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1. Stability Pact Update

(1) Appointment of New Special Coordinator and General Review of Stability Pact Activities

On 19 December 2001, the Council of the European Union issued a Joint Action appointing Dr Erhard Busek as "Special Representative of the European Union to carry out the functions of Special Coordinator for the Stability Pact for South-Eastern Europe." Dr Busek thus succeeded Bodo Hombach whose mandate as Special Coordinator was to end on 31 December.

This appointment coincides with an important period in the development of the Stability Pact and regional cooperation in general. The Pact's second Regional Conference was held in Bucharest on 25-26 October, resulting (1) in commitments of about Euro 2.6 billion (which included funds previously committed but not disbursed) and (2) in the unveiling of regional strategies in several areas and sectors—such as trade, infrastructure, private sector development, combat against organized crime and terrorism, and so on. Despite this success, there remained questions, particularly within the leadership of the EU, on the specific contribution and complementarity of the Pact with other regional collaboration efforts (such as the CEI, SECI) with the EU's own strategy, as outlined in the Stabilization and Association process (SAp) and the active and well-funded assistance partnership currently unfolding through the CARDS program.

Thus in the Council's Joint Action the new Special Coordinator was specifically tasked to "make an evaluation of the present activities and working methods of the Pact" and report to the Council no later than March 2002. It also specified that the implementation of the Joint Action shall take "into account notably the development of, and consistency with, other contributions of the European Union in the region." The Joint Action also stated that the Special Coordinator "shall liaise closely with the Office of the High Representative in Bosnia Herzegovina".

A "Stability Pact – Stabilization and Association Process Informal Consultative Committee (ICC)" (including the SP, the EU Presidency, the EU Council, and the EC) was subsequently created and met for the first time on 11 January in a spirit of constructive partnership. The EC circulated a paper detailing its own preliminary assessment of SP activities giving indication that "the Commission intends to bring quality input and concentrate its expertise and workforce, in this new phase of the Stability Pact."

As an active partner in the Stability Pact, OHR will continue to contribute to this process.

(2) Working Table II Meeting in Sarajevo – 29-30 November 2001

As co-chair of "Working Table II for Reconstruction, Development and Cooperation" for the July-December 2001 period, the Ministry of European Integration of Bosnia Herzegovina hosted a plenary meeting of the Table in Sarajevo.

The main items for review included:

1. progress on regional trade liberalization (following the MoU of June 2001),
2. progress with the Investment Compact,
3. development of a Social Cohesion Initiative, and
4. presentation by Albania, as Chair of the South East European Cooperation Process, of a plan ("non-paper") on Energy Coordination and Policy in SEE".

The Investment Compact gave an overview of its activities, in particular on the completion of the first edition of the policy reform "monitoring instruments"

(see http://www.investmentcompact.org/)

It also proposed to develop a "Regional Investment Framework" which would follow in the footsteps of the regional MoU on Trade Liberalization.

The Social Cohesion Initiative, co-chaired by the governments of France and the Federal Republic of Yugoslavia, reviewed the status of the Action Plan adopted in Bucharest in different fields of intervention such as health policy, social protection, vocational training, and labour market policy.

(3) Progress on Regional Trade Liberalization and the FRY/BiH FTA

A landmark agreement was signed by the government of BiH and the FRY on 1 February 2002. Once ratified, this agreement will immediately allow all domestically produced goods to be traded free of duty between the two countries with the exceptions of oil products and recapped tires on which duty will be phased out only by 2004. BiH already has an FTA with Croatia and Slovenia. An agreement with FYROM is now technically complete but still awaits the resolution of some final points.

The process envisaged under the MoU foresees that each of the Stability Pact beneficiary countries (Albania, Croatia, FRY, BiH, FYROM, Bulgaria, Romania) will negotiate and conclude a bilateral FTA with the other countries (thus for a total of 21 FTAs) by the end of 2002 with the general target of liberalizing 90% of intra-regional trade in value by the end of 2006.

Working Table II was informed in Sarajevo that, of the 21 agreements, five had been signed, ten were under negotiation, and six had yet to start the process. Two were, at the time (November) near conclusion. This included the agreement between BiH and the FRY. It was noted that continued donor support would be required to facilitate the technical work that remains to be done to conclude, and then implement, the remaining agreements. For instance, help would be required with the applications of "rules of origins", among others. Last but not least, the issue of how to deal with the anticipated fall in customs revenue was also underlined.

Finally, it can be anticipated that the BiH/FRY free trade agreement, by facilitating trade and simplifying border management, will have a positive impact on the consolidation of the single economic space inside BiH.

2. Real Progress in Banking Privatization and Reform

As the existence of a functional, well-regulated and competitive banking sector is fundamental to prospects for a viable economy in BiH, considerable effort has been expended by the State and Entity Governments and the IC to make this a reality. As evidence of their success, a prominent characteristic of the strengthened sector is the vigorous entry of foreign banks in the market, bringing new levels of competition and customer service to the sector.

In the privatization effort, both Entities are completing the process of identifying banks that have prospects for attracting investors, may be consolidated with other banks, or must be liquidated. The growth of privately owned banks has been strong, with 41 private banks (out of 53 total nationwide) controlling more than 80 percent of BH banking sector assets (KM 2.9 billion, out of KM 3.5 billion at 9/30/01). Majority private banks include eight formerly majority state-owned banks, and the remaining thirteen state-owned banks are in the final phase of resolution. In the RS, private banks now control more than half of the banking sector assets and foreign investors control 35 percent. Four of the eleven majority state banks have been privatized. In the Federation, on the other hand, roughly 90 percent of banking sector assets are in majority private banks and 70 percent in foreign banks. In fact, two international bank companies hold 50 percent of Federation deposits in four banks. Four of the ten majority state owned banks have now been privatized.

Equally encouraging, for the first time since the war Federation banks showed a net profit for the year – following three years of consecutive losses – in the amount of KM 33 million. Moreover, new savings increased from KM 599 million at yearend ’00 to KM 1.3 billion at yearend ’01, reflecting growing renewed confidence by the banking public. While the ownership issues are being clarified and liquidity is strong, the legal framework for the sector is also being revised. A working group composed of Federation banking officials and IC experts has recently completed a major draft revision of the Federation Law on Banks, aimed at addressing a range of deficiencies in the existing law, and has presented the draft to the Government for legislative action. The draft text has also been provided to the RS Finance Ministry for consideration of possible adoption. A follow-on joint working group will soon take up the task of harmonizing both Entities’ banking agency laws.

The bank deposit insurance facility, introduced by both Entities in 2001, is also developing well, with seven banks now members of the scheme in the Federation. State and Entity governments, following several months of working group drafting sessions involving representatives from both Entities and IC experts, are taking up draft legislation aimed at merging the two Entity schemes into a State-level body, with passage expected within the next few months.

3. Telecommunications

The pace of reform has unfortunately slowed further in the fourth quarter. Despite extensive efforts to move forward the establishment of a modern legal framework to create the basis for the reform of the telecom sector, thereby increasing BiH’s economic attractiveness, the Council of Ministers has failed so far to discuss the draft state-level Communications Law and the Action Plan. Unfortunately, this may become an obstacle in the forthcoming privatization process of the telecom operators as well. In order to have the operators ready for the privatization process, the two operators in the Federation – PTT BiH and HPT Mostar – have finally been separated into telecom and postal companies as of 01 January 2002. The World Bank and the EBRD held two privatization workshops in January 2002 in which they gathered politicians and representatives from the telecom operators and other business to discuss and identify the key issues that affect the success of a privatization.

4. Energy Sector – Fundamental reform underway

The implementation of the Power III loan project has progressed during the last three months. The objectives of Power III, set up by the World Bank, are to continue the reconstruction program in the power sector, to ensure access to reliable and lower cost electricity – supplied with reduced environmental and safety risks, and improved cost recovery by suppliers.

With the assistance of USAID the draft State-level Electricity law has been successfully consulted with the Entities and is currently before the Parliament. The law will further strengthen the single economic space in the BiH energy sector. It provides for the establishment of a regulatory commission with authority over electricity transmission, an independent system operator to manage the operation and dispatch of the transmission grid in BiH, and a single transmission company allowing for connection of the network to the grids in Western Europe. Following the adoption of the State-level law the Entities must prepare electricity laws with jurisdiction over power generation and distribution, thereby completing the legal and institutional framework in the electricity sector.

5. Economic Reform in the RS: Significant Progress, but Still Far to Go

In reviewing the legislative efforts of the RS Government, the RS Official Gazette includes 148 laws and amendments to laws within the economic area passed since the Dayton Peace Agreement in November 1995 (DPA). 101 of those were adopted before December 2000, an average of roughly 20 laws and amendments to laws per year (within the period of the DPA to December 2000). The current RS Government has adopted 47 laws and amendments to laws within one year (January 2001 to January 2002). Among the most important are: The Law on Contributions, The Law on Tax Administration, The Law on Public Procurement, The Law on Money Laundering, The Law On Citizen Income Tax, The Law on Property Tax etc. It is noteworthy that the current RS Government is the first administration to adopt an economic strategy and then to proceed based on that strategy. By doing so, *most of the primary goals for the year 2001 were reached, i.e.*:

- halting the increase of unemployment
- slowing inflation (increase of the retail price index of not more than 5%)
- regular due payment to budget users
- regular servicing of liabilities to the joint bodies in BiH
- regular servicing of external debt
- growth of actual gross national product by at least 5% (official data not yet published / forecast are below that figure)
- privatization of state capital has nearly reached the planned target of privatizing 50% of the state-owned book value

However, there is still much to do:

- a large and increasing trade deficit (increased by KM 200 million or roughly 20% compared to the year 2000)
- a continuing high unemployment rate despite a decrease of 4% in 2001
- the average net salary (roughly 323 KM) and the average pension (roughly 120 KM) are significantly lower than in the Federation
- a decrease of industrial production by roughly 12%
- continued stagnation in the privatization process

Privatization of the strategic companies is clearly one of the most important reform issues in the RS in order to facilitate market-oriented micro-level restructuring. In the fiscal area, the relatively low level of revenue collection – particularly regarding income and profit taxes – calls for concentrated attention.

Areas of major focus for policymaking in the year 2002 include:

- strengthening the operational capacity of the Directorate for Privatization
- fully implementing the Tax Administration Law, with a continued public campaign to increase RS taxpayers' awareness of their civic responsibility
- implementing an excise tax refund mechanism to prevent double taxation of excisable goods in inter-Entity trade and to tax at the level of consumption

Additional information regarding these and other RS developments can be found on the following web sites: http://www.vladars.net, http://www.rsprivatizacija.com.

6. Privatization – Heading for a good year?

In both Entities the privatization program is now progressing at a more rapid pace and the first encouraging – although very slow – results obtained in the group of small- and medium-sized enterprises (SMEs) are a sign that the restructuring of the country's economy and its transition into a free market is now well underway.

In the RS , the sale of capital in large scale enterprises through vouchers has been completed. The actual distribution of shares to the new shareholders (citizens or Privatization Investment Funds) took a long time due to the complexity of the operation and can now be considered as achieved. Most of the new General Assemblies have convened and the sale for cash or Foreign Currency Accounts of the remaining part of the State capital in every company is ongoing. So far, 66 out of 648 have been fully privatized.

In the category of small scale enterprises, the results are quite promising, with 42% of companies (115 out of 276) having now changed hands. The remaining part of this group is periodically offered and we expect more than 70 % of these firms will have been sold by the end of 2002.

For the strategic companies, the situation has not changed significantly and progress is slow. During the last three months three large enterprises (out of a total of 52) have been successfully sold to international investors. Three additional companies are under negotiation and their sale is imminent. The preparation of companies for tenders is progressing well with the assistance of the international advisors, with 21 companies having been offered. However, the rate of response by foreign investors is weak and more concentrated efforts need to be deployed by the Government and Privatization Agencies concerned as well as the FIPA (Foreign Investment Promotion Agency) to promote confidence in the future of the country and hence stimulate investments in the RS.

In the FBiH , the second round of Public Offering of Shares (POS) for certificate holders planned by Privatization Agencies for large scale companies has just been completed. The next step is to offer the remaining portion of State-owned capital for cash to major investors ready to support the financial needs and development of these companies and make them competitive both inside BiH and on the export markets. This is one of the main objectives for 2002. The third round of POS is to start in February with approximately 200 companies in this category remaining to be offered. Thus far, 14% (145 out of 1034) companies have been fully privatised. These results are disappointing and renewed efforts as already highlighted above for the RS are also needed from the FBiH Government agencies to stimulate the process.

In the small scale enterprises' category the results obtained are far more encouraging, with 62 % (199 out of 322) of the firms having been successfully sold to private interests, mostly for cash. By the end of 2002, another 20% of this category of companies should have been sold.

Since the beginning of the privatization process of strategic enterprises in 2000, only six (out of 86) companies have been sold thus far. This seems to be a very low result although one should recognize that the sale of these large firms depends on the international advisors' assistance which only effectively started at the end of 2000. As planned, the World Bank will be the last organization to enter the process and their experts are expected to start their privatization activities in the first months of 2002.

The Working Group on privatization (IAGP and FPA members) has effectively coordinated the preparatory work of the donor institutions in the last semester and one of its priority tasks has been to work out a revised list of strategic companies. The new list is reduced to 56 firms to be prepared for privatisation by international advisors. The remaining 30 companies will be privatized directly by the FPA or CPA concerned without donors assistance. The indispensable criteria of transparency, free access to data, fair treatment of bids, etc., will be respected for these companies as well and the FPA will regularly report to the Working Group on the progress made.

In both Entities, the large power and utilities' companies will be privatized at the end of the process and some of them will need to be restructured first. Most of the enterprises of this category will receive World Bank assistance.

Brcko

The Privatization Office of Brcko District published the first wave of six tenders for enterprises in Brcko District in September, 2001. The deadline for submission of bids was December 21, 2001. As a result, 24 bids were received of which 22 were considered appropriate. It is anticipated that privatization awards for these six enterprises will be made in March, 2002.

7. New PIO

The implementation of the FBiH Law on the Organization of Pension and Invalid Insurance has seen significant progress in the past month. Hampered by the existence of the two ethnically based parallel pension systems, the beginning of the implementation of this law has been long overdue. Consequently, the Federation pension system has been burdened by economic inefficiency and financial opacity. The implementation of this important law was part of the conditions for the World Bank’s Public Finance Structural Adjustment Credit II (PFSAC II).

The new single Pension Fund in the Federation was launched at the beginning of this year. The Federation government has appointed a temporary director of the fund and elected members for its Management Board. The new Pension Fund was registered on December 28, 2001; a single bank account was opened for the fund on January 11, 2002. The Pension Fund should start disbursing its first pension payment to all the pensioners in the Federation at the beginning of February.

The launch of the new Pension Fund is a significant step forward, but only the beginning of the complex pension system reforms that still need to be implemented in both Entities. Due to the fact that the reforms in the Federation involved the merger of two separate and parallel pension funds, the Management Board of the new Pension Fund has already appointed a Commission to assess the qualifications of the existing staff of the former two pension funds and to construct an operational strategy and staffing needs for the new unified fund. As a result of the reforms, some employees of the former pension funds are likely to lose their jobs, which means that there will be no facile solutions to the problems that lie ahead. The support of the International Community will be important in the upcoming months to ensure that the momentum for further reforms is maintained.

8. Tax policy and Tax administration

In December 2001 Ms. Milica Bisic was appointed as the Head of the Tax Administration (TA) in RS, resolving the issue of the Tax Administration’s normal functioning in RS. (Regulations heretofore could not be adopted without the signature of the TA’s Head.) The appointment has improved prospects of establishing a professional and efficient Tax Administration in RS.

The RS Government adopted a Decree on Allocation of Excise on the 4th of December 2001. FBiH has Gazetted the amendments regulating the allocation of excise tax in November, thus bringing the harmonization of the Excise Tax in BiH closer. The Entities are expected to meet with Brcko District authorities in March 2002 to agree upon and resolve their sales and Excise Tax laws.

The FBiH Tax Administration Law is expected to enter the parliamentary procedure for adoption by March 2002 at the latest. This law will enable smoother functioning and more empowerment of the FBiH Tax Administration. A similar Law has already been adopted in RS. Brcko has also adopted its own tax administration law.

On 14 December 2001, Gesellschaft fur Technische Zusammenarbeit (GTZ), in conjunction with OHR, convened in Sarajevo the first official seminar on Value Added Tax (VAT) in BiH. Chaired by Principal Deputy High Representative Donald Hays, the seminar was attended by the Minister for Treasury of the Institutions of BiH, Ante Domazet and officials at the Entity levels (including the District of Brcko) and by a broad range of representatives from the International Community. GTZ’s eminent VAT expert, Eckart Brandt-Pollman presented the opening technical presentation. The successful outcome of this first VAT seminar was encouraging, with the establishment of a VAT working group to steer further and possibly more specific events and exchanges of ideas during 2002.

9. Budgets

Both BiH State Institutions and the Federation have re-balanced their budgets for 2001. Slight internal modifications have occurred in the RS budget but the overall amount has remained unchanged.

The budget for the BiH Institutions has been increased by 15% but, despite an increase in transfers from the Entities, it has not yet been executed due the fact that the Law on the use on succession funds has not yet been passed and the funds have not been disbursed. This law, as well as the 2002 budget, should be passed in coming weeks as there is a provisional budget for the first three months of the year. Discussions with the IMF on this draft budget – which is about 110 million KM higher than the 2001 re-balanced budget – are continuing.

In the Federation, an increase in revenues led to a re-balanced budget 19% higher than the initially proposed figure. For 2002 budget has finally been passed at the beginning of March both at the House of Peoples and the House of Representatives and it should amount to 1,559 million KM.

The RS managed to execute its budget in 2001 nearly according to plan. The 2002 budget has been adopted and totals 890 million KM (8% more than in 2001).

In Brcko District, the 2002 budget has been passed, totalling 136.4 million KM, 20% more than last year.

Finally, as of the beginning of January, the Single Treasury Account is being implemented which should improve efficiency and transparency.

10. Transport – Moving Forward

On November 29, in Sarajevo, Ministers of BiH**,** Croatia and FRY signed a letter of intent on cooperation for the management of the Sava River Basin (under the framework of the Stability Pact). This should result in the re-opening of the river to international navigation.

BiH signed an agreement with the Central European Air Traffic Services (CEATS) in September. A contract with Croatia Control Limited to provide air traffic control services to BiH in the medium airspace became effective on 27 December 2001. Deployment of the State Border Service have been completed at Banja Luka and Mostar airports and a similar deployment at Tuzla airport will follow.

The BiH Civil Aviation Security Program has been drafted, and is being reviewed by Eurocontrol. The Operational Assistance Project (OPAS) Coordinator has established his office in Sarajevo and has now been legally appointed to the position of Administrator of the BHDCA. Regrettably, the delay in establishment of the OPAS Project prevents BiH membership of ECAC before the end of 2002. BiH membership to Eurocontrol will follow shortly thereafter.

Both the RS and Federation governments recently passed Railway Laws. For the Federation, the law incorporates both the ZBH (Zeljeznice Bosne i Hercegovine) and ZHB (Zeljeznice Herceg Bosnia) railways under the new ZFBiH (Zeljeznice Federacije Bosne i Hercegovine – Railways of the Federation of Bosnia and Herzegovina).

In the road transport sector, the state government has now passed legislation on the Law on International and Inter-entity Road Transportation, which provides the basis for state level licensing and regulation of international and inter-entity truck and bus transport.

11. BiH Economic Data January 2001 – January 2002

Source: FBiH and RS Statistical Offices

Indicator	Federation of BiH	Republika Srpska	BIH (OHR estimate)

GDP nominal 2000 GDP nominal 1999 Nominal increase 1999-2000 Real increase 1999-2000 (minus inflation)	6,698 billion KM 6,141 billion KM + 9,0% +7,8%	2,463 billion KM 2,180 billion KM + 13,0% -0,6%	9,161 billion KM 8,321 billion KM +10,0% +5,5%
Index of Industrial Production 2001 compared to 2000 12/01 compared to 12/00	 +12,2% +7,4%	 -12,9 % -25,4%	 +3,8% -3,53%
Retail Price Index 2001 compared to 2000 12/01 compared to 12/00	 +1,7% + 0,3%	 +6,5% +2,2%	 N/A N/A
Average Net Salary 12/01 compared to 2001 average	457,68 KM +7,3%	332 KM +12,7%	412,5 KM +9,24%
Number of Employed 12/01 Number of Registered Unemployed 12/01 (RS 09/01)	405.689 persons 269.004 persons	227.740 persons 153.231persons	633.429 422.235
Number of pensioners in 10/01 (RS 09/01) Average pension in 10/01	279.359 persons 170 KM	179.835 persons 105 KM	459.194 persons 145 KM
Imports 2001 Exports 2001 Trade deficit 2001 Import/Export coverage	5,113 billion KM 1,746 billion KM 3,367 billion KM 34,1%	1,697 billion KM 0,599 billion KM 1,098 billion KM 35,3%	6,810 billion KM 2,345 billion KM 4,465 billion KM 34,4%

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