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REPORT FROM THE COMMISSION

The Stabilisation and Association process for South East Europe

Second Annual Report

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Executive Summary

The Commission's Second Annual Report takes stock of progress since the first report issued in April 2002. It reconfirms the perspective of an even closer relationship with, and ultimately membership of, the European Union and recognises substantial achievements in terms of stabilisation of the region.

The report also reveals shortcomings and slow progress in the reform process in many sectors and in several countries. A theme running through both this report and those of the individual countries is the generally poor record on implementation. The main challenges ahead are identified and the Commission remains dedicated to supporting the countries in their efforts to tackle them. Genuine political will and commitment on the part of the countries themselves are indispensable in overcoming remaining obstacles to transition, development and European integration.

In this report, the Commission outlines some measures which could be considered to strengthen the process further and draw the countries ever closer to the Union in what can be considered a shared agenda for European integration. This demonstrates the European Union's continued commitment to the region. However, the time and the pace with which the region can fully integrate into the European Union ultimately depends on the countries of the Western Balkans themselves.

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

1. THE OVERALL CONTEXT

The Copenhagen Council in December 2002 confirmed the European perspective of the five countries of the Western Balkans and underlined, once again, the European Union's determination to support their efforts - as potential candidates - to move closer to the European Union. The Stabilisation and Association process remains the policy framework to help the countries along the way and is recognised and supported by the whole of the international community and by the countries of the region. It is an entry strategy - introducing European values, principles and standards in the region, which in due course will gain them entry into the European Union. The process and the prospects it offers are serving as the anchor for reform in the Western Balkans in the same way the accession process has in Central and Eastern Europe.

This year's Annual Report shows that all countries are making steady progress. It is in most countries being achieved at a slow pace, however, and sometimes more due to international input and pressure rather than a willingness or ability of the countries themselves to take ownership of and drive forward the reform process.

The country reports point to a number of areas where improvements and further reforms are required in the individual countries to allow their progress towards a closer relationship with the European Union. The Commission is continuously assisting them in their efforts to overcome obstacles to transition and development, such as the fragile institutions and poor administrative capacity, the weak application of the rule of law and the generally poor level of implementation.

The reports also demonstrate the linkages between the Stabilisation and Association process and the European Union's Common Foreign and Security Policy. One example is the recently established EU Police Mission in Bosnia and Herzegovina (BiH) which supports the broader rule of law agenda and thus complements other programmes under the Stabilisation and Association process. The envisaged EU-led follow-on to the NATO Operation Allied Harmony in the former Yugoslav Republic of Macedonia as well as to the NATO-led Stabilisation Force (SFOR) in BiH, are other examples of stabilisation efforts which will contribute to the longer term reform and association process.

The Stabilisation and Association process is designed to help the countries of the region with their transition, and is flexible enough to adjust to the needs and level of development of the individual countries - but it cannot do the job single-handed. It should be seen as a "contract" between the European Union and the countries; the Commission is continuously looking at ways to improve and intensify the process and its instruments, thus moving steadily towards a European integration process. An increased effort on the part of the Union has to be accompanied by an equally strong political commitment on the part of the countries to implement the necessary reforms. It has to be a shared agenda for European integration.

The European Union is ultimately a union of values. The governments of the region must, and are also increasingly seen to, espouse these values - values related to democracy, the rule of law, respect for human rights, protection of minorities and a market economy. It is in their own interest and the peoples of the region deserve it. Values do not change overnight, however, and we have to give the countries the time they need - and appreciate that the Stabilisation and Association process will not be a quick-fix but is a long-term policy which will bring about sustainable results.

The methodology and the structure of the Second Annual Report are basically the same as those of the first report, published in April 2002¹. The country reports examine progress made during the year, make assessments of the level of implementation of the recommendations in the First Annual Report and highlight priority areas needing attention in the coming 12 months. This report, the “Composite paper”, summarises the main trends and remaining challenges in the region, looks at the regional dimension in a number of specific sectors and discusses coherence and implementation of two of the main instruments under the Stabilisation and Association process: the assistance programme (CARDS²) and the trade measures (Annex I). An evaluation of the implementation of the Stabilisation and Association Agreements will be carried out when they have been in force for a sufficient period of time to allow such an evaluation to be made. Executive summaries of the reports on the individual countries are attached in Annex II.

1.1. Enlargement and the Western Balkans

The unification of Europe will not be complete until it includes its south-eastern part. The 2004 Enlargement will bring the European Union physically closer, indeed to the very doorstep of the Western Balkans. The successful completion of negotiations with some of their closest neighbours – who are expected to join the European Union in May 2004 - will bring about new dynamics in the European integration process and consequently have a profound impact on the countries of the Western Balkans. It should contribute to making their own perspective real and visible and reinforce the message that hard work, and the sometimes painful reforms and adjustments required to get there, will pay off. With sufficient political will and ability to reform and endorse the core values and principles of the European Union, the countries of the Western Balkans will be the next in line, at their own individual pace.

Under the present circumstances, the European prospects of the countries of the Western Balkans is of paramount importance and proves the European Union’s readiness to stand by the peoples of the region in very difficult situations. The Thessaloniki Summit in June 2003 should highlight the Union’s commitment to a European future for the countries of the region.

An enlarged Union has practical consequences. In order to meet the obligations under the acquis and their commitments in the accession negotiations, the new Member States have to ensure a high level of protection at the Union’s external borders to provide internal security while ensuring smooth and swift border-crossings. This entails closer co-operation with the future southern neighbours of the Union. An upgrading of future external borders will reduce waiting time at the borders to the benefit of all travellers.

The Enlargement will inevitably lead to the elimination of visa-free travel between the new Member States and the countries of the Western Balkans, except for Croatia which enjoys a visa-free status in relation to Schengen countries. This is a natural consequence of the candidates aligning with the visa acquis.

The fact that the Western Balkans is one of the gateways to the European Union for criminal activities, illegal immigration and other threats reinforces the need for wider law enforcement co-operation in the region. Working with neighbouring candidate countries, which are seeking to implement the EU acquis, will benefit the Balkan countries in their daily efforts to develop new practices and skills.

¹ COM (2002) 163 and COM (2002) 339-343

² Community Assistance for Reconstruction, Development and Stabilisation

The new Member States will fully adopt the European Union's Common Commercial Policy upon accession. While the trade agreements in force between the candidates and third countries will have to be terminated, the EU's international agreements and unilateral trade preferences will apply immediately in the new Member States. More than 70% of the Western Balkans' external trade will be conducted with the enlarged Union. Considering that the EU's trade preferences towards the region provides for better market access than do the current trade regimes of the candidate countries, this will be particularly beneficial and provide for greater export opportunities. Furthermore, the enlargement is expected to positively affect economic growth in the new Member States which is likely to spill over into the countries of the Western Balkans e.g. through an increase in trade. The Commission will continue to monitor EU trade with the region.

All in all, the effects of the enlargement process will be an increased exposure of neighbouring countries to democratic traditions in, for example, the administrative, judicial and police sectors, which in turn will help to consolidate the rule of law and the capacity of institutions in the Western Balkans. In addition, the candidate countries have their own experiences of transition and European integration and by sharing these, they could provide valuable assistance to the countries of the Western Balkans. Such trends can only improve the prospect of closer integration with the EU.

The Republic of Croatia submitted an application for EU membership, on the basis of Article 49 of the Treaty on the European Union, on 21 February 2003. The application will be dealt with according to the rules laid down in the Treaty. The first step would be for the Council to ask the Commission to prepare a preliminary opinion on the question whether and when accession negotiations should be started.

The membership conditions were laid down in the 1993 European Council at Copenhagen – the so called Copenhagen criteria. They require that the candidate countries ensure

“stability of institutions guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities”,

“the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union” and

“ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union”.

The importance of not only incorporating the *acquis communautaire* into national legislation, but also ensuring its effective application through appropriate administrative and judicial structures have been highlighted at subsequent European Councils.

1.2. Sharing European values and norms

The Stabilisation and Association process and the prospects of a closer relationship with the European Union offer an agenda for the countries to reform and to adopt European values and norms. Further rapprochement towards the Union means meeting demanding requirements.

The General Affairs Council of May 2002 stated that: *“The speed with which each country moves through the different stages of the SAP, taking ownership of the process, depends on the increasing ability to take on the obligations flowing from an ever closer association with the EU as well as compliance with the conditionality policy defined by the Council on 29 April 1997.”* These conditions remain a fundamental element of the Stabilisation and Association process and are integrated into the Stabilisation and Association Agreements.

There are different degrees of required compliance: the conclusion of contractual relations requires the highest degree while financial assistance and economic co-operation could be considered on the basis of a different kind of compliance. In addition, there are specific conditions attached to particular assistance programmes - for example requirements for reforms in a particular sector which would then benefit from financial assistance.

The level of compliance with the conditions set out by the 1997 Council Conclusions, as well as the countries' level of implementation of EU compatible reforms and their administrative capacity are assessed in the attached country reports.

This year's Annual Report shows that progress has been less than optimal in many areas (e.g. full co-operation with ICTY and economic reform). The Commission is currently reflecting on how different criteria benchmarks and road maps can be made more effective, how their implementation can be supported and thus encourage reform. Benchmark and road-map approaches may be useful but need to be accompanied by a set of clear and predictable measures if the conditions are not met or benchmarks are not reached. At the same time, countries meeting conditions should continue to be supported in a tangible way in progressing towards Europe. Effective conditionality must be complemented by effective support and advice on how to make necessary reforms and thus facilitate progress towards integration into EU structures.

Progress will depend on the ability and political will to introduce the necessary reforms and to implement and respect generally accepted rules and standards. These are the same democratic standards as those advocated by the Council of Europe and OSCE, and the economic reforms as sought by the World Bank and the IMF.

1.3. Public opinion and the European Union

Although information on public opinion varies from country to country, levels of public support for a closer relationship with the European Union remain high, and perceptions of the Union generally positive. It is important that the effectiveness of European Union policy to the Western Balkans is understood by and above all visible to the population of the region. Support for the reform process and realistic expectations of what it will deliver depend on an understanding of what the Stabilisation and Association process means. The region's historical ties and the aspirations of local populations to reintegrate into mainstream Europe may be instrumentalised to promote reform.

A strategy for strengthening co-ordination and communication of activities and for improving the understanding of the Union and what it can offer the Western Balkans has been elaborated by the Council. But this should be a shared task. The countries of the region must play their part in explaining to their populations the realities and mechanics of a closer association with the European Union. This would also foster the necessary sense of ownership of the process.

2. PROGRESS BY THE COUNTRIES OF THE WESTERN BALKANS IN THE STABILISATION AND ASSOCIATION PROCESS

2.1. Overall political development

The countries of the Western Balkans have invested significant efforts in the Stabilisation and Association process. Stability has essentially been restored; security has improved; all of the countries have democratically elected governments; massive reconstruction has taken place across the region; a substantial number of refugees and internally displaced persons have returned home; reforms in many sectors are underway – the cumulative effect of this is to lay the foundations for economic, social and institutional development,

for a normalisation of every-day life and for the countries' gradual rapprochement with the European Union.

Important and positive developments during the reporting period include clear signs of increasing political stability in *Albania*, which have enabled the country to move one step further towards a closer relationship with the European Union; the Council adopted the directives for the negotiation of a Stabilisation and Association Agreement with Albania in October 2002 and negotiations were formally opened at the end of January 2003. *Bosnia and Herzegovina* has pushed forward with reforms, including important measures aimed at increasing the efficiency of and advancing integration within governments at all levels. The EU Road Map was substantially completed during the autumn and the Commission will in due course prepare a study on the feasibility of Bosnia and Herzegovina negotiating and concluding a Stabilisation and Association Agreement (SAA). *Croatia* is continuing to make good progress in its transition process and adopted a plan for implementation of the SAA at an accelerated pace reflecting its ambitions for EU membership. In *the former Yugoslav Republic of Macedonia*, the Ohrid Agreement is being implemented and the census was conducted smoothly - there is an increasing readiness to find compromise solutions, confirming that the process of stabilisation and normalisation is firmly on track. Economic reforms are being implemented in *Serbia and Montenegro* and steps have been taken towards necessary constitutional restructuring and in regional relations. The Serbian Government has shown stability and calm in its reaction to the assassination of Prime Minister Zoran Djindjic. Progress continues in Kosovo, focussing on standards before status. Continued progress in Serbia and Montenegro should allow the Commission to prepare a feasibility study for a Stabilisation and Association Agreement.

Many of the pressing political, economic and social challenges identified in the first Annual Report remain, however, and the Commission will continue to support the countries in their efforts to address these and other reforms required for a closer relationship with the European Union.

The countries are adhering to the **principles of democracy**. There are, nevertheless, still shortcomings in terms of governmental culture and functioning of democratic institutions, such as a lack of respect for constitutional frameworks and exertion of political influence on the judiciary and media – although there are great variations between the countries. Parliamentary structures have improved but the functioning of parliaments and parliamentary bodies is still being hampered by the slow pace of reform, a lack of democratic tradition and efficient procedures, an endemic shortage of experience and technical expertise, as well as by a tendency to politicise parliamentary administrations. General and local elections, which were held in several of the countries over the past year, were considered basically free and fair but voter turnout was generally low, in the case of the Serbian and the Montenegrin presidential elections even rendering the elections invalid. This low turn-out is worrying in several respects: it reveals a disappointment or a lack of confidence in the political establishment and also draws attention to structural problems, such as the need to review election legislation in Serbia and Montenegro. The behaviour of many political leaders also leaves much to be desired – confrontational approaches, personal agendas, corruption, obstruction and obfuscation rather than a focus on achieving the medium to long-term needs of their populations negatively affect developments and undermine confidence in public institutions.

Unresolved, complicated or fragile **constitutional arrangements** continue to put a brake on reforms in several countries and thus on implementation of the Stabilisation and

Association process. There is an increasing sense of urgency in the need to overcome obstacles to transition and development.

Work is continuing to reform and modernise the **public administrations** and their performance is improving. While recognising progress made to date and the enormous difficulties it has entailed, public administrations nevertheless remain weak in several countries, lacking adequate administrative capacity, trained staff and budgets. The legislative process and implementation is slow for a variety of reasons, including a lack of implementation mechanisms, blockages, internal political party disputes and unclear division of power between different levels of government. As in the case of the Candidate Countries, the Commission attaches the greatest importance to ensuring that the countries reinforce their administrative and judicial capacity and it therefore provides extensive support to institution and capacity building.

During 2002, experts from the Member States and the Commission made assessments of the **justice and home affairs** sector. Progress has been made across the region in reforming their judicial systems – a key factor in ensuring the rule of law. They still suffer from a number of common deficiencies, however. The independence of the judiciary is generally not secured. All countries have a large number of pending cases in the courts, not so much due to an insufficient number of judges but to outdated procedural codes, inadequate infrastructure, inefficient court organisations with a high number of small courts and an uneven division of tasks. The countries need to foster training of judges, prosecutors and court clerks. Slow implementation and enforcement of decisions in civil cases is a common weakness. Enforcement procedures need to be simplified and the efficiency of the bailiff services improved.

Organised crime and corruption are endemic in the region, negatively affecting institutional and economic development. The commitments of the countries to tackle these problems have not been sufficiently translated into concrete measures. The decision of the Council to enable Europol to start negotiating agreements between Europol and the countries of the Western Balkans could in due course provide a useful instrument in the fight against organised crime. Until these agreements become operational, police and judicial co-operation have to be enhanced through existing instruments, notably the Interpol network. Organised crime and corruption are not constrained by borders – this has a clear regional dimension and the problems can thus only be tackled efficiently if the countries co-operate. At the Ministerial Conference on Organised Crime held in London in November 2002, the countries acknowledged that these problems pose serious threats to their stabilisation and democratisation and made a joint commitment to work together to fight crime at source, in transit and at its destination, and to implement a number of priority actions related to e.g. international standards, legislation, capacity building and co-ordination. The Summit in Thessaloniki in June 2003 will represent an opportunity to take stock of progress and for the countries to give evidence of their commitment by providing information about the first concrete achievements in the fight against organised crime and corruption. It would be useful if each country presented a national plan setting out the main elements of how to fight organised crime successfully.

The general situation in terms of **respect for human rights and protection of minorities** has progressed but there is a need for further improvement in a number of countries as regards for example implementation of legislation, equality before the law, missing persons and the right to property.

The number of **refugees and displaced persons** returning to their homes is steadily increasing³. Approximately 1,1 million people remain displaced in the Western Balkans, however⁴. While welcoming the significant progress made over the last few years, there are still obstacles which need to be tackled to enable all individuals to exercise their right to choose whether or not to return. Property repossession in BiH, which has the largest number of refugees and displaced persons, is advancing while the process is still slow in Croatia and Kosovo. Croatia has made progress on reforms of property repossession legislation but difficulties to repossess property nevertheless remain a significant obstacle to return. The regulation of property repossession varies between the countries – and needs to be harmonised. Security is still a factor hampering returns to Kosovo. Administrative procedures often remain cumbersome and do not facilitate access to basic rights, including citizenship and social benefits. Economic activities and employment opportunities in many return areas are far below national averages. Areas with a large influx of refugees have not had commensurate increases in budgets for health and social welfare. Regional exchange of information need to improve and new forms of financing of return related expenditures found.

Education is an important issue which is linked to the democratisation process and to structural reforms. The education systems need to be further developed to promote democratisation, pluralism and employment. Non-governmental youth organisations also have an important role to play in the development of open and democratic societies by promoting inter-ethnic dialogue and active participation of young people.

An active **civil society** is slowly but surely emerging in the Western Balkans, although the level of development varies considerably from country to country. Civil society organisations are engaged in an increasing number of areas, including culture, environmental protection, electoral transparency, in fostering democratic ideas and institutions. But organisations in many other areas, such as professional associations and trade unions, remain weak. The majority of civil society organisations are still at an early stage of development and need to be strengthened to be able to respond more effectively to the political, social and economic environment.

Most of the countries have made significant efforts in developing an effective legal framework for **media**. Reform programmes must continue by adopting, amending and effectively implementing the legislation necessary to cement a culture of independence and sustainability. The establishment of regulatory bodies in most of the countries is a welcome development, but they operate with varying degrees of independence and in some cases lack a clear mandate. Efforts should be directed at securing a transparent,

³ Over 120,000 returns were recorded in the region in 2001, including more than 100,000 so-called minority returns. During 2002 there were, according to UNHCR statistics, more than 102,000 minority returns recorded in BiH and, according to UNMIK statistics 2741 overall returns in Kosovo. According to ODPR(Croatia's Ministry for Public Works, Reconstruction and Construction, Department for Expellees, Returnees and Refugees), there were 9,640 minority returns to Croatia in 2002.

⁴ A total of 615,000 persons remain displaced in Serbia and Montenegro, including more than 121,000 refugees from BiH and 228,000 from Croatia, 234,000 internally displaced persons from Kosovo. There are 31,000 displaced persons in Kosovo. In BiH there are in total 405,000 refugees and displaced persons of whom 28,000 are refugees from Croatia and Serbia and Montenegro and 377,000 are internally displaced persons. More than 9,000 persons are internally displaced in the former Yugoslav Republic of Macedonia (UNHCR statistics updated to reflect the situation as of 18 December 2002). There are occasional inconsistencies in the figures between different sources and this should be kept in mind when interpreting them.

predictable and legally secure implementation of new regulatory frameworks. More efforts are also required to consolidate professional structures and raise professional and ethical standards.

Recent events have reconfirmed the importance of multiplying efforts for the democratisation of state structures. In this light, the overall level of co-operation of BiH (Republika Srpska in particular), Croatia and Serbia and Montenegro with the **International Criminal Tribunal for the Former Yugoslavia (ICTY)** in the Hague remains inadequate. Co-operation with the Hague tribunal is a legal obligation under Security Council Resolution 827 of 25 May 1993, is an obligation on Dayton signatories and is essential for further rapprochement with the European Union.

2.2. Economic development⁵

The population of the Western Balkans region is about 25 million people, and its economic size (GDP) equals some €50 billion. Croatia is the largest economy with a GDP of some €23 billion, thus accounting alone for nearly half of the region's GDP and for almost 75% together with Serbia and Montenegro. Average per capita income in the region equals €2000. Per capita income in Croatia is approximately €5100, while the average of the remaining countries is about €1350.

In 2002, the economies of the Western Balkans countries grew at a rate close to 4%, faster than the **rate of growth** of the world economy of about 2.5%. This was partly fuelled by an inflow of foreign grants and loans corresponding to roughly 7% of the region's GDP. Bearing in mind the slowdown in and the importance of the EU economy for the region, this may be considered as by and large satisfactory. Still, living standards have barely improved compared to the pre-war period and the low levels of per capita income provide future potential for significantly higher rates of growth. Growth in the former Yugoslav Republic of Macedonia reached only about 0.3% and is apparently still suffering from the repercussions of the crisis in mid-2001. Despite respectable growth rates in general the last couple of years, high registered **unemployment** levels persist, stretching from about 15% in Albania to 40% in BiH. Inflation at regional level has steadily declined and was down to 6% in 2002. Serbia and Montenegro is the only country of the region with an inflation rate remaining in double figures (though rapidly declining).

The countries' fiscal positions are weak. The general government **deficit** for the region as a whole, excluding grants, reached about 6% of GDP in 2002. The situation has improved somewhat in all countries except for Serbia and Montenegro during 2002. In general, revenue collection needs to be improved in order to reduce reliance on external financing and expenditure control have to be strengthened. Likewise, public spending should give increased priority to necessary investments, and administrative structures must be rationalised.

Further progress in **structural reforms** is needed to turn the Western Balkans countries into fully functioning market economies. The pace of privatisation and restructuring of large public companies has generally been slow, despite some progress in Serbia and Montenegro and the former Yugoslav Republic of Macedonia. This issue remains a key for the coming years. The results are better concerning privatisation of small and medium sized enterprises. There has also been positive developments with respect to reform of the banking sector. Progress can be noted in reform of the legal framework, and in an

⁵ It should be recalled that the reliability of statistics from the region is generally poor. Growth rates, levels of unemployment and other economic data should thus be interpreted cautiously.

increased confidence in the banking system. The level of bank lending is still relatively low, however.

In all the countries of the region, small and medium-sized enterprises (SMEs) are essential for economic development. In that respect it is important to improve their institutional and financial environment. In addition, the adoption and implementation of the principles enshrined in the European Charter for Small Enterprises is recommended, as it would further enhance the improvement of the business environment in line with good practice in EU Member States.

In 2001, the region's **trade** continued to grow despite the global economic downturn. Imports grew by 17%, whereas exports increased by 13%. Growth in trade continued in the first six months of 2002, albeit at a slower pace. The EU remains the region's main trading partner. In 2001, the EU accounted for about 55% of Western Balkans' total trade (ranging from some 45% for the former Yugoslav Republic of Macedonia and BiH to about 80% for Albania). Italy and Germany are the Western Balkans' two main EU trading partners, accounting for about 35% of EU trade with the region.

A first assessment of the introduction of the European Union's trade measures shows encouraging results, although much remains to be done to increase the export potential further. During the last few years, the rate of growth in exports from the Western Balkans to the EU has outpaced the increase in exports from the region to the rest of the world. However, the level of exports remains relatively low, corresponding to approximately 0.5% of total EU imports. The region's imports amount to more than twice the volume of its exports, giving rise to sizeable trade deficits. These range from 20% of GDP in Serbia and Montenegro to close to 45% of GDP in BiH. However, the current account deficit of the region is limited to approximately 7% of GDP due to an inflow of private remittances, official transfers and a positive balance of trade in services. Trade with the candidate countries is important (especially with Slovenia) and represents almost 20% of total trade for the region. Intra-regional trade remains low, at about 6% of total trade. Still, it is essential to BiH, representing some 20% of its total.

The conclusion of a network of free trade agreements (FTAs) between the countries of the region under the auspices of the Stability Pact's working group on trade liberalisation represents a major achievement. When fully implemented, these are expected to boost intra-regional trade, to enhance efficiency, increase competition and to enable economies of scale. In view of the small size of the countries' economies, regional trade integration is also expected to attract further Foreign Direct Investment (FDI) to the region. Only when the necessary conditions are fulfilled and the administrative arrangements are in place could an extension of the pan-European system of diagonal cumulation of origin to the Western Balkans be envisaged, which would then further facilitate reaping the full benefits of regional trade integration. If any such extension were to be envisaged, it should be applied in a manner which is fully consistent with all relevant community policies.

At multilateral level, the former Yugoslav Republic of Macedonia completed its WTO accession negotiations in 2002, while BiH and Serbia and Montenegro started theirs. The two countries already members of the WTO, Albania and Croatia, continued their reform programs in order to comply with the WTO accession conditions.

In order for the countries to realise the full benefits of trade liberalisation in the framework of WTO and/or Stabilisation and Association Agreements, significant improvements in the

areas of infrastructure, customs and institutional capacity, and progressive alignment with EU standards are needed, in addition to a political will to implement the agreements.

In 2002, **foreign direct investment** inflows to the region reached about €2.2 billion, corresponding to about 4.5% of the Western Balkan's GDP or some €90 in per capita terms, a slight decline compared to 2001 when FDI flows amounted to €2.5 billion. Croatia accounts for half of the inflow of FDI to the region, corresponding to €230 per capita in 2002. In comparison, the inflow of FDI to the ten acceding candidate countries was equal to about 5% of their GDP or by and large €250 per capita in 2001. With the exception of Croatia, FDI flows remain insufficient to finance the countries' current account deficits. They need to attract greater levels of foreign direct investments, not least greenfield investments.

Several macroeconomic indicators related to the development of the region's economy are moving in the right direction. Growth is sustained, inflation is being brought under control and trade is increasing. There are still some **reasons for concern**. Inequality in income distribution has increased in the region and poverty has become more widespread. Estimates on unemployment remain high, even taking into account that a substantial part of economic activity remains unregistered. Countries remain heavily dependant on foreign financing. Donor grant assistance to the region is expected to be gradually reduced, and it is necessary for the countries most reliant upon it to start shifting to other sources of financing (and growth). In addition, there is a continuous flow of people from the region seeking a future elsewhere. According to UNHCR,⁶ four of the five Western Balkans countries are included among the top-40 nationalities seeking asylum in industrialised countries, and there has been a steady increase in the number of asylum seekers from some of the countries over the past year.⁷ This process signals lack of hope for the future and leads to a loss of human resources, which in turn may lead to serious consequences for the long-term development of the countries. It is necessary to restore citizens' confidence, and to make ordinary people feel tangible improvements in their situation.

There is an essential need for continuous institutional and structural reforms. Continued weak application of the rule of law, combined with extensive corruption and a sizeable informal sector undermine confidence in the political leadership which in turn affects economic development. A substantial informal sector creates an uneven playing field for economic operators and reduces tax collection. This may in turn lead to difficulties for the State in performing basic tasks and obligations, including fulfilment of obligations and implementation of Stabilisation and Association Agreements.

3. DEVELOPING REGIONAL CO-OPERATION

Regional co-operation remains a cornerstone of the European Union's policy for the region. The European Union is built on a deeply rooted foundation of regional co-operation. Based on the EU's own experience of the benefits of regional co-operation – that political understanding, economic and social prosperity all depend on it – it believes that the countries of the Western Balkans would benefit significantly from closer co-

⁶ UNHCR: Trends in asylum applications, January-September 2002: Europe, North America, Australia, New Zealand and Japan (excluding the UK).

⁷ Serbia and Montenegro is second from the top, BiH ranks 15th, and the former Yugoslav Republic of Macedonia and Albania rank 26th and 27th, respectively. Croatia is not represented among the top-40 countries.

operation. Regional co-operation is also an integral part of the preparation for integration into European structures. Each country's contribution to achieving regional objectives will help determine its readiness to take on the demands of full integration into the EU.

Developments in the past year provide reason to be optimistic. Much progress has been made, in particular in the fields of energy, trade and transport. Progress has also been made in the field of police and judicial co-operation – with support from the CARDS programme. Levels of regular bilateral and multilateral contact have increased, and a regional approach is increasingly seen as the obvious option rather than a last resort. The challenge of the coming year is to ensure that this co-operation continues to deliver results.

3.1. Political and institutional co-operation

The last year saw an increase in the frequency and substance of multilateral and bilateral contacts in the region and beyond. Border management, the fight against corruption, dual citizenship, refugee returns, pension and social security rights, economic co-operation are all areas that have been the subject of detailed bilateral discussion in the region and, in many cases, agreement. A number of unresolved issues still have the potential to sour relations but the resolution of disputes, such as the border crossing between Bosnia and Herzegovina and Croatia at Kostajnica and progress towards resolving key elements of the Croatia/Serbia and Montenegro border dispute (Danube and Prevlaka), show that negotiated compromise is increasingly the accepted approach.

3.2. Progress in specific sectors

Infrastructure: One of the specific objectives of the SAp is the integration of the Western Balkans countries into pan-European infrastructure networks – helping the countries involved to develop infrastructure strategies with an international dimension encompassing both opening of markets and development of interconnected infrastructures. The concrete results are listed under a 'regional infrastructure project list' which currently includes 46 projects totalling some €3.46 billion, of which 52% have started to materialise (double the figure of December 2001).

The Danube Co-operation Process and Sava River Basin Co-operation: Two initiatives relevant to regional infrastructure co-operation emerged last year: the Danube Co-operation Process and the Sava River Basin Co-operation. The Danube Co-operation Process was established by 13 countries in Vienna in May 2002 – including BiH, Croatia, Serbia and Montenegro and the former Yugoslav Republic of Macedonia (as an observer). The Framework Agreement on the Sava River Basin – signed by BiH, Croatia, Serbia and Montenegro and Slovenia in December 2002 – is a good example of countries taking regional ownership of an issue, and translating potential into reality. It focuses primarily on water management, navigation and environmental protection. An action plan is now to be finalised and implementation begin.

Transport: Considering the relatively small size of the individual countries and of the Western Balkans as a whole, the only realistic and sustainable approach to transport investment needs is a trans-national one. Here, the European Union is applying a methodology similar to that used in the candidate countries. Following the Transport Infrastructure Regional Study (TIRS) completed in June 2002, the Regional Balkans Infrastructure Study - Transport (REBIS) will, until June 2003, develop policies on a number of key issues *inter alia*: identification/prioritisation of projects on a core network; reform of the various transport sectors, operational tools to support decision-making by

planning authorities and investors. Memoranda of Understanding were signed in 2002 on the Pan-European Corridors VI (the Danube river) and VIII (linking Italy with Turkey via routes through Albania, Bulgaria, the former Yugoslav Republic of Macedonia and Greece) – both of critical importance for the region.

Energy: Only regional co-operation can guarantee sustainable electricity supplies for all of South East Europe, levelling out seasonal fluctuations in production, providing reserve capacity for net importers, and properly functioning markets for net exporters. The signing, in Athens in November 2002, of the Memorandum of Understanding on the Regional Electricity Market in South East Europe and its integration into the European Union Internal Electricity Market represented a significant achievement. It launched the ‘Athens process’ that commits all the countries of the Western Balkans, Bulgaria, Greece, Romania and Turkey (with Austria, Italy, Hungary, Moldova and Slovenia as observers) to a medium-to-long-term plan to create the conditions for a functioning electricity market in South East Europe and alignment with the EU electricity network. Regular reports prepared by the Commission will monitor progress, using mechanisms like benchmarking and peer reviews, providing also an important benchmark for their progress in the Stabilisation and Association process. Legal alignment to the Community acquis and improved administrative capacity are essential steps to be taken. During 2003, the European Commission intends to set out the basic principles for a regional approach to the gas market in South East Europe.

Environment: The Western Balkan countries are actively participating in the Regional Environmental Reconstruction Programme (REReP), and increasingly co-operating with the European Environment Agency (EEA) in order to connect the Western Balkans to the European Environment Information and Observation Network (EIONET). This represents a significant increase in the level of environmental co-operation between the countries of the region as well as between them and the European Union. The Community action programme promoting environmental NGOs was extended to the Western Balkans in 2002.

Science and Technology: The European Research Area project and the launch in 2002 of the 6th RTD Framework Programme (2002-2006)⁸ link Western Balkan policies in this area with those of the Member States and the Candidate countries. The sixth Framework Programme is open to participation by countries which have concluded the necessary agreements and is also open at project level to participation by entities from third countries and by international organisations. The participation of scientists and institutions from developing countries, Mediterranean countries, the Western Balkans as well as Russia and the newly independent states will be supported. Research priorities will address the consequences of war in the region with a special emphasis on environment and health. Further action might be considered on agricultural and industrial facilities. The requirement that projects should include at least two SAp partners and three participants from the Member States/candidate countries will directly support regional co-operation within the scientific community. An EU/ Western Balkans Action Plan meeting will take place in Thessaloniki in June 2003 with the aim of adopting a regional Science and Technology co-operation policy (“Shared vision”) and an Action Plan and Work

⁸ Decision No 1513/2002/EC of the European Parliament and of the Council of 27 June 2002 concerning the sixth framework programme of the European Community for research, technological development and demonstration activities, contributing to the creation of the European Research Area and to innovation (2002 to 2006) OJ L 232/1 29.08.02

programme. This should facilitate the further integration of these countries into the European Research Area.

Information and Communication Technology is by its very nature an issue that can benefit from an international approach. The countries of the region have committed to the implementation of plans for the development of the Information Society through the signing at ministerial level of the eSEE Agenda. All countries have passed telecommunications laws but further progress in transposition, especially in implementation, is needed before the regulatory environments can be considered to be attractive to investors. In all countries, institutional capacity needs strengthening.

Statistics is an area that requires international co-operation. The countries of the Western Balkans are participating in various actions of the European Statistical System, such as Eurostat Working Group meetings with Member States and Candidate countries. Through pilot projects, the countries will gradually align their legislation in this field with the *acquis*.

3.3 Ensuring complementarity of regional initiatives

Efforts under the Stabilisation and Association process are complemented by a number of other regional and sub-regional initiatives. Key amongst these is the Stability Pact for South Eastern Europe. Another important initiative is the South East Europe Co-operation Process (SEECOP), which provides a forum for political co-ordination amongst all of the countries of the region. Others, such as the Adriatic-Ionian Initiative and the Danube Cooperation Process, involve those countries which share particular geographical characteristics. All play an important role in normalising relations and thereby contribute to achieving the objectives of the SAP.

The Stability Pact has pursued its efforts to streamline and downsize its activities in line with the mandate conferred on the new Special Co-ordinator by the Council of the European Union. In March 2002, the Special Co-ordinator of the Stability Pact presented priority objectives for 2002 and in December 2002 the Regional Table endorsed a further streamlining of the Stability Pact as well as the priorities for 2003. A primary objective is to enhance complementarity of the activities of the Pact with those of the Stabilisation and Association process.

4. STRENGTHENED PARTNERSHIP - TAKING THE PROCESS FORWARD

4.1. Continued challenge

The Commission's assessment of the countries in this year's Annual Reports carries five important messages:

- The European Union confirms its commitment to the region and supports its continuing rapprochement with the Union. A credible perspective of EU membership creates a powerful incentive for fundamental reform of these societies. The EU is clear and unambiguous about the perspective. At the same time, it must be stressed that ultimate responsibility lies with the countries of the Western Balkans themselves. Progress will depend on their will to introduce necessary reforms and to adopt European standards and values. There are no short cuts to European integration.

- The Stabilisation and Association process has proved a success in stabilising the Western Balkans. This process needs to be consolidated, however. Efforts should thus be multiplied to proactively foster security, democracy and prosperity in the region.
- Developments during the reporting period are below expectations and potential in several countries – recommendations made in the first annual report remain to a large extent unfulfilled. All too frequently, slow progress is due to a lack of political commitment and we want to stress once again that nothing can replace this commitment.
- The SAP is already a strategy for accession, adjusted to the level of development of the countries concerned. This objective was recently reconfirmed by the Copenhagen European Council in December 2002 and it is now important for the countries of the region to focus on the concrete steps to be taken to move towards this goal. The reform agenda needs to be completed and reforms correctly implemented. Countries should be encouraged to define modalities and possible deadlines for implementing reforms and meeting requirements considered necessary to develop an ever closer relationship with the Union with a final goal of full membership. The pace of this process will ultimately depend on the determination of these countries to fulfil all obligations and criteria required to each and every country wishing to join the European Union.
- The European Union, its policies and what is at stake for the region need to be better explained to all sections of society. Much of the European Union's efforts – as well as the expected future gains - are invisible to the population, while short-term and painful reforms are more visible. As mentioned above, the Union and the Governments of the region both need to better explain what we are trying to achieve in the region.

As noted in this report and in the country reports, the challenges facing the region remain tremendous and have not changed significantly since the assessment in the first Annual Report. The successful stabilisation of the region, through the Stabilisation and Association process and its instruments, has laid the foundation for further reform and faster transition - if there is sufficient political will. The continued challenges can be grouped into five main areas:

- **Building functioning democratic states.** This requires, e.g. further democratisation, strengthening of institutional capacities and of the application of the rule of law, respect for human rights, resolution of constitutional matters, the development of a vibrant civil society and independent media, respect for international obligations (e.g. ICTY) and a strong commitment by the political leaders to an ambitious reform agenda.
- In order to enhance the effectiveness of the **implementation of the Stabilisation and Association process** and in co-ordinating EU related matters, the countries need European integration services with strong support at the highest political level.
- **Social and economic development.** A major challenge for the countries is to ensure sustained economic growth, particularly in view of an inevitable decline in foreign grant assistance, while the process of fiscal consolidation is further strengthened. The business climate must improve to facilitate private sector development and job creation thereby providing a basis for further economic development and social cohesion.

- Ensuring respect for the right of all remaining **refugees and displaced persons** to return to their place of origin and creating the conditions for sustainable returns, e.g. repossession of properties and economic aspects.
- Commitments to tackling **organised crime and corruption** must be translated into concrete measures and visible results. Countries that aspire to adopt European values and standards and eventually become members of the European Union simply must get to grips with these problems.

These are of course all inter-related. Attracting foreign direct investment is an important prerequisite for the countries' economic development – but investors will only be attracted to countries which are politically stable, where property rights are clear, contracts are honoured and the judicial system is fully functioning. Refugees need a secure legal, social and economic environment, resolution of any property rights problems, trust in local authorities and good prospects for the future to return. Progress on these issues requires the countries of the region to take ownership of them.

4.2. Strengthening the Stabilisation and Association process

As the pace of reforms picks up and the countries move forward within the Stabilisation and Association process, work will naturally intensify and the instruments will be adjusted accordingly. The European Union will increasingly apply elements of the “enlargement method” – an area the Commission has developed extensive experience and expertise over the years. This is to a certain extent already being done. All parts of the Commission will be mobilised to support the countries of the Western Balkans.

The **financial assistance** provided under the CARDS programme runs from 2001 until 2006, with a multi-annual indicative programme covering the period 2002-2004. There is very little that is being done under the PHARE programme in the candidate countries which cannot be done under the CARDS programme. But the type of assistance provided has to reflect the specific needs and priorities in the Western Balkans - where several countries, due to the events in the region during the last decade, are still struggling with the consequences of the conflicts and therefore have had different starting points. As the countries develop and the needs change, Community assistance will be adjusted accordingly.

Following an initial phase of heavy focus on physical reconstruction and rehabilitation to create a basis for further development – which entailed a front-loading of funds – the focus has shifted to institution building primarily at state level, with the aim of assisting the reform processes and thus preparing the countries for a closer relationship with the European Union. There are many other areas that are vitally important for the countries' development, such as local governance and social sectors, which are not the highest priorities in the CARDS programme. More efforts in additional sectors would require either a shift of priorities away from state building efforts or additional money being allocated from elsewhere, through different forms of financing, by other donors or the governments themselves burden-sharing in these sectors. An increase of the CARDS financial allocation is currently under discussion and would enable the Commission to intensify efforts in the areas of socio-economic development and civil society, sectors affected by the impact of the enlargement process, sectors requiring additional attention, e.g. Justice and Home Affairs, and additional support for provisional administrations in BiH and in Kosovo.

The Commission intends to extend **Twinning** projects – currently being implemented or are underway in Albania and Croatia under the CARDS programme – to all the countries of the region. However, their successful introduction depends on both the countries' absorption capacity and the availability of experts in the Member States.

The European Union's decision to unilaterally liberalize **trade** with the Western Balkans countries and to subsequently enshrine this commitment in long-term contractual relations in Stabilisation and Association Agreements is starting to have a positive impact on economic development of the region. In the coming years, the trade liberalisation efforts of the countries will be necessary to further reinforce prospects of economic growth and thereby pave the way for an improvement of living standards. Trade remains a cornerstone of the European Union's policy in South Eastern Europe.

A review and **assessment of the countries' legislation** and of its conformity with EU standards will be further developed in specific sectors, possibly supported by facilities similar to those provided to the candidate countries under TAIEX (Technical Assistance Information Exchange Office).

The Commission is currently considering gradually extending participation in **Community programmes** to the countries of the Western Balkans. This would require, *inter alia*, modification of the existing regulations and the conclusion of framework agreements to provide a legal basis for participation in these programmes. Participation in community programmes in the framework of the pre-accession strategy has proven a valuable tool for familiarising the candidate countries and their populations with the Union's policies and working methods.

The countries have expressed a particular interest in a liberalisation of EU's **visa regime** and its migration policy in general. Developing a dialogue on these issues would have significant implications on the issues mentioned above regarding the perception of the EU in the region. If carefully managed, it could be a positive factor for both the Union and the countries concerned. It could also be an element of the Union's migration management bearing in mind the continued irregular migration still emanating from the region. Only when the countries have, as a minimum, substantially improved their administrative capacity and application of the rule of law, can ensure effective border control, adequate systems for document security and when serious measures are taken to combat organised crime and corruption, could the EU seriously consider reviewing its visa regime. Smooth implementation of readmission agreements would also be taken into consideration in this context. The Commission would be prepared to lead concrete discussions with the countries regarding the requirements for how to take these issues forward in concrete terms.

Political dialogue is another corner stone of the process that could be further developed. Bilateral meetings between the Union and the countries are held on a regular basis in different formats. Once the Stabilisation and Association Agreements have come into force, political dialogue will formally take place within the Stabilisation and Association Councils. Considering that many of the problems are similar in several countries, or have a cross-border dimension, the Commission particularly values a process of regular joint political dialogue between the European Union and all five countries of the region, as suggested in the Commission's First Annual Report in 2002 and endorsed by the Council.

The Summit which will be held in **Thessaloniki** in June 2003 with Heads of State and/or Governments of the Member States, of the candidates and of the potential candidate countries in the Western Balkans aims at sending a strong political message to the

countries and peoples of the region, namely that the EU is committed to the European future of all Balkan countries, and that Europe will be re-unified only after this region has become an integral part of it. The meeting should also reconfirm the commitment of the SAp countries to the rapprochement and gradual integration into the Union and their determination to work to fulfil all related criteria and conditions, including democratic and economic reforms and further development of regional co-operation. The Summit will provide an important opportunity to enhance the political dialogue, to take stock of progress accomplished under the Stabilisation and Association process and, finally, to exchange views on important developments in the Union, the region and beyond.

ASSESSMENT OF THE INSTRUMENTS OF THE STABILISATION AND ASSOCIATION PROCESS**1. Trade measures**

The extension of the European Union's autonomous trade measures (ATMs) in the autumn of 2000 established a uniform system of trade preferences for the countries of the Western Balkans.^{9,10} In 2001, these provisions were, by and large, put into a contractual agreement with Croatia and the former Yugoslav Republic of Macedonia, by the signing of the respective countries' Stabilisation and Association Agreement (SAA).¹¹ Pending the ratification of the SAAs, the Union's trade relations with these two countries are governed by the Interim Agreements.

The trade provisions offered by the European Union under the trade measures (TMs) provide the countries of the Western Balkans with duty-free access to the Union's market for practically all goods, including agricultural products, with no quantitative restrictions, except for duty-free or preferential quotas for some fishery products, baby-beef and wine.¹² The greatest change compared to previous system(s) brought about in 2000 was the almost complete liberalisation of imports of agricultural products and the abolition of quotas for sensitive industrial products.

A short period of time has elapsed since the extension of the trade measures (TMs). As of early 2003, less than two full calendar years of trade statistics are available for analysis.¹³ Consequently, it is too early to provide a definitive and detailed view on the functioning of these measures. Nevertheless, in order to provide a first basis for an evaluation of the effectiveness of the trade measures, an overview of trends in EU imports from the Western Balkans at country and product level is provided below. This overview will need to be complemented at a later stage when necessary trade statistics and economic data become available.

⁹ Council Regulation (EC) No 2007/2000 (as of November 2000), amended by Regulations 2563/2000 and 2487/2001.

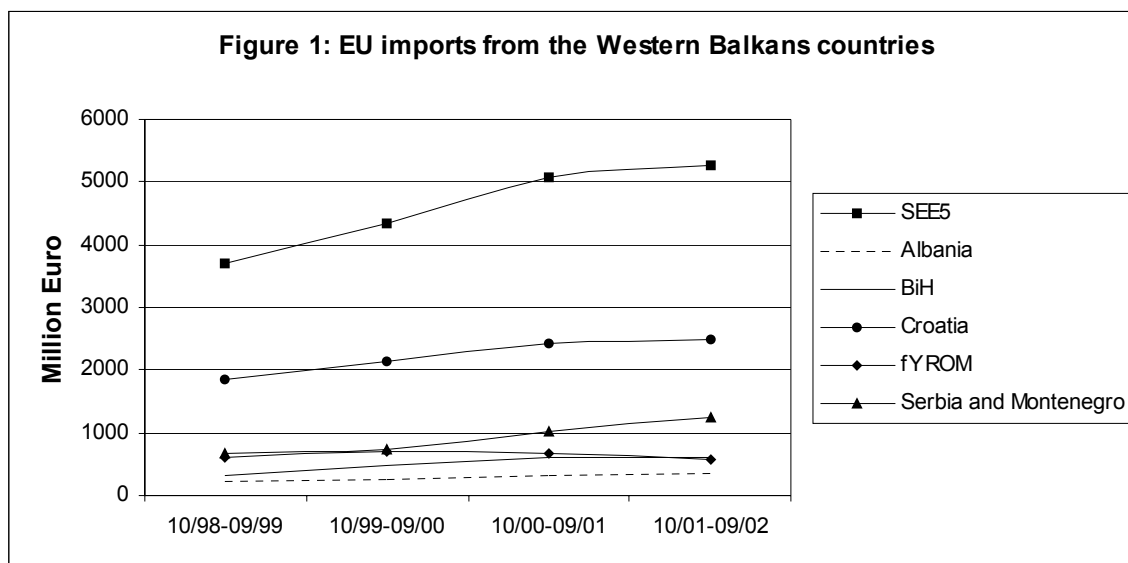
¹⁰ Previously, Albania had benefited from the EU Generalised System of Preferences, while Bosnia and Herzegovina and Croatia had been entitled to trade preferences under the first generation of ATMs introduced in 1997 (Council Regulation (EC) No 70/1997, amended by Regulations 2636/97 (for 1998) and 2863/98 (for 1999), and Council Regulation (EC) 6/2000 (January-October 2000)), which also briefly applied to Serbia and Montenegro before the preferences were revoked. Trade with the former Yugoslav Republic of Macedonia was governed by a co-operation agreement with the European Union concluded in 1998.

¹¹ Hereafter, EU trade preferences for the Western Balkans countries, as offered via the ATMs or as found in the contractual relationships with Croatia and the former Yugoslav Republic of Macedonia will be denoted as trade measures (TMs).

¹² In addition, trade in textile products is covered by bilateral agreements, providing for duty and quota free access into the EU. Serbia and Montenegro have not concluded such agreements with the EU and benefit from quotas granted unilaterally by the Community.

¹³ In January 2003, statistics on the Member States' imports from the Western Balkans countries were available to September 2002. This overview is therefore based on EU imports from the Western Balkans countries in 12 month periods dating backwards from the latest month available (September 2002). Four periods were chosen: October 1998 – September 1999, October 1999 – September 2000, October 2000 – September 2001, and October 2001 – September 2002.

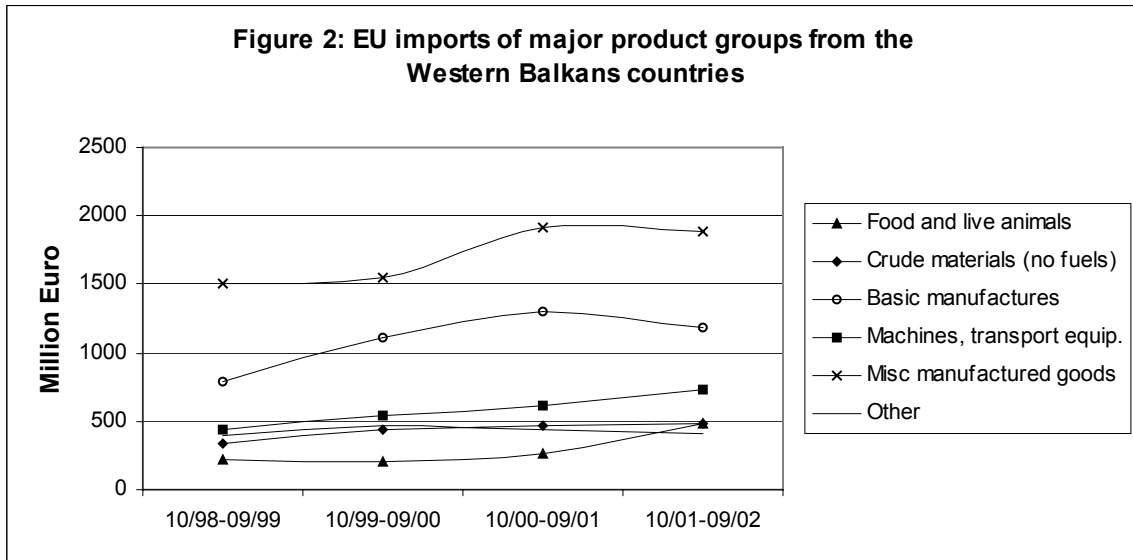
There has been a substantial increase in EU imports from the Western Balkans during the last few years, although from low absolute levels (see Figure 1). In percentage terms, EU imports have increased by some 40% since September 1999, and by 21% since the introduction of the TMs in September 2000. Despite a certain flattening out of the rate of growth of EU imports recently, the region's exports to the EU have grown at a faster rate than the Western Balkans' exports to the rest of the world (based on IMF data).



Source: COMEXT

Croatia is the largest exporter in the region, providing the EU with nearly half of its imports from the Western Balkans. Together with the Serbia and Montenegro, the two countries account for approximately 70% of the region's export to the EU. The export performance of these two countries are thus an important determinant for the development of exports from the region as a whole. Since the extension of the TMs, some countries have displayed a better export performance than others. Croatian exports to the European Union have grown by about 15%. The corresponding figure for Serbia and Montenegro is over 70%. Albanian and BiH exports to the EU have increased by close to 30%, while EU imports from the former Yugoslav Republic of Macedonia have declined continuously since the Kosovo conflict in 1999.

Figure 2 shows European Union imports of major product groups from the Western Balkans countries. EU imports of almost all the product categories have increased since the extension of the TMs in the autumn of 2000. The largest categories of imports, miscellaneous manufactured goods and basic manufactures, making up close to 60% of EU imports from the region, have slightly decreased lately, which is in line with the pattern of total trade in Figure 1.



Western Balkans' exports of machines and transport equipment, and of food and live animals, have increased considerably since the extension of the TMs. EU imports of the latter category have more than doubled, reflecting the improvement in market access brought about by the trade measures.

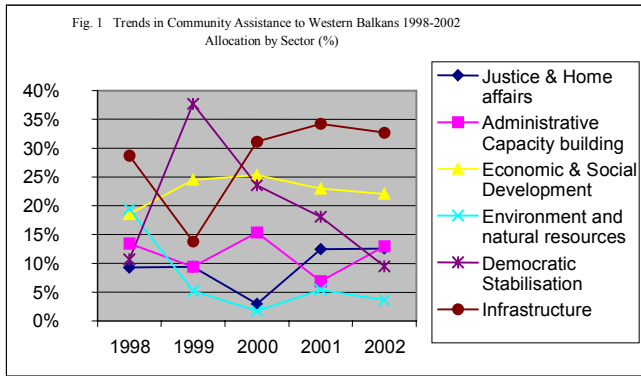
Sugar accounts for approximately half of the growth of EU imports of food and live animals. The substantial increase of EU imports of sugar from the region and the parallel growth of EU sugar exports to the region led the Commission to take several measures in order to ensure the proper application of the preferential trading arrangements for sugar, e.g. the publication of a Notice to Importers in June 2002, reinforced controls and closer co-operation with the customs bodies of the region. It was also decided to abolish refunds for EU sugar exports to the five countries of the region, as this is an incentive for the two-way trade pattern.

Based on the above, there are several signs that TMs may have had a positive effect on EU imports from the Western Balkans. Still, the countries will need more time to use the TMs to the fullest extent possible. Economic operators in the countries need to be made aware of the potential of the TMs, contacts need to be established with counterparts in the EU Member States, channels of distribution have to be worked up, and investments may be required in order to take full advantage of the improved export possibilities. In addition, the system of veterinary, and sanitary and phyto-sanitary inspections must be improved, and work on further harmonisation of standards is needed. Export promotion activities should be more developed, and adopted trade-related legislation must be implemented.

2. Community Assistance for Reconstruction, Development and Stabilisation (CARDS)

Since programming of Community assistance was formally agreed only at the end of 2001, CARDS¹⁴ still remains a relatively new instrument – implementation of the strategic orientations effectively started in 2002.

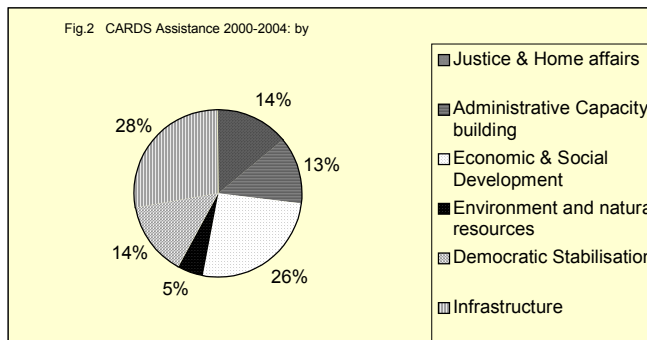
¹⁴ Council Regulation (EC) No 2666/2000 of 5 December 2000 (OJ L 306p1)



Between 1998 and 2002¹⁵, the main focus of Community assistance to the region as a whole was infrastructure and democratic stabilisation (including aid to refugees), representing 27% and 20% respectively of total assistance allocated (fig.1).

The amounts allocated to Justice and Home Affairs, administrative capacity building, and economic and social development were on average each equivalent to approximately 10% of the total.

These allocations reflect the priority given during the initial phase of assistance to reconstruction and tackling the problem of refugees. From 2001 onwards, the amounts allocated to Justice and Home Affairs and Administrative Capacity Building increased steadily (fig.2) – reflecting the Stabilisation and Association process’ emphasis on strengthening administrations’ implementation capacity.

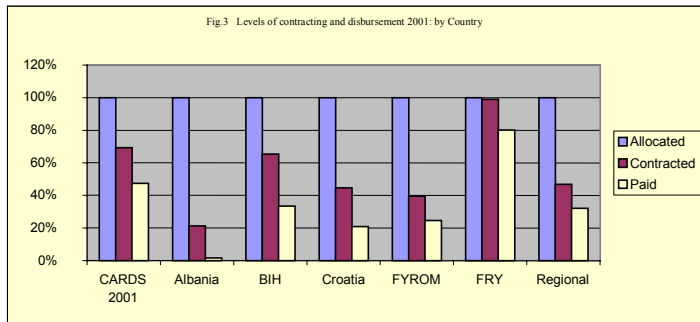


Community assistance has developed in three broad phases: an initial response to a crisis situation, with the focus on emergency operations and reconstruction; then a move to greater support for political, institutional and economic transition; and a third phase where the emphasis has been on preparing for and implementing the association process.

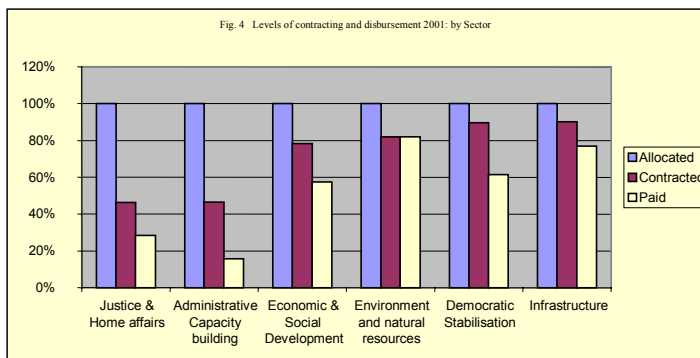
Broadly speaking, the first of these phases is close to completion. The second and third phases are at varying stages of implementation – depending on the country in question.

Whilst the focus of CARDS is on maintaining strategic priorities, the response to last year’s crisis in the former Yugoslav Republic of Macedonia shows how CARDS assistance can be adapted to a changing situation on the ground. In that case, CARDS provided support for EU action in response to the crisis and for the Ohrid agreement, through aid for refugees and displaced persons, and reconstruction assistance successfully implemented by the European Agency for Reconstruction (EAR).

¹⁵ In order to be able to identify trends, the period of analysis runs from 1998 – 2002. Until CARDS became operational, Community assistance to Albania, BiH and the former Yugoslav Republic of Macedonia was delivered through the PHARE and OBNOVA programmes, and to Croatia and Serbia and Montenegro through PHARE.



As of the end of 2002, 66% of total funds allocated in 2001 have been contracted (contracts signed) and 45% disbursed (fig.3). However, performance varies from country to country, according to the focus of activity, the implementation mechanisms, and – in those countries where management had been decentralised, notably Albania – the capacity of national administrations to absorb assistance.



Levels of contracting and disbursement are higher for infrastructure and democratic stabilisation projects, and lower for those in support of Justice and Home Affairs and Administrative Capacity Building (fig. 4). This reflects differences in the types of operation involved in these sectors - in particular the additional preparatory work often required for JHA and Administrative Capacity Building assistance.

Both the EAR and the deconcentrated approach in general – as evidenced by the performance of the Commission Delegation in BiH – have proved their effectiveness in delivering assistance on the ground.

Deconcentration was extended to both Albania and Croatia with effect from 1/12/02 and 1/1/02 respectively. The aim has been to both increase the pace of implementation and to benefit from local “on-the-ground” know-how and experience.

The current focus of Community assistance on institution building and Justice and Home Affairs – although there is still significant support for infrastructure projects, notably in Serbia and Montenegro – reflects the priorities identified in 2001. There is a particular emphasis on strengthening national administrations’ capacity to implement the reforms necessary for association.

Community assistance in Justice and Home Affairs provides a long-term framework for establishing or strengthening the rule of law – a prerequisite for delivering the broader objective of democratic, institutional, economic and social development. The fact-finding missions that took place during 2002 have provided a detailed picture of the current situation and an assessment of needs. On the basis of this assessment, the Commission is further developing its overall approach to Justice and Home Affairs in the region, helping the law enforcement agencies of the countries move closer towards European or international standards and best practices.

The development of reform in the different countries is the result of a number of interacting factors: national government initiatives, the efforts of national institutions, and the support of the international community – in particular that of the European Union. The aim of this report is to evaluate the overall state of progress in the reform process. CARDS as an instrument will be subject to a separate and specific review as set out in the CARDS Regulation [Article 13.2 – no later than 30 June 2004].

3. Community exceptional (macro-)financial assistance

The Community has also supported a number of IMF backed stabilisation and reform programmes in the Western Balkans with macro-financial and exceptional financial assistance. In 2002, the Council approved two new macro-financial assistance operations in favour of Serbia and Montenegro (up to €130 million) and BiH (up to €60 million) both in the form of grants and loans. Disbursements in 2002 (including on previously decided operations for Serbia and Montenegro, Kosovo and the Former Yugoslav Republic of Macedonia) amounted to €152 million. The release of this type of assistance is subject to the satisfactory implementation of IMF backed programmes and the fulfilment of economic policy conditions agreed with the authorities. (A more detailed account to these operations is provided in each country SAp annual report as well as in the Annual report on the implementation of macro-financial assistance in 2002 which is yet to be published).

ANNEX II

ALBANIA

Stabilisation and Association Report

EXECUTIVE SUMMARY

Limited progress has been made by Albania in addressing the many challenges it has to face. Recommendations included in the 2002 Stabilisation and Association process (SAp) report have been only partially addressed. The relative, although still fragile, political stability and renewed inter-party dialogue achieved in spring 2002 allowed the smooth election of a new President but has not yet translated into significant achievements in terms of reforms.

This new **political climate** has led to some progress in the implementation of the international community's recommendations to improve Albania's electoral procedures. However, it has not been sufficient to respond to the constitutional requirements regarding the restitution of or compensation for land expropriated during the communist era. While there has been progress in developing good regional co-operation, the implementation of the rule of law remains deficient, notably due to weak law-enforcement institutions, limited administrative capacity, corruption and organised crime. Individual freedoms and human rights are guaranteed by Albanian law, but there is clear room for improvement as regards implementation. Albanian attitudes towards minorities remain generally constructive, but there has been limited ambition to strive for higher standards.

GDP growth in Albania remained sustained and reached 4.5 to 5%, down from 6.5% in 2001. The overall **economic performance** has however fallen below expectations over the reporting period. The main reasons for this slowdown have been the continuing problem in the electricity sector, the generally depressed state of the world economy, limited growth in the agricultural sector and the insufficient performance of the customs and tax administrations. The authorities partly managed to cope with these adverse conditions: both the fiscal deficit and the inflation figures were within target. Progress in the privatisation process and the restructuring of the financial sector has been limited. The overall business climate has not improved significantly despite some initiatives aimed at supporting business promotion and encouraging local and foreign investment. Legal security remains insufficient and commercial laws inadequate to foster business development. Certain steps have been taken to improve the generally poor situation in the various Albanian economic sectors, such as transport, energy or agriculture, but these efforts will need to be sustained over the medium term in order to achieve any significant results.

After delays due to Albania's difficulties in guaranteeing political stability and implementing reforms, negotiations for a **Stabilisation and Association Agreement (SAA)** were officially launched at the end of January 2003. However, at the current pace of reform implementation, negotiations risk being long and drawn out. Before negotiations can be concluded, Albania will need to demonstrate its ability to implement the provisions of the future Agreement, and to address the priority issues identified by the European Union through its various reports and monitoring instruments. Albania should pay particular attention to the Justice and Home Affairs sector if it is to make meaningful progress in the Stabilisation and Association process (SAp). Some improvements have been noticed in controlling illegal migration towards the EU, but trafficking in human

beings, drugs and other forms of organised crime, as well as corruption in key areas such as the judicial system, customs and police, remain matters of deep concern. Improvements in the judiciary have been limited and the prosecution of crimes poor, despite an increased number of detentions. Albania will only be able to address these difficult issues if there is real commitment by the Government, the Albanian political forces and the law enforcement bodies (including the prosecution office and the judiciary), and full determination to translate that commitment into action.

BOSNIA AND HERZEGOVINA
Stabilisation and Association Report
EXECUTIVE SUMMARY

Irrespective of any ambition to accede to the European Union, Bosnia and Herzegovina (BiH) needs to become a self-sustaining state. Without self-sustainability BiH can neither meet the basic needs of its citizens in terms of security, institutionalised freedom and economic well-being, nor can it integrate into European structures. Self-sustainability is therefore a pre-condition for BiH's advance from dealing with the aftermath of war (reconstruction and peace implementation) to a **transition agenda** in which, like its central and eastern European neighbours, it can concentrate on the reform and technical adjustments necessary for integration into the EU. The past year has seen important advances, but self-sustainability is not yet guaranteed. The recently inaugurated governments with their four-year mandates will be decisive in deciding whether this can be achieved within a reasonable time-frame.

General elections in October 2002 confirmed that BiH, whatever its **political and institutional challenges**, adheres to basic democratic principles. The landmark decision on the implementation of the 2000 BiH Constitutional Court decision on "constituent peoples" has altered the dynamics of national politics and advanced integration. Other achievements such as progressive dismantling of parallel structures within the Federation of Bosnia and Herzegovina (FBiH), deployment of the State Border Service (SBS) at all border crossing points and successful military reductions indicate progress on a wide front. Nevertheless, evidence of real "reform ownership" and of a sustainable domestic political dynamic remains limited: pressure from the High Representative and the international community remained vital for many of the reforms which were initiated. An example of the failure to move from the post-war to a transition agenda is the continued impunity of indicted war criminals such as Radovan Karadzic in Republika Srpska (RS). The fight against corruption and organised crime needs to be strengthened. Failure to address these issues is incompatible with integration into EU structures.

In terms of the **economic** situation long-term sustainability is still far from guaranteed. After high rates in the second half of the 1990s fuelled by reconstruction aid, growth is slowing down. Estimated GDP is still below half its pre-war level (which BiH is expected to reach only in 2010 or later), even though the presence of the informal economy may distort this figure. The economic and social costs of poor internal harmonisation and co-ordination hamper the efficiency of the State and eliminate the benefits of decentralisation. Public spending remains excessively high, while on its balance of payments BiH continues to run a deficit both in the trade and current accounts. However, over 2002 BiH maintained macro-economic stability, low inflation and continued its efforts towards lower fiscal deficits. Foreign direct investment (FDI) improved in 2002, but BiH still needs to do more to attract foreign investors. There is little evidence that BiH has addressed its chronic dependence on assistance - although this issue will present itself with increasing urgency as international aid declines.

Progress within the **Stabilisation and Association process** (SAp) has been noted. The Road Map was "substantially completed" by September 2002. Of course, the Road Map was never a recipe for perfect government or immediate EU accession, but it was an

indication of some pressing issues and a measurement of political will to address them. Regrettably, its substantial completion took too long and its full implementation requires continued attention. The next SAP stage will be a Feasibility Report which will assess whether BiH is ready to open negotiations on a Stabilisation and Association Agreement (SAA). If it is to catch up with its neighbours, some of whom may have entered the transition phase, BiH must accelerate reform, including those mentioned in the last SAP report, and develop truly self-sustaining structures.

CROATIA

Stabilisation and Association Report

EXECUTIVE SUMMARY

The **political situation** in Croatia remained generally stable and the overall situation remained satisfactory as democratic developments are being consolidated. The Government continued to show determination in its efforts to establish a fully fledged democracy regarding the rule of law. Regional co-operation was strengthened, the Constitutional Law on the Rights of National Minorities was adopted, and important legislative modifications were adopted to facilitate refugee return. Despite these positive developments, not enough has been done to overcome other short-term priorities identified in last year report. A new law on Radio and Television (HRT) was adopted in February but it does not fully protect HRT from possible direct or indirect interference from political and state bodies. The Government's attitude in the co-operation with ICTY remains lukewarm. In practice, only limited progress has been achieved in the return process, and de facto integration of the Serb minority. Despite the adoption of a strategy, a serious problem remains the continuing weakness of the judiciary and efforts need to be concentrated in this area. The fight against corruption and organised crime need to be strengthened.

The **economic situation** continued to improve. Croatian estimated growth in 2002 is up to 5% and the outlook remains positive. Despite fiscal adjustment at central level, the general government's fiscal stance remains weak and is a source of vulnerability for the economy. High unemployment remains a main concern. Overall progress with structural reforms has recently been slow, reflecting a fragile government coalition and public opposition to a number of unpopular measures. Progress has been achieved in rationalising social transfers and implementing the second pillar of the pension system, starting fiscal decentralisation and introducing a single treasury. On the other hand, reforms lag behind in other areas, such as privatisation, education, and health. Labour market reform aiming at increased flexibility has not yet been adopted.

The Government showed a strong commitment to the implementation of the **Stabilisation and Association Agreement** and the Interim Agreement. It has adopted an ambitious programme for the integration of Croatia into the European Union, which includes a plan for the harmonisation of legislation with the *acquis*. Croatia has started to work intensively in order to align its legislation with the *acquis* and to address most of the priorities identified in the 2002 SAP Report. Important new legislative texts in areas such as competition and state aid, intellectual property and consumer protection have been prepared over the last 12 months and must be adopted as a matter of priority. In parallel, the necessary administrative capacity must be created, including the establishment of an independent State Aid Authority, in order to ensure proper enforcement of new legislation. Also, the enforcement of existing legislation often remains a challenge, due either to delays in the adoption of the necessary implementing regulations or to weak administrative capacity. More generally, Croatia needs to pay special attention to strengthening its public administration with a view to ensure that the relevant ministries and other public authorities are in a position to properly implement the numerous legislative reforms to which Croatia has committed itself.

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Stabilisation and Association Report

EXECUTIVE SUMMARY

Following a largely unstable period after the 2001 crisis, the **political situation** in the former Yugoslav Republic of Macedonia has been moving steadily towards normalisation based on the Ohrid Framework Agreement. The European Union (together with its partners in the OSCE as well as with NATO and the United States) has been consistently supporting this process. The planned EU take over of the NATO military mission in March will be a further demonstration of EU commitment to peace and stability in the country. The 15 September elections have illustrated the gradual return to normal political life. The creation of a multi-ethnic coalition Government is a very positive indication of a willingness to cooperate and to compromise on later. It will be crucial that all signatories of the Framework Agreement, including the opposition parties, continue on this path until its full implementation, the only basis for further development and strengthening of the country's institutions and capacity to move closer to the EU. After initial progress, the path of reform needs to be accelerated. The political support expressed by all major political parties for European integration should also help in launching the necessary political and economic reforms. Much remains to be done and it is now up to the Government to take and implement the initiatives needed.

In 2002, the **economic performance** of the former Yugoslav Republic of Macedonia fell below expectations even though monetary and exchange rate stability was maintained. The negative effects of the 2001 crisis stretched over into 2002 and were compounded by the weak external environment. The political uncertainty before the general elections in September and the failure to conclude an IMF agreement until February had a negative impact on the economic and business climate. The implementation of the agreement finally reached with the IMF (yet to be approved) will further build confidence in sound market-oriented economic policies to be promoted by the new Government, improving the business climate and stimulating growth. Only in this way the Government will be able to meet the costs of the reforms processes. Other key issues to be handled by the Government are the implementation of a modern Treasury system and the development of decentralised government and public finances.

With regard to the structure and functioning of the **administration**, the legal framework for the decentralisation of public administration still needs to be adopted and implemented to contribute fully to wider stabilisation of the country. As already emphasised in the SAP 2002 Report, the structure and management of the public administration has some way to go before it can adequately fulfill all the tasks required of it in a functioning democracy based on the rule of law. It is crucial that the government further develop efficient measures against corruption. Other priority reforms include the security sector and effective measures to tackle the weaknesses of the judicial system.

Rapid implementation of the Framework Agreement will also enhance progress in the **Stabilisation and Association process**, including the ongoing ratification process of the Stabilisation and Association Agreement (SAA). In the meantime, the former Yugoslav Republic of Macedonia should ensure that all obligations arising out of the Interim Agreement are fully complied with and that the preparatory works needed for the implementation of the full SAA are completed so that work can start as soon as it enters into force.

SERBIA AND MONTENEGRO
Stabilisation and Association Report
EXECUTIVE SUMMARY¹⁶

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

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

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

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

The European agenda and the **Stabilisation and Association process** remain catalysts for reform. But much time has been lost in 2002, and the state must accelerate the pace of reform and improve the implementation of legislation if it is to fulfil its potential. The continued focus on constitutional issues has distracted attention from other fundamental areas – until these are resolved, the state will struggle to achieve the necessary pace of reform. Many of the recommendations made in the 2002 SAp Report, earlier reports, and

¹⁶ The state of Serbia and Montenegro is composed of the Republic of Serbia, Kosovo (under international administration under UNSCR 1244 of 10 June 1999) and the Republic of Montenegro. This state is the same international legal entity as the Federal Republic of Yugoslavia.

at the EU-FRY Consultative Task Force have yet to be implemented and thus remain valid – and many are prerequisites for the implementation of any future SAA. The success and speed of any SAA negotiations will depend on the state's ability to demonstrate its capacity to implement such an Agreement, with much attention focussed on its track record on delivering reform. The Commission will continue to provide support and advice to the state. But EU efforts, even on the scale of recent years, cannot substitute for a lack of political will within the state. Only with full commitment and co-operation within the state, and decisive action to pick up the pace of reform, will the state be able to make the necessary progress.

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