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Newsletter

Economic Reform and Reconstruction in Bosnia and Herzegovina (BiH)

Sarajevo, May 1998, Vol. 1, Issue 3

Economic Task Force Secretariat

**OHR in co-operation with IMG International Management
Group**

Economic Indicators BiH

Federation

| Annualized growth rates* (excl. net wage) | Dec-97 | Jan-98 | Feb-98 | Mar-98 |
|--|---------------|---------------|---------------|---------------|
| Average net wage (DM) | 308 | 300 | 314 | n/a |
| Retail price growth | 9.9% | 9.8% | 9.5% | 10.7% |
| Cost-of-living growth | 8.8% | 8.0% | 8.4% | 9.5% |
| Real wage growth | 19.6% | 16.5% | 18.4% | n/a |
| Industrial Production growth | 28.2% | 7.6% | 24.6% | 12.4% |
| Real effective exchange rate | | | -7.2% | |

(Source: Federation Statistical Institute & OHR Estimates)

* Growth rate over 12 preceding months.

Republika Srpska

| Annualized growth rates (excl. net wage) | Dec-97 | Jan-98 | Feb-98 | Mar-98 |
|---|---------------|---------------|---------------|---------------|
| Average net wage (DM) | n/a | n/a | n/a | n/a |

| | | | | |
|-------------------------------------|--------|-------|-------|-----|
| Retail price growth | 12.8% | 9.5% | 13.4% | n/a |
| Cost-of-living growth | 18.7% | 16.0% | 18.5% | n/a |
| Real wage growth | 115.0% | n/a | n/a | n/a |
| Industrial Production growth | 23.7% | n/a | n/a | n/a |

(Source: RS Statistical Institute & OHR Estimates)

The official average net wage in DM in RS is considerably less than that in the Federation. However, official real wage growth in RS has been extraordinarily strong over the last year (115%). Unlike in the Federation, there is a substantial difference between retail price inflation and cost-of-living inflation.

(More information on this subject can be obtained by: the OHR Economic Department, Mr. B. Roberts, Tel: 447275 or at the IMG Economic Section, Mr. P. Hulshoff, Tel: 666273)/P>

Economic Policy and Reform

Introduction of the New Currency The new currency of BiH, the convertible marka (KM), is now being printed by the French firm Oberthur and is scheduled to be introduced into the country in early June. It will have seven denominations: 0.5, 1, 5, 10, 20, 50, and 100 KM. There will be two distinct designs per denomination. The differences in the designs are in the notes' portraits and order of alphabets (on the 5 KM note, however, the portrait will not differ). The two sets of designs will have the same legal value in both Entities. The bank notes do not bear any national symbols nor the word "coupon." They thus should be referred to as the KM currency and KM bank notes.

The first shipment of currency will arrive in Sarajevo by the end of May and will consist of denominations of 10KM and smaller. This shipment will be followed by one of larger denominations. Conversion of KM will start on the same day in early June throughout the country at approximately 100 distribution points. Offices of the Payment Bureaus will be the main location to convert convertible currencies for KM.

The Central Bank of Bosnia and Hercegovina (CBBH) will also exchange KM at its offices in Sarajevo, Banja Luka, and Mostar.

Only convertible currencies can be exchanged for KM. The conversion process will therefore be different in the three main areas where it is taking place. It will be simplest in the Bosniak area, where Bosniak Dinars are the domestic currency in circulation, because this currency is fully backed by DM reserves. A straight exchange will take place over a period of 2-3 weeks, followed by a period where exchange can take place at a more limited number of exchange points.

The KM cannot be exchanged for the Yugoslav Dinar or the Croatian Kuna, because these are not fully-convertible currencies. In the RS and Croat areas of the Federation, individuals and businesses will have to convert Yugoslav Dinars and Kunas into convertible currencies (primarily DM) and then exchange these for KM.

After the KM is introduced, it will be the legal tender currency of BiH, and people are obliged to accept it as a form of payment. All BiH public authorities will have to use KM. However, it will not be illegal for private individuals and firms to use other currencies as a payment medium.

The KM will be a convertible currency fully backed by reserves of other convertible currencies held at the CBBH. The CBBH will carry out monetary policy under a currency board arrangement. The exchange rate will be fixed at 1 KM to 1 DM, and there will be no risk of depreciation of the KM as the CBBH is obliged to take all appropriate measures to defend this exchange rate (see below for further explanation of the CBBH and its policies).

A publicity campaign on the conversion process is starting and will consist of leaflet distribution to banks, other institutions, and the general public, TV broadcasts, and

possibly newspaper ads. The conversion process needs the full support of the international community. International organizations should make every effort to pay their employees in KM, and be seen to be using KM in their operations. This will help significantly in building confidence in the new currency.

The Central Bank of Bosnia and Hercegovina The Central Bank of Bosnia and Hercegovina (CBBH) will now act as the monetary authority of BiH. Its policies will be decisive in determining exchange rate stability, and very important in determining price inflation and the level of output of the economy. The CBBH is to operate as a currency board. It cannot issue new KM without acquiring convertible-currency reserves to fully back them. This is a very strict monetary regime and essentially does not permit the CBBH to conduct independent monetary policy. The level of money available to the economy depends entirely on the level of convertible-currency reserves held at the CBBH.

The advantages of a currency board arrangement is that it produces a stable, low-inflation macroeconomic environment and does not permit the government to “overheat” the economy through excessive issuance of money. The CBBH defends a fixed nominal KM-DM exchange rate thus guarantees nominal exchange rate stability. These advantages are particularly valuable in BiH, where, because of political conditions, a central bank with discretionary power would be likely to expand the stock of money too rapidly.

A currency board is a highly desirable monetary arrangement for BiH. It should be kept in mind, however, that currency boards do entail some costs. The ability to conduct flexible monetary policy can be useful in some situations. The CBBH will not be able to act as a “lender of last resort” to banks having serious financial difficulties. It will also not be able to make short-term loans to banks having very temporary trouble in meeting their reserve requirements. Finally, in situations where the exchange rate is under pressure and the CBBH is losing its reserves, it will be required to take very

strong measures to defend the currency, in particular, as the recent experience of Hong Kong shows, sharply increasing interest rates.

Continuing Problems with State Budget Implementation According to the State budget law, which was passed on April 27 by the BiH Parliamentary Assembly, the State budget in 1998 amounts to 183 million DM. The budget is divided into two parts: administrative costs of the Common Institutions (57 mil.DM) and servicing of the external debt (126 mil.DM). The only own source of revenue of the Common Institutions are consular fees (estimated at 20 mil.DM). External financing will supply 10 mil.DM to the state budget. According to the Dayton agreement, the remainder of State administrative costs, 27 mil.DM, must be provided by the Entities, who are also required to provide all debt servicing funds.

So far, the Entities have contributed to the servicing of the debt but not to the administrative part of the State Budget. The OHR considers it to be critical that the state functions in complete compliance with the Dayton agreement. It is therefore compulsory that the State budget be implemented as designed immediately. Should this fail, there will be no chance that the Common Institutions will function according to Dayton in 1998 or later, and neither will the parallel structures cease their activities. The High Representative has reminded the Prime Ministers of both Entities of their obligations.

Organization of Public Services

State Law on Telecommunication Representatives from BiH, EBRD, ITU, and OHR met for the second time in Geneva at the end of April to discuss the first draft of the State Law for Telecommunications for BiH. Significant progress was made, and agreement was reached on a substantial part of the document.

Two important points, however, could not be resolved. First, it is not yet agreed what the exact procedure will be for the issuance of international and inter-entity licenses. It has been proposed both that all licenses be issued only by the

entity and that the State should actually issue licenses rather than just give its approval. Second, the issue of the legal status of the operators is a major obstacle to progress. The status of the operator in Mostar is undetermined, as agreement has not been reached over whether this operator should be recognized as a fully independent operator or not.

The revised text will be made available to all parties by the end of May, and ITU will again host a third meeting in Geneva on July 2.

Progress in the Road Sector In accordance with Annex 9 of the GFPA on Public Corporations, the Roads and Bridges Working Group has made considerable progress towards the establishment of a Joint Corporation in the Road sector and the development of an overall Road Master Plan for BiH. At the meetings it was concluded that the Federation of BiH and the RS will establish a special Working Group which shall focus on the preparations for the Road Master Plan' Terms of Reference. The Working group will consist of 6 members, three from each entity. It's proposals will be adjusted on entity-level, followed by submission to the State Ministry of Civil Affairs and Communication for final approval. This structure has been agreed upon, in order to secure the specific State interests like freedom of movement, an unhampered inter-entity traffic, meeting the needs of an expanding economy, and compliance to State rules and regulations.

Memorandum of Understanding in the Water Sector At a Water Working Group Meeting, held at the beginning of last April, authorities from the Federation and the RS agreed upon the text of a MoU which will clear the way for the establishment of a Commission for Co-ordination of Water Management issues (the Commission). This Commission is to function as a mechanism for inter-entity co-operation on all water-related issues, also taking into account the specific state interests. Examples of these are: Harmonisation of existing and future water related legislation and regulation, construction and restoration of water management facilities at Inter Entity boundary lines, international treaties and projects and co-operation on water related matters with the neighbouring countries.

The Commission shall have 8 members, 4 from each entity.

Representatives of the International Community (OHR, IMG, USAID, WB, EC) may take part in the Commission as non-voting members.

The official signing ceremony of the MoU is expected to take place at 26 May.

Status of Reconstruction

Successful Fourth Donor Conference The fourth donor conference for BiH was held in Brussels on May 7 and 8. The objective to confirm the 1998 tranche of the four-year \$5.1 billion target set after the signature of Dayton agreement was reached. A total of 1.2 billion USD was pledged by 30 countries and international organizations.

The conference focused mainly on economic reform and on the reconstruction needs for return of refugees and displaced persons. The recommendation from the High Representative to increase financial effort in the RS, including the eastern part, was well received. Several donors expressed their intention to put more effort in the RS than in the past. This should result in the following months to more projects being initiated in the RS. The High Representative wishes to stress again that it is important that concrete achievements be seen before the elections to be held in September. A full listing of the final pledges will be included in the next Newsletter.

For further information concerning this publication please contact:

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Status Summary Report on Reconstruction as per May 1998
(Figures in kDM)

(for the sectors: housing /education /health /energy /telecommunication /transport /water&sanitation)

| Canton | In Implementation | Completed | |
|--------|----------------------|-----------|--|
|--------|----------------------|-----------|--|

| | | | |
|----------------------------|-------------------|---------------------|---------------------|
| Unsko-Sanski | 70,391.29 | 94,763.27 | |
| Posavski | 23,697.56 | 26,234.70 | |
| Tuzlansko-Podrinjski | 70,705.03 | 204,004.78 | |
| Zenicko-Dobojski | 91,421.37 | 82,291.45 | |
| Bosansko-Podrinjski | 12,967.00 | 35,389.22 | |
| Srednjobosanski | 33,625.27 | 61,286.18 | |
| Hercegovacko-Neretvljanski | 60,240.65 | 112,386.46 | |
| Zapadnohercegovački | 7,752.00 | 6,537.00 | |
| Sarajevo | 112,866.40 | 156,424.32 | |
| Zapadnobosanski | 4,396.22 | 21,939.99 | |
| Multi-Canton | 13,065.26 | 43,903.73 | |
| Federation | 22,418.36 | 10,972.56 | |
| TOTAL FEDERATION | 523,546.41 | 856,133.66 | |
| | | | |
| Banja Luka | 13,838.55 | 30,235.47 | |
| Doboj | 12,312.01 | 19,696.57 | |
| Bijeljina | 45,083.83 | 13,502.31 | |
| Vlasenica | 12,391.88 | 15,609.10 | |
| Sokolac | 5,075.47 | 6,933.26 | |
| Srbinje | 7,600.73 | 3,760.48 | |
| Trebinje | 12,868.45 | 6,037.55 | |
| Multi-Region | 350.00 | 9,303.50 | |
| Serb Republic | 13,681.00 | 8,039.00 | |
| TOTAL REP. SRPSKA | 123,201.91 | 113,117.24 | |
| | | | |
| Multi-Canton/Region | 14,800.00 | 23,687.00 | |
| B&H | 71,960.00 | 29,329.00 | |
| Unknown | | 63.31 | |
| Grand Total | 733,508.32 | 1,022,330.21 | 1,755,838.53 |

Source of information: IMG-PIMS Database

Status Summary Report on all non-Reconstruction sectors as per

May 1998

(Figures in DM)

| Sector | Completed | In Implementation | Not Specified | Total |
|---------------------------------------|-----------------------|-----------------------|----------------------|-----------------------|
| Agriculture | 32,178,925.06 | 59,905,061.08 | 8,535,323.74 | 100,619,309.89 |
| External Debt Service | 44,595,305.98 | 0.00 | 0.00 | 44,595,305.98 |
| Finance & Trade | 10,907,139.78 | 629,600.63 | 18,540,472.43 | 30,077,212.84 |
| Industry & Industrial Finance | 58,446,269.99 | 213,623,485.46 | 30,063,412.60 | 302,133,168.04 |
| Landmine Clearing | 26,652,051.32 | 10,545,103.83 | 0.00 | 37,197,155.15 |
| Peace Implementation Activities | 100,722,877.03 | 710,499.66 | 0.00 | 101,433,376.69 |
| Social Support | 87,540,988.56 | 44,755,826.78 | 2,097,386.12 | 134,394,201.46 |
| Grand Total | 361,043,557.72 | 330,169,577.44 | 59,236,594.89 | 750,449,730.05 |

Source of information: RCM Database

Note: These reports are based on information provided by Implementing Agencies and other participants willing to contribute to the PIMS and RCM Database. Therefore, the ETF Secretariat nor the PIMS and RCM Database can take any responsibility for incorrect or incomplete information potentially contained within this report. Original values are converted to DM based on average exchange rates for 1997.

Office of the High Representative