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Economic Reform and Reconstruction Bosnia and Herzegovina

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1. The Stability Pact: Regional Integration on the Road to Europe

There is virtual unanimity, in South Eastern European countries, that the way forward is integration to Europe. Less obviously perhaps, the process of integration to Europe, will also require better intra-regional relations and enhanced cooperation, and quite importantly so, in the economic sphere. Regional cooperation is the main agenda of the Stability Pact and its three Working Tables, established since July 1999. Recently progress was signaled on trade liberalization. Bosnia Herzegovina has also become an active partner in the Pact.

Trade Liberalization

On 27 June 2001, a very significant, if little noticed, event took place in Brussels. Ministers from Albania, Bosnia Herzegovina, Croatia, FYROM, the FRY, Romania and Bulgaria—the so-called beneficiary countries of the Stability Pact—signed a

Memorandum of Understanding on Trade Liberalization. This MoU signals a commitments for these countries to liberalize 90% of mutual trade in value by the end of 2006. The MoU covers both the agricultural and industrial sectors.

The MoU foresees that already existing bilateral free trade agreements will be expanded to cover all trade partnerships between countries by the end of 2002. When fully implemented, the South Eastern European region will have become a true regional economic space, more attractive to domestic and international investors. Importantly, liberalized trade will also signal that the region is finally at peace, stable, and ready to do business.

Trade liberalization is but an important agenda item of the Stability Pact. Working Table II on Economic Reconstruction and Development also includes, among others, regional initiatives on banking, private sector development, social cohesion, the “electronic” economy, and investment.

The Investment Compact

The Investment Compact is one of the major initiatives of Working Table II. The Compact is (1) a commitment by SEE countries to undertake policy reforms to improve the investment environment, (2) a commitment by donor countries to support this process through concrete projects, and (3) a process to monitor reform, identify needs and facilitate implementation and policy dialogue. The Compact has already issued “Country Fact Sheets”—which give a snapshot on the investment environment and major policy issues—and the first draft edition of the “Monitoring Instruments” which provide, in table format, a comprehensive and specific list of policy measures with target dates, responsible agencies, and status. Each country’s work is carried through a Country Economic Team that includes participants from government, the private sector, and the international community.

The Investment Compact provide an excellent opportunity for a mapping out effort on a complex policy agenda and the occasion for regional dialogue and emulation. Donor-funded projects support this work in several areas such as best practice for bilateral investment treaties, and foreign investment promotion.

Bosnia Herzegovina will co-chair Working Table II from July to December 2001

After a late start, Bosnia Herzegovina has become an active and fully engaged partner in the Pact since October 2000. The Ministry of European Integration includes a division whose responsibility is to manage relations with the Pact, and coordinate Bosnia Herzegovina participation in activities of all three Working Tables. The Ministry recently issued a Progress Report in May 2001 and an information document "Participation of Bosnia Herzegovina in the Stability Pact for South Eastern Europe" in February 2001 (now available in English). Both documents, and the activities they reflect, were noted as very useful contributions to the Pact.

The three Working Tables function with the principle of six-monthly rotating co-chairmanship. It was confirmed in May, that Bosnia Herzegovina would succeed Albania as the co-chair until the end of December 2001. This means the international plenary meeting will be hosted by Sarajevo in November 2001, under the responsibility and coordination of the Ministry of European Integration.

This responsibility comes at an important time for both Bosnia Herzegovina and the Pact. The country is currently making efforts to accede to the Council of Europe, complete road map items for the EU Stabilisation and Association Process, and prepare for its first Consultative Group meeting with donor countries which is envisaged for late 2001. The Stability Pact will hold its second Regional Conference (formerly called Regional Funding Conference) in Bucharest on 25-26 October.

This Regional Conference should confirm clear regional strategies in key sectors as well as donor support for projects that will implement components of these strategies.

2. Stability Pact Regional Initiative on Social Cohesion: An opportunity for reform of the social sector in BiH

Following extensive consultations between partners from South Eastern Europe and international organisations, under the umbrella of the Stability Pact (SP), the "Initiative on Social Cohesion Employment Policy and Vocational Training" has recently been launched. While a representative of the French government will hold the chairmanship of the initiative the co-chairmanship, on a rotation basis, has been offered to the government of the Republic of Yugoslavia.

The Initiative attempts to address, with a regional approach, outstanding issues in the area of social policy common to all the South Eastern European countries engaged in the transition to a market economy. Among others, high unemployment, low living standards, equal access to social care, and inadequate institutional and administrative schemes have been identified as key priorities.

The various levels of governance of BiH have shown interest in fully participating in this Initiative. With the objective of assuming a proactive role and presenting a common strategy the Minister of European Integration will chair a co-ordination meeting with the participation of concerned BiH Ministers. A representative of the SP will also attend.

Bosnian authorities appear determined to use this learning opportunity, using harmonised reform programs within European Community standards, to strengthen existing programs and, eventually, to attract financial support. It is clear that the reform of the social sector not only increases public spending but can also promote economic development.

3. Privatisation – Progress and Optimism

RS –

Despite the initial problems, uncertainties and resistance to change linked with the implementation of any privatisation programme, the new Directorate of Privatisation is now well underway and making encouraging headway.

Privatisation of small-scale enterprises is progressing at a good pace, with about 100 of a total of approx. 300 companies of this category having been sold for cash thus far.

According to the RS privatisation law, 55% of the shares of large scale companies to be privatised have been offered to voucher holders until the end of March and from then on, the new shareholders have been systematically registered and notified accordingly. This group of investors comprises citizens as well as Privatisation Investment Funds (PIFs). This process has just been completed and General Assemblies of new shareholders will be convened to reflect the new ownership structure in all companies concerned. The next step is to sell for cash, through tenders or direct negotiations, the 30% of capital, with the remaining 15% being earmarked (as set by law) for the pension and restitution funds. This phase has also started and 95 companies have been sold to date.

For the group of some 52 strategic enterprises being offered for sale through international tenders and designated to receive foreign support to prepare their privatisation, the allocation of international advisors is nearing completion. In this category of enterprises, three are being sold at the moment: Banja Luka Brewery, Birac Bauxite Mines and Celex Paper Company.

Overall and at this stage of privatisation, one can consider that 37% of the total RS State owned portion of capital in all enterprises categories has passed into private hands. With the present pace of privatisation we consider that close to 50% of

the total companies' capital should have been privatised by the end of this year.

Federation –

Several changes have occurred recently in the Federal Privatisation Agency (FPA), with the nomination of a new Management Board and a new Director. Since then, a fresh impulse in the privatisation pace is clearly perceptible. Cooperation between the International Advisory Group on Privatisation (IAGP) and the FPA has noticeably been enhanced also through the recent creation of a new Working Group IAGP/FPA, of which OHR is an active player together with USAID, GTZ and EU representatives. Its purpose is to find common solutions between the IC and the local privatisation agencies, to speed up decisions and to more effectively prepare the strategic companies to be tendered.

The privatisation advisors selected by the EU have effectively started their work in more than ten of the strategic companies selected and progress is encouraging. The WB experts will, for their part, begin their advisory work by year end or early 2002 as previously agreed. The WB has selected some 24 strategic companies to which experts will be assigned.

In the Federation also good progress has been registered in the privatisation program in the last quarter. To date, 174 out of a total of 322 small-scale companies have been sold through auctions, tenders or direct negotiation.

In the large-scale enterprises, the two rounds of the first Public Offering of Shares (POS) were successfully completed at the end of May. During this phase, certificate/voucher holders could take a 33% shareholding in the capital of offered companies. 537 companies have been partially sold and the next step has now begun with the objective of selling for cash the remaining portion of the State owned capital. The second wave of POS is planned to start soon.

Concerning Aluminium Mostar, the most successful company in the whole of BiH and its biggest exporter, its disputed capital structure has led OHR to commission an independent legal audit performed by a team of local lawyers headed by an internationally-recognised legal consultant. The team's report analyses the present ownership structure and contains well balanced recommendations concerning the compensation of former employees on a non-discriminatory basis. The report will be released toward the end of August and OHR will propose its plan of action, acting as a mediator between the Government, the Federal Privatisation Agency and the Company's management to find the best means of implementing the recommendations of the report.

4. Transportation – New Agreements Paving the Way

Air Transport

At a meeting in Vienna on April 19, 2001, an agreement was signed between ICAO and BiH for the implementation of the ICAO sponsored Operational Assistance (OPAS) program, which will provide the necessary technical assistance for BiH to take over management responsibility for the authority over its air space. This includes the appointment of an interim international administrator of the BiH Department of Civil Aviation (BHDCA).

The transfer of the provision of air navigation services for the middle air space of BiH to a single interim service provider at Zagreb was confirmed at a meeting of the International Working Group June 13-14.

Rail Transport

A passenger train embarked from Sarajevo to Zagreb on Sunday, June 10 for the first time since the war broke out in the region almost 10 years ago, paving the way for improved links between Bosnia and its neighbors. The celebration also involved the re-opening of the Sarajevo rail terminal, which

has been re-built at a cost of some 3 million KM, financed by the Railway Public Corporation, BHZJK.

Negotiations for the EURO 61 million EBRD/EIB Railway Recovery Loan were completed with a signing ceremony in Sarajevo on June 11, 2001. Moneys will be used for re-construction including repair of the electrification system on 750 km of the backbone of the BiH network along European Transport Corridor Vc, and parallel to Corridor X. A Project Implementation Unit (PIU) is being established and will be 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.

Road Transport

BiH Road safety was somewhat better than in the first five-month period of last year. A total of 7,981 road accidents were registered, eight per cent less than in the equivalent period last year. Sixty-one persons were killed, while 507 were seriously injured and 1,531 were lightly injured. The most serious road accidents have been caused by excessive speed unsuited to road conditions and drunk driving.

Montenegrin Prime Minister Filip Vujanovic and his Republika Srpska counterpart Mladen Ivanic on Monday, July 8, opened a newly-built section of the highway Herceg Novi – Trebinje from Sitnice to Petijevica.

Bus services were established on the Mostar-Trebinje-Dubrovnik routes by UNHCR and Gorazde-Serb Gorazde, with the approval of a license for a local firm. Both services are important for supporting the needs of refugee returnees.

May 26 saw the inaugural meeting of the RS Trucking Association. This is a milestone in creating the basis for a BiH Trucking Association, which can represent the industry on international bodies and implement the TIR Carnet system

designed to allow BiH trucks smooth access to other European countries. The TIR Carnet system is administered by the International Road Union.

5. Telecommunications Sector – Fundamental Reform Underway

With the regulatory institutional framework – the Independent Communications Regulatory Agency (CRA) set up in March 2, 2001 – now in place, the focus has shifted towards establishing a modern legal framework. The new Communications Law will combine provisions for broadcasting issues and telecommunications, and allocate the necessary authority to the CRA for exercising regulatory tasks. However, the Communications Law still awaits adoption of the Council of Ministers.

On July 16, the CRA organised a seminar on telecommunications, gathering EU Commissioner Liikanen, Ministers, business representatives and international experts to explore solutions regarding the opening of the fixed telecommunications market. There was general acceptance that the separation of telecommunications services and postal services in the Federation as well as the privatisation of all three incumbent operators urgently need to be tackled. In addition the CRA was instructed to draw up, in consultation with the CoM, an action plan for the staged liberalisation of the sector.

The process regarding the third national GSM tender has been halted. After the Chairman of the Council of Ministers declared that he would not recognize the selection made by the CRA, two bidders out of five expressed their intention not to participate further, thus placing a *de facto* halt on the tender.

6. Banking Sector – New Entrants, New Confidence

The BiH banking sector is in the midst of a substantial transition, characterised by volatility as assessments of

banks' liquidity take place as part of the ongoing privatisation process, as well as an extensive review of existing banking regulations with a view toward drafting reform legislation. The privatisation process has proceeded particularly slowly, which has in turn delayed dynamic growth in the overall financial sector. This process is now nearing culmination, with a yearend deadline (extended from June 30 to enable ongoing negotiations to conclude) for identifying those banks that will be liquidated.

Despite systemic weakness pervading the sectors – stemming largely from widespread improper loan practices – progress is being realised in establishing sound, functional banking services for the entire country. The entry of several major foreign banks in the BiH market has stimulated new competition and introduced new standards of service, and the recent establishment of deposit insurance has already begun to generate renewed consumer confidence in bank deposit security. A working group composed of Entities' representatives and international experts is engaged in efforts to create a single deposit insurance agency and fund to enhance the viability and breadth of the deposit insurance facility.

Other positive features of the current situation include the virtually hitch-free transfer of the former payment bureaus' functions to the commercial banks, close coordination between the Entities' banking regulatory agencies and the Central Bank, and the authorities' increased awareness of the need for extensive reform of the regulatory framework.

Republika Srpska

Only one-fourth the size of the Federation banking system, the RS banking structure is small and weak, with over 85% of banking assets in state-owned banks now engaged in the privatisation process. The banking system has been undercapitalised and poorly managed, with total assets at yearend 2000 of 600 million KM, total deposits of 330 million

KM and total capital of 186 million KM. The eleven state-owned banks' Opening Balance Sheets were approved and determined to be solvent, but all tenders for these banks have been unsuccessful. There has been, however, some success in the sale of a small number of private banks, primarily to foreign banking concerns.

Federation

There are now 38 licensed banks in the Federation (down from 55 at yearend 1998), with total assets of 2.5 billion KM, total deposits of 1.7 billion KM and total capital of 625 million KM. While the Federation banking system produced net losses for 1999 and 2000, these losses declined substantially and were concentrated in a small number of banks (two banks accounted for 92% of total losses). On the whole, the condition of the Entity's banking sector is considerably healthier than that of the RS. The privatisation of the PBS-related banks has been delayed but an arrangement negotiated with the IFC (World Bank) has significantly reduced the obligations of these banks, thereby substantially increasing their potential attractiveness to investors. Four banks (Raiffeisen, Volksbank, Zagrebacka Bank and UPI Bank) have qualified for the newly-established deposit insurance fund, which insures accounts up to 5,000 KM per person, per bank. Two of the foreign banks, Zagrebacka Bank and Raiffeisen Bank, have aggressively entered the market and now account for approximately 30% of market share. Of significant importance, the Federation Banking Agency has increased its activities in addressing the problem of deficient liquidity, both in monitoring and by revising the banks' liquidity minima. Intensive ongoing efforts to improve the legal and regulatory framework of the banking system will continue to enhance consumer confidence and participation in this sector

7. Taxation – Harmonizing and Stabilizing the

Revenue Flows

In July the German Technology Zusammenarbeit (GTZ) convened its second seminar on the draft text for a new Income Tax Law for both natural and legal persons. In September the final draft will be presented to the Governments in the Entities and the Brcko District for legislative consideration. GTZ will also organize a seminar with simulations of tax revenues at different levels in BiH before this proposal on income taxes is implemented.

The Federation, the first entity to do so, has sent the amendments to the excise tax law to the Parliament. When these amendments are adopted one of the major impediments to free trade within BiH will have been removed. Later in the fall the two Entities and the District are expected to adopt a harmonized Tax Administration Law which will create a new Tax Administration (TA) in the RS (merge the Revenue Administration and the Financial Police) and provide all three TAs with tools to combat tax evasion. This new law will also facilitate cooperation and coordination of tax control and enforcement between the three Administrations.

8. BiH Economic Data January-May/June 2001

Source: FBiH and RS Statistical Offices

Indicator	Federation of BiH	Republika Srpska	BiH (OHR estimate)
Index of Industrial Production 06/01(FBiH) 05/01 (RS) compared to 2000 average 06/01 (FBiH) 05/01 (RS) compared to 06/00 (FBiH) 05/00 (RS)	+11% +11.9%	-12.6% -7.7%	+3% +5.3%

Retail Price Index 06/01 compared to 2000 average 01-06/01 compared to 01-06/00	+1.8% + 3.3%	+6% + 9.1%	N/A N/A
Average Net Salary 05/01 05/01 compared to 2000 average Average Gross Salary 05/01 05/01 compared to 2000 average	436 KM +5,3% 625 KM +3%	309 KM +11.5% 437 KM +13%	390 KM +7,2% 558 KM +5,7%
Number of Employed 05/01 Number of Registered Unemployed 05/01	406,783 persons 263,228 persons	227,740 persons 154,236 persons	634,523 417,464
Number of pensioners in 05/01 Average pension in 05/01	280,533 persons 170 KM	179,073 persons 105 KM	459,606 145 KM
Imports 01-05/01 Exports 01-05/01 Trade deficit – January to May 2001 Import/Export coverage	1,959 billion KM 0,734 billion KM 1,223 billion KM 37.5%	0,642 billion KM 0,227 billion KM 0,416 billion KM 35.3%	2,601 billion KM 0,961 billion KM 1,639 billion KM 36.8%

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