

Newsletter

Economic Reform and
Reconstruction
Bosnia and Herzegovina

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The Road to Europe is Open, But There is a Toll

This quarter's Special Edition Economic Newsletter departs from the usual format. In the wake of the results of the European Commission's Feasibility Study Report in November, which formally opened the door to the possibility of BiH's eventual entry into Europe, the Newsletter takes a retrospective look at BiH's transition since the end of the war. Examining those areas where progress has been made, and – equally important – examining those areas where progress has NOT been made, places in perspective the reforms that must be implemented before negotiations on a Stabilization and Association Agreement (SAA) can begin.

The EC has identified core economic tasks that must be completed in the next six months. These are: implementing the recently adopted Law on Indirect Tax Authority (combining customs) and the Law on Statistics, improving budget management, establishing a coherent and comprehensive trade policy, integrating the electricity market, and developing the Single Economic Space.

This represents a formidable but not insuperable challenge. Not only is there a limited amount of time, but the capacity of the governments to secure enactment of the necessary legislation and to implement the reforms will be severely stressed. The International Community has reaffirmed its willingness to provide assistance in helping the governments reach their goals.

As this Special Edition will describe, considerable progress has indeed been made across the spectrum of sectors over the past eight years. However, much more needs to be done before the economy approaches its potential and becomes fully self-sustainable: high unemployment and underemployment persists, the current account deficit continues to grow, corruption remains pervasive and the large and growing gray economy undermines the governments' ability to function effectively.

Over the next six months the present authorities, in partnership with the International Community, can seize the chance to lock BiH into an irreversible march toward full membership in the European family. This could be the most crucial six months in this country's postwar history. I believe the people of BiH have one message for their leaders: Don't Fail Us!

Ambassador Donald S. Hays
Principal Deputy High Representative

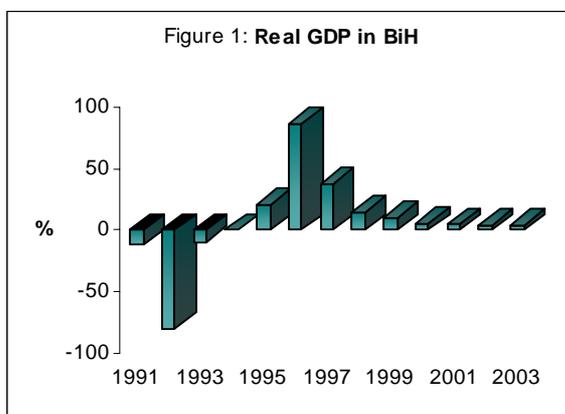
MACROECONOMIC REVIEW

‘Our head is above water. It is not enough to float. We have to swim and to swim successfully against the stream... But we cannot be satisfied with that. We must not only pay our way. We cannot be content to live from hand to mouth and from month to month in this world of change and turmoil.’ [Winston Churchill, “*The Treacherous Trap Door*” June, 1952]

Churchill's caveat still stands and Bosnia and Herzegovina has been straining to get away from hand to mouth and from month to month existence. In order to do so, it must secure

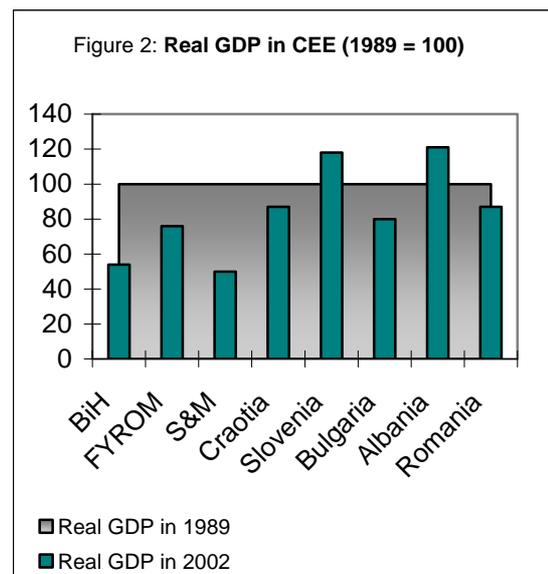
- full post war recovery and,
- transition from a socialist to a free market economy.

Issues related to these core strategic tasks have been the main focus of most projects and policies pursued by the governments, by local organisations and by the International Community. So the performance of BiH to date will be analysed in terms of the relative success or failure of efforts to complete these tasks. This will be seen in the context of other countries' experiences. The war reduced BiH's GDP from that of a comfortable middle-income country to the level of a developing economy. Nevertheless, an avalanche of assistance produced significant growth rates that, within a few years, made up for much of the ground that had been lost. Thus judging by the real GDP figures one may be inclined to conclude that the turnaround of the economy has been swift. This rapid growth has allowed BiH to keep its head above water. However, the slow-down of GDP rates has been as spectacular as the period of immediate postwar growth.



It is not clear whether these rates could ever have been sustainable beyond the immediate postwar period. In this context, the high growth of the postwar period may be seen as evidence of a successful recovery process but not as the harbinger of a new era of sustained, organic GDP growth. Rates of 20 percent per annum were the result of peculiar circumstances. The volume of international aid between 1996 and 2001 - BiH came third in the world in per capita terms and eighth in absolute terms (The Economist World in Figures 2002) - generated an economic boost akin to that of the Marshall Plan in post Second World War Europe.

In addition to relatively higher standards and improved quality of life achieved in the postwar period, BiH has experienced progress in other fields, allowing it to edge forward from the desperate situation in which it found itself at the end of 1995. The currency was stabilised and made convertible in 1997, under the Currency Board regime which has maintained that stability and convertibility. As a result, inflation has been kept at near-zero rates. Currency stability and a responsible monetary policy have created an atmosphere of confidence, reflected by rising bank deposits and a strong and highly liquid banking sector. The buoyancy of the banking sector is also due to an influx of foreign capital. However, the mobilisation of the domestic savings base and capital remains less than optimal, while remittances from abroad - estimated at some 10 percent of GDP - customarily go on consumption rather than investment, with the possible exception of investment in housing.



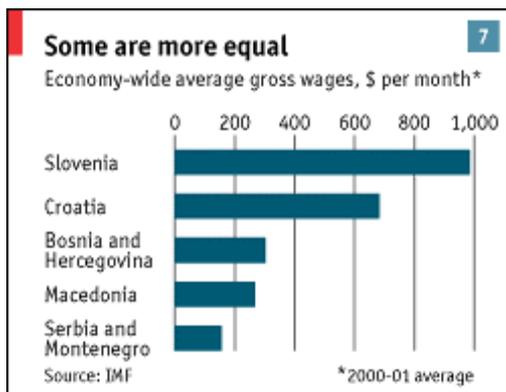


Figure 3

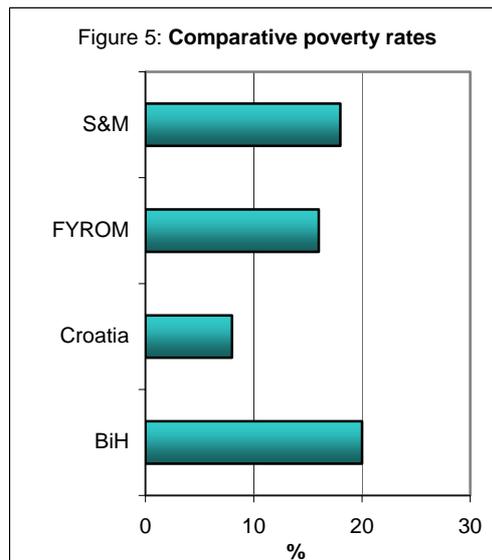
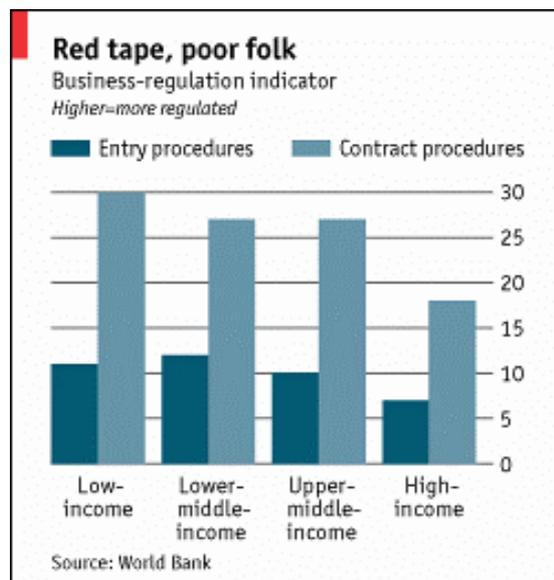
So BiH has managed to reach nominal convergence with the developed and transitional countries as far as the stability and convertibility of its currency and inflation are concerned. These efforts and the growth achieved by the late 1990s could be said to have enabled BiH to get onto the transition track. By this criterion, BiH compares relatively favourably to other countries in the region. Bearing in mind its desperately unfavourable starting point in the transition process – characterised by social trauma, political dysfunction and economic collapse as a result of the war -- progress in economic reform compares quite well to that of other republics of the former Yugoslavia (Figure 3). Nevertheless a strong monetary base and financial institutions are only a promising starting point. Much must now be done to unlock the huge potential of this country.

In an article published in November 2003, the Financial Times sought an explanation for the low BiH growth figures of the recent past. Clearly, the sprawling government apparatus that consumes more than 50 percent of GDP is a fundamental problem. Although BiH is one of the most heavily taxed countries in Europe, the actual revenue base of the BiH authorities narrowly depends on indirect taxes, such as sales taxes and customs duties. More developed countries, in comparison, possess a range of revenue streams, including direct taxes such as corporate and income taxes, for example. Fiscally, this allows them to have more room for manoeuvre for they are not overly dependent on a limited range of income sources. As a corollary, the financial viability of the BiH governments depends on the efficiency of their revenue collection. The unification of the customs service and the establishment of the Indirect Tax Authority, which will deal with the administration and collection of all indirect taxes can be expected to improve the efficiency of tax collection and reduce evasion, smuggling and corrupt practices that have dogged the system and seriously affected the BiH Government's liquidity. In general, fiscal policy has developed in a positive fashion, with

the 2003 budget being almost balanced and future budgets expected to follow suit. At the same time budgetary reliance on grants in aid and other donations has been significantly reduced, which represents a serious step forward towards fiscal independence on the part of the BiH authorities.

In an October 2003 article, "Poverty's Chains", The Economist drew parallels between a country's density of business regulation and its level of prosperity. Using World Bank data, the article concluded that the more heavily regulated a country is, the poorer its citizens are.

Figure 4.



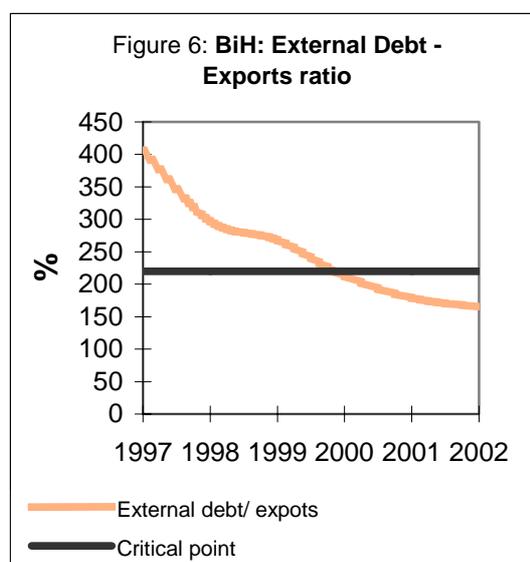
While BiH cannot be said to suffer from the most advanced form of bureaucratic sclerosis, the status quo

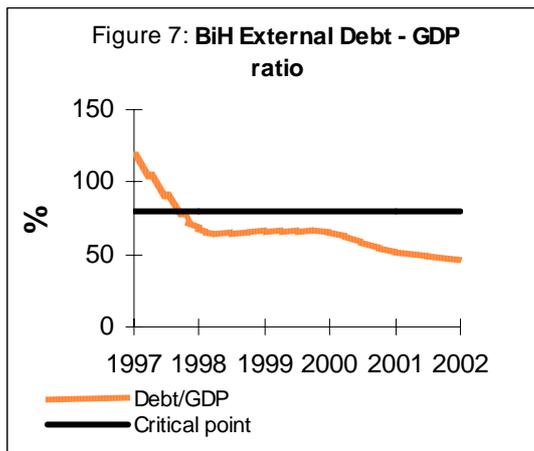
does not bode well for the transition process or plans to join the EU in this decade. BiH's poverty rates are the highest among the former Yugoslav republics, while its bureaucracy is probably the most complex. BiH has four different levels of government, all of which consume significant resources and whose procedures and frequently conflicting rules and legislative provisions hamper private entrepreneurship and deter foreign investors. Investment has consistently gravitated to more accommodating countries in the region. However, the tide may also be turning in this respect not least because of efforts undertaken as part of the Bulldozer Initiative. The object of this highly successful exercise has been to 'bulldoze' administrative barriers identified by business associations and individual businesses as illogical and contradictory and likely to deter investment and destroy jobs. Bulldozer Commissions, made up of BiH businesspeople, are actively engaged in identifying laws and regulations that should be eliminated, improved or harmonised (so as to get rid of duplicated bureaucracy and consolidate the Single Economic Space). Phase One of the Initiative produced 50 reforms in 180 days. Phase Two is well underway, and Phase Three will be launched in February.

In terms of economic liberalisation, BiH's record has been rather positive. Most prices, including that of capital, are set by market forces. Similarly, BiH has concluded free-trade agreements with all the republics of the former Yugoslavia, as well as Rumania, Bulgaria and Moldavia. Negotiations on BiH's membership in the WTO are at an advanced stage and full membership is expected relatively soon. On the other hand, recent concessions in the shape of temporary suspensions of some free-trade agreements with neighbouring countries, granted in response to the agricultural and food-processing lobby's protests, may threaten the progress of trade liberalization efforts as well as WTO accession. Furthermore, liberalization of the public utilities sector is still to be carried out. This is a crucial element in economic transition: it represents a major investment incentive, offering competitive utility rates; it advertises a business environment that meets European standards; and it also delivers tangible benefits of transition to citizens in the form of cheaper electricity and phone charges. It is expected that the privatization process in general will be speeded up and made more efficient in the aftermath of the consolidation of the privatisation agencies in the Federation. However if the governments of BiH seriously intend to achieve greater private-sector participation in the BiH economy and higher rates of growth than those achieved in recent years, a more sustained and focused effort to unblock the privatisation process must be undertaken. The systematic reduction of political interference and corrupt practices, as well as

a scaling back of unrealistic price expectations, are basic requirements for a successfully relaunched privatisation programme.

The external and internal debt obligations of the BiH authorities are considerable. After the war, many of BiH's obligations to external creditors were rescheduled and organised with the Paris and London clubs so that the country was able to begin its recovery process without immediate external threats to its macro-economic stability. This also allowed the authorities to take up some necessary new obligations under IMF and WB lending programmes that BiH has been servicing in an orderly manner ever since. In 2001 the World Bank published a study entitled "Bosnia & Herzegovina: Towards Financial Sustainability and Creditworthiness". In this study, different debt indicators were used to evaluate the sustainability of BiH's external obligations. The indicators used were debt-GDP ratio and debt-export ratio. Each ratio has a critical point that indicates the sustainability of external obligations. Debt-GDP ratio has a critical point of 80 percent while debt-export ratio has a critical point of 220 percent, according to WB estimates. For guidance, the developing-country average is 38 percent for the former and 133 percent for the latter, while the heavily indebted poor countries (HIPICs) have average ratios of 84 percent and 249 percent. The World Bank calculated the projections for BiH under two scenarios: a full reform scenario and a weak reform scenario for 2005 and 2010. Under the full reform scenario, BiH is projected to have the former ratio as 40 percent and the latter as 160 percent in 2005 and 36 percent and 147 percent in 2010. Under the weak reform scenario, these figures would be 52 percent and 231 percent in 2005 and 57 percent and 264 percent in 2010. The following two charts show the current performance in this respect.





As can be seen from Figures 6 and 7, BiH has been making significant progress. The sustainability indicators with respect to its external obligations all point to the fact that BiH is converging with the averages of the non-HIPIC developing countries. If this performance persists, then any Argentina-type crises can be avoided. On the other hand, claims on the BiH authorities from within the country are estimated at approximately KM 9 billion. Total internal claims on the BiH authorities comprise frozen foreign currency savings, claims against the authorities resulting from the war, and hundreds of thousands of unpaid salaries and pensions. The BiH economy has been held hostage by the enormity of these claims while uncertainty about the way this issue was going to be resolved has deterred investors and negatively affected the country's creditworthiness. In December 2003 the authorities agreed on a practical solution to this issue involving a combination of cash payments and bond issues. Since the governments of BiH simply do not have the financial resources to pay the entire amount now, spreading payments over time is the only reasonable way to settle claims of this size. Thus, although some claims may have to be settled at a discount, this will not be an absolute loss since the BiH economy will benefit as a whole due to the resolution of this important issue.

In December 2003 the governments of BiH made a joint presentation to a special economic session of the Peace Implementation Council. In this presentation, they outlined their plans and projections that form the core of their medium term development strategy. This plan was drawn up under the template of the Poverty Reduction Strategy Programme that has been pursued by many developing countries all over the world. Under this plan the governments project that annual GDP growth could accelerate to 5 percent p.a. between 2004 and 2007. This acceleration in the rate of growth of the BiH economy is planned to occur through a reduction in

the burden of the public sector, rationalisation of the government bureaucracy and greater participation by domestic and international investors. The fact that the authorities have already taken steps to resolve issues such as internal debt and indirect taxation means that some preconditions for the creation of self-sustainable economic growth have already been met. One other main objective has been the acceleration of the process of BiH integration with the EU. The European Commission gave a qualified response to BiH last December following the feasibility study undertaken earlier in 2003. In its final statement, the Commission noted that BiH must fulfill 16 core requirements before Stability and Association Agreement negotiations between BiH and the EU could begin. The deadline for completion of these tasks was given as June 2004. These 16 requirements are now the governments' short-term reform priorities. Once the requirements set by the EC are fulfilled and the Agreement is concluded, BiH can begin to form reasonable expectations of EU accession.

Nonetheless, accession to the EU does not make a country rich overnight. The Economist Intelligence Unit has calculated that if the current EU members' economies grow at 2 percent p.a. while those of the newly arriving countries grow at 4 percent, the Central European countries would need 50 years to catch up with the richer members of the EU. If their growth accelerates to 5 percent, this time could be cut significantly, while any slowdown would torpedo hopes of convergence. Obviously, different countries, with different starting bases would fare differently in this process, but the overall message is that accession to the EU is not a universal economic panacea. In this respect, the importance attached to the rate of growth of the BiH economy cannot be overstated – and recent results are simply not good enough. Given that BiH is starting from a relatively lower base than the countries that are joining the EU this spring, a sustained, higher rate of growth becomes a matter of cardinal importance if BiH's wish to join the EU is to be fulfilled within the present generation. In this context, a 5-percent annual growth rate is the bare minimum necessary to move forward in earnest. Anything less, and the whole process will be pushed back by a matter of decades. Therefore, self-sustainable economic growth has to be achieved in the coming years through strong private-sector growth, greater fiscal consolidation, and the reduction of wasteful public-sector expenditure. This would enable the country to rely less on different forms of (already declining) foreign assistance and to brace for the choppy waters of the international economy on its own.

Sources:
EBRD, the World Bank, The Economist, The Financial Times, CBBH, the Governments of BiH: BiH Medium-Term Development Strategy- PRSP

REGIONAL DEVELOPMENT

Northeast

Northeast Bosnia has traditionally been a major centre of mining, manufacturing, agriculture and food processing.

During the war, plant capacity in all of these sectors was substantially and extensively damaged, access to export routes was blocked and the region was heavily mined (which acted as a major obstacle to efforts to restart agriculture immediately after the war).

Even with this backdrop of destruction, however, northeast BiH has posted some dramatic steps toward recovery, notable among which has been the comprehensive repair of infrastructure, and the reconnection of normal utility services. This was made possible in large part as a result of international aid.

There have also been significant improvements in public administration. There is still an extremely long way to go in this regard, but local governments are showing some signs that they are becoming more entrepreneurial and responsive to free-market economics.

The following offers an illustrative snapshot of positive economic developments in Northeast BiH since the war:

- The Region's struggle against an aggressive grey economy; in particular, the identification of fictitious companies, has shown progress.
- Company registration processes have been simplified and speeded up compared to prewar norms.
- Companies have begun exporting to Western Europe, Canada and the US. Vegafruit in Gracanica is one example.
- The Region's focus on the economic aspects of sustainable return, has had a positive impact on the return process.
- Railway transport has been revived, even though only a few routes are active.
- The Tuzla Canton economic development strategy has been adopted and is in the implementation phase.
- Locally initiated regional development ideas have attracted funding from the EU RED project.

- SMEs have actively participated in the Bulldozer process.
- Privatization, as elsewhere in BiH, has been disappointing. In Tuzla Canton there was widespread use of the voucher system, i.e. Privatization Investment Funds (PIFs); this generally resulted in wildly speculative privatizations which brought no new working capital. In Zenica-Doboj Canton, by contrast, the privatization process was internationally supervised and privatization through PIFs generally has not occurred. However, privatization results there have also been disappointing, with the result that all of the canton's heavy industries – coal, steel, power plants and distribution – still await privatization. Likewise, privatization in the eastern RS has been only marginally successful, with few examples of significant capital investments in newly acquired businesses.
- Reform of the judicial system has resulted in marginally improved response times of courts in cases of commercial disputes.
- The introduction of a single BiH currency in both Entities has had a positive impact. In addition to this, it is important to note that the KM has shown no inflationary or deflationary activity since it was introduced.
- The introduction of a single license plate represented a quantum leap in efforts to secure freedom of movement across the IEBL, a *sine qua non* of regional development.
- Access to modern communications has increased for personal and business use.
- Reopening of Tuzla Airport to commercial traffic, a recent development, will help the process of attracting both passengers and freight associated with business development.
- The proximity to Brcko's Sava River - and its recently redeveloped Port - will be an important economic linkage to businesses throughout Northeast BiH.
- A potentially strong agricultural economy, as well as close linkages to a growing agricultural processing cluster of businesses, including Bimex, Bimal, Sava, Frutex and Vegafruit, will continue to contribute to overall regional prosperity.
- The region's strong coal and salt mining sector will continue to grow. Indeed, coal mining in the region will become a key positive factor in business growth elsewhere, including steel production.
- The region has strong reserves of forest products which, when corruption in this industry is brought under control, will become very important both for raw product sales and economic linkages to the wood processing industries which are growing in BiH.

- An emerging sector of specialized medical care, led by a regionally significant cardiac practice in Tuzla, will be an important element in the wake of expected reform within the health community.
- A growing small and medium sized (SME) business sector, and an expanding interest in entrepreneurship among area residents - particularly young people - is important.
- The City of Tuzla's inspired use of land and a natural resource to open a wildly popular salt lake is a model for the region. The lake has attracted 100,000 visitors in its first year of operation, and hugely boosted municipal revenues.

Problems Still Persist

Having noted these positive - or potentially positive - trends, it must be stressed that the region suffers from numerous economic problems.

This Map identifies areas of "promise and problems":

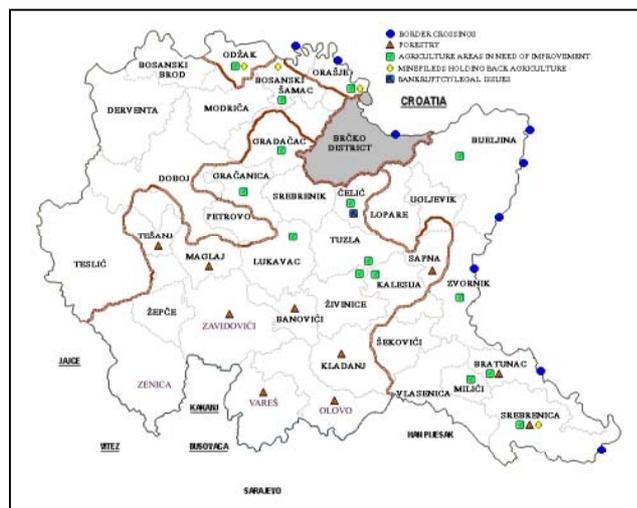
Shortcomings in the following economic sectors in northeast Bosnia and Herzegovina continue to require attention:

- Much of the region's agricultural land is underused because farmers are planting crops with marginal market-share opportunities and/or land is totally non-productive due to extensive land mines remaining from the war. Recent import/export agreements between BiH and neighbouring countries have placed agricultural producers at a pricing disadvantage. This, coupled with exhaustive regulations hampering the ability of BiH farmers to export their products, produces a net-negative impact upon this sector of the economy.
- The **Forestry Industry** throughout northeast BiH is rife with corruption and the unlawful exploitation of wood. A thorough investigation at the highest levels of government is required in order to document the full extent of the problem, and clean up the industry throughout BiH.
- Privatization of larger and very strategic businesses has not been successful. A concerted effort to push forward on privatization in this arena

is absolutely necessary for both job growth and economic recovery.

- Utilities and infrastructure are both in need of extensive reform and/or repair. Consumer pricing for electric and telecommunication utilities is a decisive disincentive to both business retention and growth. Moreover, the quality of roads, railway lines and water supplies is extremely poor.
- Many of the region's "best and brightest" young people appear to be choosing to leave the area for other countries in search of career opportunities. In addition, the remaining workforce may be eager to take on "new economy" jobs, but are unprepared in terms of education and training. As a result, in addition to the overall need to improve the economy, attention must be paid to improving educational programmes to suit potential job placement opportunities.
- There remain significant legal barriers to economic development, including overcrowded commercial court dockets, slow movement in resolving

bankruptcy cases, and little effort to adjudicate "small claims." More work will be needed during "Bulldozer III" to identify and resolve various shortcomings in commercial law (i.e., provisions needed in the Law on Construction Land to accommodate a firm's ability to acquire municipal



- land through a three-year payment plan).
- A countrywide examination of urban plans is of particular importance. There have been many incidents of a long-standing phenomenon known as "wild construction" documented in this research. The public's attitude is generally that it is easier to "beg for forgiveness than ask for consideration" after building illegally. Many of these problems find their roots in the fact that most urban plans in BiH are outdated, dating to a period prior to the war. As a result, there must be a concerted effort to push all municipalities countrywide to update their urban plans. This must be followed by strict adherence to such plans in the issuance of building permits, and penalties for those who violate planning-law provisions.

- There is a strong need to regulate all “flea markets” throughout northeast BiH. We presume that the number of unregulated marketplaces (each with dozens of small-non taxed businesses) is equally extensive elsewhere in the country. Even in the absence of empirical data, one could assume that millions of KM in lost revenues to local governments are at stake unless greater control is exerted in this critical area.

While the region enjoys rich natural resources and a good level of industrial development, and has made significant strides in overcoming the devastation of the war, its economic development, like that of much of BiH, remains hamstrung by a lack of central economic strategic vision and the dead weight of the bureaucratic hand on business.

Southeast

The Herzegovina region, composed of eastern Herzegovina located in the RS and Herzegovina-Neretva and West Herzegovina Cantons located in the Federation, although separated by two administrative structures, is economically closely connected. Before the war, giant companies employing thousands of people characterized this region. Today's economy is directed toward the development of small and medium enterprises, small-scale agricultural production, and the energy sector. Although the economy in Herzegovina is advancing, there remains a substantial pool of unused potential, primarily due to lack of domestic and foreign investment, inefficient local administration, lack of initiative, and unfavourable credit lines.

Postwar Economic Development

Right after the war, the pace of economic development varied from area to area within the region. While West Herzegovina, particularly Canton 8 (WHC) and Municipality Citluk, not burdened by chronic political disagreements, have seen the expansion of the private sector with the growth of modern companies using computerized technology, such as Lijanovici, BarPeh and Weltplast, Herzegovina-Neretva Canton (HNC), specifically the City of Mostar, has been in a more difficult position since energy has been focused on solving political problems. On the other hand, the RS part of the region has been, and remains, in the worst position as far as economic development goes. Its inhabitants are geographically isolated from the Entity political leadership in Banja Luka, and there has been little investment in the area.

Speed of implementation of economic reforms has largely depended on the stability of the political situation in specific regions. Hence, HNC and the City of Mostar have lagged behind given the parallelisms in administration, institutions and public companies that have existed as a consequence of the war and the Canton's special regime status. However, significant steps forward have been made in the past couple of years, where one by one, institutions were integrated, harmonizing their work with the existing legal regulations. Thus far, besides the unification of Canton 7 ministries and various institutions (such as the HNC Health Insurance Fund, HNC Employment Bureau, Cantonal Tax Administration, Cantonal Customs Administration, and the Cantonal Chamber of Commerce) which used to work completely separately, certain public companies have been merged with the assistance of foreign governments / organizations (for example, Bus Company – Japanese Government, PC Water Supply – World Bank.)

HNC has consolidated its budget system eliminating the separate salary payment arrangements. Although parallel bookkeeping remains, it will be eliminated with the introduction of the USAID's Financial Information Management System (FIMS), which should be in place in the first half of 2004. There are many things left to be done. Most current cantonal and municipal budgets in general are either overburdened with debts from past years or lack revenue, which leaves them with little scope for directing funds into economic development and other initiatives.

The postwar period in this region has been characterized by the development of small and medium-size enterprises. Significant international and local investment has been directed towards expanding this sector; numerous international and local organizations and NGOs, as well as local initiatives such as Mostar Business Incubator, have contributed greatly to this sector with versatile programmes and projects. While the SME sector is more developed in HNC and WHC, Eastern Herzegovina's economy is still mostly based on large companies established in former Yugoslavia, such as Tool Factory, Novotex, Bilecanka, Elektroprivreda, and TEP Gacko.

Significant foreign investments, like those made to Ledo Citluk, Lasta Capljina, Norfish Mostar, Nerfish Mostar, Uniline Grude and Aluminij Mostar, have contributed to a great extent to regional growth. In addition, Carnex Company from Serbia and Montenegro made the first major foreign investment in the eastern RS, opening the shareholding poultry processing plant in Ljubinje.

It should be noted that in recent years various companies from Herzegovina have become significant exporters. As the largest exporter in BiH, Aluminij Mostar exported 180 million KM during the first nine months of this year. Among other big exporters are Tool Factory Trebinje (largest exporter in the RS), Fortuna Trade Tours, MI-MO, Nerfil and Hercegovinalijek from Mostar, Feal and Listo from Siroki Brijeg, Weltplast from Posusje, UNIS-Igman from Konjic, Bobita from Citluk, and Prodex and Lumen from Grude. Most of these firms prove that successful privatization and foreign and domestic investment are the way toward export-oriented production and a reduction of BiH's foreign-trade deficit.

In general, privatization in this region has not brought expected results. Although cases of successful privatization exist, by and large the process has been slow and has been characterized by small investments, an insufficient number of new jobs and a lack of new managerial expertise. The privatization process in HNC was even more complex due to double-registered companies and disputable privatization cases that ended in court. While, thus far, in WHC approximately 45 percent of companies subject to privatization have completed the process, in the HNC around 67 percent have been completely privatized. In the eastern RS (seven municipalities), however, only around 37 percent of companies completed the privatization process.

Most Developed Industrial Branches in the Region

Since Herzegovina has always been a centre of agriculture (including wine-producing), tourism, energy production and the tobacco, metal and textile industries, it comes as no surprise that these sectors are the main pillars of economic progress today. However, compared to the prewar trend of giant mass-production, these sectors are mostly organized around small-scale production.

The whole Herzegovina region is endowed with natural resources and a good climate, creating excellent conditions for extensive agricultural production, and offering opportunities for job creation with relatively small investments. Overall, agriculture after the war has been developing through the expansion of family businesses rather than through any revival of former giants such as HEPOK. Many international and local organizations have devoted much of their investment and effort to this sector. One example of a successful agricultural project, financed by the Spanish Government, is Popovo Polje. This project, located on the inter-Entity boundary line (IEBL), has brought not only advancement in agricultural production, but has also drawn together farmers from the two Entities.

OHR South has, together with USAID's LAMP project, sought to connect agricultural producers with their markets, and has taken steps to help coordinate the activities of all international organizations working on this issue.

Wine growing and wine producing have long been among Herzegovina's most important industries. Herzegovina has 98 percent of all the vineyards in BiH. Along with the wine growing tradition, the region is famous for producing autochthonous brands of high-quality wines such as Zilavka and Blatina. Today, this sector is recovering, and it is estimated that 25 to 30 percent of prewar vineyards are in use.

Herzegovina region has two tobacco factories (Mostar and Ljubuski) and has good potential for growing tobacco, which is important since factories producing tobacco products currently import most of their raw material. This industry is one that could employ a large workforce once fully developed, but currently lacks subsidies and other kinds of support.

Tourism offers potential for economic development and job creation; it is one of the trademarks of this region. Besides many cultural-historical monuments, the coast at Neum and the Neretva River, all of which offer possibilities for different types of tourist attraction, the most developed tourism in Herzegovina is religious tourism (around 250,000 pilgrims from around the world visit Medjugorje every year). The number of people visiting the region was limited after the war, but numbers have been rising with every season. A recent change, which came about as the result of the Bulldozer Initiative, concerning visa regimes for East European countries, represents an additional step forward. The opening of the Old Bridge and a BiH Investment Conference, both of which are planned for 2004, will help restore Mostar's position as an established international tourist destination.

The metal industry is also fairly developed in the region, and is mostly based on medium and small companies working on production of aluminum products. Almost all of these companies work to high-quality standards and their goods are being exported. Also, the textile and clothing industry, which is currently operating at a very low level compared to the period before the war, has achieved some success due to investments made during the privatization process (for example, Nerfil, Mostar).

One of the sectors that has developed greatly since the war is the meat-processing industry. Herzegovina has three big meat-processing companies, Lijanovici from Siroki Brijeg, GIPI from Citluk and Carnex from Ljubinje, that employ a large number of people. However, these

industries are currently facing difficulties due to an unfavorable business environment that makes them uncompetitive in the local market.

Mostar Airport

Mostar Airport is one of the keys to economic regeneration in the area. Due to its optimal geographical situation, it could provide all kinds of services for the region throughout the entire year. The Airport was rebuilt in 1998, mostly with European aid (the EC has invested four million Euros in the Airport during the last six years). Competence over the Airport has recently been transferred from Mostar Municipalities with a Croat majority to the City of Mostar. (The City took over competencies regulated by the Interim Statute, which was a precondition for further investment by the Federation Government, the Canton, and the City.) Currently, the City authorities together with their partners are working on fulfilling technical conditions for a successful hand-over of the Airport's maintenance from SFOR to the City of Mostar.

Regional Strategy and Cooperation

The gap that existed in the immediate aftermath of the war in the cooperation between different parts of the region has gradually been reduced through the implementation of trans-IEBL projects and economic reforms and through the harmonization of Entity laws and regulations, opening up new possibilities for cooperation and helping to consolidate the Single Economic Space. Whereas in the past, cities and municipalities concentrated on developing economic strategies exclusively for their respective areas, nowadays their activities have shifted toward a regional economic development approach.

Already through the Bulldozer Project, officials and businesspeople from the entire region have joined together to address those obstacles that prevent companies from running at full capacity and prevent them from creating new jobs. With the assistance of the EU RED project, Herzegovina formed its Regional Economic Development Agency (REDA Herzegovina) in the autumn of 2003. In November 2003, 26 Herzegovina municipalities' mayors and ten business associations signed the Agreement on the Agency's establishment and cooperation. Work is now underway to map out a regional economic development strategy.

Remaining economic development paths

Given that most of the Herzegovina region suffered serious damage during the war, postwar economic progress has been considerable, even though few firms have succeeded in achieving prewar production levels.

At the moment, the most important thing for this region is to develop a regional economic strategy in order to exploit in an optimal way its extensive economic potential, with clear goals and direction. A regionally oriented approach will also improve the present level of cooperation within the region and encourage links between Dubrovnik, Trebinje and Herzeg-Novi.

Regional development will certainly be accelerated if new investments can be secured. As a precondition for attracting these future investments, Herzegovina must ensure political stability and efficient public administration, through administrative reform and rationalization of public employment practices. It must demonstrate that it is seriously curbing mismanagement and fraud in Entity, canton and municipal administrations. The beginning of implementation of the treasury project will definitely contribute to greater control and more efficiency in public spending.

Slow and ineffective privatization has been recognized as one of the major barriers to stronger economic growth, and greater efforts need to be invested in the recently re-launched privatization process. Although the first international public tender for the strategic company "Granit" in Jablanica was announced at the end of October 2003, the privatization of other companies needs to be accelerated and completed, especially companies that are strategically important, such as those in the energy and telecommunications sectors.

Mostar Airport deserves special attention. The optimal operation of the airport will have a crucial bearing on the success of efforts to develop the regional economy as a whole and tourism in particular. All levels of government will have to be engaged in order to make the airport fully operational before the BiH Investment conference (February 2004) and the Opening Ceremony of the Old Bridge (July 2004).

Herzegovina has natural resources in tourism, agriculture, wine producing, fish-farming, electricity and tobacco production, and it has well developed metal, textile and meat-processing industries. In order to obtain the full potential of these sectors the region needs new investments and it needs to make sure that economic reforms are fully implemented. More must be done to create a business-friendly environment and support domestic producers and exporters.

Northwest

The northwest region is composed of the Banja Luka region, located in the RS, and two cantons located in the Federation (Canton 1, headquartered in Bihac, and Canton 10, headquartered in Livno) and it covers roughly one third of BiH's territory and around one third of its population.

The northwest region is in the midst of the transition process towards the market economy. Transition efforts are currently focused on:

- Privatizing state-owned assets/companies
- Developing a supportive business environment and financial sector

Progress in transition continues at a modest pace; completion of the privatization programme will be a key priority for sustainable development of the region in the near future.

The industrial sector of the Banja Luka region made some progress before the war in exporting to Western markets. However, the goods produced at best met minimal Western standards and were widely regarded as inferior.

Major sectors of the Banja Luka region industries include mining, paper, textiles, leather goods and shoes, furniture, lumber and food products.

The industrial sector is generally overstaffed and often uses obsolete technology. The main reasons for poor competitiveness in the sector are:

- High relative capital costs (in relation to productivity) ratio compared with neighbouring countries, although gradually decreasing;
- Overstaffed companies with incentives to maintain employment, given Government subsidies;
- Outdated technology;
- Slow and delayed privatization, which undermines minimum restructuring efforts.

State-owned companies located in the Banja Luka region which were scheduled to be tendered by the end of 2003 were: Mljekarska industrija, Banja Luka (Dairy), Pivara Banja Luka (brewery), Boska Banja Luka (department store), Svila Celinac (textile), HPK Draksenic Kozarska Dubica (chemical corn processing), Jelsingrad Banja Luka (production of

machinery), and Fabrika Duvana Banja Luka (tobacco factory).

One of the largest European iron ore mines, "Ljubija" located near Prijedor, yields 3.6 million tons of iron ore per year, with reserves assessed at 500 million tons. This was the largest supplier of the former Yugoslavia steel works before the war.

Agricultural land accounts for almost 44 percent of the Banja Luka region, and the region has a comparative advantage in terms of agriculture. A good resource base exists for most forms of temperate crop and livestock production. Agricultural production is organized in small-scale private farms which average 3.5 ha. This fragmentation of farms has led to limited use of modern farm technology. Crop production has recovered in the postwar period and is now close to the prewar level.

Fruit production is very well developed in the Banja Luka region. Fruits grown in the region are apples, plums, pears and berries.

Small-scale farms also dominate the livestock sector. State-owned farms achieved production levels close to those of Western Europe before the war, but have now almost collapsed after waiting too long for privatization.

Fish farming is well developed and the region is a good location for high-quality fish farming (trout in particular).

Further development of farming through education, providing incentives and marketing could double the performance of the agriculture sector

The service sector has been growing rapidly. Business services such as management, training services and business intelligence are emerging. In 2001 foreign banks penetrated the local market and have considerably improved financial services. The insurance sector has growth potential, but reform of the sector is in its initial phase. Significant FDI in the insurance sector is expected in the near future.

Canton 1

In addition to its favourable geographical position and water potential (including geothermal springs in Gata, Sanski Most and Velika Kladuša), Canton 1 has arable land, woods and mineral ores. There are also natural beauties that attract tourists, while climate conditions support the development of various industries.

Canton 1 has favourable conditions for the development of agribusiness, and very good potential for food production. (The UN has identified this area as

being ecologically suitable for the production of organic food.) There are 196,308 ha of agricultural land, out of which 102,490 ha are arable, 91,203 ha are given over to pasture and 2,615 ha to orchards.

There are 190,880 ha of woodland in Canton 1. These woods are of higher quality than woods in the other part of BiH and they significantly determine the economic structure of the canton. Forestry has a long tradition in the area and the municipalities of Bihać, Bosanska Krupa, Sanski Most, Ključ and Bosanski Petrovac have developed wood-processing facilities.

Although the extent of geological surveying in Canton 1 is still poor, deposits of various ores have been found: lignite in the area of Sanski Most, bauxite in Bos. Krupa, manganese in Bužim, barite in Velika Kladuša, argil in Cazin and Sanski Most, and gypsum in Kulen Vakuf.

The main industries in the canton include furniture and housing appliances production, food processing, machinery, rubber and plastic production, paper production, textiles, leather goods, shoes and timber.

Principal reasons for a lack of competitiveness in these industries include: slow and delayed tender privatization of large companies, overstaffed companies, outdated technologies, administrative barriers for registration of companies and inadequate cantonal legislation.

Tourist attractions in the canton include rivers, geothermal springs, caves, woods and some historical locations. Tourism could potentially become the canton's second significant economic resource. In 2002 there were 20,971 overnight stays, representing a tourism growth index of 159. Privatization of certain tourist facilities could bring fresh capital and significantly improve the development of this industry.

Although privatization, along with the development of private entrepreneurship and the financial services sector, is a key reform issue for the canton, the process faces significant challenges. The privatization of the biggest prewar employer, Agrokomerc, suffered significant delays due to a lengthy ownership dispute. Nevertheless, there are some positive examples of newly privatized companies, such as the Bihac dairy, whose new owner, Meggle, paid old debts and started to expand the production base.

There are eight banks operating in C1 region and 13 insurance companies. In 2001, two foreign banks opened offices in the canton, considerably improving financial services; the insurance sector has growth potential, but foreign investments are still needed.

Canton 10

Canton 10's natural resources are encompassed by three fertile valleys (Livanjsko, Duvanjsko and Glamočko), favourable climate conditions for agricultural production, clear water and chemically unpolluted land, rich forests and lignite mines.

The three fertile valleys are suitable for production of grain (rye, barley, oats and wheat) and potatoes. However, cattle-breeding remains the most prevalent agricultural activity.

With roughly 300,000 m³ annually, production and sale of timber represents the main Canton 10 export. However, the degree of final processing of wood products is extremely low.

Industrial facilities have mainly been based on raw natural resources in the area. There is extensive scope for wood-processing, which, along with the production of wood products (other than furniture), is the main industrial activity. Exploitation of coal and moss represents the second significant industry in the Canton.

Canton 10 has solid potential for tourism development. Forests, caves, lakes and other natural beauties are largely unvisited due to the absence of organized tours. There is also potential for hunting tourism. Currently, the only tourist income comes from winter tourism based in the mountains near Kupres.

Privatization in the canton, as elsewhere in BiH, has not produced expected benefits. There are still some 30 companies in the Canton which are not privatized.

In recent years the number of registered enterprises has slowly increased in all industrial sectors, although a significant number of illegal businesses still exist.

Sarajevo Region

Sarajevo's location makes it a strategic political and economic hub. Although the mountainous environment currently somewhat hinders commercial traffic to the eastern part of the region during harsh winter conditions, significant public works have been planned to increase accessibility to this area.

Sarajevo region enjoys a central continental climate. Tourists to this region have access to the 1984 Olympic ski slopes and the Mediterranean coast within a couple of hours driving distance. The geographical diversity of

the region is only equaled by the diversity in demographics and economic potential.

As the capital of Bosnia and Herzegovina and the Federation of Bosnia and Herzegovina, Sarajevo naturally represents the centre of gravity of economic activities in the country. The parliaments and governments of BiH and the FBiH are located in Sarajevo. Courts and other State and Federation institutions are situated in the city, as are diplomatic and consular missions, and the headquarters of foreign businesses, NGOs and aid missions.

Although the government and parliament of Republika Srpska are located in Banja Luka, the RS capital, formally, is the RS part of Sarajevo. The RS part of Sarajevo Region gravitates towards Sarajevo and not Banja Luka.

The wartime population exchange between Sarajevo and eastern Bosnia has only partially been reversed. The Sarajevo region now includes up to a quarter of the population of the country, with the city of Sarajevo accounting for approximately 400,000 people. Many displaced persons chose to remain in urban centres, rather than to return to their original rural environment. This has led to a sharp increase in the disparity between property prices in urban versus rural or even sub-urban areas.

With the completion of the highway between Sarajevo and Zenica, an important artery has been added to national and international traffic in BiH. With some of the other infrastructural projects that are either underway or being planned, Sarajevo has the potential to grow into a more significant transport hub for road transport. The transit through Bihac, Travnik, Sarajevo and Visegrad could become an important access road to Macedonia, Greece and beyond.

Railway infrastructure is in place and regular services are operational to key locations, such as Ploce's port, on the Mediterranean coast and Brcko on the River Sava. From Sarajevo, regular railway services are also maintained with Budapest, Zagreb and Belgrade.

The premises of Famos, an important state-owned industrial multinational before the war, are successfully being turned into an industrial zone through the privatization of this company in parts. Recently, a greenfield location in Vogosca Municipality has also been designated for development into an industrial zone.

Sarajevo Airport is emerging as a strategic BiH economic artery. Its cargo operations are a clear contributing factor to the success of national and international businesses in the Sarajevo region.

Local and sub-regional public transport in the region is well developed. Sarajevo has a number of tramlines, a fine grid of buslines inside the city and good connections to other locations both in the Federation and the RS.

Utility infrastructure is well developed in urban areas, including electricity, water, gas and telephone. However, gas is not available outside the city municipalities of Sarajevo. The further from urban centres, the more likely it is that other utilities are also harder to come by. Remote villages in the eastern parts of the region do not always have more than electricity and some even lack that.

Information and communications technology is developing in the region. A number of initiatives aim to boost computer literacy and promote ICT as a career opportunity. However, existing regulations still make it difficult for this branch of industry to take off fully.

Access to capital in Sarajevo, understandably, is good. Many national and international banks have their headquarters in the city. Their office networks, however, are often limited to the main cities in the country. In particular, potential clients for agricultural credits often complain about the distance they have to travel and the rates banks charge for credits. A growing number of banks and other financial institutions have micro-credit schemes or loans targeting the agricultural sector.

Fixed assets account for more than 80 percent of the total assets of corporate entities in Canton Sarajevo. Current assets make up some 15 percent of total assets. The currency swap with the change from DM to Euro, however, showed that a significant volume of capital lies dormant in the hands of private individuals.

Regional Initiatives

In 2000, the municipalities in the Sarajevo region decided to coordinate their economic development efforts under the umbrella of a new organization: SERDA (Sarajevo Economic Region Development Agency). SERDA has emerged with the other Regional Development Agencies under the coordination of an EC programme (EU RED). SERDA is funded by 20 municipalities, the Canton and the City of Serb Sarajevo.

In eastern Bosnia, a similar organization was established to coordinate the work of 11 municipalities in the Upper Drina region. This organization, REDRIN, is set to become part of SERDA in the course of 2004. At that point, SERDA will be responsible for the coordination of economic development activities throughout the Sarajevo region.

SERDA has also been instrumental in the success of the Bulldozer Initiative in the Sarajevo region. One of SERDA's employees has been appointed coordinator of the Regional Bulldozer Committee. In this capacity, he has been responsible for helping entrepreneurs in the region formulate and lobby for reform proposals aimed at eliminating legislative roadblocks to economic growth and development.

Unemployment in the region is particularly low among skilled and highly skilled workers, affecting principally unskilled workers. Unskilled labour accounts for 40 percent of the unemployed.

Sarajevo University has a large number of faculties and benefits from extensive international cooperation. Close cooperation exists, for example, with universities in Bologna, Melbourne and with Massachusetts Institute of Technology. This has had a positive impact on academic standards in the Sarajevo region as a whole. Another contributing factor has been the return of BiH citizens who have studied or gained professional experience and credentials overseas.

Furthermore, a great number of young people have been able to obtain working experience with some of the international organizations in Sarajevo, leading to a sharp increase in language and other skills.

Gorazde has the potential to provide key vocational training for the eastern part of the region, with a sophisticated (although underutilized) vocational training centre.

Within the region, the municipalities in the Upper Drina area have a higher birthrate. However, with many young people moving to urban centres, this trend may soon reverse. The disparity in wages between the RS and FBiH will only exacerbate the exodus from the rural Upper Drina region.

The city of Sarajevo is an active partner with a great number of cities around the world. These include Amsterdam, Ankara, Istanbul, Basel, Barcelona, Vienna, Brussels, Friedrichshafen, Florence, Graz, Kuwait City, The Hague, Innsbruck, Kuala Lumpur, Lyons, Rome, Rimini, Naples, Calgary, Sidney, Split, Stockholm, Venice and Zagreb.

Croatia, Slovenia and Germany are the main trade partners for both import and export with Canton Sarajevo. Sarajevo accounts for almost 20 percent of the international trade generated in the Federation of Bosnia and Herzegovina. International trade in eastern Bosnia is focused on Serbia and Montenegro, Croatia and Slovenia.

As many as 90 percent of businesses operating in Sarajevo region are privately owned. The rest are either state owned, of mixed ownership, or registered

cooperatives. However, a very substantial part of the total corporate assets in Sarajevo is still in the hands of state-owned enterprises.

In the area of Canton Sarajevo, the most significant sector in terms of employment is industry and mining, accounting for around 25 percent of the working population. Other significant sectors include wholesale and retail trade, education and culture, trade, construction, and communications. Predictably, the more urbanized municipalities -- Sarajevo Centar, Novo Sarajevo and Novi Grad -- generate most employment.

Calculated by the number of businesses, trade is the most significant sector in Canton Sarajevo, followed at some distance by industry, real estate, and rental and business services.

Measured by income generated, it is also trade that leads the field. Other significant contributors are industry, transport and communications, and utilities.

In terms of profitability, transport and communications are by far the most significant sector. Other sectors in which significant profits are registered include the processing industry and trade.

Tourism to the Sarajevo region is mainly centred on Sarajevo Canton. Roughly three quarters of the total number of tourists to Sarajevo come from abroad. The tourism potential of the eastern part of the region focuses on adventure-tourism such as hiking, bicycling and rafting.

The Sarajevo region, and especially the eastern part of the region, is rich in forestry resources, such as beech. Although the industry is plagued by corruption and suffers heavily from illegal logging and illegal exports, reforms are underway that aim to utilize the potential in this sector more fully and more responsibly.

Other successful sectors in the eastern part of the region are small-scale agriculture and cattle breeding. The production of berries and other fruits, the collection of herbs and mushrooms, and production of meat and dairy goods are particularly successful here. A number of food-processing companies in the Sarajevo region rely heavily on production from this area.

Finally, the Upper Drina area is rich in energy-related resources. There are several coal mines and one large hydroelectric plant in Visegrad. Concrete plans exist to build another hydroelectric dam in the territory of the municipality of Foca/Srbinja.

Regional assets

Tourist attractions in Sarajevo region include the ski resorts in Bijelasnica and Jahorina, as well as climbing, hiking, horseback riding and trekking also in the mountain ranges of Zelengora, Igman, and Trebevic

and the nature reserves of Perucica, and Rakitnica Canyon, the source of the river Bosna and the Black River, the area of the Bijambara caves, Skakavac waterfall and sulfur springs. There is also rafting on the Tara and the Drina Rivers.

Sarajevo has a great number of historical, religious and other significant buildings, as well as ancient historical sights, structures and fortifications, many of them located in or near the old market in the city centre.

The decline of the large industrial conglomerates, although severely detrimental in terms of short-term social and economic conditions, has proved to be a blessing for the region's ecology. That, together with low labour costs, fertile soil and the fact that most agricultural activities traditionally take place without the use of pesticides and herbicides, has rendered some parts of eastern Bosnia ideal for organic produce, medicinal herbs and wild mushrooms.

In Sarajevo, the municipality of Ilidza has a number of thermal springs with water temperatures of up to 60 degrees Celcius. Some of these sources have enjoyed international fame for centuries for their therapeutic effects. The municipality is also where Sarajevo's main supply of drinking water comes from.

Reumal Fojnica is a therapeutic and rehabilitation facility of international renown with several hundred beds. The area possesses a wealth of thermal and mineral springs, pristine nature and a variety of medicinal herbs. Fojnica used to be a centre of mining and handicrafts and is now best known for the thermal springs that are intensively used for the spa facilities.

The Sarajevo cantonal government is intent on strengthening the region's economic foundation. For that purpose, it has identified a number of priority sectors. These include banking, trade, industry (particularly pharmaceuticals, food, electronics and optics), and public health.

Significant projects for quality living where progress can be expected in the coming year include the Riverina project on the outskirts of Sarajevo and the Bosmal towers in the centre of the city. SERDA also intends to improve development of small startup companies with its business incubator project. Another SERDA project would see the resumption of operations at the spinning mill in Trnovo. In the Upper Drina area, progress could be made with the start of the Buk Bijela hydroelectric plant and the revitalization of the Maglic wood-processing factory.

A start in the construction of the transit road between Renovica and Mesici would not only unlock the transport connectivity between Sarajevo and the Upper Drina region, but also in a broader perspective help

open the trans-IEBL corridor Bihac, Travnik, Sarajevo, Visegrad.

The project "Sarajevo Multi Media Corridor", is already starting to develop the regional economy in a number of ways:

- Stimulating international health tourism to the Sarajevo region, for example for cardiovascular surgery, dental care or cosmetic and reconstructive surgery. The Sarajevo region also offers quality recuperation programmes.
- Developing "adventurism", such as skiing, snowboarding, hiking, trekking, cycling, rafting, horseback riding, paragliding, etc.
- Centre of Technological Excellence, in cooperation with Massachusetts Institute of Technology
- Community Access Points, enhancing regional cohesion by providing socially or geographically isolated locations with a place where facilities and activities are offered centred around Internet connectivity.
- Expanding culture-based tourism attractions, such as the Sarajevo Film Festival and the Theatre Festival throughout the Sarajevo region. Creating a whole month of gallery exhibitions, music festivals, cinema performances, sports competitions and other cultural events in the entire region.

Central

The region's climate is especially conducive to agriculture. Located in the heart of Bosnia and Herzegovina, bordering the other four economic regions, the Central region has long-standing commercial ties with the country's other principal urban centres -- Sarajevo, Tuzla, Banja Luka and Mostar. Although the region boasts several towns of great historic importance, including former regional administrative centres, commercial activity now focuses on Zenica. Unfortunately, the economic importance of Zenica has declined with the postwar demise of the BH Steel complex. Nevertheless, Zenica does possess the infrastructure necessary to attract future economic activity.

The Central region is well situated to become a significant communications nucleus for Bosnia and Herzegovina. Already, many transport companies have chosen the region for their headquarters. The recent completion of the Zenica–Sarajevo highway has cut the traveling time to and from the capital to approximately 30 minutes.

The region is mountainous, mostly covered with forest, pastures and valley plots of limited size for agricultural production. The area is rich in natural resources with several coal, iron, bauxite, quartzite and other mines. The area also is famous for its mineral water springs. The forestry industry is significant throughout the region. The Vlasic Mountains dominate the area, intersected by the Bosna, Lasva and Vrbas rivers. None of these rivers is commercially navigable.

The political situation, particularly in the municipalities in Central Bosnia Canton, is complicated by opposition between Bosniak and Croat parties. The influence of the difficult political situation is illustrated by problems in the reorganization of the forestry sector at the cantonal level. Decisions on office locations and appointments of directors are subject to fierce political discussion. However, this problem could hopefully be resolved fairly soon at one of the upcoming Canton Assembly sessions. The same opposition also prevents the establishment of a unified education system. Only now are schools for Bosniaks and schools for Croats being unified administratively.

Given the fact that political differences run deep, it is not surprising that politics have also entered the realm of economic development. Communal divisions are often reflected in the workplace and in a company's choice of business partners. At the same time, however, many municipal administrations are making a concerted effort to have the composition of the municipal staff reflect the last pre-war census, rather than the current demographic situation.

Refugee return has been fairly successful, despite difficult economic conditions. However, returnees have tended to be elderly people. Younger people have migrated to cities or abroad. The security situation is no longer a factor in the return process.

Physical infrastructure is one of the weaknesses of the region. There is only one highway in the area, and only rail infrastructure through Zenica, with no airport for commercial transport. Central Bosnia Canton is currently developing a 25-year spatial plan for "fast road access". All forms of future infrastructure have already been planned. There will be a major road through the canton directly accessing a future highway between Budapest and Sarajevo, connecting Jajce, Mrkonjic Grad and Bihac with Travnik and Vitez. The

region intends to capitalize on its geographically central location, and become a hub for intra- and international traffic and trade. Electricity supply and advanced telecommunications facilities will be set up along the highways to facilitate the establishment of new economic zones.

There is a strategy for spatial planning in the Federation, but it has not yet been fully developed or adopted. The cantonal spatial plan has been harmonized with EU infrastructure planning regarding international European corridors. The cantonal plan is largely based on a BiH-wide spatial plan drawn up before the war. This BiH plan expired in 2000. The next steps should include further elaborating the Federation's and national spatial plans and harmonizing municipal infrastructure development plans.

Zenica is a city with a prominent industrial past, hosting BH Steel and a number of coal and metal mines. With the transition from the centrally-planned economy to the open-market economy, factories such as BH Steel have found it difficult to rebuild their facilities and regain the market they lost during the war. Since 1992 the machinery and production process has not been updated. However, the facilities, infrastructure and human capital still represent a significant asset if properly put into operation. The rail transport infrastructure in Zenica currently remains underutilized.

The capacity of the Sarajevo–Ploce connection, which is of utmost significance for cargo transportation in BiH, and especially for Zenica Steel, is not fully utilized due to problems with signing the Protocol on Ploce Harbour with the Croatian Government.

Access to capital is not as strong as in larger urban areas. There are fewer banks to provide credits. Both Central Bosnia Canton and Zenica-Doboj Canton have instituted a sizeable revolving credit fund from the proceeds of privatization.

Regional Development

Economic regions do not conform to the current administrative boundaries. Some of the municipalities in the Central Bosnia and Zenica-Doboj cantons gravitate in different directions. Kresevo, Fojnica and Kiseljak have always de facto been part of the Sarajevo economic sphere. Jajce traditionally was strongly linked with the Banja Luka region. Vitez, Travnik and Novi Travnik currently form a strong economic axis within the Central Bosnia Canton, but had strong economic ties with Zenica. Busovaca never conclusively leaned either way, but now links the economic systems in the Central Bosnia region with that of Sarajevo.

Economic development in the central region is complicated. The strong urban centres of Sarajevo, Tuzla, Banja Luka and Mostar exert a pull on all sides. The central part of Bosnia has always been a bone of contention among larger urban centres. Political and communal differences pull the municipalities into subgroups within the region. Croats orientate towards Vitez or Kiseljak, Bosniaks towards Travnik or Zenica and Serbs towards Banja Luka or Doboj. Especially in the northern part of the region, the fight for economic influence is fierce, among the central region, Tuzla and Banja Luka. However, the ambitious plans for infrastructure development are sure to redefine these directions of gravitation.

Business associations are geographically organized but centered around a limited number of economic activities. The main goal of these associations is joint representation at trade fairs. The associations furthermore advocate for change that will support business development. They generally receive a very positive evaluation from interlocutors. There is potential for a more extensive role for these associations in providing expertise or market access or linkage. Political interference in these business associations is limited.

The organization that ultimately has brought municipalities in the central region together under one umbrella is REZ (Razvoj Ekonomska Zajednica). The REZ concept goes beyond mere economic cooperation, but also includes components of public administrative reform in the municipalities. REZ operates a successful micro-credit program for housing loans and also for small businesses.

REZ operates from Zenica, since this is the most natural core of an economic region in central Bosnia. The economy in central Bosnia before the war mostly revolved around Zenica. Good road and railway infrastructure in Zenica exists, but it is currently woefully underutilized.

REZ has been a very active and progressive player, not just in regional economic development or in improving the efficiency and effectiveness of local administrative structures, but also in promoting the Bulldozer concept. REZ has been one of the most active and constructive partners in submitting suggestions for Bulldozer reforms.

The population of REZ's central region, totaling some 640,000, is generally highly educated. The region has a relatively young population, with a working-age population of almost 67 percent and approximately 23 percent of the population under 15 years old. Many young people graduate but cannot find employment. Official unemployment figures for the region exceed 45

percent. Several programs have been started in order to give the young some working experience. This year, Zenica will open its own university.

Unemployment is fairly evenly distributed over age, ethnicity and gender. However, there is an overrepresentation of people with low or no education. Wages in the REZ region are lower – on average by 10 to 15 percent -- than anywhere else in the Federation.

Communal links are responsible for good economic connections between parts of the REZ region and Croatia. Furthermore, important trade occurs with Slovenia, Germany and Italy. Several Italian companies have recently found partners in the region to set up production facilities or establish a foothold in Eastern Europe. There is strong regional cooperation particularly with the Lombardia region in Italy.

A number of German companies have also started cooperation or production here in order to profit from the low labour costs and availability of expertise or raw materials. There are some links between municipalities in this region and German municipalities, for example between Travnik and Leipzig. Some German companies have shown an interest in industrial gas production and processing, while a number of British and Indian companies are interested in investing in metallurgy.

There are strong historical economic links with the Sala region in Hungary.

International links with the Middle East are reflected in the investment of Kuwaiti businesspeople in BH Steel Zenica. There is an initiative by a Turkish company to invest 120 million KM to open the wood-processing factory in Zenica.

Strong sectors in the REZ region include agriculture, forestry, cattle breeding, tourism, leather and clothing, and metallurgy. The Vlasic Mountain area is exceptionally fertile. Vlasic cheese and Travnik cheese enjoy an international reputation. Several food-processing companies throughout Bosnia and Herzegovina acquire significant amounts of their raw material in this region.

Vlasic Mountain is also well known for adventure tourism such as hiking, paragliding, climbing, alpinism, skiing, horseback riding and mountain biking. Besides adventure tourism, historic, religious and cultural tourism have great potential.

Metallurgy is the logical choice for a region so rich in natural resources. Although some of the factories are now outdated, several new enterprises have sprung up to take advantage of untapped potential.

Zenica has a successful and renowned trade fair called "ZEPS" where international businesses gather annually to explore new business opportunities.

Several international organizations have recognized the agricultural potential of the region and have launched programmes to foster and modernize agricultural production facilities. Domestic partners such as the UPI bank and KLAS are involved in some of these programs.

The region is also an important electricity producer, with thermo-electric plants in Kakanj and just outside the REZ region in Jajce. These plants will in due course require modernization in order to meet European emission standards.

Retail is well developed in Vitez, where a small number of successful businesses have attracted a multitude of other retail shops, creating a veritable shopping boulevard.

The expertise and infrastructure related to the former metallurgy industry in Zenica is still in place but underutilized. This underutilization may be a direct consequence of the fact that Zenica, as well as some other cities in BiH, has traditionally been in the shadow of Sarajevo, attracting limited attention from international investors, donors and benefactors. Being a seat of the second largest European steel factory, Zenica needs more attention in terms of financial assistance for modernization of these or alternative industry capacities, in line with European ecological standards. It would take significant investment to utilize fully Zenica's metallurgy capacities, as some of these facilities are more than 100 years old. However, current management of BH Steel and "Zeljezara Zenica" are cleaning the site – leveling old and exhausted facilities. For example, of four blast furnaces only one remains. Another issue which needs to be resolved is rail transportation and, as mentioned above, the Ploce Protocol.

A strategic plan has been developed by the agricultural faculty of the University of Sarajevo, in co-operation with the Mostar-based Institute for Agronomy. Regular agriculture, hydro-potential and forestry are particular strengths.

Mineral mines: Quartz, clay and rocks for building materials are among some of the natural resources of the region. There are also a number of thermal and mineral water springs. Several concessions have already been given to companies to start exploiting this potential. As with many start-ups in BiH some of these companies lack sufficient expertise for their task.

AGRICULTURE

Phytosanitary

Establishing a Phytosanitary Agency is an EC Feasibility Study requirement. If it is not done in the first half of 2004, BiH risks not being able to enter Stabilisation and Association negotiations with the European Union. The present system, with divided jurisdictions between Entities, is inefficient and totally unsatisfactory from the business point of view. It makes it harder for BiH farmers and food processors to sell their products overseas. At the same time it makes it easier to import food products, with inadequate fiscal supervision and inadequate quality and safety checks.

Despite the urgency of this issue, there has been a delay of more than three months in setting up the BiH Phytosanitary Agency (Administration for Plant Health Protection). The primary legislation providing for the establishment of this Agency was adopted in August 2003 but since then the relevant ministry, the BiH Ministry for Foreign Trade and Economic Relations (MOFTER), has taken only limited steps to carry the process forward. In addition, the work of the BiH Phytosanitary Commission (the body set up provisionally to deal with phytosanitary issues until the Agency is established) has been rendered completely inactive because of inadequate financing. This political and administrative failure has had a direct and serious negative impact on the BiH economy in general and on BiH farmers and food processing workers in particular. It has also hindered efforts to increase the level of food safety in BiH. It is imperative that the Phytosanitary Agency is established by June of this year.

Veterinary

The prewar veterinary service was efficient, and BiH enjoyed a positive animal-health environment. The meat-production and meat-processing sectors exported to the EU and the US. The veterinary system was seriously disrupted during the war and then re-established as two separate systems, one for the Federation and one for the RS, with little or no coordination between the two.

The establishment of the State Veterinary Office in (2000) was a very significant step forward. In the period

1995–2003 BiH was assessed as a country with significant risk to animal and human health due to the presence of several diseases. This situation is at least partly due to the absence of an efficient countrywide veterinary regime. One of the SVO's first priorities must be to improve the veterinary inspection system (border and Entity) in accordance with the EC recommendations from 2000 and the BiH Veterinary Law.

Statistics

The High Representative's Decision enacting the BiH Law on Statistics and establishing the BiH Statistics Agency (BHAS) is crucial in creating the conditions for successful macroeconomic management. Implementation of the Decision will provide BiH with an efficient statistics service that meets the needs of domestic and international users of statistical data. It will also fulfill one of the EC Feasibility Study requirements.

The Decision requires harmonization of Entity statistics legislation and regulations with the provisions of the BiH law, and requires the Entities to enter into negotiations with a view to combining their Institutes with the BiH Agency so that all aspects of collecting, processing and disseminating statistics are dealt with at the state level.

Harmonisation has proceeded satisfactorily, but merger negotiations so far have been fruitless. OHR has been invited by BHAS to relaunch the negotiation process.

FISCAL SECTOR

The Central Bank (CBBH)

The CBBH began operations on 11 August 1997 and is thus quite a young organization. It is a state-level institution, the only monetary authority in BiH, operating across the entire country, through five offices. The CBBH Law specifies clearly the functions that the bank must carry out and also sets a number of limitations on its operations. Subject to these legal requirements and restrictions, the CBBH is completely independent of political influence.

Monetary policy

Monetary policy is the CBBH's most important function. The bank operates monetary policy through a strict currency board arrangement, which is stipulated in the CBBH Law. There were three main reasons for the choice of a currency board for BiH's monetary policy:

- A) It provided a firm nominal anchor in the form of a fixed exchange rate in a situation where there was significant economic instability;
- B) It removed discretion in a situation where there was considerable difficulty in establishing institutions and making political decisions;
- C) Currency boards had been established in some eastern European countries and were working well.

The three essential features of the BiH currency board are:

- A) A fixed exchange rate specified in the law;
- B) Full foreign exchange backing for all the KM liabilities of the central bank;
- C) Full convertibility of the CBBH's KM liabilities into the anchor currency.

The fixed exchange rate

The initial exchange rate was set at 1 KM = 1 deutschmark. The choice of the DM as the anchor currency for the BiH currency board was an easy one, as the DM had long been a very stable currency and it was already widely used and trusted in BiH. Subsequently, when the DM was replaced by the Euro, the CBBH Law was changed to make the Euro the anchor currency for the BiH currency board. The new exchange rate was specified in the CBBH Law at exactly the same rate as the DM had been linked to the Euro, i.e., 1 KM = 0.51129 Euros. This means that the exchange rate of the KM has been unchanged since the CBBH began operating. The transition from the DM to the Euro as the anchor currency was smooth and the impact on the KM and the currency board was very positive.

The KM liabilities of the CBBH, which are the KM currency in circulation and the deposits of the BiH commercial banks at the CBBH, have to be fully backed in convertible foreign assets. The table below shows that the CBBH has maintained this full foreign exchange backing for the KM since 1998 and had 'free reserves' of KM 144 million at the end of August, 2003.

TABLE 1: CBBH FOREIGN RESERVES (End of period in KM millions)

DATE	NET FOREIGN RESERVES	MONETARY LIABILITIES	FREE RESERVES
Dec 1997	144.1	160.3	-16.2
Dec 1998	283.3	253.9	29.4
Dec 1999	865.7	836.7	29.0
Dec 2000	1021.2	973.2	48.0
Dec 2001	2666.6	2591.6	75.0
Dec 2002	2463.2	2345.1	118.1
Aug 2003	2405.0	2260.0	143.8

This table also illustrates the way in which the KM gradually substituted for the other currencies that were in use in BiH thus leading to a steady increase in the CBBH balance sheet from 1997 to 2000. This trend accelerated during the Euro conversion period in late 2001 and early 2002. In all, the CBBH sent DM 4.3 billion of DM banknotes back to Germany from BiH during this conversion period and the CBBH's foreign reserves more than doubled.

The success of the currency board arrangements:

The currency board has ensured a very successful monetary policy for BiH. The KM has been stable against the DM and the Euro since it was introduced, and inflation in BiH is now low and stable, as noted in the table below.

INFLATION IN BIH. (Retail price index, Annual % growth)

Year ended.	Federation of BiH.	Republika Srpska	BiH Average
DEC 2000	4.0	16.1	8.0
DEC 2001	0.3	2.2	0.9
DEC 2002	-0.7	2.4	0.3
JUL 2003	0.4	1.4	0.7

KM use has risen steadily in BiH and the KM is now the dominant transactions currency in all parts of the country (however, Euros are also generally accepted, at least for larger transactions). In addition, the

proportion of bank deposits denominated in KM has also grown steadily, though more than 50% are still denominated in foreign currency. Importantly, the KM has remained fully convertible in BiH since it was introduced, and this stability has been an important element in increasing the level of foreign direct investment coming into the country.

The Banking Sector

In the course of the postwar reconstruction and reform process, the banking sector in BiH has arguably proceeded further and faster than any other economic sector. Consumer confidence has returned, with the result that deposits have increased dramatically and bank lending has also begun to rise. Competition in the banking sector is now very real. Whereas in the immediate postwar period there were 76 banks in BiH, an inevitable consolidation and liquidation process has taken place, resulting in less than half that number at present. Spurred by the entry of strong foreign banks with long experience in established European banking regulatory frameworks (foreign investment in the banking sector has exceeded that in any other sector), consumers are benefiting from increased competition and reliable banking practices.

Over the recent past, banks' lending rates have fallen substantially, reflecting the newly competitive environment. However, these rates are still relatively high. Prior to 2002 most lending rates exceeded 20 percent, but average short-term lending in 2003 appears to be in the 10-percent range, with long-term rates somewhat lower. Observers generally agree that the principal reasons for this favourable decline include the reform of the payments system, increased minimum capital requirements for banks (forcing mergers and liquidations of weaker banks), the ability to conduct inter-Entity banking operations, the introduction of deposit insurance and the privatization of government owned banks. The table below reveals the shift in capital structure of the banks since 2000.

Capital structure in BiH banking sector (%)

	31.12.00	31.12.01	31.12.02	31.5.03
State Capital	47	19	10	8
Private Capital:	53	81	90	92
Domestic	NA	25	24	21
Foreign	NA	56	67	72

Future initiatives in the Banking Sector

The progress in this sector is evident in the absence of any specific EC Feasibility Study requirements. In an effort to achieve greater efficiencies, enhance the Single Economic Space and reduce costs, discussions are ongoing to consider merging the Entity banking regulatory agencies under the umbrella of the Central Bank. (The Deposit Insurance Agencies were merged at the State level in 2002.) Similar discussions are also taking place to consider possible consolidation of the stock exchanges and securities commissions.

Law on the Indirect Taxation System of Bosnia and Herzegovina (ITA Law).

On 29 December 2003, the BiH Parliament adopted the ITA Law. This law has now come into effect, meaning that legally the Entity Customs Administrations have ceased to exist and there is one countrywide Indirect Taxation Authority.

During the last quarter of 2003, the Entity Governments signed an agreement that allowed for the transfer of competency from the Entity level to the State Level in the field of Indirect Taxation. This agreement was made under Article III 5 (a) of the BiH Constitution and was the first time that such an agreement had been reached under this provision.

Additionally, the new Director of the Indirect Taxation Authority, Kemal Causevic, was selected and subsequently appointed by the Council of Ministers.

Budgets

The annual budget drafting process and drafting of the State and Entity Budgets for fiscal year 2004 got properly underway in the last part of 2003. An IMF Mission travelled to BiH in December and reviewed the Entity and State Budgets to ensure that they comply with the IMF Standby Agreement.

The review produced satisfactory results and, subject to the Entity and State Budgets being passed within the expenditure limits prescribed by the IMF, the next tranche under the Standby Arrangement should be made available.

The setting of Entity and State Budgets for 2004 has also had to address the challenge of the transfer of new competencies to the State level and a corresponding resource transfer from Entity to State Level. The Entity and State budget laws, when they are passed, will contain clauses that permit necessary transfers to take place.

INFRASTRUCTURE AND UTILITIES SECTOR

Transport

Developing all modes of transport infrastructure in accordance with European standards is a major factor in BiH's EU integration. The BiH Ministry for Transport recently emerged as a separate entity out of a departmental restructuring process. This is a basic prerequisite for developing a coherent transport policy. In order to move forward, the new Law on Railways for BiH must be passed during this year. The law will provide for open track access and single infrastructure management and control. It is important to note that BiH is not developing its transport infrastructure in a vacuum. Neighbouring countries are upgrading their transport systems and making strategic decisions on hubs and routes, and BiH must act swiftly in order to avoid being left on the margins of the Southeast European transport grid. The BiH railways system will remain in disarray, and there will be serious questions about operational safety, until the Railway Law is passed. In addition, governments and donors will question what their contributions are supporting in terms of how this sector is being managed.

Union Internationale des Chemins de Fers (UIC) discusses membership issues every September at a special meeting. Last September, the BiH Railway Public Corporation applied for entry to the Inter-Rail pass network. The Inter-Rail Pass entitles holders to unlimited rail travel throughout the 29 member countries' networks. Until now, BiH and Albania were the only two countries in Europe that are not members of this scheme. With the railway links to Budapest, Zagreb, Belgrade and Ploce, BiH can participate in the Inter-Rail pass scheme as a viable destination for travellers from other countries. The BiH application was successful and only operative details need to be resolved in the course of 2004. Active participation is scheduled to take place in 2005. Participation in this scheme will allow BiH to promote itself more effectively

as a genuine tourist destination, especially for the youth market, at which Inter-Rail is primarily aimed. BiH's participation will also contribute to an improved country image, since the fact that BiH was not an Inter-Rail pass country only served to reinforce a sense of isolation at home and abroad. Higher tourist numbers as a result of participation in this scheme will bring clear benefits in terms of higher hotel occupancy rates and higher demand for some goods, such as traditional BiH handicrafts, as well as different kinds of services. Higher passenger traffic and profits will enable the railway companies in BiH to invest more in infrastructure and rolling stock, thus improving the level of service for local and foreign travelers.

In road transport, moreover, a licensing commission under the full control of the BiH Transport Ministry must be established for the issuance of truck CEMT licenses, now being sold on the black market. The authorities have already undertaken to do this. The cost of establishing such an administration can be borne by an administrative charge for truck licenses, which would allow the commission to be set up immediately.

Civil Aviation

Postwar Civil Aviation in BiH was effectively relaunched by the publication of the Civil Aviation Master Plan, drawn up by an EC/ICAO commission and published in July 1996. The plan led to the first EC/ICAO project, covering immediate priorities for air navigation services.

Sarajevo Airport was reopened to civilian traffic in August 1996. Since then, the EC/ICAO project has been implemented in stages, allowing the progressive restoration of BiH sovereignty over its own airspace.

BiH has had to win back recognition as a full member of the European air network. This process has seen the reopening of air routes between BiH and Serbia and Montenegro, integration in the European Civil Aviation Conference, and the establishment of the National Search and Rescue Centre, in Banja Luka in 2002.

During 2003 the BiH authorities assumed full control of Sarajevo Airport. In addition a BiH Civil Aviation Law was enacted in December 2003. BiH is now preparing to become a full partner with EUROCONTROL and the Joint Aviation Authorities.

Major dates in Civil Aviation of BiH

11 July 1996: Publication of the first Civil Aviation Master Plan.

August 1996: Sarajevo Airport reopens for commercial traffic, the first BiH airport to do so.

11 September 1997: Signature of the MOU¹ between the Council of Ministers and the International Community and creation of the BiH DCA².

October 1998: SFOR³ reallocates to the BiH DCA the whole of BiH's upper airspace. (FL4 330 up to FL 450)

April 1999 till August 2001: First stage of the EC5/ICAO6 project.

August 1999: First Civil Aviation Law with the legal establishment of the effective role of FED.CAD⁷ and RS.CAD.

27 January 2000: SFOR restores BiH's commercial upper airspace, from FL 290 up to FL 390, to BiH DCA. By agreement, air traffic control of this airspace is shared between FATCA⁸ of Belgrade and ATSA⁹ of Zagreb. A portion of "en route" charges is reimbursed to BiH.

31 August 2001: Responsibility for intermediate airspace (FL100 up FL 290) is transferred from SFOR to BiH DCA. CCL¹⁰ of Zagreb provides control within this airspace. (CCL as successor of ATSA)

10 October 2001: Restoration of the upper airspace is extended to FL 410.

November 2001: Signature and starting of the second stage of the EC/ICAO project, called EC/ICAO OPAS¹¹ project.

27 September 2002: BiH becomes a member of the ECAC¹².

October 2002: Reopening of route to Serbia and Montenegro,

Opening of the National Search and Rescue Centre in Banja Luka.

1st January 2003: FED.CAD and SIA¹³ on behalf of BiH assume full management of Sarajevo Airport.

April 2003: Start of third stage of the EC/ICAO project, as part of CARDS¹⁴ programme. This project, called ASATC¹⁵, will support the further development of the Civil Aviation Authority. It is planned to continue until 2005.

¹ MOU : Memorandum Of Understanding

² DCA : Department of Civil Aviation

³ SFOR : Stabilization FORce

⁴ FL : Flight level, (FL x 100 = thousands of feet, FL 330 = 33 000 feet)

⁵ EC : European Community

⁶ ICAO : International Civil Aviation Organization

⁷ CAD : Civil Aviation Department

⁸ FATCA : Federal Air Traffic Control Authority

⁹ ATSA: Air Traffic Service Authority

¹⁰ CCL : Croatia Control Limited

¹¹ OPAS : OPERational ASsistance

¹² ECAC: European Civil Aviation Conference

¹³ SIA : Sarajevo International Airport company

¹⁴ CARDS : Community Assistance for Reconstruction Development and Stabilization

¹⁵ ASATC : Aviation Safety and Air Traffic Control.

17 November 2003: The first civil radar of BiH is put into action at f Sarajevo Airport.

December 2003: The new Civil Aviation Law is passed by the Parliament of BiH.

Telecommunications

The post-war period was characterized by reconstruction of the telecom infrastructure and the creation of three telecom monopolies along ethnic lines. First steps toward the Single Economic Space based on free and open market access and competition among the operators were only taken after the establishment of the state Communications Regulatory Agency (CRA), with full regulatory powers over telecom and broadcasting operators. The number of fixed-line subscribers was 272,000 at the end of 1996. By the end of 2003 it had risen to around 910,000. The growth rate of mobile services has been even more remarkable. At the end of 1998, there were only 17,212 mobile users in BiH. Today there are almost one million. However, the level of unused market potential becomes clear if BiH is compared to EU candidate countries (see chart).

Establishing a countrywide BiH telecom market has taken place gradually and is far from complete. The adoption of the State Telecom Sector Policy at the end of 2000 was an important first step. This identifies phased liberalization and privatization of the incumbent operators as the best model through which BiH telecom operators can attract investment and provide necessary services. The adoption of the State Communications Law in 2003 and the establishment of an independent regulator (Communications Regulatory Agency, CRA – see www.cra.ba) by the High Representative in 2001 as well as a new State Ministry for Communications and Transport in 2003 completed the legal and institutional framework.

All telecom services except international telephony have been liberalized. From the beginning of 2006 new entrants will be allowed to provide international telephone services. However, the three incumbent telecom operators (Telecom Srpske, BH Telecom and HT Mostar) still enjoy *de facto* monopolies of fixed-network operations in their operating areas. Recent audits of the three companies revealed alarming patterns of mismanagement and incompetence, which have cost consumers and taxpayers huge amounts of money. In light of this, the Entity governments committed themselves to implementing reforms aimed

at improving management practices and eliminating endemic corruption in the telecom sector. Measures include enacting a Law on Public Procurement and a Law on Public Enterprises. These laws will institutionalize management oversight and modern accounting standards. They have not yet been adopted by the Entity governments and sent to the parliaments.

Some competition exists within the mobile sector, where each of the two licensed operators is required to provide countrywide coverage by April 2004. However, this competition – and the consequent price and service benefits to subscribers -- could be increased substantially if the issue regarding the third mobile operator could be resolved. The licensing process of the third mobile operator (operating on the basis of permission from the former Herceg-Bosna Government) under the Telecom Sector Policy has been held up for two years. On 23 December, the Council of Ministers eventually decided to set the price of the licence premium at 140 million KM. Although this amount significantly exceeds the figure that was recommended by an independent consulting company, the CRA has now to finalise the licencing process on the basis of this Council of Ministers' decision.

Resolving the issue of the third mobile licence, together with the start of tariff regulation and implementation of a pro-competitive interconnection regime, is the main challenge in the next year. This would help BiH expand the availability of high-quality communications services and use of Internet and other information and communication technologies.

Chart 1

Number of fixed line subscribers in BiH

Year	1996 (end)	1997	1998	1999	2000	2001	2002
Total number of fixed line subscribers	272.000	303.000	730.000	800.000	850.000	N/A	902.836
% in population (estimate 3.8 mil)	7.16	7.97	19.21	21.05	22.37	N/A	23.76

Source: CRA estimates

Chart 2

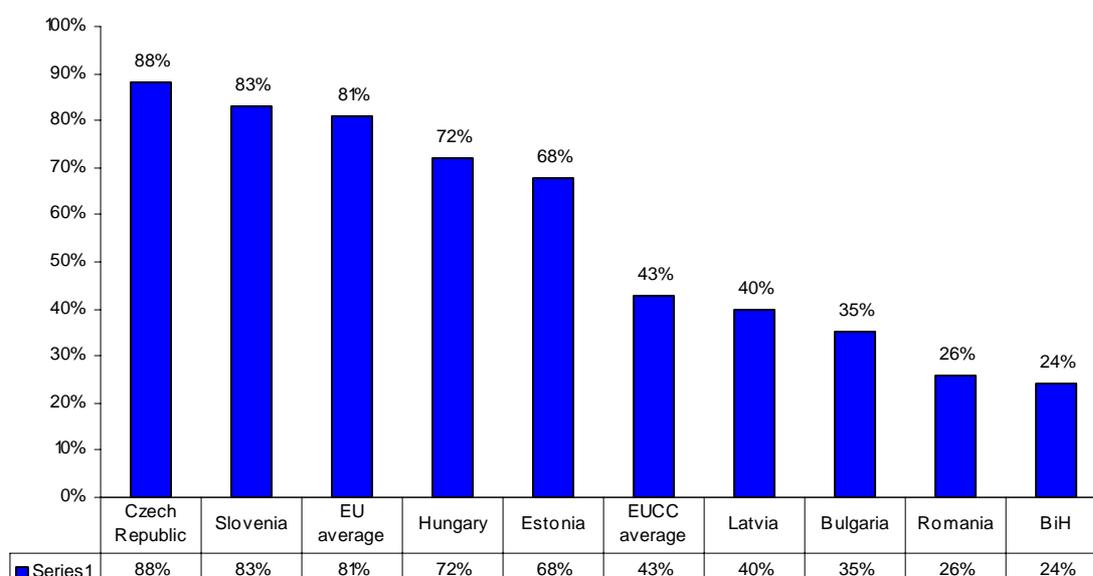
Number of mobile subscribers in BiH

Year	1996 (end)	1997	1998	1999	2000	2001	2002	mid 2003
Total number of mobile subscribers	1.020	8.310	17.212	50.000	262.000	444.400	527.100	906.100
% in population (estimate 3.8 mil)	0.03	0.22	0.45	1.32	6.90	11.70	13.87	23.85

Source: CRA

Chart 3

Mobile Penetration Rate (mid 2003) – BiH Compared with a number of EU candidate countries



Source: 4th Report of Monitoring of EU Candidate Countries, 16 December 2003; funded by the EC Directorate – General Information Society

Energy

Significantly damaged during the war, the BiH electric power infrastructure has been in the focus of reconstruction efforts for several years. The most recent efforts within the electric power sector, however, encompass not only reconstruction but also reform activities. The multi-donor Power III project focuses on reconstruction and reform of the sector, which will enable its optimum development.

The reform process involves changing the sector structure in order to establish a new legal framework, a new regulatory framework and separate generation, distribution and transmission facilities, which are now integrated in three monopolistic enterprises.

Moreover, reform includes implementing sectoral changes that will satisfy requirements of relevant EU Directives. BiH has signed an MoU on the Regional Electricity market in Southeast Europe (SEE) and its Integration into the EU International Electricity Market (2002 and 2003). This Memorandum was signed with the goal of establishing a regional electricity market, which will be integrated in the EU Internal Electricity Market. For each participating country, this requires meeting a number of conditions affecting the electricity sector. By meeting these conditions, BiH will be able to participate in the SEE regional market and subsequently in the EU internal electricity market. This will represent BiH's first practical step into the EU.

As planned, restructuring of the sector under the Power III project entails the following:

- the three existing electric utilities will be unbundled, and separate generation, distribution and transmission companies will be created;
- independent State and Entity regulators will be established to regulate relationships among all market participants as well as pricing methodologies;
- a Single Transmission company and Independent System Operator will be created at the State level to ensure proper functioning of the transmission system.

Importantly, since the Power III project follows the EU Electricity Directive, its implementation ensures that the requirements for the SEE Regional Market will be met.

As a result of numerous delays, the Power III project fell 12 months behind schedule, prompting donors to make continued technical and financial support conditional on greater progress in implementation.

In addition to earlier adoption of the State and Entity Electricity Laws (in 2002), in the last several months there have been several key steps forward in the reform process:

- Appointment of Regulators:
 - State Electricity Regulatory Commission appointed
 - FBiH and RS Regulator Commissioners appointed.
- Adoption of harmonized RS and FBiH Restructuring Action Plans completed. These documents lay out tasks and deadlines for the successful completion of the reform programme.
- Signed Agreement on Establishing the Transmission Company and Independent System Operator by the two Entity PMs.
- Transmission Company and Independent System Operator Laws adopted by the CoM (next step is adoption by BiH Parliament).

These achievements have ensured continued donor assistance and will also play an important role in EU integration as reform of the electricity sector will be one of the key indicators of BiH's progress in the Stabilisation and Association Process.

PUBLIC SECTOR AND ECONOMIC TRANSITION

2003 did not see significant improvements in BiH's social sector. Social problems remain pervasive: pensions are low, official unemployment is close to 40 percent of the labour force, the health-care system is characterized by disinvestment, and the system of war veterans' benefits in the Federation is divided and characterized by unreasonable benefit promises by politicians, which neither Entity can afford. Certain improvements have been made, however.

Pensions

Pension levels remain very low, but pensions are being paid regularly in both Entities and no new arrears have been incurred since the pension funds started implementing the High Representative's Decision stipulating that benefit levels must be linked to the level

of collected contributions. Current pension levels do not cover basic living costs of senior citizens, but broader economic reforms will have to be completed before pension levels can increase. In this respect, growth of the official economy and a reduction of the grey sector are crucial.

Another problem that burdens the pension system is the inter-Entity dispute over pension entitlements. The RS has withdrawn from the Inter-Entity Pension Agreement of 2000 and insists that pensions be paid from the Entity on whose territory they were earned. Currently, pensions are paid from the Entity in which pensioners registered their claims during the war or prior to the Inter-Entity Agreement. This is an extremely complex issue from a legal, financial, and ethical prospective whose resolution will require multi-disciplinary expertise.

Health

Like the rest of the public sector, the health sector faces serious financial difficulties. The situation is especially bad in the RS, where annual health contributions per insured individual are as low as 114 KM, while the Federation Cantons on average collect 249 KM through health insurance. However, the financial reports of the two Entities are different; these figures do not represent a reliable basis for assessing the relative financial position of healthcare in the two Entities, other than to say that both face serious difficulties.

With the unification of the parallel health insurance funds in Canton 7, Health Insurance Funds have been established in all 10 Cantons in the Federation. Despite the fact that certain aspects of parallelism have still not been addressed, this unification represents a major step forward in improving the health system in Canton 7. Efforts must now be made to eliminate all parallelisms.

Future reforms in the health sector will have to focus on improving coordination between the Cantons and the Entities, improving the cost-effectiveness of health services, and building a service quality assurance system. One of the main problems in the Federation is the lack of coordination in health-policy development among Cantons. It appears that the new FBiH Health Minister is taking a more proactive role in this area, which is a welcome sign.

War Veterans

Among the largest items in the budgets of both Entities are expenditures to cover benefits for war veterans and invalids and families of killed soldiers. These expenses

currently amount to around half a billion KM per annum. With the assistance of the World Bank, reforms are under way to rationalize these benefits in both Entities. The RS government has already prepared a draft of the new law regulating the rights of these groups. The draft is within limits laid down by the World Bank and its adoption should introduce financial discipline and transparency to the benefits system.

A draft version of the Federation Law on the Rights of War Veterans, Disabled War Veterans, and Families of Killed soldiers has been introduced in the Federation Parliament. As much as the Federation needs this law (since currently there is no uniform regulatory framework in the Federation) the draft needs to be improved in order to make it compatible with available budgetary resources, and to improve the transparency and accountability of the system. OHR expects the Federation Ministry for War Veterans and Disabled Soldiers' Affairs to work in close coordination with the World Bank in the coming months to create a good law that guarantees benefits to this category of the population while introducing financial discipline and transparency in the process. The success of this important effort will require a high degree of professionalism and foresight on the part of the Federation Government and Parliament and representatives of the beneficiary population.

Privatization

Of 15 enterprises scheduled to be tendered by the end of 2003, 14 have been tendered. The highest-profile privatization has been the sale of the Holiday Inn Hotel.

Efforts have been made to transfer competency for the privatization of strategic enterprises from the Canton Privatization Agencies to the Federation Privatization Agency (FPA), with a view to streamlining and speeding up the process. In addition, a single website, describing privatization opportunities in both Entities, was launched at the start of 2004.

Business Environment

The Law on Accounting and Auditing Standards mandates the use of international standards in the education, training, professional conduct and lifelong career development of accounting and auditing

professionals in BiH. A new Commission for Accounting and Auditing Standards will implement uniform testing for accountants and auditors and monitor the implementation of international standards by the profession.

The law provides for a single set of titles to be used by professionals throughout BiH and for mutual recognition of titles by the Entities.

One of the key goals of this legislation is to foster the development of a competent, credible private-sector accounting and auditing profession, fully empowered to practise countrywide, promoting investment and fostering economic growth.

The law is expected to be enacted by the BiH Parliament by the end of January 2004.

Bulldozer



The Bulldozer Committee was launched on 12

November 2002. Although the initiative received the support of the High Representative and the main international financial organisations, the most crucial support came from BiH businesspeople. The purpose of this initiative was to build a working partnership between BiH politicians and businesspeople and identify specific clauses in the existing rules and legislation that hinder investment and job creation in BiH. The Committee set itself the task of having "50 reforms enacted within 150 days".

In Phase I, the Committee received input from more than 500 firms. Reform proposals covered issues such as double taxation, cumbersome administrative procedures, and bureaucratic requirements that actually make it harder to run successful businesses and therefore to create and sustain jobs. Within the Bulldozer Committee, each proposal was studied in detail by a qualified group of lawyers and economists, who developed legal solutions and assessed the likely consequences of proposed reforms for the business environment. During three Plenary Sessions, the Committee voted on the best 50 proposals. These were presented to the governments in the spring of 2003. Certain reforms were adopted by means of a government decision; others (amendments to existing laws) were sent to the parliaments. The parliaments passed all the Bulldozer amendments, just 30 days beyond the original 150-day deadline. On average, the Bulldozer Initiative produced one economic reform

every four days. A Phase I implementation report will be published in February.

Bulldozer Phase II was launched on 4 June 2003. The aim of Phase II has been to continue promoting the legitimate interests of the business community, local advocacy associations and civil society and to further develop the working partnership with elected representatives. In view of the lessons learned during Phase I, six regional Bulldozer Committees were established by organizations representing local businesses in their areas. In addition, a specialized Bulldozer Committee on Agriculture, Agribusiness and Natural Resources was set up. The Committees' focus has been to identify new reforms at the municipal/cantonal/regional level and to oversee the implementation of Phase I reforms at the local level.

In the summer of 2003, the three Prime Ministers, the six Heads/Speakers of Parliaments, the Mayor of Brcko, and seven Bulldozer local representatives signed an agreement called "The Protocol for Prosperity", which commits them to continuing and deepening their support for the Bulldozer reform process.

Phase II has produced another set of 50 reforms that are currently being reviewed by the governments. Adoption of these reforms, through parliamentary procedure or by government decision, is expected in the course of this spring.

Phase III will be launched in early February. In Phase III the International Community will assume a completely subsidiary role, supporting the Bulldozer process when invited to do so. Day-to-day coordination and management of the process will be taken over by a BiH NGO established expressly for this purpose.

BiH Economic Update

BiH Economic Data January 2001 – October 2003

Source: FBiH and RS Statistical Offices

Indicator	Federation of BiH	Republika Srpska	BiH (OHR estimate)
GDP nominal 2001 GDP nominal 2000 Nominal increase 2000-2001	7,224 billion KM 6,698 billion KM + 7.8%	2,993 billion KM 2,734 billion KM + 9.5%	9,161 billion KM 8,321 billion KM +10,0%
Real increase 2000-2001 (minus inflation in RS 6.5%)	+ 6,7%	+ 3%	+5,5%
Index of Industrial Production			
11/03 (10/03 RS) compared to 2002	+ 3,1%	+ 25%	N/A
11/03 (10/03 RS) compared to 11/02 (10/03 RS)	-6,5%	+ 13,7%	N/A
Retail Price Index			
11/03 (10/03 RS) compared to 2002	+0,2%	+ 3,3%	N/A
11/03 (10/03 RS) compared to 11/02 (10/03 RS)	+0,4%	+ 2,2%	N/A
Average Net Salary 10/03 10/03 compared to 2002 averages	528,38 KM + 9,5%	386 KM + 6,0%	480,9 KM + 8,3%
Number of Employed 10/03 (RS 6/03)	387.198 persons	249.186 persons	N/A
Number of Registered Unemployed 10/03	303.054 persons	147.635 persons	450.689 persons
Number of pensioners in 10/03 (RS 08/03)	285.085 persons	183.870 persons	N/A
Average pension in 10/03 (RS 08/03)	198,85 KM	135 KM	N/A
Imports Jan-Nov 03 (RS –Oct)	5,609 bill KM	1,789 bill KM	N/A
Exports Jan-Nov 03 (RS – Oct)	1,673 bill KM	0,428 bill KM	N/A
Trade deficit Jan-Nov 03 (RS – Oct)	3,936 bill KM	1,361 bill KM	N/A
Import/Export coverage	29,8%	23,9%	N/A