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Intelligence Report

DCI Interagency Balkan Task Force — *22 December 1995*

Serbia: Struggling Economy, Stagnant Reforms [redacted]

With the signing of the peace agreement and relief from sanctions, Belgrade now faces protracted struggle on numerous economic fronts—in restoring production and living standards, reestablishing trade, and normalizing relations with international financial institutions. The suspension of sanctions will yield only modest benefits over the next year because of the dilapidated state of the Serbian economy and a shortage of capital. Output and trade will grow in 1996 but—like living standards—will remain well below prewar levels. Milosevic may find himself increasingly vulnerable to blame if the economy recovers slowly. However, securing international financial assistance will take time and require demonstration of a commitment to economic reform despite hardliner opposition at home. [redacted]

Partial Recovery in Output and Trade is Likely . . .

Although the suspension of sanctions will boost Serbia's battered economy over the next year, production and trade will remain well below prewar levels. War priorities and sanctions-induced shortages have taken a considerable toll on what was already a foundering, obsolescent economy.

- According to the Federal Statistical Office, Serbia's GDP in 1993 and 1994 was less than half of 1989 output; sanctions, which had their greatest impact on industry and transport, hampered Belgrade's access to raw materials and spare parts. Agricultural output--down 16 percent in 1994 from 1990--suffered the least.

- Press reports indicate that a few industries have increased output in 1995 by as much as 40 percent over 1994, but their production remains at less than half of prewar levels; overall industrial output is down 10 percent this year, according to Embassy reporting. [redacted]

Finance Minister Zebic is forecasting 13 percent growth in 1996, according to press reports, but that is likely to prove optimistic; most industries will have to scramble for financing to resume even partial production; before sanctions, major Yugoslav industries were dependent on imports for 60 percent of raw or semi-finished materials.

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- Managers of textile factories say equipment is in working order but they lack the financial resources required to replenish inventories of such basic goods as cloth, zippers, and buttons.

- Managers of a copper rolling mill estimate it will take a year to restore production to normal levels.

- A spokesman for the steel industry estimates that basic production could be restored by mid-1996 but does not expect output to reach normal levels until the second half of next year. [redacted]

According to US Embassy reporting, the Serbian business community sees the best prospects for restoring production capabilities in the former export industries that require little in the way of imported materials and equipment—and thus the least foreign exchange. The most likely sectors include agricultural products, non-ferrous metals and minerals, furniture and clothing.

- According to press reports, the Pancevo fertilizer plant—an exporter before sanctions—has resumed normal production of ammonia now that natural gas supplies have been restored, and management hopes to have all production lines operating by the end of the year. [redacted]

Embassy reporting makes it clear, however, that even former leading export sectors have been badly hurt by sanctions and many will need time to recover. One textile firm that recently signed a $25 million contract to export clothes to France—contingent on the lifting of sanctions—had to send workers home on forced leave because of a lack of fuel and raw materials. [redacted]

. . . But Winning Back Customers Will Be Tough

Former exporters who manage to resume production may not be able to find foreign buyers for their goods. According to Embassy reporting, Serbian enterprises are concerned about changes in foreign markets over the past three years that will make it tough for them to regain a foothold. WTO has replaced GATT, the EU's internal market has expanded, and reform economies in Eastern Europe are now strong competitors. Moreover, many enterprises had been losing their ability to compete in foreign markets even before sanctions were imposed because much of Serbia's industrial base already was technologically obsolete. [redacted]

- Officials in the nonferrous metals industry--which formerly exported 75 percent of production--claim they cannot compete with the newer, more efficient production technologies of foreign producers. [redacted]

Although many former trade partners have resumed contacts and signed agreements, imports and exports will remain well below presanctions levels. We estimate FRY trade could surpass $2 billion in 1996, about one-third of its foreign trade in 1992, according to official statistics. Serbia's best bets for exports are with Russia and the

This memorandum was prepared by [redacted] Office of European Analysis. Comments and queries are welcome and may be directed to Chief, DCI Interagency Balkan Task Force on [redacted] border states, but Russian officials are cautious about trade approaching pre-sanctions levels anytime soon, probably because they have new sources of supply for non-agricultural goods they formerly purchased from Serbia. In any case, a lack of hard currency will force Belgrade to push Moscow for barter and countertrade.

- According to one press report, Russia needs to import 4 to 6 million tons of grain this year and is looking to Serbia to provide 1 to 2 million tons; another press report indicates Serbia will export 2 million tons of wheat and one million tons of corn, in exchange for oil and oil products.

- Russian natural gas piped through Hungary already has returned to pre-sanctions levels of 186.5 million cubic meters per month [redacted]

Neighboring states will resume trade with Serbia but many people in them will lose some hard currency earnings from sanctions-busting smuggling of gasoline and other goods into Serbia. Most of these countries have claimed billions in trade losses from upholding sanctions.

- Bulgaria and Romania already have signed trade agreements, according to press reports. [redacted]

. . . And Living Standards Will Remain Depressed

The Serbian population has been extremely hard-hit by sanctions and war, and while Milosevic's popularity is high in the wake of the Dayton agreement, a slow and partial recovery does not bode well for improvements in living standards or for popular morale. Hyperinflation—which plagued consumers in 1993—has been brought down, but inflation is still running at 120 percent annually, according to press reports. Official unemployment is at 50 percent and incomes are at less than half of prewar levels. The head of the Belgrade Institute of Economic Sciences estimates that restoration of prewar living standards will take a minimum of seven years, according to press reports.

- Until sanctions were lifted, urban households faced tough choices monthly between food and heat; electricity rates were tripled this year, and bills must be paid in advance. Shortages of natural gas often forced households to rely on electric space heaters, overloading the power grid and further diminishing energy supplies for industry.

- Budget shortfalls have prompted Belgrade to postpone pension payments to veterans and the elderly; according to Embassy reporting, payments for November and December will be put off until next year in order to balance this year's budget.

- Many umemployed workers engaged in black-market activities during the sanctions have now lost a lucrative source of income [redacted]

No Money to Rebuild

Investment in the repair and upgrading of industry and infrastructure are key to long-term recovery and improving living standards. Serbian economists, who estimate that investment needs over the next three years will total $8.5 billion, note that investment has fallen from 19 percent of GNP in 1990 to 12 percent in 1994, even as GNP has collapsed. Belgrade has few domestic resources to draw upon, however. Serbia's banks—like the country's larger state-owned and private industries—are run by government officials affiliated with the ruling socialist party. After years of extending unlimited credit to cronies in moneylosing enterprises, they have built up huge portfolios of bad debt. Independent banking experts estimate that at least half of Serbia's 108 banks, including all of the large ones, are operating in the red.

- The ten largest state enterprises account for half of the foreign debt and half of all enterprise financial losses, according to a Serbian economist. [redacted]

The banks also have minimal deposits. Domestic savings are negligible because of public distrust of the banks, which seized people's hard currency deposits in 1992-1993 with no guarantees of repayment.

- Hard currency remittances from abroad—Belgrade estimates 300,000 workers abroad may be sending home as much as $630 million annually, according to Embassy reporting—are hoarded by the public and converted only out of necessity, primarily on the black market. [redacted]

With nowhere to turn at home, Serbian banking officials and academics admit the need to attract foreign capital to restore the economy. Former investors and business partners are likely to lead the pack in scouting out investment opportunities in Serbia, as they evaluate the profitability of reestablishing previous relationships. A number of foreign businesses visited Serbia earlier this year in anticipation of the end of sanctions, and several business delegations are in country now evaluating prospects for investment and joint ventures. Without a government commitment to economic reforms that eliminate restrictions on ownership and profit repatriation, however, most foreign businessmen will be wary.

- According to Embassy reporting, foreign firms considering operations in Serbia include Siemens, Alcatel, Ericsson, and Deutsche Telecom.

- According to press reports, a Krupp delegation met in Serbia in early December with the Trepca Corporation and the Jugometal Company, two Serbian nonferrous metals conglomerates, to discuss trade and joint ventures in third-country markets. [redacted]

Windows Remain Closed at Foreign Banks

Serbia may hope to draw on aid from international financial institutions as well as foreign investment, and is anxious to lay claim to a share of the hard currency assets of the former Yugoslavia. Access to either could take time, however. Fundraising for reconstruction aid for the Balkans is focusing on Bosnia; Serbia is starting almost from scratch in dealing with international financial institutions; and the release of most of the funds recently unfrozen by UN Resolution 1022 remains in question:

- Serbia can expect a share of humanitarian aid administered by the UNHCR, but reconstruction fundraising spearheaded by the EU is focused on trying to underwrite the World Bank's proposal for $6 billion in aid for Bosnia and Croatia.

- To normalize relations with international financial institutions, Serbia must negotiate four separate agreements on its share of former Yugoslav debt and arrears—with the World Bank, the International Monetary Fund, the Paris Club of official creditors, and the London Club of commercial creditors; Serbia's share of some of these debts has not yet been negotiated.

- While some countries have moved to release frozen assets of the former Yugoslavia, banks in many countries intend to wait until successor states issues are resolved, according to Embassy and press reports. Bonn has cautioned German banks that they would be responsible for compensating any parties who might be shortchanged in the distribution process. [redacted]

Other successor states, worried that Serbia would lay claim to all of the frozen assets, came to an agreement last month on the shares of these assets each would claim. They agreed to use the formulation adopted by the International Monetary Fund to apportion one component of former Yugoslav debt among the successor states.

- Serbia would receive only 36.5 percent of frozen assets under this formulation. However, Belgrade may be willing to settle for this amount to avoid lengthy and costly disputes in numerous foreign courts. [redacted]

Reforms Would Help . . .

Settling debt and normalizing relations with the IMF, the World Bank, and other creditors will help reestablish lines of credit. For the kind of substantial lending required to rebuild the infrastructure and fund other industrial projects, Belgrade will have to agree to macroeconomic performance targets and demonstrate commitment to economic reforms.

- National Bank President Avramovic effected stabilization policies last year that brought Serbia out of hyperinflation, and last month succeeded in devaluing the currency. But he faces considerable opposition from hardliners—including Mira Markovic, a leader in the ruling party and Milosevic's wife—in pursuing major reforms, such as privatization of large state enterprises.

- Avramovic's hospitalization last week for kidney and heart problems throws the future of the reform program further into question; he has neither strong allies nor a likely successor in his efforts to reform the economy. [redacted]

But Will Milosevic Support Them?

In the wake of the peace talks, Milosevic will be under pressure at home to demonstrate that the removal of the sanctions—for which he blamed the economy's woes—will start Serbia on the path to economic recovery. Although establishing credit and gaining financial assistance from the West would be difficult and time-consuming at best, Milosevic's job is made more difficult because he will have to convince the international community of Serbia's commitment to economic reform, while confronting the virulent anti-reform stance of his wife and other hardliners.

- In separate talks with Carl Bildt and Romanian Prime Minister Vacaroiu, Milosevic acknowledged that Serbia needs to reform and to shut down debt-ridden industries, but in a meeting with a US Congressional delegation in Belgrade he was evasive on privatization.

Given his wife's strong public campaign against Avramovic, Milosevic is most likely to allow him to try to keep the ball rolling on reforms, but keep enough distance to be able to blame Avramovic for reform failures or continued economic malaise. He also will maintain public support for the Dayton agreement, partly in the hope of using that support to claim Belgrade has earned consideration for Western financial assistance. In the meantime, he probably will evaluate the potential for other sources of financial assistance and international cooperation:

- To persuade potential lenders abroad while minimizing hardliner dissent at home, Milosevic may seek a middle ground on the privatization issue; his new Minister-Coordinator for Economic Recovery recently put forward a "go-slow" approach on privatization, utilizing strict evaluation criteria on a case-by-case basis.

- To tap into hoarded foreign remittances, Milosevic could declare support for banking reforms that would offer real interest rates and encourage deposits of hard currency, but to win back popular trust the banks would probably have to offer compensation for previously seized assets as well.

Milosevic may see new opportunities in expanding trade and economic cooperation with Russia, the former Soviet republics, and China as preferable to espousing a reform effort in hopes of eventual Western assistance.

- He may view the success of the Communists in the Russian elections last week as conducive to asking for—and getting—more from Serbia's relationship with Moscow.

- Belgrade's trade delegation to Beijing this month, headed by Federal President Zilic, signed an investment protection agreement and received a pledge of Chinese support for Belgrade's reconstruction efforts.