

# **Economic Newsletter Vol. 4, Issue 2, April 2001**

## **Economic Reform and Reconstruction Bosnia and Herzegovina**

### **Feature Article:**

#### **A Clear Path to the Future: the EU Road Map**

If there is one long-term project in BiH that meets with clear consensus and unambiguous interest across the international community and within the country's fragmented political environment, it is the prospect of joining Europe. For all practical purposes, "Europe" as a political and geographic horizon has become synonymous to "peace and prosperity." With equal agreement, the accession process is expected by all to be lengthy and, at times, arduous.

While the EU has made the commitment to see BiH, and all countries in SEE, reach, in due course, "candidate" status and then full EU membership; it has outlined requirements which must be fulfilled for the accession process to move forward. These requirements are embodied, itemized in fact, in what is widely known and referred to as the "EU Road Map." The Road Map essentially lists short-term policy reform objectives that must be met for the EC to undertake a Feasibility Study towards a Stabilisation and Association Agreement (SAA) that will establish the framework to obtain EU candidacy status. It specifies both a concrete agenda for reform and indicator of political commitment.

While the contents of the SAA are meant to be specific to each country's circumstances, all SEE countries follow the same general process—i.e. (1) demonstrated commitment to policy reform, (2) Feasibility Study, and (3) SAA. So far only the FYROM has reached, in April 2001, the SAA level. Feasibility Studies have been completed for Croatia and Albania. The Study, in the case of Croatia, concluded that the country was ready for negotiations on a SAA while the opposite conclusion was reached for Albania.

BiH is now at a critical juncture in this process. By the middle of this year, the EC is expected to determine if sufficient progress has been made on the Road Map to recommend a Feasibility Study. There is more at stake than the long-term prospect of EU membership. There are increasing indications that the EC, the largest donor in BiH, will condition levels of future assistance to demonstrated progress towards the SAA. Moreover, the holding of a Consultative Group meeting of all donors may also depend, among other issues, on Road Map progress.

The specific Road Map items reflect both key reform issues of immediate relevance, and—in a longer-term perspective—building blocks for the social, economic and political environment expected to prevail in a normally functioning EU country. There are 20 items in three main areas: (1) political, (2) economic and (3) democratic development.

The 6 economic items are:

- abolishment of payment bureaus,
- establishment of State Treasury,
- removal of all trade barriers between entities,
- establishment of a single BiH National Institute for Standards,
- adoption of laws on Competition and Consumer Protection, and
- implementation of FDI legislation.

The first two items were largely completed by the beginning of this year. The abolishment of the payment bureaus, a very important step for the promotion of market-based financial intermediation, went more smoothly than expected. The Law on the State Treasury was adopted in September 2000. As a ministerial state-level agency, the Treasury will obviously play a key role in the development of central institutions.

Differences in regulations and standards can act as a barrier to internal trade. Efforts have been made to identify

and remove remaining obstacles, but more remains to be done. (Harmonization of entity excise taxes was a significant recent accomplishment for internal trade in excisable goods.) A Law on Copyrights and Industrial Property should also be on the legislative agenda before long. To help smooth out differences on policy reforms issues an institutional framework for direct negotiations, at senior levels, between the entities has been set up.

A National Institute for Standards, Metrology and Patents was duly established in November 2000, but adequate funding for this State institution remains a difficult issue. A draft Law on Consumer Protection is currently under consideration by the Council of Ministers but will likely need be revised before adoption. A Law on Competition is awaiting parliamentary procedure. Finally, the implementation of the Foreign Direct Investment Law must be achieved in the entire country.

Overall, even if good progress on Road Map economic items has been made, the jury is still out on whether pending issues can be overcome in the near future. Demonstration of commitment to reform remains the key. It need also be mentioned that other, non-economic, areas of the Road Map will be decisive for the EC in making its decision to pursue with the Feasibility Study. These include, to mention one of the most important and still contentious items, the adoption of a permanent election law. Failure to bring resolution in any key area would likely result in the Feasibility Study being postponed to another political cycle. \*\*\*\*\*

### **Further Strong Growth in 2000, But Serious Problems Remain in the Balance of Trade**

Preliminary analysis of published data of the Entities' Statistical Offices indicates that BiH experienced continued high economic growth rates in 2000. The increase of industrial production indicates that the GDP growth rate will be above 5% (final GDP 2000 data are expected by mid-2001). Net salaries increased in both Entities significantly and contributed positively to consumer demand. The inflation rate (retail price index) continued at a very low level in the Federation, and remained at a higher level in the RS, indicated by a sharp price increase of services and agricultural products. The employment situation did not change substantially in 2001 – a level of 646,000 official jobs was maintained as well as a persistently high level of unemployed persons.

In addition to the serious situation in the social sector (high unemployment and low pension level payments) the problems in the balance of payments are a cause of concern, with no discernible progress achieved in the past year. Import levels are almost triple those of exports, thus suggesting that the potential offered by recently opened EU markets is not being exploited by BiH companies. Further economic reforms – particularly in privatization and restructuring – must be accelerated in 2001. While an increased inflow of foreign direct investment would facilitate the restructuring of the economy, creating a favorable investment climate remains a challenge for the BiH authorities.

### **Public Utilities**

#### **Implementation of Dayton Annex 9 High Level Coordination Continues**

The five-member, Prime-Minister-level BiH Commission on Public Corporations (CPC) met again April 17, 2001 after a five-month hiatus in the wake of the general elections in BiH. The two new Entity Prime Ministers and the new Federation Deputy Prime Minister have assumed their role on the Commission and agreed to move forward with work on analysis and design of new Annex 9 public corporations in the fields of gas transportation, power transmission, radio transmission infrastructure and posts. Expert working groups are being formed.

### **Transportation Sector News**

A key milestone on the road to recovery and reform in the transportation sector was the completion of the twenty-year Transportation Master Plan by the Japanese International Cooperation Agency (JICA). The final draft, completed after two years of work, was unveiled at a seminar on February 8, 2001, attended by the Ministers responsible for transport from the State and the Entities. There was general acceptance of the findings and consensus to implement the recommendations. Copies of the final JICA report will be available in late May 2001.

### **Air Transport**

Another milestone in the transportation sector was the opening of the new airport terminal in Sarajevo on March 14, 2001, financed largely by the EU and the Dutch Government. In addition, a new air service was inaugurated by Air Commerce and Mastair, providing twice weekly service between Sarajevo and Banja Luka and on to Ljubljana.

### **Revitalizing the Railways**

The Railway Public Corporation, designed to manage the railway infrastructure within BiH, was recently legally registered in the two entities. Negotiations for the EURO 50+ million EBRD/EIB Railway Recovery Loan went into the final stages. Moneys will be used for re-construction of a backbone of the BiH network along European Transport Corridor Vc, and parallel to X. A Project implementation Unit (PIU) will be established within the RPC and located at Doboj. The loan project will also receive technical assistance from Canada and the US-TDA for a corporate information system, business planning, railway accounting systems and tendering processes. On the Zagreb-Bihac-Knin railway line freight service was re-inaugurated in January 2001 after a nine-year stoppage. Passenger trains are to be added this summer. However, many stretches of railway infrastructure are suffering from the lack of maintenance and this is an increasing concern. It has meant that some portions of line operate below acceptable safety levels.

An international Conference on Railways in BiH was held in Banja Luka on May 4 that brought together international railway representatives, decision-makers from government and local railway officials to explore solutions that would lead to more intensive and more efficient use of the BiH railways system. The conference addressed reconstruction and financing requirements and helped identify key reorganization needs.

### **Road Improvement Measures**

There is a continuing need for road network maintenance improvement and for structural improvements at critical bottlenecks to improve road traffic safety. Both, the Federation and RS have been in negotiations with the EIB for a new EURO 60 million road improvement loan. BRIC, the new Joint Road Infrastructure Public Corporation, is expected to develop common road standards and to coordinate road network management between Entities. The World Bank has plans for a new Road Assistance Project (Transport III) worth USD 30 million, focusing on roads in key economic corridor roads and addressing road safety problems. The Sarajevo – Pale road was recently opened on an interim basis to permit traffic in and out of Sarajevo to and from Pale and further east. Republika Srpska is in negotiations with the EIB for using part of a Euro 20 million loan for permanent reconstruction of the section affected by landslides.

### **Progress with Telecommunications Sector Reform**

The new Telecommunications Policy for BiH that promulgates privatization and staged liberalization of the sector by 2005 was approved by the BiH Council of Ministers in November 2000 and became official on February 14, 2001. The functions of the BiH Telecommunications Regulatory Agency (TRA) and of the Independent Media Commission (IMC) were combined on March 2, 2001 to form the new Communications Regulatory Agency (CRA). The organizational changes at the regulatory level are expected to result in a more decisive and coordinated implementation of pro-market reform in the communications sector. The World Bank has offered technical assistance with sector restructuring, privatization and other transition measures, including for the separated postal services, as well as regarding a concession for the radio transmission infrastructure system and to explore e-commerce and cyber-park opportunities. On April 30, 2001 the CRA granted national GSM licenses to the two state-owned mobile telephone operators, PTT-BiH and Mobilna Srpska. Concurrently, a call for tenders for a third national GSM license was issued. Closing date for submissions is June 15.

### **Energy Sector Reform Electricity Law Delays**

The start of energy sector market reform in BiH still awaits passage of an appropriate Electricity Law in the RS. The submission of new Electricity Laws to Entity Parliaments endorsing, among other, a new regulatory institutional framework, is a key condition for obtaining World Bank (IDA) approval of the Power III Loan Project worth US \$230. NORAD of Norway has assisted with the drafting of the new Electricity Laws. Interest in co-financing Power III has been expressed by EBRD, EIB, Germany, France, the Netherlands, Greece and Canada. Even if all conditions were met today, given the delays encountered so far in achieving consensus on the parameters for sector reform, Power III loan disbursements will not likely happen before 2002.

## **Tax Reform**

The International Monetary Fund projects regarding harmonization of the Sales Taxes has been finished during April 2001. The governments in the Republika Srpska and the Federation of Bosnia and Herzegovina have reached the following agreement:

1. the general sales tax rates will be 20% in both Entities
2. the lower rate 10% in both Entities
3. no exemptions for constructions materials
4. no sales tax on the whole sale margin

The Federation government has temporarily lowered the road tax and sales tax on oil. This was necessary in order to avoid jeopardizing the agreed harmonisation of taxes reached last year. When the government in Republika Srpska has restored the level of road tax, the decision in the Federation will be amended.

On April 5<sup>th</sup>, the Federation Government adopted a proposal for consideration by the Federation Parliament to lower the wage tax by 5% and the contribution on salary by 1.5%. No analyses were conducted on what impact it would have on the municipalities' and cantons' income. The tax burden for employers in the Federation is high, but as long as there is no proper registration and control of taxpayers, IC experts say, tax cuts can have the opposite effect than intended: instead of increasing the budget with more taxpayers complying with the system, the authorities might face a decrease in the revenues paid in.

On April 3<sup>rd</sup>, the German Technology Zusammenarbeit (GTZ) began their work on the modernisation of the Income Tax Law for physical persons and corporations, with a 5 day seminar in Banja Luka. By January 2002 a harmonised Income Tax Law should be in place in both Entities and the Brcko District.

## **Payment Bureau Elimination**

At the Peace Implementation Council in Madrid in December 1998, it was decided that in the framework of the necessary economic reforms in Bosnia and Herzegovina a transfer of the functions of the Payment Bureaus to the relevant public and private institutions was called for. The deadline for the reform process, resulting in the dismantling of the Payment Bureaus, was set for December 31, 2000.

Since the beginning of 1999 the International Advisory Group for Payment Bureaus and Payment System Transformation, chaired by USAID and consisting of representatives of all major organizations with an interest in finance and economics, has been assisting the local authorities to accomplish this complex and important task.

The new payment system, enabling financial transactions of commercial banks via the Central Bank's clearinghouse, started operating successfully on January 5 of this year. After a short period in which the banks adjusted to their increased responsibilities and workload, the payment system is currently operating smoothly.

Beside the establishment of a new payment system, a number of functions that were previously carried out by the Payment Bureaus have been transferred to the appropriate public institutions such as the Cantonal and Entity Treasuries, Tax Administrations, Customs Administration, Statistical Agencies, and the agencies responsible for privatization in both Entities.

The transfer of the responsibility to carry out all of these functions to the above mentioned institutions are considered to be a major step forward for the economic development of Bosnia and Herzegovina. The reforms allow for a financial system that is more reliable and less costly for its customers and for more transparency and control of government revenues and expenditures. Thereby, the successful completion of the project is expected to have a major impact on the general business environment of Bosnia and Herzegovina.

## **Privatization**

### **Voucher Offer/Public Offering of Shares (POS) -**

In the Republika Srpska, the Voucher Offer that began in November of last year ended on March 15. Citizens and thirteen Privatization Investment Funds (PIFs) were offered 55% of state equity in 830 enterprises. Out of a total of 49 million vouchers issued, over 84% were utilized, of which PIFs collected 57% which were invested in 530 enterprises. The remaining 30% of state-owned stakes in enterprises initially offered will be privatized either for cash or by conversion into shares and traded on the stock exchange now being established. The next steps in the process include the calculation of the percentage of ownership and the issuance of statements, and full operation of the Central Registry of Securities.

In the Federation, the first round of the first wave of the Public Offering of Shares (POS) which began on October 30, 2000 was completed on March 28. A total of 542 enterprises were offered to certificate holders, both citizens and ten PIFs. The amount of certificates subscribed was 4.25 billion KM, of which 1.2 billion KM was directly invested and 3.05 billion was invested by PIFs. A total of 76 out of 542 enterprises were successfully sold, i.e. where the subscription was in the range of plus/minus 20% of the initial price. The remaining 466 enterprises, which were either over- or under-subscribed, will be offered for sale through the second round of the first wave beginning on April 16, when a pro-rata method will be applied. Privatization officials and IC advisors agree that the POS must be completed by yearend without further alterations.

### **Tender Privatization**

In the RS, the international community has committed to provide assistance for 52 enterprises selected by the International Advisory Group on Privatization (IAGP), which is now underway. To date, the Directorate for Privatization (DFP) has carried out eight unsuccessful tenders, but the DFP's Department for Sales of Strategic Enterprises has only recently become fully operational, with a more successful outlook in store.

In the Federation, 86 enterprises were selected by the IAGP for tender privatization with consultant assistance being initiated by IC donors. It should be noted that strategic sector utilities (e.g., energy, telecommunications, natural gas and water) will require special analytical efforts by donors and BiH governments. In the energy sector, the objectives will be: to achieve a restructured and competitive power system with substantial international private sector participation under a modern energy regulatory framework; and expanded integration of the BiH power system with other Southeast Europe countries and Western Europe.

## **Economic Data BiH for 2000**

Source: RS and FBiH Statistical Offices

| Indicator   | Federation of BiH | Republika Srpska  | BiH (OHR estimate) |
|---|-------------------|-------------------|--------------------|
| Index of Industrial Production 2000 compared to 1999 average                | +8,8%             | +5,6%             | +7,7%              |
| Retail Price Index 2000 compared to 1999 average<br>01/01 compared to 01/00 | +1,2%<br>+ 4,3%   | +13,6%<br>+ 12,2% | N/A                |

|  |   |   |   |
|--|---|---|---|
| Average Net Salary 2000<br>2000 compared to 1999 average<br>Average Gross Salary 2000<br>2000 compared to 1999 average | 413 KM<br>+16%<br>606 KM<br>+9%                             | 277 KM<br>+22%<br>386 KM<br>+18%                          | 365 KM<br>/<br>528 KM<br>/                                  |
| Number of Employed in 2000<br>Average Registered Unemployed  | 412,311<br>persons<br>265,542<br>persons                    | 227,740<br>persons<br>154,236<br>persons                  | 640,051<br>419,778  |
| Number of pensioners in 12/00<br>Average pension in 12/00  | 281,005<br>persons<br>171 KM                                | 172,405<br>persons<br>80 KM                               | 453,410<br>persons<br>136 KM                                |
| Imports – total for 2000<br>Exports – total for 2000<br>Trade deficit in 2000<br>Import/Export coverage                | 4,8 billion KM<br>1,4 billion KM<br>3,4 billion KM<br>29,5% | 1,7 billion KM<br>0,8 billion KM<br>0,9 billion KM<br>48% | 6,5 billion KM<br>2,2 billion KM<br>4,3 billion KM<br>33,8% |

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