations from the Serbia and Montenegro Parliament and the European Parliament, was held in December 2004. Although no formal relations exist with the European Economic and Social Committee, an introductory visit establishing contacts with civil society has taken place. The EU Monitoring Mission continued to operate on the basis of its Joint Action.

The first **European Partnership** for Serbia and Montenegro was adopted by the Council in June 2004 (*see part C – European Partnership: Overall Assessment*). The short-term priorities of the European Partnership coincide to a large extent with the recommendations issued in the context of the Enhanced Permanent Dialogue. In autumn 2004, Serbia and Montenegro – at State Union level and at the level of the Republics - adopted the respective components of the action plan addressing the European Partnership priorities. Further to the discussions held in the framework of the EPD, the authorities have updated the action plan. As a result of the plan, Serbia and Montenegro has been able to make progress in addressing a number of the short-term priorities and also some medium-term priorities.

The EU is Serbia and Montenegro's main trading partner. Trade integration with EU has been rising since 2000 and the EU share of total imports reached 49% between January and August 2005. For the same period, the EU share of total exports reached 55%. A significant proportion of both Serbia and Montenegro's exports are raw materials or goods with a low level of processing and relatively low value-added. Iron and steel, fruit, vegetables and sugar constitute the largest components in the case of Serbia. Exports of agricultural goods have returned to earlier levels. Montenegro's exports are dominated by aluminium. By contrast, the goods imported are generally more highly processed. While there is a positive trend of increasing imports of capital goods (pointing to higher investment in the country and underpinning structural reforms), the growth of consumer goods imports remains significant. Since 2000 Serbia and Montenegro has benefited from Autonomous Trade Measures (ATMs) granted by the European Community. These measures allow almost all imports originating in Serbia and Montenegro to enter the EU without quantitative restrictions and exempt from custom duties. The only exceptions are some beef and fish products, sugar and wine, to which tariff quotas apply. During the year, following discussions on Serbia and Montenegro's customs provisions, the Commission secured preferential access on certain agricultural products thereby ensuring respect for the provisions of the standstill clause. In addition, an agreement on trade in textile products between the European Community and the Republic of Serbia was signed in March 2005 and entered into force in July 2005⁴. Serbia and Montenegro is the country for which the ATMs have created the largest margin of preference over

⁴ This agreement does not include Kosovo (UNSCR 1244).

competitive suppliers, in particular for fruit, vegetables, leather, chemical and steel products. However, the overall opportunities offered by the preferences have yet to be fully exploited. Neither Republic has been able to fully realise the export potential created by the ATMs, which shows that restructuring efforts of some industries and further reform are still required.

Community assistance

Since 1998 **Community assistance** to Serbia and Montenegro has totalled more than EUR 2.6 billion. The EC has been providing significant support to Serbia and Montenegro under a variety of instruments, including CARDS assistance, macro-financial support and humanitarian aid. In recent years, the emphasis has shifted away from reconstruction and is now more concentrated on institution-building, economic development and reform, and support for civil society, in line with the European Partnership recommendations.

The main EC financial instrument in Serbia and Montenegro, the CARDS programme, is managed by the European Agency for Reconstruction (with the exception of Tempus programme and Customs and Taxation projects).

CARDS assistance, which supports Serbia and Montenegro's participation in the SAP, targets a number of sectoral interventions in support of three broad priorities:

Democratic stabilisation

Good governance and institution-building (including public administration reform, justice and home affairs and support to customs and taxation)

Economic and social development (including infrastructure, environment and the Tempus programme⁵)

The support provided through CARDS in 2005 is mainly focused on European Partnership priorities, which take into account the political and economic situation in Serbia and Montenegro and the requirements Serbia and Montenegro must fulfil in order to be able to implement an SAA. Total CARDS assistance allocated to Serbia and Montenegro in 2005 amounts to EUR 183.5 million (State Union: EUR 7 million, Serbia: EUR 154.5 million, Montenegro: EUR 22 million).

Serbia and Montenegro also benefits from the regional CARDS programme, which in 2005 has an overall budget of EUR 40.4 million to support actions of common interest for the Western Balkan region, for example in the fields of infrastructure, institution-building and cross-border cooperation.

In addition to CARDS assistance, Serbia and Montenegro is also a priority country for the European Initiative for Democracy and Human Rights and benefits from the LIFE environmental programme, as well as from the 6th Framework Programme for Research and Development.

The Commission has agreed with the authorities on a Supplemental Memorandum of Understanding to grant additional macro-financial assistance to Serbia and Montenegro (up to EUR 70 million: EUR 45 million grant + EUR 25 million loan). This assistance is expected to be disbursed in two tranches during 2005 and 2006 provided that external financing needs

⁵ Under the Tempus programme, the European Commission supports different types of activities, including Joint European Projects between universities in the EU and the partner countries and Structural Measures aimed at supporting national reform processes. So far, the Commission has supported a total of 63 co-operation projects in Serbia and Montenegro.

remain and Serbia and Montenegro meets the associated economic reform conditionalities and performance criteria as laid down in the Supplemental Memorandum of Understanding.

The EU agreed at the 2003 Thessaloniki summit to open participation in Community programmes to the Western Balkan countries, following the model of previous enlargements. Therefore, a Framework Agreement between the Community and Serbia and Montenegro on participation in Community Programmes was signed in November 2004. The Community ratified the Agreement in May 2005, and Serbia and Montenegro did so in July 2005.

Twinning

In its efforts to help Serbia and Montenegro to strengthen its administrative capacity, the EU has also decided to extend the “*twinning*” mechanism to the Western Balkans. “Twinning” makes the Member States’ public sector expertise available to the partner country through the long-term secondment of civil servants and accompanying short-term expert missions and training. The Western Balkans can also draw on Member States’ expertise through “twinning light” (projects of up to six months’ duration).

A twinning will assist the bodies of the State Union as well as the two Republics which co-ordinate and support the European Integration process.

The Republic of Serbia started to use the assistance of Member State institutions through the twinning programme under the CARDS 2004 Annual Programme. The Ministry of Agriculture, Forestry and Water Management is implementing a twinning project to strengthen its administrative and policy analysis capacities. The Ministry of Mines and Energy is implementing a twinning project to assist in the implementation of the unbundling and reform of the energy sector and to establish national and regional energy markets. The Ministry of Justice is implementing a twinning project to facilitate the alignment of legislation and administration with EU standards. A twinning project is also helping the General Secretariat of the Government of the Republic of Serbia to strengthen policy development and decision-making at the centre of the Government. A further eight twinning projects are being prepared under the CARDS 2005 annual programme for Serbia to support the development of the veterinary, phytosanitary, food-safety laboratory, wine, water, transport and health administrations as well as to strengthen the ability of the Ministry of Interior to combat organised crime.

For Montenegro two twinning are under preparation, support to special prosecutor on organised crime and support to police academy.

B. IMPLEMENTATION OF THE STABILISATION AND ASSOCIATION PROCESS

1. Political situation

The conditions of the Stabilisation and Association process were set out in the conclusions of the General Affairs Council in April 1997. To become EU members, the countries need to satisfy the criteria established in the Copenhagen European Council conclusions of June 1993. The Copenhagen political criteria stipulate that countries must have achieved “stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.”

Elements for examination include democratic principles, human rights and the rule of law, respect for and protection of minorities and regional cooperation. In addition to these, specific elements of relevance to individual countries are examined, including respect for international obligations such as peace agreements and cooperation with the International Criminal Tribunal for the former Yugoslavia (ICTY).

In the Feasibility Report, the Commission found that:

*“The **functioning of democratic institutions and the respect for rule of law** in Serbia and Montenegro have improved – although this has been slow and sometimes partial especially owing to the legacy of the past regime.*

Some progress has recently been made towards constitutional and legal certainty but it remains open to challenges. The recent agreement to revise the Constitutional Charter concerning the State Union Parliament direct elections is a particularly welcome development. The functioning of the parliaments and the executives has improved but it is still affected by structural weaknesses.

There are ongoing efforts in both Republics to tackle public administration reform through intensive legislative activities. However, implementation of this reform is still at a very early stage. The level of administrative capacity remains generally low. In Serbia, although unevenly distributed across the various levels and branches of the administration, there is a core capacity to deal with European integration and notably with the negotiation of an SAA. In Montenegro, while efforts have been made to reinforce the European integration structures, this capacity is affected by the lack of human resources throughout the administration. At the State Union level, administrative capacity is constrained in particular by the lack of stable budgetary allocations. Army reform has continued but much remains to be done to ensure effective democratic control.

*The overall respect for **human and minority rights** has significantly improved over the recent years, but considerable further steps are needed at both the level of legislation and of enforcement. Accession to the Council of Europe in 2003 and ratification of its key human rights instruments were a major step forward, but difficulties as to their full implementation still persist, in particular concerning the Office of the Government Agent for the European Court of Human Rights and the jurisdiction of the State Union Court. Respect for minority rights saw progress, but occasional incidents occur. Police ill-treatment needs further comprehensive action. Little progress has taken place in relation to the investigation of crimes committed during the previous regime. Freedom of speech is generally respected, but restrictions to independent media persist. There is no anti-discrimination legislation and human rights institutions, such as the Ombudsman, need to be established at all necessary levels and strengthened.*

*As regards the respect of the **United Nations Security Council Resolution 1244 on Kosovo**, Belgrade's constructive engagement on the Kosovo issue will help to advance Serbia and Montenegro's European perspective, while obstruction could turn into an obstacle.*

*Serbia and Montenegro has recently made significant progress in meeting its international obligations concerning **co-operation with the ICTY** after a period where co-operation had been seriously deficient. There are no more backlogs with regard to waivers to witnesses. Access to documents has substantially improved, though this process is still sometimes obstructed by parts of the administration and the army. In recent months, a significant number of indictees has been transferred to The Hague.*

Overall, the political criteria are sufficiently met at this stage for opening SAA negotiations."

The section below provides an assessment of political developments in Serbia and Montenegro since the publication of the Feasibility Report, including the overall functioning of the country's executive and its judicial system, the rule of law, respect for human rights and protection of minorities and regional issues. Such developments are closely linked to Serbia and Montenegro's ability to implement the reforms and reach the standards that are required to make further progress in the Stabilisation and Association process and towards the EU.

1.1 Democracy and the rule of law

Constitutional and legal certainty has remained precarious. Although the **functioning of the institutions** of the State Union has improved in relative terms, their efficiency continues to be adversely affected mainly by the conflicting interpretations of the Constitutional Charter. The revision of the Constitutional Charter, which was adopted in June 2005, has restored the legitimacy of the State Union Parliament but its functioning remains weak. The State Union Court has started working, although its capacity continues to be limited and the agreement on the scope of its powers remains largely untested. The State Union Parliament has still not adopted the State Union legislation that would give a more solid basis to the financing of the State Union in line with the Constitutional Charter. The recent revision of the Constitutional Charter also made it clear that the law on the **referendum**, whereby a Republic can decide to withdraw from the State Union, "must be based on the internationally recognised democratic standards" and that the Republic organising the referendum "shall cooperate with the EU respecting international democratic standards as stipulated by the Constitutional Charter". The Venice Commission is expected to deliver an opinion on the compatibility of the Montenegrin law on referendum with internationally recognised democratic standards as Montenegro indicated its intention to hold a referendum after the end of the period prescribed in the Constitutional Charter.

The authorities at the level of the State Union and the Republics are making efforts to respect a common understanding on the **distribution of powers** enshrined in the Constitutional Charter. In practice, problems persist with regard to the articulation of competences between the State Union and the Republics in a number of areas, often due to the lack of a constructive approach. In particular, there has been no progress on harmonising different visa regimes or developing an integrated border management system at State Union level. As regards those competences that were transferred to Republic level, inter-republic cooperation has continued to develop, though mostly not on a formal basis.

As regards the **revision of the constitutions** of the two Republics, no actual progress has been made, due to the continued lack of consensus within each Republic on completing this key reform. In Serbia the most controversial issues are the way the new constitution is to be adopted and the modalities of future decentralisation, while in Montenegro the key issue remains an apparent lack of political will to engage in substantial reform until after the referendum. Moreover, since the provisions of the current constitutions largely date back to the Milosevic era they do not provide all the guarantees that are necessary for the consolidation of democracy, the rule of law and, in the case of Serbia, full respect for human and minority rights. This remains a serious concern.

In both Serbia and Montenegro the **rule of law** remains fragile because of constitutional and legal uncertainty, structural weakness and undue politicisation of the administration and the judiciary, the high level of corruption, the pressure exerted by organised crime, and obstruction from parts of the institutional, political, military and state security systems. While there is an increasing awareness of this among civil society, few efforts are made by the authorities to deal with the legacy of the past and reinforce the rule of law. The situation therefore remains a source of concern.

Parliament

State Union

Further to the revision of the Constitutional Charter, which was adopted in June 2005, direct elections to the Parliament of Serbia and Montenegro – originally planned for March 2005 - will now be held separately in the two Republics at the same time as elections to the respective parliaments. The mandate of the current members of Parliament has been extended until such elections take place, thus retroactively restoring their legitimacy.

The functioning of the State Union Parliament, which has limited competences, has remained weak. During the reporting period, it has adopted three laws and a number of ratification laws of international agreements. The State Union Parliament continues to lack specialised staff. Parliamentary control of the military has remained weak.

The State Union Parliament adopted a Resolution on European integration in June 2005. Even though it was not approved with a political consensus, this is a welcome development. This resolution should strengthen the link between internal reforms and EU integration requirements as well as parliamentary control over the Council of Ministers in that process.

Serbia

The legislative activity of the Serbian Parliament has intensified further. The adoption of the new Rules of Procedure in June 2005 represents a significant step forward. The new rules reinforce the role of the parliamentary committees in law-making, with a view to increasing the efficiency of Parliament's work. They also strengthen parliamentary control over the Government and the role of the Committee for European Integration. Parliament continues to lack specialised staff. Although parliamentary sessions are open to the public, the law-making process still suffers from inadequate public consultation and does not fully take into consideration the expertise of relevant professional or international organisations. There has been no development as regards the electoral legislation.

Recent problems in relation to the transfer of MPs from the opposition to the ruling coalition have highlighted the need for a clearer regulation of the issue of the parliamentary mandates and a scrupulous respect of rules concerning incompatibility of functions. The decision of the Democratic Party (DS) to withdraw from the parliamentary works gives rise to concern.

In spite of limited resources, the Committee for European Integration has continued to carry out valuable work in implementing the priorities from the European Partnership and amending relevant legislation, although its opinions have not always been fully taken on board. The Committee, however, has limited expertise to check the compatibility of legislation with EU standards and relies upon external resources.

Montenegro

In Montenegro, the opposition, which boycotted the work of Parliament from September 2003 until autumn 2004, has still not resumed fully the work in the parliamentary committees. New rules of procedure are still awaited. The Parliament has continued its intensive legislative activity. There has been no development as regards electoral legislation.

In June 2005 a Resolution on European integration was adopted with the support of both the parliamentary majority and part of the opposition. This is a welcome development. This resolution should strengthen the link between internal reform processes and EU integration requirements as well as parliamentary control over the Government in that process.

The functioning of the Committee for European Integration remains weak and inadequate, due on the one hand to political difficulties, and on the other to lack of resources, including specialised staff. While the relevant bills forwarded by the Government contain a statement on compatibility with EU standards, the Committee itself has very limited expertise to perform similar checks.

Government

State Union

No progress has been made as regards the work of the State Union Council of Ministers, which continues to suffer from structural weaknesses (in particular concerning coordination and the performance of some individual ministries) and from the problems relating to compliance with the Constitutional Charter.

The high-level Serbia and Montenegro Council for European Integration, set up to give political direction and strategic guidance to the country's EU aspirations, has not met since April 2005.

The position of the European Integration Office continues to be fragile, due to both a lack of resources and structural weaknesses as regards its formal status and competences. While the Office has made efforts to implement the relevant priorities of the European Partnership, it has not been put in a position to develop technical and administrative guidance for EU integration-related activities. Coordination with the respective republican institutions has improved, though some difficulties persist. Co-operation between the European Integration Office and the State Union Parliament, notably the parliamentary European Integration Committee, is good but there is no formal mechanism for checking the compatibility of legislation with EU standards.

With a view to the opening of the Stabilisation and Association Agreement negotiations, the State Union Council of Ministers set up the Serbia and Montenegro negotiating team in July 2005. The Minister of Foreign Affairs was appointed head of the team. Three working groups were established for those chapters of the agreement where the State Union will lead the negotiations (preamble, political dialogue, general principles, institutional provisions, transitional and final clauses, visa/asylum/migration, and harmonisation). The relevant negotiation platform has been adopted.

Serbia

In Serbia the lack of coordination within the Government persists. There has recently been a worsening of relations with the civil sector and the media both of whom have been raising the issue of war crimes, and in particular the Srebrenica massacre; this attitude from the side of the Government reflects a continued failure to appreciate the role that civil society and the media play in a democratic society and worrying tendencies towards political interference in their work. Of equal concern have been the apparent attempts by some members of the Government to interfere with the functioning of the justice system.

A comprehensive strategy for joining the EU was adopted by the Government in June 2005. This is a welcome document which needs to be further elaborated and followed by increased involvement of line ministries and agencies in the European integration process. In line with the October 2004 parliamentary Resolution on EU Integration, the Government regularly submits reports on the activities in that process, which are usually debated in the parliamentary Committee for European Integration. The mechanism institutionalised in the Government Rules of Procedure, whereby every proposed bill must be accompanied by a statement on compliance with EU standards, has been implemented, with substantial involvement of the European Integration Office. The Government has shown reluctance to forward the statement to Parliament, as part of the justification of a bill, in spite of requests by the Committee for European Integration, which still needs to develop its capacity to produce such expert reports.

The new Law on Government has upgraded the position of the European Integration Office by putting it under the responsibility of the Prime Minister, who has in turn delegated European integration affairs to the Deputy Prime Minister. This Office continues to develop the institutional capacity for coordination on EU-related issues in cooperation with the European integration contact points established in all line ministries. It has developed a key role in the preparation of annual action plans for harmonising Serbian laws with the EU *acquis*, and is in charge of submitting quarterly reports on the implementation of these action plans. The first such report has been prepared and published and contains valuable information about ongoing activities and future requirements. The Office lacks the institutional capacity to ensure that the actions by the Government and administration properly satisfy SAP political criteria.

With a view to the opening of the SAA negotiations, the Serbian Government has appointed the Deputy Prime Minister as head of the negotiating team and has set up six working groups. The negotiation platform has been adopted by the Government.

Montenegro

In Montenegro the functioning of the executive continues to be characterised by smooth decision-making. Implementation capacity remains weak, although the authorities have undertaken steps to tackle this issue. In spite of the recent adoption of a strategy on the fight against corruption and organised crime, the environment remains conducive to corruption. Efforts have been made to take on board the relevant international expertise concerning the content of some major draft laws in preparation. Cooperation with civil society has continued to progress on EU-related issues, but the overall situation needs further improvement. NGOs have protested against government interference in media freedom.

Having consolidated its infrastructure and resources, the Ministry for International Economic Relations and European Integration is playing an increasing role in the coordination of EU-related activities, including the preparations for Stabilisation and Association Agreement negotiations, and should continue to focus on the European integration agenda. There is a

standing Government Coordination Group on EU-related issues, involving the line ministries and relevant agencies. The mandatory statement on the compatibility of draft laws with EU standards is implemented in the governmental law-making process. The relevant drafts forwarded to the Parliament contain the statement on compatibility. There are also increasing references to EU standards or SAP criteria in the text of justifications accompanying some important bills and forwarded to the Parliament.

With a view to the opening of the Stabilisation and Association Agreement negotiations, the Montenegrin Government has appointed the Minister for European Integration as head of the negotiating team and has set up six working groups. The negotiation platform was adopted by the Government.

Public administration

State Union

No progress has been made as regards the State Union administration, which still lacks any genuine civil service legislation, with detrimental consequences for the status and accountability of State Union officials. Furthermore, the precarious financial situation of civil servants persists.

Serbia

Pending the adoption and full implementation of new laws, the Serbian administration remains overstaffed but at the same time suffers from a shortage of qualified personnel and undue political interference, which affects both institutional and policy continuity.

In the context of the reform strategy, the Serbian Parliament adopted the Law on the Government (which is currently being reviewed by the Serbian Constitutional Court, following an initiative by the People's Advocate Office of the President), and the Law on Public Administration and the Law on Civil Servants. Regulations on the salaries of civil servants are still pending. The authorities have indicated that most of the by-laws implementing the Law on the Government have been adopted, with the notable exception of the new rules of procedures of the Government. A law creating the function of an Ombudsman was passed in September 2005. This is welcome development. This law now needs to be implemented in particular by securing adequate budgetary means to the Ombudsman's Office. As regards the Provincial Ombudsman in Vojvodina, in spite of limited resources and infrastructure, the Office has developed a wide range of activities, including *ex officio* actions to investigate human rights abuses. There is no specific information on the follow-up to the Ombudsman's recommendations, apart from general statistics for 2004 claiming that out of 265 cases 188 were resolved at the level of the Ombudsman while 71 were not receivable.

As regards decentralisation, which is a key issue in the context of the debate on the constitutional revision, there are concerns on the impact that the recently adopted law on Government may have on local self-government. There is still a need to grant to municipalities the right to own and manage properties.

Montenegro

In Montenegro further progress has been made in completing the legislative framework of public administration reform. In practice, implementation capacities continue to be weak, in terms of both funds and infrastructure and personnel and training. This is coupled with problems of poor accountability and continued political interference.

The establishment of the Authority for Human Resources Management, which still needs to become fully operational, is a positive step. The implementation of the legislation is ongoing. The new recruitment policy is operational but the new organisational structure and new salary system are still not fully in place.

The Ombudsman's Office is still at an embryonic stage. The Ombudsman's annual report, released in June 2005, notes that relations with the authorities are mostly good, except at local level, where the lack of understanding of this institution seems to be the key reason for insufficient cooperation. An awareness-raising campaign was conducted in summer 2005. The available statistics (for 2004) indicate that in numerical terms the follow-up to the Ombudsman's recommendations has been satisfactory (out of 34 recommendations issued, 19 have been complied with and 15 have not).

Some developments have taken place in the field of decentralisation where the Government has set up a co-ordination body for local government reform. Several laws related to decentralisation are pending.

Defence reform

Defence is a **State Union** competence. The reform of the military continues to meet with significant resistance and obstruction from some political actors and elements within the army itself. The adoption of the military doctrine is pending. Despite efforts undertaken, the State Union parliamentary committee which is supposed to ensure democratic control over the military continues to be weak. This is a source of serious concern. Financial management is notionally entirely in the hands of civilian institutions (State Union Ministry of Defence and Council of Ministers, Supreme Defence Council, Governments of the two Republics), but the overall system of allocation and management of military funds has been the subject of controversies and confrontations between the State Union and republican (notably Serbian) authorities, culminating in the recent resignation of the Minister of Defence. The continued lack of the relevant legislation at State Union level and conflicts between different actors have added to concern over the transparency of military expenditures and allocation of military property.

At the same time, reform continues to be constrained by scarce financial resources. The issue of the ownership and rationalisation of military assets has been only partially resolved by the establishment of the Fund for military reform, whose legality continues to be disputed. Its functioning is also affected by the decision-making on the disposal of assets, which is subject to cumbersome procedures involving prior consent by the republican governments: this has led to sales of military assets in Serbia being blocked.

There have been further personnel changes and downsizing. Although the Ministry of Defence, with international assistance, has been making efforts to minimise the social impact, redundancies have led to protests and in some cases social unrest.

There is still resistance within the military system to the rule of law and cooperation with the ICTY.

Serbia and Montenegro is seeking membership of NATO's Partnership for Peace, but this is contingent upon full cooperation with the ICTY.

Judicial system

As regards the *structure* of the judiciary, the two Republics have two autonomous judicial systems, formally linked only by the authority of the **State Union** Court. Montenegro's authorities have not yet found a satisfactory solution for the premises of the State Union Court

which, according to the Constitutional Charter, should be located in Podgorica. The State Union Court continues to sit temporarily in Belgrade, with the bulk of its budget coming from Serbia. The State Union Court, which has nine appointed judges and only basic equipment and support staff, has inherited more than 1000 unsolved cases from the former Federal Constitutional Court and Federal Court. In the course of 2005, the State Union Court has reportedly solved 350 cases, out of which 50 concerned constitutionality and legality. According to the authorities, there is now agreement on the exact scope of the State Court's powers (notably with regard to vetting of the constitutionality of acts of the Republics and the implementation of the European Convention of Human Rights) though the decision-making procedures of the Court need to be improved. Pending these modifications, the agreement on the scope of powers remains largely untested.

The transfer of powers of military justice to civilian courts, which took place in January 2005, has been implemented smoothly as regards criminal and civil matters. To this effect, in Serbia specialised departments have been formed within the regular courts. Concerning administrative matters, there is a considerable backlog of 3500 administrative cases inherited from the former Supreme Military Court. In Montenegro, these cases are dealt with by the administrative courts established earlier in 2005. In Serbia, the administrative courts which will take over the administrative cases will be established only in 2007.

Judicial cooperation between the Republics, which includes the mutual recognition of court decisions in both civil and criminal matters and honouring requests for legal aid between the courts, has continued to develop on the basis of a Memorandum of Understanding signed by the two Ministries of Justice in June 2004. Good cooperation exists in practice, although it depends on professional and personal relations rather than on a systematic and sustainable approach.

In **Serbia** the judiciary has continued to exhibit serious weaknesses. Its *independence continues* to be severely undermined by political pressure on the *appointment* of judges and prosecutors and their activities, and the system remains heavily burdened with the legacy of the previous regime. On the positive side, steps have been taken to ensure the effective functional independence of the War Crimes Prosecutor.

The lack of adequate resources to ensure financial sustainability and provide for better functioning is reflected in the continuing inefficiency of the justice system. At present, with the Justice Ministry solely responsible for the *judicial budget*, there is limited scope and capacity for the judiciary to influence budgetary decisions so that they address actual needs.

Serbia has so far failed to provide the legislative framework and to create and support an institution with the mandate to develop and implement a comprehensive *training* programme for judges. There is neither initial induction training for newly appointed judges nor continuing legal education for sitting judges. The Judicial Training Centre remains a very weak institution. Present training activities for the judiciary are donor-driven, with little coordination or direction provided by Serbian authorities, and are very limited in terms of participating practitioners, scope of training and results achieved.

In spite of efforts to improve legislative provisions (mainly in the area of civil law) aiming at shortening procedures and measures to deal with the sizable *backlog* of cases, the continuing inefficiency of the judicial system represents a serious obstacle to the reform process.

As regards the reform of criminal legislation, the Criminal Code and the law on witness protection were adopted in September 2005. The revision of the Code of Criminal Procedure and supplementing legislation as well as the law on police are still pending.

Finalisation of the Serbian Government's judicial reform strategy has been delayed. Although the strategy defines as priorities the independence, accountability and efficiency of the judicial system, it also includes worrying provisions on the reappointment of judges after the initial limited mandate of five years, which in the absence of clear, professional criteria and transparency in the appointment procedure severely undermine the independence of the judicial system. Equally worrisome are the provisions placing the prosecutor system under the Ministry of Justice, in particular given the envisaged transfer to prosecutors of all the investigative tasks so far attributed to the investigative judges. Once it has been aligned with relevant international standards, the success of this important reform process will largely depend on the political will to implement it and on securing the full support and involvement of the legal professions and practitioners in its future implementation.

Despite considerable improvements in the legislation in both criminal and civil matters in **Montenegro**, proper implementation remains a source of serious concern. Although the legislative provisions on the organisation of the judicial system have been amended to secure the *independence* of the judiciary, in practice this is often obstructed by political influence over the *appointment* procedure for judicial positions, in the absence of clearly defined criteria for the appointment of judges and prosecutors and swift implementation of these criteria.

The Judicial Training Centre, which is still a largely donor-dependent institution, has continued to provide training of appointed judges, mostly on the implementation of the European Convention on Human Rights. The law envisaging comprehensive *training* of judges and prosecutors and the strengthening and financial viability of the Judicial Training Centre has not yet been adopted.

Following the establishment of the administrative and appellate courts in January 2005, some additional judges have been appointed with a view to clearing the *backlog* of inherited cases and handling the increased volume of new cases. Delays in court proceedings are the main category of complaints brought to the attention of the Ombudsman.

The Special Prosecutor for Organised Crime has been appointed and the Office is now operational, but only modest results have been achieved so far in addressing the issue of organised crime, compared to the scale of the problem and the threat it represents to society. There has been little progress as regards the implementation of the witness protection law, due to insufficient cooperation between the judiciary and the police and inadequate financial support.

In both Republics, care should be taken to further develop the legal framework for witness protection, in such a way as to ensure that the safety of vulnerable witnesses is appropriately balanced with the accused's right of defence.

Anti-corruption policy

International surveys continue to indicate that Serbia and Montenegro suffers from a high level of corruption.

In May 2005 the **Serbian** Government submitted to the Parliament a strategy for the fight against corruption, developed with Council of Europe assistance. This strategy needs now to be adopted by the Parliament. In the meantime, problems have emerged with the preparation of the Action Plan for implementation and the establishment of the lead institution, the anti-corruption body, whose role and relationship with the existing structures remain to be fully defined. The Anti-Corruption Council, established as a focal point and an advisory body to the Serbian Government in 2001, has finalised several reports on alleged corruption cases,

involving high-ranking officials, but the serious allegations raised and documented were not further investigated or properly addressed by the Government.

Conflicts of interest remain a concern, as there have been delays in implementing the new legislation and the results so far have been limited. The Government is still reluctant to fully implement the law on free access to information. This continues to undermine transparency in public policies. While the law on the financing of political parties has had some positive effects in terms of increased financial transparency, problems still exist with the content of the law and its implementation.

In **Montenegro** anti-corruption activities are still far from sufficient. At present, the central institution is the Anti-corruption Initiative Agency, which has no investigative or operational authority. This is one of the reasons for the lack of tangible results over the years, despite the numerous cases of corruption reported by the NGO sector. A joint strategy against corruption and organised crime was adopted by the Government in August 2005. It was developed under the lead of the Ministry of Interior, including input from the relevant ministries, agencies, civil society and international organisations. Under this strategy, the central body responsible for implementation will have investigative and operational powers.

The Law on Conflict of Interests has been implemented with difficulty and contains problematic provisions allowing members of parliament to be members of boards of public companies. This legislation needs to be reviewed in line with international standards. The laws on political parties and their financing are being implemented with difficulty. Political parties failed to fully observe the legal deadlines and procedures for reporting financial assets and the financial management of electoral campaigns. Moreover, this law was further amended in May 2005 in a way that undermines the principle of equity in the election process and abolishes the upper limit for budgetary allocations. Other laws are still only in preparation, such as the draft law on free access to public information, which was backed by the NGO sector but is currently in the parliamentary procedure.

Serbia and Montenegro continued to participate in the Council of Europe's GRECO initiative (Group of States against Corruption). Evaluation visits in the two Republics took place in September 2005.

1.2 Human rights and the protection of minorities

Observance of international human rights law

In April 2005 the period for the implementation by Serbia and Montenegro of the commitments it undertook when joining the **Council of Europe** came to an end. The Council of Europe's assessment stated that "after more than two years of Council of Europe membership, Serbia and Montenegro has now honoured a large number of accession commitments, in particular when it comes to signature and/or ratification of Conventions and even more so adoption of relevant legislation." The Council of Europe pointed out a number of areas requiring further efforts, in particular constitutional reform, reconciliation and facing the past, local democracy, the functioning and independence of the judiciary and prosecution service, and protection of minorities. Serbia and Montenegro continues to be subject to post-accession monitoring on a quarterly basis.

As regards the uniform implementation of international obligations throughout Serbia and Montenegro, the authorities claim that the role of the State Union Court's of the convention on Human Rights and Fundamental Freedoms has been clarified but practical implementation remains to be realised. While the State Union Council of Ministers adopted the decree on the

appointment of a state agent in February 2005, the agent was appointed in September, and the appointment of his deputy is still pending. Moreover, there are concerns about the budget allocations for the agent's office for 2005. In the meantime, around 750 cases against Serbia and Montenegro are pending before the European Court of Human Rights. Other Council of Europe conventions, such as the European Charter on Regional and Minority Languages and the revised European Social Charter, should be ratified shortly.

As regards the right to the protection of personal data, Serbia and Montenegro have ratified Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data (ETS No. 108) in September 2005. However, it is a matter of concern that this has been done without the previous adoption of an appropriate national Law.

Civil and political rights

No progress has been made on enforcing the Serbian Law on the Accountability for Human Rights Violations (the "*Lustration*" Law).

As regards *mass graves* identified in Serbia, to date, no indictment has yet been brought.

In the area of the *prevention of torture and ill-treatment*, limited progress has been made in Serbia as regards the investigation of all allegations of human rights violations during the state of emergency in March / April 2003. The parliamentary Committee for Security and Defence concluded in May 2005 that "unselective detentions" and "human rights abuses and torture" took place in that period, but the issue is a source of continuing political confrontation. The Office of the Inspector-General in the Serbian Ministry of Interior reported that out of 37 cases brought to its attention in that context, 20 were rejected as unfounded, 6 torture cases were confirmed and 11 are still being investigated.

Efforts to implement the European Convention for the Prevention of Torture have continued, for example by educating relevant parts of the State Union and republican administrations. No progress has been made by the authorities in reacting to the cases brought by the UN Committee against Torture. The lack of transparency and adequate information concerning the number of possible cases of police torture and the measures taken remains a major problem in both Republics. In Serbia, the Office of the Inspector-General in the Serbian Ministry of Interior has continued its work. To date there has been little concrete information as to the outcome of various cases and any sanctions against the police officers alleged to have committed abuses. The independence of the internal control system needs to be maintained and reinforced. In Montenegro, human rights NGOs continue to claim that police torture during detention is a problem, but that action is often obstructed by the police itself. The new Montenegrin Law on Police provides for internal control mechanisms, which now need to be fully implemented. Notably, police ill-treatment in the prison in Spuz (September 2005) needs to be fully and transparently investigated.

In Serbia, the reform of *pre-trial detention* is contingent on the comprehensive revision of the Code of Criminal Procedure, which is still pending. In Montenegro, the Code of Criminal Procedure in force since 2003 limits the possibility of pre-trial detention to serious circumstances and to specified cases only, where the prescribed penalty must be ten years of imprisonment or more. The principle that proceedings should be conducted without undue delay is introduced in such cases, as well as provisions on mandatory defence.

Prison conditions remain precarious in both Serbia and Montenegro because of legislative, administrative and infrastructural problems. The recently adopted Serbian reform of the legislation on the execution of penal sentences and on juvenile offenders needs to be fully implemented. In the meantime, efforts have been made to improve prison conditions in

several correctional facilities in order to meet the requisite standards, in particular as regards conditions in prison hospitals. This is becoming particularly relevant in the most serious cases which entail longer prison sentences, such as organised crime and war crime cases.

As regards *access to justice*, the basic legal framework on legal aid is laid down in the current State Union constitutional provisions referring to equality before the law, the right to legal protection, representation and defence. In Serbia mandatory defence is provided for in the case of serious criminal charges and in the case of police detention. In civil cases, the right to free defence is mainly defined in terms of the cost of the lawsuit and limited thereto. At present there is a lack of coherent planning and management of legal aid, with the result that laws are not being applied and there is no clear mechanism for ensuring the quality of legal aid. In Montenegro the system of free legal aid has not yet been introduced. In criminal cases, some provisions exist for serious cases and in instances of financial hardship. In civil cases, some aid is available to meet costs. In practice, the existing provisions are not being fully implemented.

As regards *religious freedom*, there are constitutional guarantees of freedom of thought, conscience and religion at all levels. In Serbia there has been no progress in the adoption of new legislation, which needs to be in accordance with international standards concerning the equality of religious organisations and the principle of separation of church and state. There have been considerable delays in legal proceedings concerning religiously motivated incidents, notably the burning of mosques in the aftermath of the March 2004 violence in Kosovo. In Montenegro the legislation regulating the status of religious communities is obsolete and needs further improvements to be fully in accordance with international standards. As regards *conscientious objection*, the Decree on civilian service has been implemented with difficulty, as the number of alternative institutions assigned for this purpose has proved to be insufficient. Furthermore, the Decree was amended in January 2005 in a non-transparent manner, with the introduction of what seem to be undue restrictions, although the Ministry of Defence insisted that their aim was to counter perceived abuses of the right to conscientious objection.

Freedom of expression and media in Serbia saw improvements through the abolition of prison sentences for slander/libel and replacement by fines. There are also occasional cases of state officials in Serbia publicly denigrating and even threatening journalists, which undermine media freedom. This problem has escalated recently, with acts being targeted particularly at media which are critical of the Government and, more specifically, those that advocate the need to address the legacy of the past, including war crimes and organised crime. The new amendments to the Broadcasting Law, adopted in August 2005, which are widely contested by professional organisations, contain provisions that undermine the independence of electronic media, in particular at municipal level, by introducing further delays in the timeframe for privatisation. The amendments centralise the work of the Broadcasting Council and no longer recognise the specificity of Vojvodina as a multicultural region. In Montenegro media freedom suffers from political interference. In April 2005, NGOs protested against the distribution by the Montenegrin Ministry for Foreign Affairs of a media analysis critical of the media that were not seen as supporting independence, and suggesting government interference, notably with the editorial policy of the state broadcasting company. The legislation regulating media concentration has not been adopted.

The Serbian law on free access to public information is still not being fully implemented. The Office of the Commissioner for public information became operational only in June 2005; the Agent also reports problems concerning the administration's understanding of the law and its continuing ignorance and frequent reluctance to comply. In Montenegro similar legislation is still pending in Parliament.

New legislation on *freedom of association* is still pending in Serbia. Meanwhile, there continue to be difficulties with the status of both political associations and representatives of civil society, due to the lack of a proper legal framework. Montenegro has a satisfactory law on NGOs, but further action is still needed on the issue of tax exemptions. In May 2005 Montenegro also adopted the new law on public associations, which appears to be in line with international standards.

As regards *non-discrimination*, while Serbia and Montenegro is a signatory to all relevant international instruments, including Protocol 12 to ECHR (this protocol entered into force in May), there has been no progress in the adoption of a comprehensive anti-discrimination law, although specific laws have been adopted or are in preparation in both Republics, addressing gender equality and protection of vulnerable groups. Legislation in Serbia and Montenegro only very sporadically mentions prohibition of sexual discrimination as a separate obligation (media and labour legislation). According to human rights organisations, discrimination based on sexual orientation is a problem. In general terms, it appears that the level of protection against discrimination in Serbia and Montenegro is still far from the EU standards requiring the implementation of the principle of equal treatment between persons irrespective of racial or ethnic origin and the establishment of a general framework for equal treatment in employment and occupation, irrespective of religion or belief, disability, age or sexual orientation.

As for *property rights*, both individual and communal, there has been limited progress in Serbia concerning preparation of new legislation in cooperation with the Council of Europe. The restitution fund reportedly has at its disposal 42 million euros. Meanwhile, the law on registration of nationalised property was adopted in May 2005, stipulating July 2006 as the deadline for registration. Former owners regarded this law as a further undue delay in the restitution process. There has been no progress concerning the restitution of church property either. In Montenegro, the implementation of the law adopted in March 2004 has been difficult. The restitution fund increased in 2005 as privatisation revenues grew; the municipal commissions established to deal with restitution requests have rendered several first instance decisions. None of these is enforceable at the moment, and they have therefore not yet been fully implemented.

There is a well developed and very active *civil society* in Serbia and Montenegro. Its situation remains precarious, notably in Serbia due to the continued lack of adequate legislation and the knock-on effect on financial sustainability. In Montenegro there is a law dating from 1999, but this needs further improvements, in particular concerning the financial position of NGOs, but also their participation in public policy. The Montenegrin Government has still not adopted the platform for cooperation with the NGO sector. In both Republics NGOs remain heavily dependent on donor support. The authorities have made efforts to take the opinions of the civil sector on board, notably in the area of poverty reduction; parliaments have become more open, allowing NGOs to attend sessions; both the Serbian Office for European Integration and the Montenegrin Ministry for European Integration have signed special memoranda of cooperation with NGOs. On the other hand, the administration continues to show insufficient understanding of the genuine role of NGOs in a democratic society: in both Republics NGO activities that imply criticism of the government, and in particular those that draw attention to sensitive, often unpopular issues, are publicly denigrated.

Economic and social rights

Serbia and Montenegro signed the revised European Social Charter in March 2005, but its ratification is pending.

As regards *gender equality*, in spite of the fact that there are no legal restrictions, the representation of women in public life (in parliaments and governments at all levels) remains poor, as is their practical access to job opportunities. The situation is difficult, largely because there is neither a general anti-discrimination law nor specific legislation or coordinating activities on gender equality (although the latter is in preparation). The existence of Councils for Gender Equality has so far produced limited results. There is thus an urgent need to prepare Actions Plans for gender equality. One of the most important gender problems in Montenegro is the high level of domestic violence. In Montenegro, the trafficking of women remains a source of concern.

No development has taken place as regards respect for the *rights of the child*, in particular to eliminate discrimination against minority and disabled children. The issue of childcare centres remains to be tackled.

As regards *socially vulnerable and disabled persons*, there is still no specific legislation regulating the rights of persons with special needs in Serbia. In Montenegro the law on the protection and implementation of the rights of persons with mental disorders was adopted in May 2005. In practice, disabled people in both Republics often remain subject to discrimination. Access to social services is still difficult. The de-institutionalisation of the mentally ill has not even started.

As regards *labour rights*, both Montenegro and Serbia have new, comprehensive legislation. In Serbia, a new labour law was adopted in May 2005. Enforcement remains rather weak.

As regards *social dialogue*, competences are held at the level of the Republics. Social dialogue takes place mainly at the tripartite level, whereas bipartite social dialogue is at an embryonic state yet. Employers associations are not sufficiently developed and both employers' associations and trade unions need to further develop their technical and administrative capacities. In **Serbia**, the Economic and Social Council has started meeting but the representativeness criteria set to participate in the council have led to disputes between social partners concerning legitimacy and representations rights. In **Montenegro**, the Government is now planning to set up a revamped version of the Economic and Social Council. Neither in Serbia nor in Montenegro is the Economic and Social Council perceived by stakeholders as an independent, neutral and a powerful advocate.

Minority rights, cultural rights and the protection of minorities

Serbia and Montenegro is a signatory to all relevant international instruments in this area. It has ratified the Framework Convention for Protection of National Minorities, and the ratification of the European Charter of Local and Regional Languages is pending. International agreements have been signed by Serbia and Montenegro with countries in the region (Hungary, Romania, Croatia and Former Yugoslav Republic of Macedonia).

The establishment of National Councils for minority groups under the 2002 Minorities Law has continued, although in Serbia only. The initial difficulties concerning the funding of their activities have been resolved, and the financing of the Councils has now been institutionalised in the Serbian budget. The legislation needed to regulate their status and work, which is in preparation, has still not been adopted. Despite improvements, ethnically motivated incidents still occur, reflecting the legacy of the past decade and systemic issues in the implementation of existing standards.

Sporadic incidents have been reported across Serbia, including in Vojvodina, directed against minority populations, particularly ethnic Hungarians. These incidents are not the result of a deliberate policy of the authorities but the authorities' response need to be more resolute and

timely. The high-profile Council for National Minorities, chaired by the Serbian Prime Minister, which was established in October 2004 after the incidents in Vojvodina, has taken a proactive role and has initiated follow-up measures to the recommendations formulated by the European Parliament on the basis of the fact-finding mission that took place in January 2005, concerning notably education and, albeit so far with limited results, the judiciary and law enforcement. It is necessary, however, to introduce more transparency and regular information sharing to all interested parties and public in general about the activities of the Council.

As for Southern Serbia, the coordinating body, which was restructured and re-activated in March 2005, was fully constituted in June 2005, with the high-level participation of the Serbian President and Prime Minister. Since its reconstitution, some progress has taken place in field of education but local politicians have expressed concern about the working of the body, and in particular the level of engagement of line ministries. In September, for unrelated political reasons, the head of the Coordination Centre was replaced.

Montenegro has continued to prepare its own legislation, although this has been seriously delayed by the lack of political consensus, particularly about the arrangements for the political representation of minorities. In practice, respect for human and minority rights is mostly satisfactory, though there is still insufficient representation of minorities in public administration, despite constitutional guarantees.

Work has continued on the integration of the Roma, but the situation of this community remains precarious. There is continuing discrimination against Roma people, whose economic and social conditions are difficult (the percentage of poverty among Roma is four to five times higher than the national average). On the basis of the comprehensive Strategy for Integration and Economic Empowerment of Roma, drafted by the State Union Ministry for Human and Minority Rights (as part of the activities concerning the Decade of Roma Inclusion, 2005-2015), a number action plans in the areas of media, social protection, displaced persons, women and returnees have been prepared by the relevant Serbian ministries and are awaiting approval. In practice there is little cooperation between this State Union Ministry and the Montenegrin authorities, which have prepared a separate action plan for Montenegro. Implementation of Roma rights remains difficult: in both Republics there is a lack of accurate statistics on their real number, and a significant proportion of the Roma population do not possess basic personal documents. In addition, prejudices against this minority group among the majority population are strong and have in some cases been hampering plans for their resettlement; similar problems have been impeding activities relating to the education of Roma children. Resources for implementation are scarce, and the governments rely heavily on donor support, notably in the process of readmission. The situation of Roma people who are internally displaced is particularly difficult in both Republics.

1.3 Regional issues and international obligations

Cooperation with the **International Criminal Tribunal for former Yugoslavia (ICTY)** is an international obligation for Serbia and Montenegro as a UN Member State and as a signatory of the Dayton / Paris Agreements. It is also an obligation under the Council of Europe post-accession commitments and an integral part of the EU's political conditionality under the Stabilisation and Association process. ICTY cooperation is an international obligation for Serbia and Montenegro as a whole and therefore also concerns the Republic of Montenegro.

In the report submitted to the UN Security Council in June 2005, the ICTY Prosecutor noted that significant progress had been made, but that the authorities' policy of "voluntary surrenders" had reached its limits. One handover took place on the eve of the endorsement of the Feasibility Report by the EU Council of Ministers in April. Another handover took place in mid-September as a result of the co-operation between Belgrade's authorities and Republika Srpska. The Belgrade's authorities have also contributed to the arrest of two indictees in Argentina and Russia, who have not yet been transferred to The Hague. There are still a number of indictees at large, in particular Ratko Mladic and Radovan Karadzic, who need to be brought to justice. The authorities are expected to take action in this respect.

The National Council for Cooperation with ICTY, chaired by the State Union Minister for Human and Minority Rights, has continued to take important decisions concerning waivers for witnesses and access to documents; there is no backlog of ICTY requests. The implementation of the Council's decisions is still sometimes obstructed by those in the administration and the army in possession of documents but unwilling to cooperate with the ICTY. The Montenegrin members have not resumed their participation in the Council.

Serbia and Montenegro has not yet fully aligned itself with the EU common position on freezing the assets of ICTY fugitives. The State Union draft law on freezing the assets of ICTY fugitives is pending before the State Union Parliament. In the meantime, the Serbian judiciary has issued an order freezing these assets. In Montenegro, no such an order has been issued, as the authorities claim that no ICTY fugitive has registered property there. If they had, an order to freeze their assets could be issued on the basis of the existing criminal legislation.

As regards **domestic war crimes trials**, domestic courts have continued to be cooperative and are doing good work in trying some low-profile cases (notably the Ovcara case). Some further steps have also been taken to improve their organisational and infrastructure capacities. The recent amendments to the Criminal Code introduce new offences of crimes against humanity and genocide, but the important issue of command responsibility has been only partially addressed by making failure to prevent and notify criminal activity against humanity a crime. Cooperation with the police continues to be insufficient, and both the judiciary and the police are still subject to heavy political pressure. The overall political climate is such that there is no guarantee that any high-profile war crimes trials could be conducted in a fair and transparent manner. As regards Montenegro, the trial concerning the deportation of a number of Bosnian refugees in 1992 has started.

Serbia and Montenegro continues to have a positive attitude towards the **International Criminal Court** (ICC). Serbia and Montenegro has consistently refused to sign bilateral agreements giving exemptions from ICC jurisdiction. It should continue to do so.

There are no major problems in Serbia and Montenegro's compliance with the **Dayton Agreement**, apart from the outstanding cases relating to cooperation with ICTY. There have been mixed developments as regards the need to address the issue of war crimes, with the most notable positive being the actions by the Serbian President concerning the commemoration of Srebrenica.

Full respect of **United Nations Security Council Resolution 1244**, governing the current status of Kosovo, is an obligation for Serbia and Montenegro as a UN member and a key requirement for regional stability.

The Belgrade-Pristina sectoral dialogue has been making progress. Four working groups on technical areas of mutual interest are in place: Energy, Returns, Transport and Telecommunications and Missing Persons. Both delegations have been able to travel to both

Pristina and Belgrade without hindrance. In general, there is a need to intensify the frequency of the dialogue.

With few exceptions, Kosovo Serbs, who massively boycotted the elections, are still not participating in the Provisional Institutions of Self-Government (PISG). The participation of Kosovo Serbs in these institutions, in order to voice their legitimate concerns about the implementation of the UN-led Kosovo standards, is now crucial and should be encouraged by Belgrade.

Belgrade and Kosovo Serbs (the latter apparently disunited) have also dismissed the Kosovo Decentralisation Plan. A positive step was, however, taken in mid-September, when delegations from Pristina and Belgrade met to discuss decentralisation, in a meeting organised by UN Secretary-General's Special Envoy and hosted by the Austrian Foreign Ministry. This encounter facilitated an exchange of views and greater understanding of respective positions. There needs to be now a greater compromise that allows more concrete progress to be achieved in this important issue. Moreover, the fact that representatives of the Provisional Institutions of Self-Government taking part in regional initiatives and conferences have experienced difficulties in entering Serbia continues to be an issue that needs to be followed up.

In line with UNSCR 1244, Belgrade should encourage participation with a view to promoting the development of a democratic, multi-ethnic society in Kosovo in the interests of all Kosovo communities. Furthermore, Belgrade's constructive engagement in the Kosovo issue will help to advance Serbia and Montenegro's European prospects, while obstruction could become an obstacle.

The high number of **refugees and internally displaced persons** continued to aggravate already difficult socioeconomic conditions in both Republics. Furthermore, the precarious situation of this vulnerable population group has a significant impact upon the overall political situation and the current trend towards radicalisation in the country.

According to data released by UNCHR in January 2005 after the comprehensive refugee re-registration exercise, there are currently around 140 000 refugees and 245 000 registered internally displaced persons. The fall in the number of refugees is partly due to the implementation of new legal provisions allowing dual citizenship, as some people lost refugee status by acquiring Serbia and Montenegro citizenship. Serbia and Montenegro is also participating in the regional initiative on the return of refugees with Bosnia and Herzegovina and Croatia. Although dialogue between Belgrade and Pristina on the important issue of returns of internally displaced persons has not progressed, some co-operation was achieved between Kosovo and Montenegro with the establishment of a protocol on the returns of internally displaced persons.

In **Serbia** the authorities continue their efforts on both repatriation and local integration, in cooperation with partners in the region. The implementation of the agreement on the return of refugees with Bosnia and Herzegovina has continued to facilitate safe returns. There has been no progress in the adoption of new refugee legislation.

Montenegro has prepared its own national strategy to allow either repatriation (or removal to a third country) or local integration, but financial resources for its implementation are scarce, thus affecting prospects for putting the strategy into practice. According to the relevant international organisations, practical problems concerning labour and related rights for refugees still occur, but the authorities are taking action to address the issue through legislative changes.

The unresolved situation concerning the practical exercise of voting rights for internally displaced persons from Kosovo who are currently in Montenegro but wish to vote in the Serbian elections persists. The two Republics need to work together to ensure that internally displaced persons do not remain disenfranchised.

Serbia and Montenegro has continued to pursue a policy aimed at improving relations with all its neighbours with a view to contributing to regional stability. It continues to take part in intensive **multilateral cooperation**. Under the auspices of the Stability Pact, Serbia and Montenegro has concluded the full network of bilateral FTAs with all the Western Balkan countries and with Bulgaria, Romania and Moldova. The FTA with the former Yugoslav Republic of Macedonia has been also revised. It is now critical that these international commitments are also fully implemented.

Bilateral relations with all countries, in both the political and the commercial sphere, have continued to improve, though sporadic problems recur. Some important issues are still outstanding, notably border demarcation with Croatia and BiH and the suits pending against Serbia and Montenegro before the International Court of Justice, filed by these two countries. The celebration of the tenth anniversary of Operation Storm by Croatia and the reaction to this in Serbia also placed a strain on bilateral relations. On the other hand, the high-level presence of Serbia and Montenegro at the Srebrenica commemoration was an important gesture contributing to regional reconciliation. Recently, new tensions have occurred in relations between the Serbian Orthodox Church and the non-recognised Macedonian Orthodox Church, affecting generally good relations with the former Yugoslav Republic of Macedonia.

1.4 General evaluation

As regards the **political situation** and the state of *democracy and rule of law* in Serbia and Montenegro, constitutional and legal certainty has remained precarious. While the legitimacy of the State Union Parliament has been restored and functioning of the Serbian parliament has improved with the adoption of new rules of procedures, the overall functioning of democratic institutions remains affected by structural weaknesses. No actual progress has taken place as regards the revision of the Constitutions of the two Republics.

Constitutional issues in Serbia and Montenegro, notably with respect to the relationship between its two constituent Republics and the functioning of the institutions of the State Union, should be addressed in a constructive spirit and in full respect of the Constitutional Charter of Serbia and Montenegro. This applies also to a possible referendum on independence of either Republic. Such a referendum will have to comply to and internationally recognised democratic standards, in the light of the forthcoming recommendations of the Venice Commission.

There has been progress in both Republics concerning the legal framework of public administration reform, but the implementation of this reform is still at a very early stage. No progress has taken place as regards the reform of State Union public administration. The level of administrative capacity remains generally low. The administrative structures with a view to the SAA negotiations have been set up at the level of State Union and the two Republics.

Defence reform continues to meet serious obstruction, due to insufficient democratic control and lack of transparent financial management.

The State Union Court has started working although its capacity remains weak and the agreement on the scope of its powers is still largely untested. The transfer of powers of military justice to civilian courts has been implemented smoothly, with the exception of the considerable backlog of the administrative cases. The judiciary has continued to be affected,

especially in Serbia, by serious weaknesses and its independence is undermined by undue political interference.

Corruption remains a serious concern. Some progress has taken place with the development of anti-corruption strategies which now need to be finalised – in Serbia - and effectively implemented.

As regards the respect for *human rights*, Serbia and Montenegro has made progress in implementing the commitments undertaken by when joining the Council of Europe notably with the appointment of Government Agent for the European Court of Human Rights. There have been problems with regard to freedom of expression and civil society. Cases of police ill-treatment have occurred. Little progress has taken place in relation to the investigation of crimes committed during the previous regime. There is no comprehensive anti-discrimination legislation yet. Respect for *minority rights* has continued to see some progress, but incidents still occur.

Serbia and Montenegro achieved significant progress in *co-operation with the ICTY* in the run-up to the Commission Report on the preparedness to start SAA negotiations, in particular delivering a significant number of indictees to The Hague Tribunal. Since then there continues to be good co-operation with regard to waivers to witnesses and access to documents, though this process is still sometimes obstructed by parts of the administration and the army. Serbia and Montenegro has made some further, though limited, progress to bring remaining fugitives to justice. This progress must be continued until full co-operation with ICTY is achieved.

As regards the respect of the *United Nations Security Council Resolution 1244 on Kosovo*, Belgrade has intensified dialogue with Pristina on technical matters of common interest. However, it has not actively encouraged Kosovo Serbs to participate in the Provisional Institutions of Self-Government. Belgrade's constructive engagement on the Kosovo issue will help to advance Serbia and Montenegro's European perspective, while obstruction could turn into an obstacle.

Regional co-operation at the multilateral and bilateral level continues to improve, although sporadic problems occur.

2. Economic situation

While this Report updates the Feasibility Study of spring 2005, the economic chapter occasionally refers to older data, due to data limitations. The economic developments since April 2005 are included in the paragraph on progress towards economic stability and competitiveness.

2.1 Progress towards economic stability and competitiveness

Serbia

Reform momentum was regained. The government's commitment to macroeconomic stabilisation and structural reform has been volatile. While there seems to be some consensus on the need for market-oriented reforms, the population's perception of their standard of living having fallen vis-à-vis the late eighties and early nineties serves sometimes as a limitation to otherwise fast economic reforms.

Economic activity accelerated in 2004. Real GDP growth in Serbia reached an estimated 7.5%, mainly supported by services, in particular retail trade (17.9%), as well as agricultural production (19.8%) and industrial output (7.1%). In the first half of 2005, GDP grew by 6.1% year-on-year, driven by a large expansion of services, more than compensating a decline in manufacturing output.

Republic of Serbia - Main Economic Trends

		2000	2001	2002	2003	2004	2005	
Real GDP growth	Percent	5.2	5.1	4.5	2.4	8.6	6.1	1st half
Inflation rate	Percent (average)	69.9	91.1	21.2	11.3	9.5	17.1	Jan-Sep
	Percent (end-of-period)	113.5	39.0	14.2	7.6	13.4	16.5	Sep
Unemployment rate	Percent of labour force	NA	12.2	13.3	14.6	18.5	NA	
General govt balance (1)	Percent of GDP	NA	-1.2	-3.7	-2.3	-0.3	NA	
General govt balance (2)	Percent of GDP	NA	-0.8	-3.5	-2.6	-0.8	NA	
Trade balance (4)	Percent of GDP	-21.0	-24.5	-25.2	-23.6	-31.0	-21.0	1st half
Current account balance	Percent of GDP	-7.1	-9.7	-12.9	-12.3	-15.5	-7.6	1st half
Current account balance	Percent of GDP	-3.9	-4.6	-8.9	-7.3	-13.1	-6.6	1st half
External debt (4)	Percent of GDP	132.0	103.2	76.5	69.9	62.0	54.0	1st half
	Billion EUR	12.3	13.3	12.5	12.6	12.0	11.6	1st half
Debt-export ratio (4)	Percent	600	595	491	461	354	268	1st half
Foreign direct investment	Percent of GDP	0.3	1.4	3.6	6.9	4.3	5.5	1st half
	Million EUR	27.1	184.2	594.3	1242.0	826.4	664.0	1st half

(1) Before grants. (2) After grants. (3) Net. (4) For 2000-2004 Serbia and Montenegro together. For 2005 Serbia only.

Sources: national authorities, IMF, EC estimates

The negative savings-investment balance led to widening of external deficits. Domestic investment grew strongly while national savings declined, particularly in the non-government sector, resulting in a widening of the savings-investment balance to 13.1% of GDP in 2004. The current account deficit before grants reached 15.5% of GDP. Exports grew by 25.8% in euro terms and imports by 33.6%. Exports covered a mere 36% of imports. Private remittances continued to be high at 14% of GDP while FDI reached a mere 4% of GDP in 2004. Between January and July 2005, the deficit of the balance of goods and services has declined by 21% compared to the same period a year earlier as exports and imports grew by 37% and 4.5%, respectively. Foreign exchange reserves continued to increase in 2005 and reached EUR 4.1 billion end-August. External debt declined to 62% of GDP or 2.5 times

projected exports of goods and services for the year 2004. However, despite the July 2004 debt reduction by London Club creditors, the debt-to-GDP ratio has remained relatively high as an increasing share of the external deficit is financed by debt.

Inflationary pressure has mounted. Twelve-month inflation (retail price index) accelerated to 13.8% in December 2004 and to 16.5% in September 2005, driven by buoyant domestic demand, increases in administered prices, rising cost of fuel imports, strong wage growth and the one-off effect of the VAT introduced in January.

Employment remains low and unemployment high. Official figures of registered unemployed show an unemployment rate of 32.4% at end-2004, as compared to 27.2% three years earlier. Adjusted for those who are registered as unemployed but pursue activities in the informal sector of the economy the unemployment stands at below 20%. Long-term unemployment concerns around 70% of the unemployed. Employment is on a declining trend and the employment rate stood at 57.9% in 2003. Employment flexibility and legislation have, in general been improving, but some deterioration of flexibility has also been reported. The impact of newly created companies on job creation has remained insignificant so far. However, the informal sector is estimated to account for an estimated 30% of total employment. The Serbian government adopted an ambitious employment strategy for the period 2005-2010 in April 2005, which describes general conditions and steps to be taken in order to achieve the strategy's projected goal of reducing the unemployment rate to 10.5%. Progress with regard to employment and social policy is part of the work towards European standards. Further efforts to establish economic and social rights as well as to promote employment and encourage social dialogue will contribute to improving governance and economic performance.

Monetary policy remained unchanged. The National Bank of Serbia attempted to follow a policy to balance the objective of maintaining price stability with external competitiveness and continued to implement its flexible "managed float" exchange rate regime. The Serbian dinar depreciated against the euro by 13.4% in 2004 and 5.7% during the first seven months of 2005. In 2005, authorities re-focused their priorities on keeping inflation in check and aimed for a slower depreciation.

Fiscal retrenchment continued. The consolidated general budget deficit of Serbia for 2004 was reduced to 0.3% of GDP from 2.3% in 2003. Reflecting strong domestic demand and improved tax enforcement efforts, fiscal revenues grew to 45.2% of GDP from 42.7% in 2003. In particular customs and excise revenues grew strongly. Expenditures were generally under tight control, although new social security arrears vis-à-vis the private sector were recorded. Reportedly, the introduction of the VAT in January 2005 helped to boost revenues, but expenditure remained high. For 2005 a fiscal surplus is projected.

The overall macroeconomic policy mix was tightened. The overall macroeconomic policy mix has been tightened in the second half of 2004. In particular an expansionary wage policy (the average real wage grew by 10.4%) has led to wage increases above productivity growth and has been undermining broadly stability-oriented fiscal and monetary policies. However, in the second half of 2004 there was a tangible deceleration of real wage growth, which broadly continued in 2005. To help curb the high domestic absorption, the fiscal policy stance has been significantly tightened in 2004 and 2005. To curb strong credit growth consumer credit regulation has been tightened in December 2004. While this had some mitigating impact on consumer lending rapid growth in credit to enterprises continued unabated.

Prices are broadly liberalised. Price controls on most goods and services are abolished, except for oil and oil derivatives, medicines, one type of bread and flour, coal and gas for

heating, electricity, postal services, telecommunication services and railway traffic. Electricity prices were increased to 3.6 euro cent per kWh in 2004, to catch-up with cost recovery. Further adjustments were implemented in July 2005 and in line with dinar depreciation and rising world oil price new adjustments have been announced. Administered prices (including fuel) account for 40% in the retail price index.

The share of the private sector in GDP remains small and the level of competition low. Despite progress in privatisation in recent years a competitive and dynamic private sector has not yet been established. The share of the private sector in Serbia remains low, whereas state and social ownership still governs a large part of Serbia's output. The absence of a larger share of private sector activity is a substantial obstacle for the provision of a dynamic supply of competitive domestic products and services, and adversely effects inflation and external accounts.

Privatisation has been progressing, but is far from completed. The total number of privatised companies reached 1,524 by end-May 2005, of which 43 were sold through tenders, 1,175 small and medium sized enterprises were sold through auctions, and shares of 324 enterprises were floated at the Belgrade Stock Exchange. The process of restructuring some 76 large and insolvent companies, which were selected by the Privatisation Agency for restructuring, progressed slowly. However, the adoption of amendments to several key laws (such as the laws on privatisation, share fund and financial markets) in May 2005 might help accelerate this process. Of particular importance is the provision which will allow for debts towards the state and state bodies to be automatically written off prior to privatisation. Substantial progress has been made in restructuring and privatisation of the banking system. Most importantly, the sale of Jubanka was successfully completed in February 2005 for EUR 152 million. Two other state-owned banks have recently been sold and three are currently in the process of being privatised. However, two large and systemically important banks still remain state-controlled and efforts would need to be accelerated to privatise a majority in these two banks to a strategic investor. By the end of April 2005 the share of foreign ownership in total bank assets had risen to 52%. The restructuring of network industries, such as the energy, telecommunications and transport sector is still in its initial phase. There is a certain progress in the creation of a necessary regulatory framework and establishment of well-equipped regulatory agencies for these sectors.

Loss-making state-owned enterprises continue to hinder the development of a dynamic private sector. In the Serbian economy, highly indebted socially-owned companies, that need to be closed or restructured and privatised, and state-owned companies with a high number of surplus work-force still play a predominant role.

Administrative barriers to market entry have been reduced, but the business environment is still hampered by bureaucratic obstacles and lack of access to finance. The average time needed to register a company has been substantially reduced to 10 days from over 51. In addition, the initial capital requirement has been significantly lowered from USD 5,000 to EUR 500. The latter was one of the major reasons for the high number of new companies established in the first few months of 2005. While the registration itself is not regarded as a key impediment for starting a business, there are still many bureaucratic obstacles which are hampering enterprise creation. In particular, there remains scope for improvement in a number of areas which impact the business environment, including corporate governance and financial reporting standards. In this context it is also important to mention that the World Bank registers remarkable progress during the 12 last months in Serbia.

Exit barriers remain high while the new bankruptcy law still needs to be implemented. The average time to resolve bankruptcies is 2.6 years at a cost of 23% of the estate value and a

recovery rate of 16.6%. A centre for enforcement of bankruptcy procedure at the Privatization Agency was established in February 2005. It acts as a bankruptcy administrator for companies with the majority of state or socially-owned capital. At end-May, 39 enterprises were under its control. However, no bankruptcy procedure has yet been completed.

The slow and inefficient functioning of the judiciary system is seriously hampering the economy. With regards to the execution through courts, the average number of days necessary to execute the court procedures is over 1,000. Sale of housing premises is subject to high taxes, while it takes almost 200 days to register a property with a transaction tax of 5%. The real estate cadastre is in poor condition and almost 80% of all houses and apartments are not registered.

Competition in the banking sector has been increasing. At end 2004, 46 banks operated in the Serbian market. This number has further declined to 40 at end-September 2005 and included 14 majority foreign banks which are among the largest in terms of financial strength. However, in spite of the relatively high number of banks, their capacity (measured by overall credit activity relative to GDP) and efficiency remains low. The interest rate spread remained high and at end-August 2005 the average deposit and lending rates stood at 3.3% and 13.4%, respectively. Reflecting an increasing confidence in the banking sector in line with progress in bank restructuring, remonetisation continued. Broad money increased from about 20% of GDP at end-July 2004 to 26% at end-July 2005. Euroization, measured as the share of foreign-currency deposits in total deposits, rose by 3.3 percentage points in one year, reaching 69% at the end of June 2005. Buoyant economic activity, pent-up demand for durable consumer goods and a surge in foreign borrowing by commercial banks and the corporate sector resulted in a lending boom. As a result, the share of credit as a percentage of GDP exceeded 19% at end-June 2005.

A capital market has begun to develop, but is still in an early stage. Securities' trading volumes have been on the rise recently and the overall market capitalisation at the BSE (including bonds) has sharply increased from EUR 3.7 billion in October 2004 to over EUR 5 billion in February 2005.

The National Bank of Serbia (NBS) implemented prudential measures to reduce macroeconomic and prudential risks. Since January 2005 the stock of commercial banks' foreign borrowing of maturities of up to 4 years and all new foreign borrowings by commercial banks independent of maturities are subject to a minimum reserve requirement of 21%, thereby reducing the bias in favour of foreign-sourced funding. Effective April 2005, all short-term deposits of foreign banks with banks operating in Serbia are equally subject to the 21% reserve requirement. In July 2005, the reserve requirements on enterprises' foreign currency deposits and commercial banks' foreign borrowing were increased from 21% to 26%. Moreover, to reduce prudential risks, the NBS increased the capital adequacy ratio from 8% to 10%, effective as of April 2005. After assuming responsibility for insurance supervision, the NBS stepped up enforcement of prudential requirements in this sector, leading to the withdrawal of the licenses of about half of the insurance companies operating in Serbia.

Educational attainment remains low. Serbia has a relatively low average level of education as only about 53% of its adult population had secondary or tertiary educational attainments. This fact, together with a largely obsolete technology, helps to explain why the country's most successful exports are lower-level processed goods and unskilled labour-intensive products. Vice versa, the predominance of low skilled activities and jobs have not encouraged up-grading of the labour force's formal skills.

Investment expenditure accounted for 18.5% of GDP in 2004. Foreign direct investment in Serbia fell to 4.4% of GDP in 2004, after having reached 7.1% in 2003, partly a result of a period of political uncertainty in the first half of 2004. Between January and July 2005, FDI have more than doubled compared to the same period a year earlier, partly a result of the international sale of majority state-owned banks.

In 2004, 0.4% of GDP was earmarked for research. Though this looks rather low, it is still four times the amount earmarked for his purpose in 2001. In late 2003, the Serbian government passed a decision to gradually increase spending for research and development and reach 3% of the budget by 2010.

Agriculture remains an important part of the economy. Serbia has still a relatively large share of agriculture. In terms of value added it amounted to around 16.6% of GDP in 2002, and is estimated to have fallen to somewhat below 16% in 2004. Industry accounts for about 30% of GDP.

Private sector activity is concentrated in small and medium size enterprises. SME's account for about 97% of the total number of active enterprises in Serbia. They employ about 50% of the total number of employees and their share in GDP is about 40% (small 23.3%, medium 16.5%).

In 2004, foreign trade grew strongly, primarily due to the large increase in imports of goods and services. Exports of goods and services increased to 24 of GDP from 20% in 2003 while imports surged to 54% of GDP from 43%, respectively. The degree of openness, defined as the sum of export and import volumes in percentage of GDP, has been rising to 78 in 2004 compared to 63% a year earlier. Trade integration with EU has been rising since 2000 and the EU share of total imports reached 49% between January and August 2005. For the same period, the EU share of total exports reached 55%.

As part of the preparations for the forthcoming SAA and WTO negotiations, in June 2005 Serbia has submitted for Parliamentary adoption a new foreign trade law including some amendments to make it fully compatible with WTO and EU standards. This will enable it to abolish certain protective measures which are not in line with the general principles of free movement of goods, such as the import licensing system for certain iron and steel products.

Price competitiveness in exports has remained broadly stable. The real effective exchange rate, based on consumer prices, has been hovering around the same levels for around two years.

Montenegro

The regulatory framework and business environment have been improved. The legislative and institutional frameworks needed on the fundamentals of economic policies have progressed significantly but are not yet complete.

Economic growth accelerated. Real GDP in Montenegro rose by 3% in 2004, largely based on increased industrial production. Electricity and gas production rose by 21%, and the production of main export-oriented metal products steel and aluminium, which represented 45% of total production, grew by 13.4%. In the first quarter of 2005, GDP grew by 1.9% compared to the same period a year earlier.

Republic of Montenegro - Main Economic Trends

		2000	2001	2002	2003	2004	2005	
Real GDP growth	Percent	3.1	1.0	0.8	2.5	3.0	1.9	1st qu.
Inflation rate	Percent (average)	NA	22.8	17.8	7.9	3.4	3.7	Jan-Aug
	Percent (end-of-period)	24.8	28.0	9.4	6.7	4.3	3.5	Aug
Unemployment rate	Percent of labour force	32.7	31.5	30.5	25.8	22.6	NA	
General govt balance (1)	Percent of GDP							
General govt balance (2)	Percent of GDP	NA	-1.6	-2.1	-3.3	-2.2	NA	
Trade balance	Percent of GDP	-45.1	-49.4	-35.5	-26.1	-29.2	-19.9	1st qu.
Current account balance (1)	Percent of GDP							
Current account balance (2)	Percent of GDP	-14.9	-18.6	-13.0	-7.3	-9.7	-10.1	1st qu.
External debt	Percent of GDP	65.7	64.3	73.2	34.4	34.1	NA	
	Billion EUR	0.671	0.674	0.894	0.472	0.502	NA	
Debt-export ratio	Percent	NA	260.6	191.3	102.2	80.7	NA	
Foreign direct investment	Percent of GDP	NA	1.0	7.1	3.2	3.5	10.2	1st qu.
	Million EUR	NA	10.6	86.9	43.8	51.8	161.0	1st qu.

(1) Before grants. (2) After grants. (3) Net.

Sources: national authorities

External imbalances widened further. The recorded current account deficit widened in 2004 to 9.7% of GDP (after grants). This high deficit is mainly due to an increased merchandise trade deficit, as a result of the increased import of consumer goods and intermediate goods. Revenues from tourism represented 12.2% of GDP in 2004, a 19% increase over 2003. The external debt of Montenegro amounted to EUR 502.4 million at the end of 2004, representing 74.5% of Montenegro's public debt and 34.1% of the total GDP. This is an increase of 14% compared to 2003. Montenegro does not have outstanding debts with commercial creditors (London Club). The main lenders are the World Bank institutions, with a total share of 55%.

Inflation continued to decline further. Retail-price inflation (RPI) declined to 4.3% in 2004 and to 3.5% in August 2005. In the first eight months of 2005 retail prices rose by 3.7% year-on-year.

Unemployment remained high and employment declined further. The participation rate was of 51.7% in 2004. Unemployment in 2004 was 14% lower than in December of the previous year but still high at a 22% rate. At the same time, employment also decreased by 1.3%. Such trends are partly driven by an update of the Employment Bureau records removing those not fulfilling the prescribed conditions. There are important skills mismatches. Underinvestment in education and training, inefficiencies in spending and poor performances of the education and training system appear as major challenges to develop a workforce with needed skills.

The scope of monetary policy remained limited due to unilateral euroization. Cash reserves (defined as deposits by the Central Bank with foreign banks) amounted to EUR 53.5 million or 39% more than at the end of 2003. Most of the deposits were term deposits in EUR (94%).

Fiscal consolidation continued. The government deficit declined to 2.2% of GDP in 2004 from 3.3% in 2003. In this period, revenues increased by 6.4%. Revenues were smaller than expected due to the cut of taxes on wages by 10% and the introduction of a tax relief in property taxation. Expenditures rose by only 3.3% over 2003.

The overall macroeconomic policy mix is not completely appropriate. In 2004, salaries grew much faster (by 11.7%) than inflation (4.3%), reducing Montenegro's competitiveness and subsequently contributing to the further deterioration of the current account deficit.

Price liberalization is almost complete. Only a small number of products or services relating to natural monopolies or public and communal utility services are subject to administrative price control (i.e. drugs, oil and derivative products or postal services).

Privatisation is continuing but not yet completed. 70% of the state-owned capital has been privatised until June 2005. The state still had a majority ownership in 17 large companies at the end of 2004. In 2005, Telecom Montenegro was privatised. Another major privatisation process, concerning the aluminium company KAP, is undergoing. In the banking sector all but one last bank with majority state-ownership, Podgoricka Banka, has been privatised already. This last sale is estimated to be concluded by end-2005. The government launched an ambitious project for the restructuring of 97 companies to be either privatised or liquidated, and their assets sold. In the particular case of the companies privatized through the Mass Voucher Privatization (MVP), the shares are slowly being consolidated through trades in the two stock exchanges of Montenegro. This process should facilitate in the medium term the completion of the restructuring plans.

Business registration has been simplified. The new Company Law simplified the process of business registration and reduced the minimum capital requirement for limited liability companies. As a result, there has been a notably increase in the number of business registrations, most drawn from previously unregistered businesses engaged in the informal sector. In January 2005 the Commercial Court of Podgorica had 25,775 companies and entrepreneurs registered. The bankruptcy procedure lasts less for small private companies, than for medium and large enterprises. At the end of 2004, there were 145 bankruptcy procedures recorded for small enterprises, and 85 of them finalised, while in the same period, out of 194 bankruptcy cases started for medium and large enterprises, 134 were still unresolved.

Businesses in Montenegro tend to avoid the courts when resolving commercial disputes. In practice firms recur to informal practices or other institutions to enforce contracts and reduce uncertainty in transactions. In particular, they rely heavily on pre-payments and establishing long-lasting relationships with suppliers and customers. To address the issue on the restitution of property confiscated or nationalised under the communist regime in the former Yugoslavia, or indemnification, when restitution is not possible, a new Restitution Law, was adopted in 2004 though its implementation remains unclear. Although land titles registration is computerized the Cadastral Office does not have yet reliable land information.

Banking intermediation has risen. The banking sector's total assets amounted to 29.1% of GDP at the end of 2004, representing an increase by 27% over year-end 2003. The three largest banks accounted for 59%, and the combined assets of the five largest 77% of total assets in 2004, indicating a moderate degree of concentration. The rising confidence in the domestic banking sector was reflected in the rise of deposits by 29.5% in 2004. The lending-deposit spread was about 7.6% in 2004. Interest rates on loans ranged from 1.5% to 36%, while interest rate on deposits with an agreed maturity in EUR ranged from 2% to 12%.

Non-banking financial institutions play a very limited role as a source of financing for the private sector. The two stock exchanges in Montenegro, Next Montenegro SE and Montenegroberza SE registered a turnover of EUR 42.9 million and total capitalisation of EUR 1,284 million in 2004. The total assets of two micro-credit financial institutions (MFIs) in the Republic of Montenegro rose in 2004 by 24%.

Banking supervision complies broadly with international standards. Risk control is largely in compliance with the basic "Basel principles", but banks face high risks in Montenegro as the institutional arrangements for collateral and creditors' rights are underdeveloped. In particular, a central credit register, although formally established in the Central Bank, it is not

yet operational. This register is intended for the exclusive use by the Central Bank and not to be open to commercial banks or others. Thus, reliable data on the creditworthiness of potential borrowers or customers are not available, and until 2004, when the government adopted the Law on Mortgage, real estate could not be effectively used as instruments for creditor protection. The right of establishment of foreign banks, including subsidiaries, is still not fully granted.

Expenditure on education, including spending by social funds, was about 5.4% of GDP in 2004. 94.6% of this amount was spent on the wage bill, and only 5.4% was spent on non-staff items. The student/teacher ratio is very low in many cases. To address this problem, the Ministry of Education and Science has recently produced new norms and standards, linked to the number of students rather than the number of classes. There continues to be a mismatch between the vocational skills produced by schools.

Montenegro spent significant resources on active labour market programmes (ALMPs). Around 0.6% of GDP is spent mainly on in-house services such as counselling and job search assistance as well as on youth and direct job creation measures through a micro credit scheme. Part of the reduction in the number of unemployed people was due to the Program for the Continuous Encouragement of Employment and Entrepreneurship, providing loans in order to employ previously unemployed persons. Flexible forms of employment, like part-time and temporary work, are almost entirely absent in the Montenegrin economy. Progress with regard to employment and social policy is part of the work towards European standards. Further efforts to establish economic and social rights as well as to promote employment and encourage social dialogue will contribute to improving governance and economic performance.

Public capital investment represented 2% of GDP in 2004, up from 1.6% in 2003. Capital investment in infrastructure accounted for only about 20% of total capital investment, or about 0.4% of GDP. Foreign direct investment (FDI) amounted to 3.2% of GDP in 2004. This represents an increase of 29% over 2003. FDI inflows were mostly driven by the privatisation process and additional investment by the new owners and concentrated in services (73%) and the acquisition of property (21%). Preliminary data point at a sharp increase of FDI during the first half of 2005.

Enterprise restructuring is continuing. The first phase of the enterprise restructuring programme offered post-privatisation support to 11 medium-sized enterprises, and pre-privatisation restructuring to four large enterprises. Most of the enterprises have already started implementing the agreed restructuring programmes. One of the most serious problems affecting restructuring is the lack of funds to cover severance payments to redundant workers.

The sectoral composition of the economy is slowly changing. The share of employees in private sector services grew over the past five years modestly from 29% to 31%, while in industry it fell from 33% to 28%, and in agriculture it was stable with 3%. Services (including public sector), manufacturing, and agriculture economic sectors represents about 60%, 25% and 13% of GDP, respectively. Almost 60% of employment is in the public sector.

Government subsidies and net lending still account for about 1.6% of GDP, as state-owned enterprises still lack hard budget constraints and budgetary discipline. There is still hardly any competition policy established.

Trade openness increased, but is still modest. Export of goods and services rose in 2004 by 2% totalling 42% of GDP, and the degree of openness attained 81%. The level and change of trade integration with the EU 25 increased from 14% in 2003 to 47.7% of total value of exports in 2004, while imports (which represents 113% of exports) from the EU 25 also

increased from 39.8% in 2003 to 42.6% in 2004. The trade integration within the State Union remains high. Serbia is, after the EU, the main trade partner of Montenegro, with a share of 31.5% of Montenegrin total exports and 30.3% of its imports.

Exports are strongly concentrated on aluminium. Driven by a rise of the average price of aluminium by 20%, the export of aluminium grew by 44% in EUR terms.

Price competitiveness has further fallen. The continued appreciation of the EUR caused for some Montenegrin companies, such as the Aluminium Plant Podgorica (KAP), Port Bar, Shipyard Bijela, a tangible loss of competitiveness. Also wages grew faster than labour productivity in 2004, causing further pressure on price competitiveness.

2.2 General evaluation

In both Republics, the **economies** operate to some degree within the framework of functioning market principles. Further vigorous reform efforts are necessary to address the shortcomings in competitiveness.

In Serbia, economic activity remained relatively robust in the first half of 2005. Fiscal tightening continued, reflecting mainly strong domestic demand and improved tax enforcement. The trade deficit narrowed in the first half of 2005 and international reserves have improved. The completion of negotiations with the London Club of commercial creditors in 2004 has contributed to the reduction of the level of external debt. Momentum has been regained in respect to structural reforms and in particular further progress has been made in restructuring and privatisation of the banking system.

However, the government's commitment to macroeconomic stabilisation and structural reform has been mixed. Inflation and wage pressure have mounted and external imbalances remain high. Also labour markets continue to show very significant imbalances. The business environment is still hampered by bureaucratic obstacles and the slow and inefficient functioning of the judiciary system is seriously affecting economic development. The share of the private sector in GDP remains relatively modest and the level of competition low. Despite progress in privatisation, a competitive and dynamic private sector has not yet been established. The government sector still absorbs a large share of resources, undermining the free interplay of market forces and hindering an efficient resource allocation. Losses by publicly- and socially-owned companies remain a burden on public finances.

In Montenegro economic growth strengthened. Inflation continued declining further with price liberalisation almost complete. Privatisation has further advanced. Unemployment declined somewhat. The budget deficit narrowed in 2004. Bank lending has risen from low levels as confidence in the banking sector has begun to return.

However, external imbalances widened and external debt increased further. The share of the private sector is still relatively moderate. Private sector development is still impeded by weaknesses in the judiciary. High wage growth negatively affected export competitiveness and employment levels.

3. European standards

This chapter gives an evaluation of the implementation of the Stabilisation and Association Process. Alongside an evaluation of relevant developments in key areas since the April 2005 Feasibility Report and the first European Partnership, the section gives an overall assessment of Serbia and Montenegro's progress towards approximating European standards and of what remains to be done. This section also incorporates an assessment of Serbia and Montenegro's administrative capacity in its various aspects. Serbia and Montenegro must upgrade its institutions, management capacity and administrative and judicial systems, at the level of the State Union, the two Republic and at a lower level, with a view to making further progress towards meeting European standards. This requires a well-functioning and stable public administration built on an efficient and impartial civil service, and an independent and efficient judicial system.

In the Feasibility Report, the Commission found that:

“The State Union of Serbia and Montenegro and its two Republics have progressed in the implementation of the European Partnership's priorities and should be in a position to liberalise the movement of goods, workers, services and capital with the European Union, possibly with different liberalisation schedules. Both Serbia and Montenegro have embarked on trade liberalisation with their neighbours.

Negotiation and implementation of the demanding Stabilisation and Association Agreement (SAA) obligations will constitute a challenge. Given the substantial amount of bilateral trade, the SAA will require significant commitments on the side of both Serbia and Montenegro – since neither is a WTO member - in political, administrative and financial terms. The process of bilateral trade liberalisation with the EC would require further efforts in structural reforms, to reinforce both Republics' capacity to resist the competitive pressure arising from an SAA, improve export performance and reduce current account deficits. One of the key elements to consider in this respect is for both Republics to possess the necessary standards and certification capacities to trade with the EU. The Republics will also need to ensure that the objective of trade liberalisation is understood and shared by the domestic economic stakeholders.

Both Serbia and Montenegro must prove that they are able to continue to sustain their commitments to reform and to regional trade liberalisation in order to be able to function as reliable long-term partners in the implementation of an SAA. In particular, they should respect the obligations and procedures agreed under the FTAs, and an ability to comply with the “standstill” condition under the Community's autonomous trade measures.

Serbia and, in particular, Montenegro will have to improve the capacity to conduct three separate negotiation processes at the same time, i.e. the SAA, the WTO accession process and the regional process for further development of the FTAs. Both Republics will also need to establish solid consultation mechanisms to involve domestic stakeholders in the process.

*Sustained efforts will be necessary to **improve legislative and administrative capacities** in all areas in the future Agreement.*

Both Republics should continue to develop - and avoid creating new barriers to - movement of goods, services, persons and capital on the Serbian and Montenegrin market. In this context, the two republican Central Banks will have to complete the agreement on a fully operational system of corresponding accounts to ensure free flow of payments within the State Union.

*Following the adoption of the new legislation on **Intellectual Property Rights**, Serbia and Montenegro must adopt and implement comprehensive strategies to adequately enforce the legislation and protect IPR. Serbia, and in particular Montenegro, should pursue their efforts to create transparent and open **public procurement** procedures ensuring fair and non discriminatory conditions of competition for EU suppliers. In the area of **competition**, both Republics should adopt legislative and administrative frameworks including anti-trust, mergers, state aid, and liberalisation and state monopolies. The two Republics should continue to strengthen the administrative capacity to fully implement the agreement in the area of **customs** (including rules of origin) and **taxation** in order to raise revenue collection and compensate for the impact of the agreement on the level of their customs duties. The State Union of Serbia and Montenegro as well as both Republics should strengthen considerably their institutional capacities in the area of **statistics**. The **electronic communications** sector policy needs to be further developed towards liberalisation. Furthermore, as regards **transport and energy**, Serbia and Montenegro should ensure the interconnection and interoperability of appropriate infrastructure, and implement their commitments under the South East Europe Energy community treaty.*

*In the area of **justice and home affairs**, the establishment of the State Union Court and the restriction of military jurisdiction are positive developments that need to be followed by effective implementation. As regards visa asylum, migration and integrated border management, the concrete articulation of competences between the State Union and the Republics remains problematic despite some recent progress. While the reform of the judiciary has started in both Republics, the independence as well as the efficiency of the judiciary remains weak. The police and security services are also areas where legislative and administrative reforms are long awaited. The fight against organised crime, money laundering and corruption, which are serious challenges to the rule of law, is at a rather early stage.”*

3.1 Internal market

3.1.1. Free movement of goods

No particular developments can be reported in the field of **standardisation and certification**.

The State Union needs to continue its preparations for new legislation on standardisation, accreditation, metrology and technical requirements for products. These laws aim at ensuring compatibility with the relevant EU *acquis*, in particular as regards free movement of goods. For further progress at sectoral level it is crucial to establish a sound horizontal legislative framework. Key functions such as standardisation, accreditation, conformity assessment, certification and market surveillance should be segregated. New legislation is also being developed at the level of the Republics, for instance on product quality systems and environmental requirements.

The Serbia and Montenegro standards body) is a Partner Standardization Body in the European Committee for Standardization (CEN) and has in February 2005 applied to become an affiliate member of the electrotechnical standardization office CENELEC. The progress of Serbia and Montenegro standards body is hampered particularly by the lack of CEN affiliate status, the lack of transposed and implemented European Standards, the lack of valid legal framework for standardisation and the continued existence of mandatory standards from the former Yugoslavia.

No progress can be reported in the area of **metrology**. As regards accreditation, the national accreditation body is an associate member of European Co-operation for Accreditation EA.

As regards **market surveillance**, the existing system in Serbia is based on pre-market control of products. There is a need to establish an appropriate market surveillance structure based on adequate product legislation required under the new approach directives and phase out contradictory pre-market controls. In Montenegro, progress has been made in adopting horizontal legislation. Product surveillance is performed in fields where legislation is established. Surveillance activities are regulated by the 2003 Law of State Surveillance.

The two Republics are making progress in aligning their legislation with the EU legislation. However, EU directives in New or Old Approach sectors have not yet been transposed in the legislation of Serbia and Montenegro. Both Montenegro and Serbia need to avoid creating further barriers to trade and to strengthen administrative capacity. Internal consultation mechanisms, screening and notification of draft technical regulations prior to their adoption need to be introduced to avoid non-tariff barriers. A variety of areas (e.g. quality legislation, rules on chemicals and packaging) are still regulated by the Republics in a rather uncoordinated way.

In the area of **consumer protection**, **Serbia** has recently adopted a new framework law and a new law on advertising, while the **Montenegrin** Parliament still needs to adopt a similar Consumer law. Overall, despite positive legislative steps, consumer protection both in Serbia and in Montenegro still remains weak. Administrative capacity needs to be strengthened in both Republics to correctly implement and enforce their respective new laws.

3.1.2. Movement of persons, services and right of establishment

No substantial developments can be reported in the areas of **movement of persons** and the **right of establishment**.

As for the freedom to provide services, good progress can be reported in Serbia, which adopted a package of new laws in July 2005 in the area of financial services. A Law on Deposit Insurance law introduces compulsory bank insurance of private persons' deposits in the case of bankruptcy. All banks are obliged to pay a premium which amounts to 0.3% of the minimum capital required by the law to establish a bank. A separate law established a new Agency for Deposit Insurance to manage the Fund for Deposit Insurance. Serbia has also amended its Law on Banks and other financial organisations, imposing an obligation on banks to insure their deposits with the Agency for Deposit Insurance and establishing procedures for withdrawing a bank's operating licence. A new Law on Bankruptcy and Liquidation of Banks and Insurance Companies was also adopted to regulate the procedures for bankruptcy and the closure of banks and insurance companies.

Serbia also amended its Law on Insurance, introducing stricter control of the work of insurance companies and tightening up conditions for establishing new insurance companies. The amendments regulate the privatisation procedure of insurance companies and further develop financial supervision by defining the National Bank of Serbia's (NBS) role in supervising insurance companies. Since 2004, when responsibility for insurance supervision was transferred to the NBS, it has revoked the licences of 15 insurance companies and ordered their liquidation, while three others have voluntarily agreed to cease operating.

In conclusion, although both Republics are making progress in these areas, sustained efforts will be necessary to improve legislative and administrative capacities to enable both Serbia and Montenegro to assume future SAA obligations. In this context it is also important that the Republics take steps to eliminate any discrimination against workers legally residing in the

country. Both Republics should continue to develop - and avoid creating new barriers to – the free movement of services and the right of establishment on the common Serbian and Montenegrin market.

3.1.3. Free movement of capital

There have been limited developments in this area in Serbia and Montenegro. No progress was made in ensuring the free movement of capital within the State Union.

In Serbia, foreign exchange transactions are currently governed by the 2002 Foreign Exchange Law. Current payments have been liberalised, as have foreign direct investment and the repatriation of profits, but short-term **capital movements** are still restricted. Restrictions on foreign ownership and capital investment still persist. In the insurance sector, for instance, foreign natural persons or legal entities may found an insurance company only as a joint venture with a Serbian partner, and such a company is not allowed to carry out reinsurance activities outside Serbia. In June 2005, the rules on transfers by diplomatic and consular missions were relaxed.

In Montenegro, current payments have been liberalised, as have foreign direct investment and the repatriation of profits. A new Foreign Exchange Law and a law on foreign current and capital transactions further liberalising **capital movements** were adopted in July 2005. In the field of **payment systems**, the previous government-controlled clearing and settlement agency and the payment and clearing system in Montenegro were abolished and a new inter-banking payment system established.

In both Republics, the acquisition of real estate by non-residents is still subject to a reciprocity requirement based on treatment in the respective country of origin.

In their efforts to approximate EU legislation in this area, Serbia and Montenegro need to develop plans for full liberalisation of capital movements. The two republican Central Banks will have to complete the agreement on a fully operational system of corresponding accounts to ensure the free flow of payments within the State Union.

3.1.4. Customs and taxation

Some progress has been made in the area of **custom rules** and **taxation**.

Serbia adopted amendments to the Customs Law and the Customs Tariffs Law in July 2005. The tariff structures have been harmonised with the EU structures, called combined nomenclature. Serbia started electronic lodging of declarations in June 2005.

Montenegro adopted amendments to the Customs Law and the Customs Service Law in April 2005. The law on free zones has been adopted.

Following the introduction of VAT in January 2005, **Serbia** is currently reforming its tax administration introducing a new legal framework and improving the staff skills. Serbia has amended its legislation on tax procedures and tax administration introducing new rules to prevent fiscal evasion and increase the tax discipline. The law on excise has also been amended in June 2005, expanding the quantity of excise goods and changing rates. Furthermore the Parliament adopted amendments to the VAT law, including the introduction of VAT refund for donor assistance. Serbia is also continuing to implement its strategic plan for the improvement of the administrative capacity of the tax authorities.

Montenegro has introduced changes in tax legislation which allowed the reduction of the rates of personal income tax and company profit tax. Tax administration has been strengthened.

The **administrative and operational capacity** of the customs authorities of the two Republics is improving. Both customs administrations have established units dealing with origin of goods, enforcement and internal affairs. Reforms of the customs administrations include staff management systems, control policies and approximation of procedures to EU standards. The legislative alignment to the EU *acquis* is progressing although important areas such as transit procedures and warehouses are not yet properly aligned. Serbia and Montenegro have started to carry out post-clearance controls. Memoranda of Understanding have been signed with neighbouring customs administrations.

However, the administrative capacity needs to be further strengthened, especially in the area of control of origin and sustained efforts are needed to continue approximation of the two Republics' customs legislation to the EU *acquis*. Further alignment to EC customs standards is needed, in particular as regard simplified procedures and risk analysis. The lack of skilled customs officers, IT systems and risk analysis are areas which should be dealt with as a matter of priority.

In the area of **taxation** both Republics must continue to tackle the problems of the grey economy and to broaden the tax base through comprehensive tax reforms. This implies a further improvement of the collection and control capacity and further progress of the implementation of tax laws. More efforts should be done in order to tackle the important problem of fraud in the area of excise duties. The fight against corruption also needs to be pursued and reinforced in order to achieve a non-discriminatory application of tax laws.

Further alignment of the legislation with the EU *acquis* will need to be carried out. There is also a need to carry out a legislative gap analysis with the EU *acquis*. Both Republics should also commit to the principles of the Code of Conduct on business taxation. As a first step they need to carry out a gap analysis aimed at identifying the existing measures which could contradict those principles

3.1.5. Competition

Serbia and Montenegro has made some progress in this area.

In the area of **anti-trust**, Serbia has adopted in September 2005 a competition law. Under the law a new competition authority is envisaged, which would be able to draw on the experience and staff from the former Antimonopoly Commission of Yugoslavia. Montenegro still has to adopt such legislation.

Both Republics need to ensure fully independent competition authorities which are equipped to ensure efficient enforcement practice, giving priority to cases with a serious effect on the market and ensuring deterrent sanctioning of infringements. Both Republics also need to develop their competition advocacy, by adopting a coherent horizontal approach to promote competition policy in the fields of market liberalisation, privatisation, restructuring, the screening of draft legislation regarding competition aspects, improved public procurement practices and an overall strengthening of the rule of law, as well as by raising the awareness of competition rules and their economic benefits.

In the area of **state aid** control, both Republics have set up structures within their respective Ministries of Finance in order to monitor state aid and prepare for a control regime. In Serbia

a first state aid report, covering 2003 and part of 2004, has been adopted. Montenegro recently adopted a similar report for the same period.

Montenegro and Serbia need to strengthen their new state aid structures and ensure full transparency, by establishing a comprehensive aid inventory and reporting system for all aid measures in force, based on an EU-harmonised state aid definition. Gradually, each Republic will also need to set up a system of ex-ante control of all new aid measures and alignment of existing aid measures, through an operationally independent state aid authority, with the power to authorise or prohibit all aid measures and to order recovery of unlawfully granted aid.

In conclusion, Serbia and Montenegro have taken the first preparatory steps towards setting up republican regimes for anti-trust and state aid control, but efforts should be intensified in order to make these regimes operational.

3.1.6. Public procurement

In the field of **public procurement**, there have been no legislative or administrative developments in Serbia Montenegro has made some limited progress, by including the State Union institutions in the procurement rules. The State Union Ministry of Defence and Serbia and Montenegro Army are included since in the list of contracting authorities published by the Commission for Public Procurement. Moreover, preparations have started in Montenegro for enacting a new public procurement law.

Serbia, and in particular Montenegro, need to continue aligning their legislation with the acquis. Key aspects should be addressed such as scope of application, definitions, respect of the main procurement principles, thresholds, procedures, eligibility, qualification and award criteria, publication requirements and independent review mechanisms. Administrative capacity to implement and enforce procurement legislation needs to be considerably strengthened. Both Republics should ensure that operators from one Republic can benefit from national treatment in the other and that State Union institutions are covered by statutory procurement rules.

3.1.7. Intellectual property law

Some legislative progress has been registered in Serbia and Montenegro. In July 2005 Montenegro adopted a framework law for the implementation of **intellectual property rights** (IPRs). The Montenegrin Government also adopted a decree on customs procedures which strengthens the protection of IPRs.

Serbia adopted a new law in the fight against high-tech crime which also improves the protection of IPRs. It establishes a new organisational structure and sets up a special prosecutor's office with responsibility for the issue. After an intensive period of adoption of legislation in the field of intellectual and industrial property rights at State Union level, the Republics should now set up proper structures for implementation and enforcement of the laws. **Enforcement** is gradually improving but is still very limited due to administrative capacity and financial constraints (e.g. seized goods stocked in too few warehouses, recycling and lack of destruction of counterfeited products seized). In March 2005, the Serbian Government announced that action would be taken to "root out" piracy and counterfeiting under the slogan "zero tolerance for piracy". However, the implementation of enforcement actions needs to be vigorously pursued. The Republics also need to ensure that the State Union Intellectual Property Office has the necessary administrative capacity, in terms of both staff and budget, to perform its tasks. Moreover, the administrative capacity of all collecting

societies should be consistently enhanced and additional societies will need to be established to ensure appropriate remuneration of rightholders.

The expertise and capacity of trade and market inspectorates, as well as law enforcement agencies (tax and economic police, customs) to deal with IPR infringements should also be reinforced, and coordination between all agencies needs to be improved.

3.1.8. Statistics

Some progress has been made in both Montenegro and Serbia.

For demographic and social statistics, both Republics are making progress in developing a Household Budget Survey. Montenegro also developed a harmonised Labour Force Survey, of which the results were published June 2005. For macro-economic statistics, Serbia has disseminated a first set of quarterly national accounts while Montenegro has made good progress in the development of a Consumer Price Index as well as conducted a pilot survey on import and export price indices.

In the area of agriculture and fishery statistics, Montenegro has made some progress in livestock statistics. Due to scarce human resources, plans for development of other agricultural statistics were postponed. Both Serbia and Montenegro have initiated the development of a Farm Account Data Network by conducting study visits.

The statistical infrastructure, the legal basis and the management capacity have improved. However, given the complexity of the national statistical system with two republican offices and one for the State Union level as well as the limited resources especially for the State Union and in Montenegro, progress is slow. There is an insufficient level of coordination among the statistical offices at the State Union level and the level of the Republics. The republican statistical offices have not come equally far in the progress of harmonisation, and they are therefore using different standards and classifications when producing sector statistics. All three statistical offices, and especially MONSTAT, need to develop statistics in all sectors. When more statistics exist in both Republics, it will also be possible to better aggregate statistics on the State Union level.

3.2 Sectoral policies

3.2.1. Industry and SME

Both Montenegro and Serbia have made some progress.

SME policy and the business environment are improving in Montenegro. A new mortgage law has been adopted, which should, for example, facilitate access to finance for companies. The Republic has also continued to make progress with the implementation of the European Charter for Small Enterprises.

In general, there are numerous training and counselling activities for SMEs, and the local consultancy market is steadily developing and gaining recognition. Limited progress has been made on business advocacy/ representation, which is developing in Montenegro, but still on an ad-hoc, case-by-case basis. Although a specific agency for SME development (SMEDA) exists, a permanent, formal and transparent system or institution for dialogue with the SME sector still needs to be developed.

As regards financial instruments, limited micro-credit and guarantee funds are available, and two state-owned funds provide loans to businesses at favourable rates (the Development Fund

of Montenegro and the Employment Office when new jobs are created). A new Investment Promotion Agency has also been set up and its director has been appointed.

Montenegro has started to look at rationalising and speeding up licensing procedures at municipal level through a pilot project, which, once mainstreamed in all municipalities, could further modernise the whole company start-up process.

Serbia, too, has made good progress in the area of SME policy and the business environment. The implementation of the European Charter for Small Enterprises continues through the consolidation and expansion of entrepreneurship learning in education and training. There are numerous skill development programmes for current and would-be entrepreneurs. The implementation of the new Law on the Registration of Business Entities is helping to modernise and rationalise company registration procedures. Since early 2005, about 68,000 companies have re-registered. In July 2005 Serbia also amended its Law on Registration of Economic Entities, introducing new provisions on the contents of the register.

An information technology society strategy was adopted at the beginning of 2005, which includes plans to develop online access for companies and e-business. There is also some progress to be noted in the development of social dialogue in Serbia, with the setting up of the National Social and Economic Council in March 2005.

Serbia adopted new legislation on tourism in May 2005.

As far as administrative capacity is concerned, the Agency for the Development of Small and Medium Sized Enterprises (ASMEE) is the main government agency working under the Ministry of Economy to support the development of the SME sector. ASMEE has 100 employees, 85 of whom are working in regional agencies. In both Republics, the use of research and innovation policy as a means to support economic reform and capacity building is still low.

In the area of corporate accounting and auditing, Serbia will need to adopt a new law on accounting and auditing to address a number of weaknesses in the current legislation in relation to the quality of financial information and other shortcomings in the legal and regulatory framework. Enforcement of financial reporting standards is generally weak. The procedures for the approval and oversight of the auditing profession need to be significantly improved and the number of qualified auditors should be increased.

Serbia and Montenegro will also have to develop an official standard-setting body and needs to update translations of the international accounting standards. Effective structures need to be established to ensure the development of the accounting and auditing professions.

3.2.2. Agriculture and fisheries

Some progress has been made in the field of agriculture.

In terms of administrative capacity, the Ministry of Agriculture has recently strengthened its capacities by establishing a policy unit, which drafted the recently adopted strategy for the agricultural sector in Serbia.

In the veterinary sector, Serbia passed new framework veterinary laws in September 2005. It should now adopt implementing legislation and strengthen the established veterinary office. The upgrading of Serbian laboratories should continue. The implementation of a system for identification and registration of animals and their movements continues to make progress. In the phytosanitary sector, new laws on seeds and planting material have also been adopted.

Montenegro is also working on an overall strategy for the agriculture sector. Montenegro's Veterinary Law, adopted in 2004, enabled the establishment of the Veterinary Directorate and veterinary laboratory (for food quality control) to deal with consumer health and protection. The veterinary laboratory is now operational, but needs further strengthening. It is in the process of accreditation. The sanitary inspection service is also responsible for quality control.

In the area of fisheries, no particular developments have taken place apart from questions related to tariffs. Montenegro was added last year to the list of countries from which fish can be imported into the EU. A more determined effort is needed to move closer to European standards under the Common Fisheries Policy, in particular in the areas of resource management, inspection and control and in market and structural policies.

In the phytosanitary and veterinary sectors, both legislation and administrative capacities will have to be further aligned with European standards. Serbia should also urgently adopt the new food safety framework law and reorganise food-chain laboratories and sanitary inspections. Further improved coordination is needed within the government to find a coherent approach to the rules and regulations in the phytosanitary and veterinary sectors. Montenegro will need to establish administrative structures in the phytosanitary area. In the area of fisheries, Montenegro needs to strengthen its laboratories further in order to explore its full export potential. Both Republics should also pursue work on adopting new legislation on plant protection.

3.2.3 Environment

There has been some limited progress in Serbia and Montenegro's efforts to approximate European standards in the environmental area.

Both Republics have succeeded in integrating the environment into other policies in the energy field. By adhering to the Energy Community Treaty signed in October 2005, Serbia and Montenegro both agreed to respect EU environmental legislation and requirements relevant to the energy field.

As regards **horizontal legislation**, Serbia has taken steps to implement the Convention on Access to Information, Public Participation in Decision-Making and access to Justice in Environmental Matters (Aarhus Convention). Public participation in decision making is foreseen in certain provisions of legislation on environmental impact assessment, strategic environmental assessment and integrated pollution prevention and control. The Law on access to information of public interest was adopted. In Montenegro, public hearings on draft laws are obligatory. The Environmental Protection Fund in Serbia became operational in 2005, with initial funding from the Ministry of Finance. Own resources such as environmental charges (as the existing ones on biodiversity products) are expected to be the financial sources for the Environmental Protection Fund in the future.

In the field of **waste management**, Serbia is pressing ahead with its legal reform programme on issues such as packaging waste and hazardous waste export. Serbia continued to implement its Waste Management Strategy adopted in 2003. Montenegro has adopted a National Policy on Waste Management and Strategy on Waste Management, which are now in the implementation phase.

Limited progress can be reported in the field of **water quality**. Montenegro adopted a Master Plan and Feasibility Study on Waste Water Treatment for the central and northern region and a strategy for the coastal region. Poor water and sanitation remain key challenges for both Republics.

No new legislative developments are to be reported on approximation to European standards in **air quality, nature protection, chemicals and genetically modified organisms, and noise**. In Montenegro the Environmental Monitoring Programme for 2005, adopted in early 2005, but not yet in implementation, is devoted to air, soil, water, ionising radiation, biodiversity and noise. Serbia has pursued approximation to EU environmental legislation, with important steps forward as regards horizontal legislation (environmental impact assessment) and integrated pollution prevention and control. In Serbia as well as in Montenegro, approximation to European standards in those areas where draft legislation already exists should be actively pursued, so that the process can be completed in the near future. This also applies to the strategies currently in preparation, and which are foreseen for adoption by end 2006.

However, implementation and enforcement need to be considerably strengthened, notably through the adoption of implementing strategies and plans and institutional capacity building. Both Republics need to pay attention to strengthening administrative capacity. Following adoption in late 2004 of the Serbian Law on the System of Environmental Protection, Serbia now needs to further strengthen the Agency for Environmental Protection and the Environmental Protection Fund. Enforcement of the newly adopted legislation will require significant efforts in both Serbia and Montenegro. Financing plans have to be developed as regards investments required to meet European standards, particularly in the field of water and solid waste, and to tackle pollution at existing hot-spots.

3.2.4. Transport policy

Both Serbia and Montenegro have made some progress in the transport field.

At regional level and to ensure their proper connection to the **trans-European transport network**, Serbia and Montenegro are participating actively in the implementation of the June 2004 Memorandum of Understanding on the South East Europe Core Regional Transport Network, including the Transport Observatory (SEETO). They also participated in the High Level Group on the extension of the major trans-European transport axes to the neighbouring countries and regions, established in 2004.

Regarding **road transport**, Montenegro has established a Directorate for Roads, following the adoption last year of the Law on Roads. This body is responsible for management, maintenance and construction. The fact that the Directorate for Highways will remain in existence until the end of year 2005 may cause an overlapping of competences between the two bodies. A road infrastructure maintenance plan was adopted in May 2005.

In the area of **rail transport**, Serbia adopted a new law on railways in early 2005. Some progress has been made in the restructuring and privatisation of the state rail company. The new law constitutes a major step towards alignment of national law with the EU railway acquis, despite some uncertainties as to separation of infrastructure management and rail service provision. The law requires compensation for public service obligations and setting up an independent office, which is to function as both regulatory body and safety authority.

In the area of Inland Waterways, Serbia is working on a Masterplan for inland navigation, with the help of the European Agency for Reconstruction. The opening of the bridge over the Danube in Novi Sad, which was reconstructed with EU assistance, has eliminated one of the main bottlenecks for navigation on the Danube. The temporary pontoon bridge, which only allowed for a limited number of passages, was removed.

With regard to **air transport**, Serbia and Montenegro has established a joint Civil Aviation Directorate and an Agency for Air Traffic Control. Serbia and Montenegro has initialled a

“Horizontal Agreement” with the European Community on certain aspects of air services and is pursuing negotiations on a European Common Aviation Area (ECAA) Agreement with the EU. The present regulatory situation is fairly traditional and out of step with a liberal market approach foreseen by the ECAA Agreement. Accident investigation is not set up in an independent way. A programme for incorporating EU legislation is underway. The recommendations of the ECAA Assessment Visit carried out in June 2005 should be implemented.

With regard to **maritime transport**, Serbia and Montenegro are contracting parties to several International Maritime Organisation conventions. It remains to be confirmed whether the most relevant of these conventions, from the *acquis* point of view, are properly implemented. Serbia and Montenegro have fulfilled their international obligations under the SOLAS Convention which are relevant for maritime security.

Although progress has been recorded, both Republics need to further review their legislation to assure progressive alignment with EC legislation and EU transport policy, in particular in relation to overall liberalisation and the equal treatment of foreign operators, as well as to technical and safety standards.

3.2.5. Energy

Both Serbia and Montenegro have made progress.

Following the adoption last year of a new Serbian Energy Law, the Serbian Energy Agency became operational as the regulatory authority with its board approved by Parliament. The Parliament has also approved the Serbian energy development strategy for the period up to 2015. The strategy provides a new framework for the sector and includes institutional, restructuring and planning elements.

The unbundling process of the state electricity utility Electric Power System of Serbia (EPS) continues. EPS is in charge of generation, distribution and sales. A newly established entity is responsible for the energy network and grid management. A transmission system and market operator still need to be established.

The Serbian Energy Efficiency Agency was established under a decree from 2002. A strategy for investments in the district heating sector, bringing greater effectiveness, efficiency and reliability, should also be adopted.

In Montenegro, the Energy Regulatory Agency became operational in 2004, and some progress has been achieved in restructuring the electricity sector. The Electric Power Industry of Montenegro remains the only energy company, with 67% of its shares owned by the state. Generation, transmission, distribution and supply functions have been unbundled, but separation of its management and accounting functions is behind schedule. A new energy development strategy should be finalised soon. While a new pricing methodology is still in preparation, tariffs have already been increasing towards cost recovery levels. The sector continues to suffer from a permanent deficit in cash flows and working capital. Collection rates need to be improved. Further restructuring, including a social programme to cope with redundancies, is needed.

Both Republics have played an active role in the establishment of the Energy Community Treaty. The treaty is aimed at creating a regionally integrated energy market for electricity and natural gas as part of the wider EU market. It was signed in October 2005. The implementation of commitments made in the framework of the Athens Memorandum, which preceded the Treaty, is progressing slowly in Serbia and Montenegro.

Based on an energy efficiency strategy completed in 2004, a department for energy efficiency was created within the Ministry of Economy. A strategy for the development of Montenegro's considerable hydroelectric potential should also be elaborated. Legislation on radiation protection and nuclear safety needs to be developed in both Republics.

Both Republics are continuing to make progress in the energy sector, and core legislation is in place. However, Serbia and Montenegro still faces major challenges, and the operational and financial situation of the sector remains poor. Administrative capacities need to be strengthened. Many key issues remain unsolved, namely maintenance, modernisation and enhancement of the infrastructure, and the creation of additional capacity.

3.2.6. Information society and media

Some progress has been registered in Serbia and Montenegro as regards electronic communications and information technologies, although there is still some overlap between State Union and republican laws, which creates a degree of regulatory confusion in the sector.

In Serbia the exclusive monopoly of fixed lines ended in June 2005. The Telecommunications Law was adopted in 2003, but its application has been delayed until August 2005 as the appointment of the Management Board of the Telecommunications Agency took place only in May 2005. The Telecommunications Agency is not yet operational due to a lack of financing. Without an operational Agency it is impossible to implement aspects of liberalisation and to introduce competition into the market. Serbia has not yet adopted its strategy for the development of the electronic communications sector and needs to amend its legislation to align it with European standards.

In Montenegro, the privatisation process has been finalised with a Hungarian telecommunication company buying 51% of the state's shares in Telekom Montenegro. A telecommunication development plan was adopted by the Government in June 2005.

Montenegrin policy-making and development of the sector have improved, although some issues such as cost accounting and accounting separation still need to be addressed by the regulatory authority. The telecommunications infrastructure is broadly adequate. However, to improve the situation in the market and to offer better conditions to consumers, important elements of competition, such as carrier election, number portability and unbundled access to the local loop, need to be introduced. Tariff rebalancing has not taken place and the interconnection charges in place are very high, which is a barrier to market entry.

In the area of **information society services**, Serbia and Montenegro has signed but not ratified the Council of Europe Convention on Cybercrime. It will need to align its legislation with the European standards on electronic commerce and conditional access services.

As regards **audiovisual policy** in Montenegro the Broadcasting Council developed a strategy on the use of the spectrum that was implemented through a tender for licences completed in June 2005. The Montenegrin Broadcasting Council approved the Rule Book on advertising in electronic media.

In Serbia, the lack of implementation of the Telecommunications Law and, as a consequence, the absence of a plan for frequencies that could permit the Broadcasting Council to issue licences or to have some control over the broadcasters, together with the lack of a proper budget hamper the normal functioning of the Broadcasting Council. Serbia amended its Broadcasting Law in August 2005. The amendments, which were widely contested by professional organisations, provide for the extension of the deadline for the transformation of the Serbian Radio Television RTS from its present government-controlled role into a public

broadcasting service to March 2006, as well as the postponement of the privatisation of broadcasters operated by local government to July 2007. The amendments also envisage the introduction of an obligatory subscription fee to be levied for Radio Television Serbia. (*see also the paragraph on freedom of expression and media in section 1.2 Human rights and protection of minorities – Civil and political rights*)

3.2.7. Financial control

As regards financial control, an area that was not covered in the Feasibility Report, Serbia and Montenegro is invited to upgrade its Public Internal Financial Control (PIFC) system in line with international internal control standards for the public sector, international internal audit standards and EU best practice. More specifically, Serbia and Montenegro should develop decentralised managerial accountability supported by an adequate financial management and control system and by functionally independent internal audit.

In order to benefit from a harmonisation of financial management and control as well as internal audit system throughout the public sector, Serbia and Montenegro should establish a central harmonisation unit (CHU). The CHU should be a central directorate within the Ministry of Finance reporting directly to the Minister of Finance on development and progress in the field of PIFC. The CHU needs to be responsible for discussing the principles of PIFC across the Public sector, draft a strategy paper to be discussed and approved at the government level, draft and implement the necessary legislation and the organisational infrastructure as well as for co-ordination of methodology and training of managers and staff involved in financial management and control and functionally independent internal audit. The tasks of the CHU should be further developed in line with the implementation of the changes to the PIFC system.

These activities will affect the legal and institutional frameworks as well as human resources over a longer period. A strong and continuous commitment and support from the highest political and managerial level is therefore necessary.

Serbia and Montenegro is invited ensure an operational external audit system in accordance with the declarations of the International Organisation of Supreme Audit Institutions.

3.2.8 Other policies

Progress with regard to **employment and social policy** is part of the work towards European standards. Further efforts to establish economic and social rights as well as to promote employment and encourage social dialogue will contribute to improving governance and economic performance.

3.3 Justice, freedom and security

3.3.1. Visa, border control, asylum and migration

The two Republics continue to operate different **visa** regimes based on different travel document requirements, while the State Union has to implement these two different regimes in the State Union Consular Offices. Montenegrin visa rules concerning nationals of the Russian Federation, Ukraine and Albania are not in line with the acquis. The enforcement situation for these two different regimes as regards travel between the two Republics remains unclear (previous police controls on persons at the airport seem to now to have been replaced by check of passengers lists). While at State Union level efforts are being made to harmonise

the visa regimes, there is a need to pass the requisite coherent legislation on visa policy at the level of the Republics and subsequently establish a uniform system throughout the country.

As regards **border management**, in Serbia the transfer of border control from the State Union army to the police has been delayed, reportedly owing to problems with logistics and equipment. Needs assessment and planning of the transfer process have to be improved in order to ensure proper planning of the implementation of the integrated border management system. Serbia is drawing up its national strategy on integrated border control. Montenegro's strategy is being finalised. These strategies need to be approved and implemented without delay. Local integrated border management coordinators have been appointed, but the question of appointing a coordinator at State Union level, to ensure uniform implementation, remains unresolved. In Montenegro, the law on state border is pending and the Government has enacted a Decree on Border Crossings Management.

In the field of **asylum**, the two Republics have not yet adopted the laws that are necessary for the implementation of the State Union framework law. While the number of asylum seekers is limited - in the period January-August 2005 only 35 asylum seekers were registered at the UNHCR Office - both Republics need to have a system in place in order at least to meet Geneva Convention requirements. In both Republics, the implementing asylum legislation is being prepared in co-operation with United Nations High Commissioner for Refugees (UNHCR). The UNHCR continues to handle most asylum cases, as there are still no systematic mechanisms to identify asylum seekers at land, sea or air borders. The establishment of these mechanisms is mainly contingent upon the adoption of the legislation at the level of the Republics. In Serbia, there is only one reception centre for asylum seekers and refugees, with very limited capacity and inadequate infrastructure. In Montenegro at present there are no reception capacities, though these are planned for 2005.

As regards **migration**, illegal immigration continues to be a problem. There were 1053 illegal entries in Serbia in 2004, compared to 862 in 2003. The latest figure for 2005 is 486. In Montenegro the number of illegal entries recorded in the first five months of 2005 was 238, compared to 94 in 2004. After the adoption of amended Criminal Code in Serbia in September 2005, in both Republics the legislation classify human trafficking and separately trafficking in children, slavery, transport of enslaved persons, production of forged documents and facilitating illegal border crossing as criminal offences. The existing cooperation at the working level between the National Teams responsible for fighting human trafficking in the Republics needs to be strengthened. The twelve readmission agreements that have been initialled so far (e.g. with the former Yugoslav Republic of Macedonia, Greece, Romania, the Czech Republic, Poland, France and Great Britain) need to be signed, ratified and fully enforced, along with the 15 readmission agreements which are in force since 2003. Further efforts are needed, notably to resolve the problem of the readmission and integration of Roma people.

3.3.2. Money laundering

Fight against money laundering is dealt with in wider strategies developed by the Republics to fight against corruption and organised crime. The relevant legislation on fight against money laundering is in force in Montenegro since March 2005. Under this legislation, attorneys at law and currency exchange offices are obliged to report suspicious transactions. Banks cannot invoke financial secrecy to prevent the reporting of suspicious transactions. In Serbia the new law on Money laundering, covering a broader range of laundering activities, including a more exhaustive list of obligors and regulations on data processing under the official secrecy rules with the view to alignment with EU standards has not yet been adopted.

Some positive developments are taking place in the meantime: the Financial Intelligence Units are fully operative in both Republics, and they signed the Memorandum of Understanding on cooperation. In Serbia, the Financial Intelligence Unit, which operates on the basis of the 2002 Money Laundering Law, has concluded a Memorandum of Understanding with the Central Bank, which supervises currency exchange offices. A similar Memorandum of Understanding with the Customs Office is being finalised. In Montenegro, the Financial Intelligence Unit is cooperating with the Ministry of Interior, Prosecution Offices and Tax administration. A Memorandum of Understanding with customs authorities is under way. Montenegro's Financial Intelligence Unit was admitted to the EGMONT group in July 2005, following positive evaluations by MoneyVal.

According to the available statistics on cases initiated and processed, the enforcement of the anti-money laundering legislation needs serious improvement, in particular in the context of the perceived scale of the problem of corruption, organised crime, the large informal economy and the high level of cash transactions.

3.3.3. Drugs

Serbia and Montenegro is considered to be a major transit point for crime networks, but a relatively small market for drug dealers. There are indications that there is production of marihuana. The consumption of synthetic drugs is increasing. Both Republics have made efforts in this field and should examine their approach in the light of the recently adopted EU Drugs Strategy for 2005-2012 and the EU Drugs Action Plan for 2005-2008. The implementation of international conventions and national legislation needs to be speeded up. Serbia has not yet adopted a national anti-drugs strategy. Once repressive means are in place, the focus will also need to turn to prevention measures. Appropriate legislation on precursors and the necessary technical means to identify the respective substances is in the adoption procedure. Operational inter-agency cooperation (Police, Judiciary, Ministry of Health), though informal, is good. In Montenegro, legislation on precursors is in force, but international cooperation on fighting the production and trade in precursors needs to be enhanced.

3.3.4. Police

In Serbia, the draft Law on Police, which aims at enforcing the professionalism, accountability and transparency in the organisation and future work of the police, is in parliamentary procedure. The legislation on the security services is still pending; its adoption and full implementation are urgently needed as a basis for further reforms in the sector, to ensure accountability, professionalism and efficiency. The existing internal control department - police inspectorate has been strengthened from 50 to 200 staff. Demilitarisation (abolition of military ranks) of the police is ongoing in line with the foreseen legislation. The Law on Higher Education in the Police has not yet been adopted. In Montenegro, laws on the Police and the National Security Agency were adopted in April 2005 and their implementation is at an early stage. Decentralisation and civilian control of the police are foreseen in the new legislation. A set of implementing by-laws, including the code of conduct for the police is in preparation. Internal inspection within the police needs to be reinforced.

In both Republics, there is a need for effective law enforcement, better police cooperation, the development of intelligence and risk analysis tools, improved training and motivation systems and the introduction of a code of ethics for the police. Lack of adequate financing remains a problem.

3.3.5. *Fighting organised crime and terrorism*

Organised crime remains a source of serious concern in both Republics. The ratification and implementation of international conventions and the finalisation of national strategies and action plans need to be speeded up. Threat analysis needs to be introduced, as well as tools such as intelligence gathering, secret surveillance techniques and the development of a common database. The seizure and freezing of assets, bank accounts and the proceeds of crime appear to be problematic in practice. Legislative developments and institutional capacity to ensure seizure of assets obtained illegally are urgently required.

In Serbia, the action plan to implement the National Strategy for Organised Crime has not yet been finalised. The law on witness protection has been adopted but the financing of the witness protection system remains inadequate. While a number of witnesses are currently protected by the existing structures within the Organised Crime Directorate of the Serbia Police, there is a need to reinforce these units. In Montenegro the Strategy for the Fight against Organised Crime and Corruption was adopted in July 2005 by the Government. The implementation of this strategy remains of utmost importance, in particular with the view to present serious security issues highlighted by the recent murder of a senior police official who was investigating high-profile organised crime activities. In Montenegro the Special Prosecutor for the fight against organised crime has access to police units and to experts from any other public institution, but the institutional capacity and expertise of the Special Prosecutor's office need to be further strengthened.

Concerning **trafficking in human beings**, in Serbia some measures are in place to protect victims of trafficking (shelters and a call centre) and the recently adopted Criminal Code differentiates between human trafficking and smuggling of migrants. Also in Montenegro the legislation differentiates between the two.

As regards **terrorism**, the ratification and implementation of the International Convention on the Fight against Terrorism needs to be speeded up. The International Convention for the Suppression of Acts of Nuclear Terrorism was signed in September 2005. In Serbia, the new Criminal Code has introduced terrorism and financing of terrorism as specific offences.

3.4 General evaluation

Serbia and Montenegro has made progress towards meeting **European standards**. In the area of *internal market*, both Republics have made overall some good progress. They must now continue to make sustained efforts to improve legislative and administrative capacities with a view to future SAA obligations. They must also avoid creating new barriers between them.

Both Republics are making some progress in the area of *free movement of goods*. No particular developments can be reported in the field of standardisation and certification. In the areas of *movement of persons and the right of establishment*, no substantial developments have taken place. As for the *freedom to provide services*, good progress can be reported in Serbia which adopted a package of new laws in the area of financial services. Limited developments have been registered in both Republics as regards *free movement of capital*. In Montenegro a new foreign exchange law and a law on foreign current and capital transactions further liberalising capital movements were adopted. No progress was made in ensuring the free movement of capital within the State Union as the two republican Central Banks have not yet completed the agreement on a fully operational system of corresponding accounts.

Some progress has been reported in the area of *customs*. Serbia adopted amendments to the customs law, and to the customs tariffs law harmonising the tariff nomenclature with the EU

combined nomenclature. Montenegro adopted amendments to the customs law and to the customs service law. The administrative and operational capacity of the two republican customs authorities is improving but still needs to be strengthened significantly. In the area of *competition*, both Republics have adopted new anti-trust legislation and have set up basic structures to monitor state aid. Further efforts are required to make the republican regimes for anti-trust and state aid control operational. In the field of *public procurement*, no legislative or administrative developments have been registered in Serbia. Montenegro has done some limited progress by including State Union institutions within the scope of procurement rules. Administrative capacity to implement and enforce procurement legislation needs to be considerably strengthened, especially in Montenegro. Both Republics should ensure that operators from one Republic can benefit from national treatment in the other and that State Union institutions are covered by statutory procurement rules. Concerning *intellectual property rights*, some legislative progress has been registered in both Republics. Montenegro adopted a framework law for the implementation of intellectual property rights. Enforcement is gradually improving but further actions need to be vigorously pursued. The role of the State Union Intellectual Property Office must be fully recognised by the two Republics and this Office needs to be provided with the necessary administrative capacity to perform its tasks.

As regards *sectoral policies*, there has been some progress, although uneven. In the area of *industry and small and medium enterprises*, both Republics have done some progress with the implementation of the European Charter for Small and Medium Enterprises. Some progress has been made in the area of *agriculture*. In particular, Serbia has strengthened the administrative capacity of the Ministry of Agriculture and has passed new framework veterinary laws. Concerning *environment*, there has been some limited progress in both Republics. In particular, Montenegro adopted a Law on Integrated Prevention and Control of Pollution. Both Republics have made some progress in the *transport* field, in particular through the participation in the South East Europe Core Regional Transport Network. In the *energy* field, both Republics have made progress. In Serbia the Energy Agency has become operational and energy development strategy for the period up to 2015 has been approved. The unbundling process of the state electricity utility continues. In Montenegro, some progress has been achieved in restructuring the electricity sector. Serbia and Montenegro have signed the South East Europe Energy Community treaty.

Concerning *information society and media*, some progress has been registered. In Serbia, the exclusive monopoly of fixed lines has come to an end but the Telecommunications Agency is still not operational due to lack of financing. In Montenegro, the privatisation process of the fixed-line telecom provider has been finalised. As regards *audiovisual* policy, no progress has taken place in Serbia which amended its broadcasting law to extend of the deadline for the transformation of the Serbian Radio Television from its present government-controlled role into a public broadcasting service, as well as to postponement of the privatization of broadcasters operated by local governments. In Montenegro the Broadcasting Council has implemented a tender for licenses of the use of the spectrum.

As regards *justice, freedom and security*, no actual progress has taken place in the areas where responsibilities are shared between the State union and the two Republics. The two Republics continue to operate different *visa* regimes. In both Republics, national strategies on integrated *border control* are still in preparation and - in Serbia - the transfer of border control from the State Union army to the police has been delayed. In the field of *asylum*, the two Republics have not yet adopted the laws that are necessary for the implementation of the State Union framework law. As regards *migration*, the readmission agreements have to be fully enforced.

As regards the areas falling within the remit of the Republics, some legislative progress has taken place concerning the fight against *money laundering*. As regards *police* reform, progress

has taken place in Montenegro with the adoption of the laws on the police and the national security agency. In Serbia, the new legislation on police and security services is still pending. *Organised crime* remains a source of serious concern in both Republics. A strategy on fight against corruption and organised crime has been adopted by Montenegro.

C. EUROPEAN PARTNERSHIP: OVERALL ASSESSMENT

Serbia and Montenegro's progress and overall state of implementation of the Stabilisation and Association process since the Report on the preparedness of Serbia and Montenegro to negotiate a Stabilisation and Association Agreement with the European Union, issued on 12 April 2005, has been examined above. This section assesses briefly the overall extent to which the priorities of the European Partnership, adopted by the Council in June 2004⁶, have been implemented. It therefore covers developments over a larger period than the preceding parts of this report.

The purpose of the European Partnership is to assist the authorities by identifying short and medium term priorities which need to be carried out by Serbia and Montenegro to make further progress towards the EU. The priorities have been selected on the basis that it is realistic to expect that the country can complete them or take them substantially forward over the next few years.

A distinction is made between short-term priorities, which are expected to be accomplished within one to two years, and medium-term priorities, which are expected to be accomplished within three to four years. The European Partnership forms the basis for programming assistance from EU funds.

Overall, Serbia and Montenegro – at the level of both State Union and the Republics - has made some good progress in implementing the European Partnership's short-term priorities, and has also started to address some of the medium-term ones. The implementation of the priorities has affected in some cases by lack of legislative developments and rather frequently by the lack of administrative capacity. Moreover, serious difficulties have been experienced in the areas where co-operation between the State Union and Republics was required.

Political situation

Some progress has been made on the **constitutional issues** related to the implementation of the Constitutional Charter but the constitutional and legal certainty remains precarious. The *State Union* Court has been established and the scope of its powers has been agreed, although this remains largely untested. The *State Union* Parliament has adopted its Rules of Procedure and set up its committees. However, no actual progress has taken place as regards the revision of the Republics' constitutions, and the issue of the financial viability of the *State Union* institutions has not been adequately solved. Moreover, the legitimacy of the State Union Parliament has been restored only through a revision of the Constitutional Charter. **Army reform**, which is a *State Union* competence, remains a very serious challenge. Some progress has been made with the adoption of the defence strategy, while the adoption of the military doctrine is pending. The issue of military property has only been partially solved. Restructuring of the armed forces (a medium-term priority) has continued, but has been facing resistance. Significant efforts are still needed in this area. The **electoral law** reform in *Serbia* has not yet been completed and the legislation on financing of political parties, which has had some positive impact, has not yet been fully implemented.

In the field of **public administration reform**, the administrative capacity of the institutions dealing with European integration at the level of the *Republics* has been strengthened. Despite efforts, the formal status and capacity of the European integration office at *State Union* level

⁶ Council Decision 2004/520/EC of 14 June 2004 on the principles, priorities and conditions contained in the European Partnership with Serbia and Montenegro including Kosovo as defined by the United Nations Security Council Resolution 1244 of 10 June 1999 (OJ L 297, 26.6.2004, p. 21)

have remained rather weak. Coordination between the institutions dealing with European integration has generally improved. The establishment of European integration units in the line ministries (medium-term priority) has continued, though their capacity is often still quite limited. In *Serbia* the public administration reform is ongoing, based on a comprehensive strategy, and the legislation is being adopted, but budgetary provisions are inadequate. In *Montenegro* the strategy and related legislation are being implemented, but the situation remains difficult, in particular due to the lack of resources. The Authority for human resources management has been set up. At *State Union* level no progress has been made in this respect (medium-term priority). In *Serbia*, parliamentary reform (medium-term priority) has seen progress with the adoption of new Rules of Procedure.

Concerning **local government** (medium-term priority), further reform in *Serbia* is contingent upon the adoption of the new Constitution; there are concerns on the impact that the recently adopted law on Government may have on local self-government. Fiscal decentralisation has not been achieved. In *Montenegro* some positive developments have taken place but relevant legislation has not yet been adopted. .

As for **judicial reform**, the transfer of military jurisdiction to civilian courts has been implemented smoothly, with the exception of the considerable backlog of the administrative cases. In *Serbia* judicial reform is ongoing and the functional independence of the war crime prosecutor has been reinforced. However, the judiciary continues to exhibit serious weaknesses and its independence remains undermined by undue political interference. The establishment of administrative and appellate courts has been postponed until 2007. In *Montenegro* the implementation of the criminal legislation and the legislation on the prosecutor continues. Administrative courts and appellate courts have been set up. However, the judiciary continues to exhibit serious weaknesses and despite some legislative reforms its independence is undermined by undue political interference. In *Serbia* the domestic capacity to try war crimes (medium-term priority) is being developed, but remains insufficient as regards high-profile trials. In both *Republics* prison conditions remain an issue in particular due to lack of budgetary resources. Training of prison staff is ongoing.

In the field of the **fight against organised crime and corruption**, UN convention provisions have still to be adopted. Moves to allow the EU Member States to send liaison officers to Serbia and Montenegro and the follow-up to the Palermo convention are still pending. In *Serbia* the Government has submitted to the Parliament an anti-corruption strategy. The law on conflicts of interest has been adopted but its implementation has brought so far limited results. In *Montenegro* the strategy against corruption and organised crime has been adopted. The law on conflicts of interest has been implemented with difficulty and needs to be reviewed.

As regards respect for **human rights and protection of minorities**, there has been progress in meeting the Council of Europe accession commitments, also with the regard to the European Conventions on Human Rights and Fundamental Freedoms and on the Prevention of Torture. Their uniform implementation of these conventions throughout the State Union remains so far largely untested. In *Serbia* the law setting up an Ombudsman office has been adopted, and in *Montenegro* The Ombudsman Office is being strengthened though further efforts are required. As regards the elimination of torture, there has been some improvement in *Serbia* with the establishment of the Inspector-General's Office in the Ministry of Interior, but the UN reports that the authorities are not taking up the cases raised by the UN Committee against Torture. In both *Republics* there is still lack of transparent complete information as to the number of cases and the actions taken.

No comprehensive legislation has been adopted in the field of anti-discrimination. As concerns freedom of expression, in *Serbia* prison sentences for slander have been replaced with fines. The Broadcasting Council has been set up but recent amendments to the broadcasting legislation have given rise to concern. The law on free access to information was adopted, but it is still not being fully implemented. The laws on associations and on legal status of foreign NGOs are still pending. In *Montenegro* the legislation concerning free access to information is still pending, and the Government has not yet adopted the strategy concerning cooperation with NGOs. In *Serbia*, the transformation of state-owned television into public service broadcasters (a medium-term priority) has been postponed. In *Montenegro*, the transformation is ongoing, but political and budgetary problems persist. As regards property rights, *Montenegro* has adopted a law which is not yet fully implemented. In *Serbia* the registration law has been adopted but the restitution law is still pending.

Concerning **refugees, internally displaced persons (IDP) and minorities**, cooperation between the *Republics* and the *State Union* remains problematic. Cooperation has increased with Bosnia-Herzegovina and Croatia to facilitate returns. The dialogue with Pristina on the returns issue has started. Discrimination against the Roma and - in Montenegro against IDP – continues, though some legislative steps have been taken.

In the area of **regional and international cooperation/obligations**, there has been significant progress as regards cooperation with the ICTY, but full cooperation has not yet been achieved. As for Kosovo, under resolution 1244, the dialogue has resumed on some subjects of common interest, but UN travel documents and car number plates are not yet recognised. *Serbia* and *Montenegro* is contributing to regional stability and cooperation. Under the Stability Pact, all Free Trade Agreements have been ratified and the Free Trade Agreement with the former Yugoslav Republic of Macedonia has been revised. The Memorandum of Understanding on the South East Europe Core Regional Transport Network has been partly implemented. Progress has taken place as regards the establishment of a regional energy market with the signature of the Energy Community Treaty.

Economic situation

Progress has taken place as regards **macro-economic stability**. The outstanding debt towards commercial creditors, the London Club, has been reduced after an agreement on a substantial 62% write-off was reached in 2004. In *Serbia* prudent monetary policy has contributed to macro-economic stability, though inflation is threatening again. Subsidies are being reduced and wage bills frozen in both *Serbia* and *Montenegro*. In *Serbia* the health system reform is under preparation (a medium term priority), while further steps in pension system reform have also been taken. Structural reforms should continue and speed up. The inflation should be put under control. **Price liberalisation** is almost complete in Montenegro. In *Serbia*, prices are broadly liberalised and; energy prices have been adjusted but not yet at cost recovery level. The same applies for *Montenegro* though the gap is narrower in its case. **Restructuring, privatisation** and/or liquidation of large socially-owned and state-owned enterprises are ongoing at a rather slow pace in *Serbia* and with some progress in *Montenegro*. Restructuring of public utilities is at a very early stage in *Serbia* and is ongoing in *Montenegro*. Reform of the banking sector is ongoing and the privatisation of banks is accelerating in *Serbia*. In *Montenegro*, with the exception of one bank, the privatisation of the banking sector is practically completed. The development of a stable and functioning **land and real estate market** remains at an initial stage; legislation on the cadastre in *Serbia* is under preparation while in *Montenegro* is not yet fully implemented due to the lack of accompanying legislation.

A 2005-2010 strategy for the **employment** has been adopted by the *Serbian* government; in *Montenegro* the labour law and the law on employment have been adopted. As regards **statistics**, the revision of the current master plan resumed under the new time-frame (2006-2008), whereas the adoption of statistical law at the *State Union* level is pending the adoption of adequate legislation at the *Republics'* level. Concerning the **management of public finances**, in *Serbia* the system has improved and some important tax reforms have been implemented in particular with the introduction of the VAT. The tax administration is under revision, operating procedures and organisation improved and controls have been intensified. In *Montenegro* tax legislation has been amended to reinforce collection and control. The law on supreme audit institution has been adopted in *Montenegro* while in *Serbia* it is underway.

European standards

As regards the European standards, most priorities in the field of the **internal market** have become non applicable due to the twin-track approach, on which basis the internal market / trade action plan has been revised by the two *Republics*. Import levies (and additional charges) introduced in violation of the stand still clause of the autonomous trade measures were reviewed in co-operation with the EC. The abolition of the **import licensing system and export duties** is still pending. Comprehensive reform of the **customs** administration started both in *Serbia* and *Montenegro*. Herein, the administrative capacity has been strengthened in many areas while a continuous training of customs officers is underway. As regards **public procurement**, there are still inter-republican obstacles due to existence of domestic preferential schemes. Concerning **business registration**, in *Serbia* the law transferring this function from the Commercial Court to an independent agency has been adopted and is being implemented. In the **anti-trust** area *Serbia* adopted a competition law. *Montenegro* has not yet adopted the relevant legislation. **State aid** co-ordination points have been appointed in each Republic and have produced initial state aid inventory reports. In the field of **intellectual property rights**, a set of legislation was adopted at the *State Union* level. Implementing legislation is under preparation by the *Republics*. Penal provisions were somewhat strengthened in both *Republics*; however, ex officio proceedings are not yet possible neither in *Serbia*, nor in *Montenegro*. Enforcement remains weak and has to be improved. In the field of **capital movement**, the system of corresponding accounts in commercial banks to ensure free movement of capital between the two *Republics* has not yet been established.

Concerning **agriculture**, in *Serbia* the veterinary framework law has been adopted but the legislation on food safety is still pending and thus no clear division of responsibilities in the areas of veterinary, sanitary and phytosanitary control has been established yet, nor has the Food-Chain Laboratories Agency been set up. The administrative capacity building of the veterinary directorate is nevertheless underway as is the case with the Ministry of Agriculture itself. Policy formulation was strengthened and the agricultural strategy adopted. In *Montenegro* the legislation on veterinary matters is being implemented and the veterinary laboratory is established. Similar is taking place in the phytosanitary field. Drafting of the agricultural strategy in *Montenegro* is underway, while additional efforts are needed as regards capacity building vis-à-vis the Ministry of Agriculture. Measures aiming at improving agricultural waste management and reducing pollution are in preparation, but administrative capacity is lacking here as well.

As regards **transport**, in *Serbia* the legislation on railways has been adapted and the development of a national transport strategy has started. In *Montenegro* the laws on road transport and on rail transport have been adopted, and the road directorate has been established at the Ministry of Transport. Its financing is not clearly defined yet. In *Serbia*, the strengthening of capacity building, including the preparation for large investments, and the

earmarking of sufficient resources for the maintenance of transport infrastructure and institutions have progressed slowly due in particular to the lack of funds. In *Montenegro* there has been some progress in this respect.

In the field of **energy**, in *Serbia*, the energy law and the strategy for the development of the energy sector until 2015 have been adopted and the energy Agency has been established. The environmental audits on energy plants are ongoing and the issue of the worst polluters starts to be addressed. In *Montenegro*, the energy policy has been adopted and the energy development plan and energy efficiency plan are under preparation. The unbundling and restructuring of the electricity power utility is in progress. In *Serbia* the unbundling and restructuring of the utility, a medium-term priority, is in progress as well as the establishment of the institutional structures. In *Montenegro* the energy regulator has been reinforced. The partnership between the public and private sector is being developed.

As regards **industry and SME**, both *Republics* are implementing the European Charter for SME. In *Serbia* a new law on bankruptcy has been adopted. In *Montenegro* the development fund is being restructured and an investment promotion agency has been established.

In the area of **telecommunications and media**, limited progress has taken place in *Serbia* with a view to a liberalisation of the market and the establishment of an operational regulatory agency. In *Serbia*, the establishment of the Broadcasting Council was completed. However, the Broadcasting law was amended in August 2005. The amendments provide for the extension of the deadline for the transformation of the Serbian Radio Television from its present government-controlled role into a public broadcasting service to March 2006, as well as the postponement of the privatization of broadcasters operated by local government to July 2007. In *Montenegro*, there is some progress in this respect: the landline monopoly was successfully privatised and the regulatory agency is functioning well. The transposition of the new EU framework is in preparation.

In the field of **environment**, in *Serbia*, the law on environmental protection has been adopted and the environment protection agency has started operating. In *Montenegro* the strategy on waste has been adopted, but limited progress has taken place in its implementation as well as in the development of the legislative framework.

Concerning **Justice and Home Affairs**, the **judicial** and **law enforcement** co-operation within each Republic and between the two *Republics* has improved but the memorandum signed by the two Interior Ministries is not fully implemented. In *Serbia* the law on police has not yet been adopted, seriously affecting the law enforcement reform and restructuring of the police. The comprehensive reform of the legislation on the organisation of the judiciary is still pending but there has been progress in the reform of the criminal legislation with the adoption of the new Criminal Code. In *Montenegro*, the laws on police and on security services have been adopted and the implementation initiated.

As regards **border management**, the development of a *State Union* level approach and mechanisms to ensure consistent implementation at the level of the Republics has not taken place, due to disagreements over competencies. The implementation of the relevant priorities of the Justice and Home Affairs Ministerial Meeting of November 2003 has been delayed. In *Serbia*, the demilitarisation of the border control has been delayed, while it has been implemented in *Montenegro*. In terms of cross-border facilitation, some progress has taken place in *Montenegro* through the opening of new border posts while in *Serbia*, new border posts are contingent on budgetary availability.

In the field of the **fight against organised crime, trafficking, drugs, money laundering and terrorism**, the co-operation between the *Republics* has not been formalised although good co-

operation at operational level continues. Inter-agency co-operation within each Republic remains limited. The development of the capacity to seize assets is dependant on the adoption of the relevant criminal legislation. In *Serbia*, criminal intelligence is being developed. In *Montenegro* this remains hampered by insufficient personnel and financial support. In both *Republics*, training is ongoing with international assistance. The implementation of the specific oriented measures agreed at the Justice and Home Affairs Ministerial Meeting of November 2003 has started. There has been limited progress in the preparation of a co-operation agreement with Europol pending the adoption of the necessary legislative provisions. National strategies in the area of fight against drugs need to be finalised and implemented. Progress has taken place as regards the fight against trafficking in human beings including provisions on assistance to victims. In *Montenegro* there has been some progress in field of anti-money laundering as regards the adoption of the legislation and formalising the international cooperation. As regards the fight against terrorism, legal provisions have been introduced in the new Serbian Criminal Code; ratification and implementation of international conventions need to be speeded up. Concerning witness protection, a law has been adopted in Serbia, but further efforts are necessary to implement an effective system of witness protection. In the field of asylum, some progress has taken place notably with the adoption of the *State Union* framework law on asylum but the implementing laws at the *Republics'* level are still pending. In the area of visa the different regimes applied by the each *Republic* persist.

Serbia and Montenegro's progress in addressing the issues identified as priorities by the June 2004 European Partnership is discussed in more detail in other parts of this report, notably in part B.3. and in the Report on the preparedness of Serbia and Montenegro to negotiate a Stabilisation and Association Agreement with the European Union.

On the basis of the findings of this report, the Commission proposes a revised European Partnership for Serbia and Montenegro for adoption by the Council. The European Partnership will continue to be a key tool for guiding Serbia and Montenegro's efforts to move closer to the EU. It should be given the necessary political attention and should help Serbia and Montenegro to set its legislative and institution-building agenda.

STATISTICAL ANNEX

STATISTICAL DATA (as of 1 September 2005)

Serbia and Montenegro

Note: the inclusion or exclusion of the province of Kosovo (UNSCR 1244) is explicitly noted for many indicators, for other indicators this remains to be clarified.

Basic data	Scale	Unit	Foot-note	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Population: total	Thousand	Number	1)	8.432	8.425	8.412	8.394	8.373	8.343	8.326	8.114	8.153	8.1
Total area of the country	Unit (x1)	km²	2)	102.200	102.200	102.200	102.200	102.200	102.200	102.200	102.200	102.200	:

National accounts	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Gross domestic product	Million	National currency	3)	44.172	79.039	109.352	149.803	191.585	396.494	782.434	998.206	1 189 000e	:
Gross domestic product	Million	EUR	4)	8.224	10.973	14.561	14.003	9.477	9.821	13.159	16.450	18 253e	:
Gross domestic product per capita	Unit (x1)	EUR	4)	780	1.037	1.374	1.319	1.162	1.206	1.619	2.027	2 239e	:
SI: Growth rate of Gross domestic product at constant prices (national currency), relative to the previous year	Unit (x1)	%	5)	6,1	5,9	7,4	2,5	-17,7	5,2	5,3	3,8	2.1e	8.3
SI: Employment growth (national accounts), relative to the previous year	Unit (x1)	%	6)	:	:	:	:	:	-0,2	1,3	-2,2	-4,7	:
Labour productivity growth: growth in GDP (constant prices) per person employed, relative to the previous year	Unit (x1)	%	6)	:	:	:	:	:	5,4	4,0	6,1	7.2e	:
SI: Unit labour cost growth (national accounts), relative to the previous year	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:

GDP per capita at current prices	Unit (x1)	PPS		:	:	:	:	:	:	:	:	:	:
SI: GDP per capita at current prices, PPS, EU-25=100	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
SI: Labour productivity, PPS (GDP per person employed), EU-25=100	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
Agriculture (NACE Sections A+B): share of total gross value added	Unit (x1)	%	3)	:	:	19,3	18,4	20,6	21,1	20,9	16,3	:	:
Industry (excluding construction) (NACE Sections C to E): share of total gross value added	Unit (x1)	%	3)	:	:	32,7	31,5	30,3	28,2	28,4	28,0	:	:
Construction (NACE Section F): share of total gross value added	Unit (x1)	%	3)	:	:	5,1	5,3	4,2	3,9	3,7	3,8	:	:
Services (NACE Sections G to P): share of total gross value added	Unit (x1)	%	3)	:	:	42,9	44,8	44,9	46,8	47,0	51,9	:	:
Final consumption expenditure, as a share of GDP	Unit (x1)	%	3)	:	:	90,5	98,9	96,9	98,8	:	:	:	:
Final consumption expenditure: household and NPISH, as a share of GDP	Unit (x1)	%	3)	:	:	65,5	70,7	68,0	70,5	:	:	:	:
Final consumption expenditure: General government, as a share of GDP	Unit (x1)	%	3)	:	:	25,0	28,2	28,9	28,3	:	:	:	:
—Gross fixed capital formation, as a share of GDP	Unit (x1)	%	3)	:	:	11,7	11,6	12,6	15,4	:	:	:	:
—Stock variation, as a share of GDP	Unit (x1)	%	3)	:	:	6,4	-1,1	-0,5	-6,6	:	:	:	:
Exports of goods and services, relative to GDP	Unit (x1)	%	3)	:	:	17,8	23,4	11,2	9,2	:	:	:	:
Imports of goods and services, relative to GDP	Unit (x1)	%	3)	:	:	26,3	32,8	20,3	16,8	:	:	:	:

Inflation rate	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
SI: Consumer price index: total (CPI), growth relative to the previous year	Unit (x1)	%		79,0	92,4	21,6	29,9	44,9	85,6	89,2	16,5	9,4	10,0

Balance of payments	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Balance of payments: current account total	Million	EUR		:	:	-1 093p	-522p	-526p	-350p	-395p	-1 516p	-1 551p	-2 355p
Balance of payments current account: trade balance	Million	EUR		:	:	-1 689p	-1 434p	-1 300p	-1 919p	-2 836p	-3 741p	-4 077p	-5 671p
Balance of payments current account: exports of goods	Million	EUR		:	:	2 315p	2 586p	1 458p	1 687p	1 921p	2 193p	2 521p	3 111p
Balance of payments current account: imports of goods	Million	EUR		:	:	4 004p	4 020p	2 758p	3 605p	4 757p	5 934p	6 598p	8 882p
Balance of payments current account: net services	Million	EUR		:	:	311p	321p	143p	174p	466p	282p	255p	320p
Balance of payments current account: net income	Million	EUR		:	:	21p	9p	8p	-1p	-29p	-101p	-184p	-151p
Balance of payments current account: net current transfers	Million	EUR		:	:	264p	582p	624p	1 395p	2 004p	2 044p	2 454p	3 111p
Balance of payments current account: net current transfers - of which government transfers	Million	EUR		:	:	:	:	:	293p	660p	524p	420p	420p
Direct investment (FDI) in the reporting economy	Million	EUR		:	:	655	101	105	55	184	505	1.203	771

Public finance	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
General government deficit/surplus,	Unit (x1)	%	7)	:	:	:	:	:	-1.2e	-0.8e	-2.9e	-4.3e	-1.1e

relative to GDP													
SI: General government debt, relative to GDP	Unit (x1)	%	7)	:	:	:	:	:	169,3	132,1	89,6	71,9	52,

Financial indicators	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Gross foreign debt of the whole economy, relative to GDP	Unit (x1)	%		:	:	:	:	105,5	124,0	106,4	70,9	64,2	58,
Gross foreign debt of the whole economy, relative to total exports	Unit (x1)	%		:	:	:	:	500	538	452	385	351	25,
Money supply: M1	Million	EUR		444	790	1.317	852	1.259	461	975	1.525	1.457	1.4
Money supply: M2	Million	EUR		655	1.120	1.766	1.177	1.591	561	1.141	1.803	1.828	1.8
Money supply: M3	Million	EUR		932	1.462	2.286	1.696	2.126	1.111	2.101	3.113	3.584	4.0
Total credit: credit by monetary financial institutions (MFIs) to total residents (consolidated)	Million	EUR		3.154	4.005	5.180	4.287	5.260	3.918	4.498	2.971	2.934	3.8
Interest rates: day-to-day money rate, per annum	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
Lending interest rate (one year), per annum	Unit (x1)	%	8)	:	:	78,0	60,9	46,1	78,7	34,5	19,7	15,5	15,
Deposit interest rate (one year), per annum	Unit (x1)	%	9)	:	:	62,7	122,5	43,1	64,4	44,2	19,4	14,5	16,
EUR exchange rates: average of period - 1 euro= ... national currency	Unit (x1)	Number		2,266	6,301	6,479	10,490	11,735	15,156	59,781	60,704	65,165	72,
EUR exchange rates: end of period - 1 euro= ... national currency	Unit (x1)	Number		6,206	6,431	6,528	11,703	11,735	58,675	59,706	61,515	68,313	78,
Effective exchange rate index (1999=100)	Unit (x1)	Number		:	:	:	:	:	:	:	:	:	:
Value of reserve assets (including	Million	EUR	10)	:	:	:	:	296	564	1.325	2.186	2.839	3.1

gold)													
Value of reserve assets (excluding gold)	Million	EUR	10)	:	:	:	:	158	430	1.139	2.077	2.728	3.0

External trade	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Trade balance: (all goods, all partners)	Million	EUR		:	:	:	:	-1.687	-2.165	-3.276	-4.278	:	:
Value of exports: (all goods, all partners)	Million	EUR		:	:	:	:	1.405	1.853	2.125	2.406	:	:
Value of imports : (all goods, all partners)	Million	EUR		:	:	:	:	3.092	4.017	5.401	6.684	:	:
Terms of trade (export price index / import price index), relative to the previous year	Unit (x1)	Number		:	:	96,8	100,0	92,6	100,2	103,1	98,0	101,6	:
Share of exports to EU-25 countries in value of total exports	Unit (x1)	%		:	:	:	:	44,5	48,1	51,3	51,8	:	:
Share of imports from EU-25 countries in value of total imports	Unit (x1)	%		:	:	:	:	50,8	49,4	51,9	55,2	:	:

Demography	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Natural growth rate : crude rate of natural increase (births minus deaths)	Unit (x1)	per 1000		-0,4	-1,4	-1,8	-2,3	-3,1	-3,2	-2,1	-2,7	-2,7	-2,
Net migration rate: number of immigrants minus the number of emigrants	Unit (x1)	per 1000		:	:	:	:	:	:	:	:	:	:
Infant mortality rate: number of deaths of children under one year of age relative to 1000 live births	Unit (x1)	Number		13,7	14,6	12,4	11,8	11,2	10,7	10,6	10,2	9,2	7.5
Life expectancy at birth: male	Unit (x1)	Years		69,9	69,9	69,8	69,8	69,9	69,9	70,1	69,9	70,0	:

Life expectancy at birth: female	Unit (x1)	Years		74,7	74,7	74,7	74,8	74,9	74,9	75,2	75,2	75,2	:
Labour market	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Economic activity rate (15 - 64): proportion of the population aged 15-64 that is economically active	Unit (x1)	%		:	:	:	:	68,0	68,2	68,3	68,1	68,6	:
SI: Employment rate (15-64): proportion of the population aged 15-64 that is in employment	Unit (x1)	%		:	:	:	:	57,9	58,8	58,8	57,9	57,2	:
SI: Employment rate (15-64), male: proportion of the male population aged 15-64 that is in employment	Unit (x1)	%		:	:	:	:	66,7	67,8	67,7	66,8	66,4	:
SI: Employment rate (15-64), female: proportion of the female population aged 15-64 that is in employment	Unit (x1)	%		:	:	:	:	49,5	50,1	49,7	49,0	48,1	:
SI: Employment rate of older workers (55-64): proportion of the population aged 55-64 that is in employment	Unit (x1)	%		:	:	:	:	20,5	20,7	19,9	18,4	18,0	:
Agriculture, forestry and fishing (NACE Sections A+B) as a share of total employment	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
Industry (NACE Sections C to E) as a share of total employment	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
Construction (NACE Sections F) as a share of total employment	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
Services (NACE Sections G to P) as a share of total employment	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
SI: Unemployment rate: proportion of the labour force that is	Unit (x1)	%		:	:	:	:	13,7	12,6	12,9	13,8	15,2	:

unemployed													
SI: Unemployment rate, male: proportion of the male labour force that is unemployed	Unit (x1)	%		:	:	:	:	11,7	10,6	11,2	12,4	14,4	:
SI: Unemployment rate, female: proportion of the female labour force that is unemployed	Unit (x1)	%		:	:	:	:	16,2	15,2	15,1	15,8	16,4	:
Unemployment rate of persons < 25 years: proportion of the labour force aged <25 that is unemployed	Unit (x1)	%		:	:	:	:	53,1	49,6	46,8	45,6	45,6	:
SI: Long-term unemployment rate: proportion of the labour force that is long-term unemployed	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:

Social cohesion	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
SI: Inequality of income distribution: ratio of top quintile to lowest quintile	Unit (x1)	Number		:	:	:	:	:	:	:	:	:	:
SI: Early school-leavers: proportion of the population aged 18-24 having not completed upper secondary education and who are currently not in any education or training	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
SI: Children aged 0-17 living in jobless households: share of children aged 0-17	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
SI: Persons aged 18-59 living in jobless households: share of persons aged 18-59	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:

Standard of living	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
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Number of passenger cars / population	Unit (x1)	per 1000	11)	161,3	165,8	188,3	208,4	201,9	166,9	177,9	165,6	170,3	:
Number of main telephone lines (fixed) / population	Unit (x1)	per 1000		252,9	262,8	278,0	277,0	258,8	283,7	336,5	306,3	318,6	:
Number of subscriptions to cellular mobile telephone services / population	Unit (x1)	per 1000		:	1,8	10,3	28,6	:	:	239,9	357,2	418,1	:

Infrastructure	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Density of railway network (lines in operation)	Unit (x1)	per 1000 km ²		39,7	39,7	39,7	39,7	39,7	39,7	39,7	39,7	39,7	:
Length of motorways	Unit (x1)	km		374	374	374	374	374	374	374	374	374	374

Industry and agriculture	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Industrial production volume index (2000=100)	Unit (x1)	Number		95,0	103,0	113,0	117,0	90,0	100,0	100,0	102,0	99,0	100,0
Agricultural production volume indices of goods and services (at producer prices) (previous year = 100)	Unit (x1)	Number		104,0	101,0	107,0	97,0	99,0	87,0	117,0	98,0	93,0	:

Innovation and research	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
SI: Spending on human resources (public expenditure on education) as a share of GDP	Unit (x1)	%		:	:	:	:	3,9	3,9	3,6	:	:	:
SI: Gross domestic expenditure on research & development, relative to GDP	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:

SI: Percentage of households who have Internet access at home. All forms of Internet use are included. The population considered is aged 16 to 74.	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
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Environment	Scale	Unit		1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
SI: Total greenhouse gases emissions, CO ₂ equivalent (1990=100)	Unit (x1)	Number		:	:	:	:	:	:	:	:	:	:
SI: Energy intensity of the economy	Unit (x1)	kg of oil equivalent per EUR 1000 GDP		:	:	:	:	:	:	:	:	:	:
SI: Share of renewable energy in electricity consumption	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:
SI: Road freight transport as a share of total inland freight transport (Modal split of freight transport)	Unit (x1)	%		:	:	:	:	:	:	:	:	:	:

estimate

forecast

provisional

As of 30 June.

Including Kosovo (UNSCR 1244).

1999 onwards: excluding Kosovo (UNSCR 1244).

1995 to 2000: using market exchange rates; 1996 to 2000: recalculated by the World Bank method; 1999 onwards: excluding Kosovo (UNSCR 1244).

1995 to 1999: at 1994 constant prices, method based on Material Product System; 2000 to 2004: at 2001 constant prices; 1999 onwards: excluding Kosovo (UNSCR 1244).

Employees, farmers, helpers and other economically active persons are included in total employment; 1999 onwards: excluding Kosovo (UNSCR 1244); source: Lal Force Survey.

Data not yet validated.

Commercial bank weighted lending rates, short term credits.

Commercial bank weighted deposit rates of households up to one year.

Including portfolio investments.

2002 and 2003: excluding Montenegro.

Note:

The full set of Key indicators is available in http://europa.eu.int/estatref/info/sdds/en/coop_eur/coop_eur_base.htm.

The definitions of the indicators that countries have been requested to follow can be found (in English) in

http://europa.eu.int/estatref/info/sdds/en/coop_eur_definitions.pdf, which also includes the definitions of the few

indicators extracted from Eurostat's database, and from Comext. When countries have indicated divergences from the definitions requested these are indicated in a list of the footnotes.