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Intelligence Report

DCI Interagency Balkan Task Force — *7 February 1995*

Serbia: Rough Road After Sanctions

Serbia's financial difficulties are likely to continue even after UN sanctions are lifted because of the country's expected difficulty winning access to funds from international financial institutions (IFIs) such as the IMF and World Bank. Belgrade has made little progress toward free-market reforms, possibly even regressing under the embargo, and limited financial resources and political pressures are likely to continue even after sanctions end, making Serbia an unattractive borrower.

Serbia Among the Poor

Serbia's economy has been so hard hit that it has probably fallen close to that of Albania in terms of per capita national income.

- According to official statistics, Serbia has a lower GDP per capita, higher debt burden, higher unemployment rate, and higher inflation than its impoverished neighbor.

- Official statistics exaggerate the decline, however, because they do not measure the contribution that extensive gray market activities make to the economy. As a result, Serbians continue to be materially better off than Albanians because of preexisting wealth--substantial financial resources held by individuals--which has buffered the populace against the full effects of the embargo.

	Bulgaria	Romania	Serbia	Albania
GDP (Bil. $)	42.7	60	10	3.7
GDP Per Capita	3800	2800	800	1100
Unemployment (%)	16.3	10.9	>40	18.0
Official Forex Reserves (Mil. $)	1060	1800	500	200
External Debt per Capita ($)	1400	172	425	272
Inflation: % per month	5.0	2.8	12.4	1.2

*Note: Macroeconomic data for Serbia are highly suspect. Independent economists claim that 1994 GDP could be as low as $5 billion. Foreign exchange reserves also could be considerably higher, given reserves held by firms and individuals, but may not be accessible to Belgrade.

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Long-standing Problems Hobble Economy

The Serbian economy was already in a fragile state prior to the breakup of Yugoslavia.

- Serbia made little progress towards implementing economic reforms during the 1980s, lagging far behind both Slovenia and Croatia in terms of privatization, banking and financial reforms, tax policy, and foreign investment laws.

- The economy also continued to be burdened by an increasingly inefficient industrial sector, which the government propped up to maintain employment.

- Financial support to large enterprises came from closely linked commercial banks, which Belgrade pressured to provide both debt-equity swaps and easy credit. This severely weakened the banking system, saddling many banks with nonperforming loans and chronic liquidity problems. [redacted]

UN Embargo Hastens the Slide

The UN embargo has exacerbated these existing problems and created new economic challenges which Serbia will be hard pressed to address.

- Large state enterprises have increased their reliance on government subsidies as Belgrade has provided easy credits in order to minimize social unrest and allow the domestic production of strategic goods to replace imports.

- Serbia's social welfare commitments have also ballooned as Belgrade has promised to support over a million workers laid off as a result of sanctions.

- Many commercial banks have been forced into bankruptcy. [redacted]

Although the private sector has grown substantially under sanctions with the expansion of gray and black market activities, much of this activity is dominated by organized crime which will not be easily controlled after sanctions are lifted. This is likely to hamper the efficient functioning of the private sector and deter foreign investment. In addition, many small businesses profiting from the premium prices they charge for embargoed goods are unlikely to survive once prices drop to world market levels. [redacted]

This memorandum was prepared at the request of Mr. Leon Fuerth, Assistant to the Vice President for National Security Affairs [redacted] Comments and queries are welcome and may be directed to Chief, Interagency Balkan Task Force, at [redacted]

Serbia also will have considerable difficulty meeting its international debt obligations. It currently is in default on all its international obligations as a result of the freezing of its foreign financial holdings. These assets are likely to remain tied up even after sanctions end, as the other former Yugoslav republics put in claims for a share of the assets of the former SFRY. Serbia will have problems meeting its debt obligations without these funds, given its currently depleted hard currency reserves and the difficulty it is likely to have reestablishing old trade ties.

- Neighboring countries have taken over many of its traditional markets in Eastern Europe and the CIS since sanctions were imposed.

- Serbia's best prospects probably lie with reestablishing commercial links to old partners in the other Yugoslav republics and with Russia, where covert business contacts have continued despite the UN embargo. [redacted]

Spotty Progress

In Serbia's favor, the current governor of the national bank, Avramovic, has attempted to fight inflation with a fairly orthodox austerity program.

- He has implemented tight monetary policy and attempted to increase hard currency reserves through enhanced tax collection to support the value of the dinar.

- He continues to push for fiscal restraint by the republic and federal governments to avoid fueling inflation through government overspending, including advocating temporary wage caps. [redacted]

While these policies have eased Serbia's plight under sanctions, they, ironically, are likely to be jeopardized by the end of the embargo as public expectations of a rapid improvement in living standards rise. The Milosevic regime may find that continuing restrictive policies risks a serious public backlash.

- Belgrade could find it politically untenable to continue controlling wages and limiting subsidies to inefficient enterprises. Loosening these policies could accelerate already significant levels of inflation.

- Serbia's budget shortfalls could increase markedly as the military, laid-off workers, and pensioners lobby for an increase in their benefits.

- Belgrade may be hesitant to privatize large enterprises if this risks worsening the employment situation.

- Restructuring the banking system also may lag if Belgrade continues its policy of using commercial banks to shore up enterprises. [redacted]

All of these factors will limit Serbia's attractiveness to the IFIs and lower its chances for financial borrowing.

What the IFIs Will Want From Serbia

Both the IMF and World Bank are likely to insist on the following before seriously considering lending to Serbia.

- A stable political situation, with minimal prospects of military conflict reoccurring with either Croatia or through indirect Serbian participation in Bosnia.
- Continuation and possibly strengthening of the Avramovic measures consisting of tight credit and wage policy, as well as a balanced budget with curbs at least on military spending --the largest budget item--and industrial subsidies.
- Substantial progress on economic reforms, particularly privatization and banking reform.