

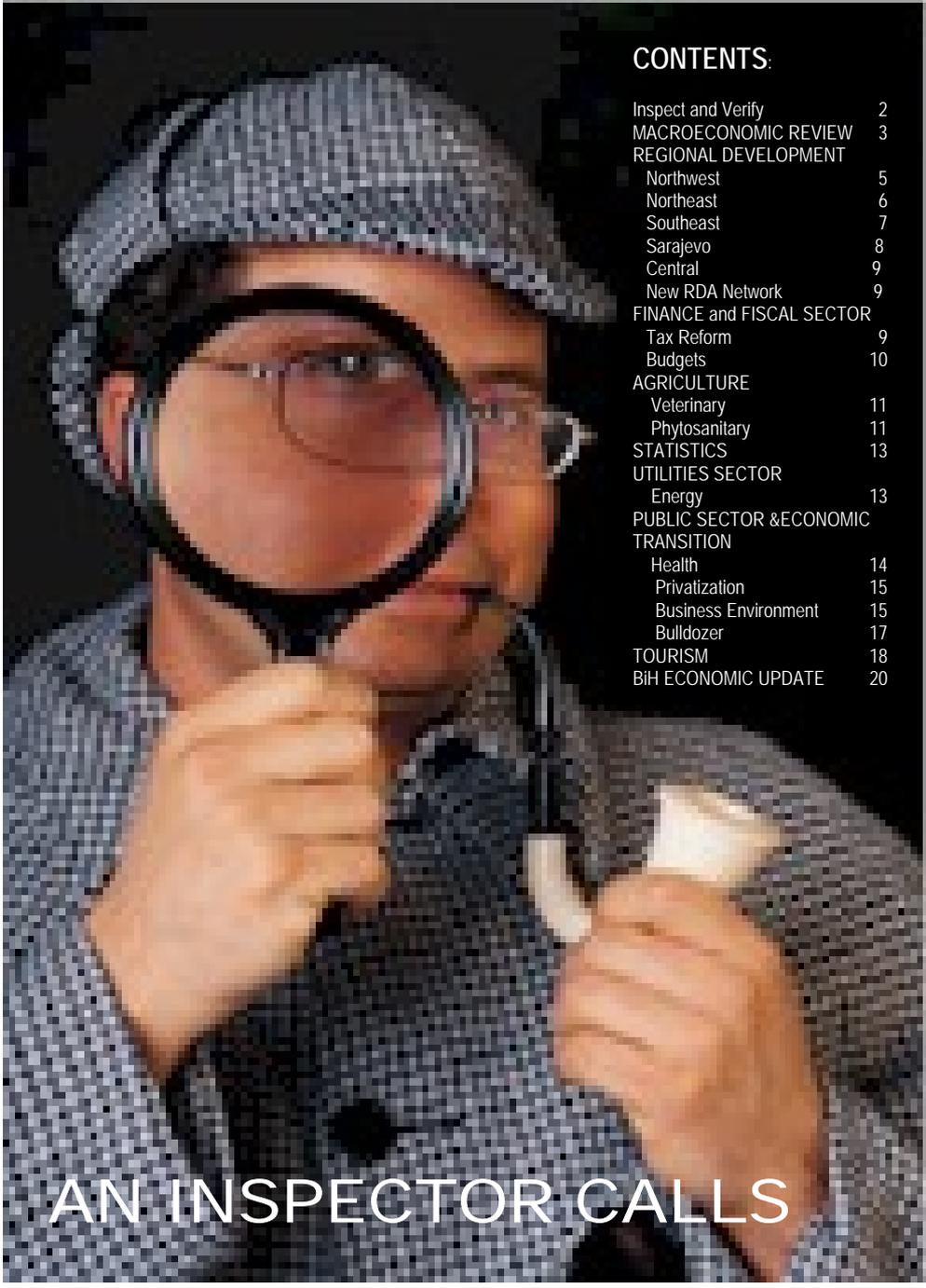
Bosnia and Herzegovina Economy & European Integration

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NEWSLETTER

CONTENTS:

Inspect and Verify	2
MACROECONOMIC REVIEW	3
REGIONAL DEVELOPMENT	
Northwest	5
Northeast	6
Southeast	7
Sarajevo	8
Central	9
New RDA Network	9
FINANCE and FISCAL SECTOR	
Tax Reform	9
Budgets	10
AGRICULTURE	
Veterinary	11
Phytosanitary	11
STATISTICS	13
UTILITIES SECTOR	
Energy	13
PUBLIC SECTOR & ECONOMIC TRANSITION	
Health	14
Privatization	15
Business Environment	15
Bulldozer	17
TOURISM	18
BIH ECONOMIC UPDATE	20



AN INSPECTOR CALLS

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Inspect and Verify

The leading article in this quarter's newsletter refers to the extraordinary fact that despite the tens of thousands of tourists who flocked to Mostar this summer for the re-opening of the Old Bridge the tourism authorities were only able to record an extra 6,000 visitors. BiH is successfully attracting more and more tourists – but because statistics gathering is fractured, tourism policy development is based on guesswork. Those hordes of undocumented sightseers are certainly not reflected in the volume of tourist tax collected by the authorities – which means that, in addition to losing indispensable economic data, the authorities are losing desperately needed cash.

And what goes for tourism goes for the rest of the economy.

Yet rationalising BiH statistics gathering is a modest task that can deliver very substantial results.

Reforming the inspectorate system is a challenge of equally manageable proportions. It doesn't involve vast administrative change; it simply requires the application of a reasonable amount of political will to draft and enact acceptable legislation that will help eliminate corruption and inefficiency from a function that sits at the very heart of economic life.

BiH's inefficient inspection system (too many inspectors, too many overlapping inspections) is deterring investment – it has to be fixed. Because inspections are crucial to maintaining standards right across the spectrum of commercial activity, the unsatisfactory state of the current system continues to undermine the economy as a whole.

Inspectorate reform has been successfully implemented in Croatia and Serbia & Montenegro – and it can be organized and implemented in BiH with equal success, but only if governments and politicians focus on the issue now!

Nuts and bolts exercises such as statistics gathering and inspection may be unglamorous – but they absolutely have to be tackled. Continued neglect of these reforms could compromise BiH's economic recovery. That would represent political blundering and social irresponsibility of truly monumental proportions.

Ambassador Donald S. Hays
Principal Deputy High Representative



Where Have All the Tourists Gone?

In July, thousands of visitors flocked to Mostar to witness the re-opening of the Old Bridge. Informal figures suggest that as many as 150,000 people may have visited the city in the week of the opening ceremony. The ceremony itself was a near-perfect sound-and-light extravaganza executed with a precision and flair that surprised previously sceptical observers.

This massive influx of visitors should have been a phenomenal windfall for the hoteliers and shopkeepers of Mostar and elsewhere in the country. And perhaps it was. But you wouldn't know it from the official figures. According to the BiH Federation Statistical Institute, a mere 6,000 additional foreign tourists visited the Federation this summer compared to last summer.

So where did all the foreign tourist go? They didn't go into the Federation Statistical Institute's figures, that's for sure. Nor did their valuable foreign exchange go towards improving BiH's tourism infrastructure through the tourist tax. And in view of the well-documented ineffectiveness of the sales tax (soon to be replaced by VAT), the money these visitors spent on trinkets, *slivovic* and Bosnian coffee is unlikely to be channelled via the fiscal system to fund new and better social services.

The Old Bridge re-opening illustrates a major potential strength and an existing serious weakness in the BiH economy. The country has competitive resources – Mostar is a priceless tourism attraction, and the professionalism of the opening ceremony (featuring opera singers and pop stars crooning under the stars in a glitch-free TV set-piece) demonstrated that there is no shortage of people who know how to make the most of this resource. Indeed the reopening ceremony followed a three-month tourism-promotion campaign spearheaded by the High Representative and the Foreign Minister and

Deputy Foreign Minister which had generated a huge amount of renewed interest in BiH among tour operators in the Netherlands, Sweden, Germany, France and the UK. Doubtless a majority of the foreign visitors who witnessed the opening ceremony went back to their own countries hugely impressed by the warmth and charm of BiH hospitality (and the competitive prices compared to neighbouring Croatia).

But because the administrative infrastructure is not yet fully in place and fully operational, BiH as a whole was unable to exploit this tourist windfall properly. While money poured into a limited number of businesses in the two or three weeks either side of the bridge opening, the official statistics gathering agency managed to count just 6,000 additional visitors.

When you consider that what happened in Mostar this year happens in Medjugorije every year you get an idea of how serious the problem is. And the same pattern is evident throughout BiH.

When things are going right (and they are increasingly going right in the tourism sector) we often do not know about it, because there are no reliable statistics to illustrate what's happening. And because there are no reliable statistics, policy development is reduced to a hit-or-miss exercise based on anecdotal rather than empirical evidence.

Equally damaging is the disconnect between the real economy and the fiscal structure. Underreporting and tax evasion (a huge number of hoteliers clearly forgot to register tens of thousands of visitors over the summer) mean that income from successful economic sectors is not channelled to the authorities so that they can plough money back into these sectors in terms of promotion, training and strategy development. At the same time, the endemic nature of tax evasion contributes to a climate of routine, if petty, illegality that has done so much to erode business ethics and competitiveness in BiH.

This disconnect between appearance and reality is also evident if we look at the money supply figures. It is often argued that BiH is in dire straits due to its persistent Balance of Payments deficit. Yet, as figures published by the Central Bank and highlighted in the OHR's monthly economic report point out, a corresponding decline in the liquidity of the BiH economy or of the country's Currency Board has not taken place. On the contrary, the demand trend for the KM is such that the Central Bank recorded a positive balance in its trading in KM worth some KM 3 billion between July 2003 and July 2004. This is corroborated by persistent month on month inflows of liquidity.

This means that the holders of foreign currencies are continuing to exchange their holdings into the domestic currency. Through the workings of the Currency Board, this inflow is directly translated into an infusion of money in the BiH economy. The monetary indicators show that this is actually taking place (albeit at a much slower pace than might be expected). So, instead of experiencing a trade-deficit induced catastrophe, BiH is soaking up capital that is higher than the annual amount of foreign direct investment.

How can this be? Even the World Bank is mystified. In its most recent paper, the Bank notes that forecasting the BiH balance of payments is difficult due to "...sizeable non-debt creating capital flows, which are believed to result in large part from unidentified transfers, and to a lesser extent from a drawdown on foreign exchange savings held abroad."

Since these inflows do not appear to be recorded in the current account it is quite likely that the supposedly abyss-like deficit may not be as bad as it appears at first sight. The little acknowledged fact that money is actually flowing into the country is important when the future creditworthiness and public investment capability of BiH is being considered.

But when the money flows in, what happens to it? This brings us back to the tourism example.

We don't know exactly what happens to it. In the absence of efficient statistics gathering we have to proceed by deduction.

Fresh supplies of foreign currency immediately result in more KM in circulation. Yet inflation has remained negligible despite the apparent increased inflows and the increased aggregate level of private consumption.

Central Bank sterilisation measures (see below) and the fact that the commercial banks maintain there is a shortage of creditworthy borrowers have meant that the excess liquidity has not played havoc with the economy.

Another contributory factor to the limited inflationary impact of capital inflows is the significant underutilised capacity in the economy, as exemplified by high unemployment (even the most conservative estimates put the jobless rate at around 15 percent). Since the economy is not running at full capacity, the large capital inflows have not been inflationary. Only when economies start running at or near full employment does excess liquidity start to generate inflation. Owing to the circumstances peculiar to the BiH economy, this does not seem to be the prospect for quite some time.

Some of the incoming money continues to flow freely as cash in the BiH economy, while a sizeable proportion ends up in the banking sector. In general, the excess of liquidity ought to reduce interest rates, and this has happened to some extent. BiH lenders and depositors tend to enjoy better rates than most of their counterparts in the Euro-zone (this applies to depositors, who put money in the banks at 5-6 percent per annum - more than they would get in Frankfurt - and to the banks, which charge 16-18 percent).

The majority of deposits appear to be 'sight' deposits (requiring no notice before withdrawal) and the month on month analysis of sight deposit rates does appear to be in line with what one would expect from a trend denoting excess liquidity in the system - these rates are now 0.85 per cent per annum.



Growing, but unquantifiable, buoyancy in the economy is also indicated by a recent upswing in consumer credit, a trend which has been accompanied by a rise in the proportion of private consumption as a share of GDP as well as by a corresponding decline in the rate of private savings as a share of GDP. This trend, however, has been repeatedly checked by the Central Bank, which has increased the banks' reserve requirement, so that by the end of the current calendar year, required reserves will amount to 10 percent of a bank's capital, excluding its cash holdings. This policy has had a dual function: both to sterilise some of the potential excess capital in the economy and to check any potential imprudence on the part of the banks which, faced with excess liquidity, might have been tempted into concluding less than optimal lending arrangements. This is projected to have a dampening effect on the private consumption aggregate.

The capital influx has undoubtedly given impetus to the grey economy. Even a superficial comparison between the size of the monetary inflows and the size of balances held at banks would suggest that quite a lot of cash is still unaccounted for. This invisible liquid capital not only means less government revenue, it means a corresponding underestimation of many economic activities that take place on a daily basis.

What can we conclude from all of this?

The BiH economy may be expanding faster than the annual five percent that has been the norm for the last four years. Some sectors, including tourism, may be starting to show signs of take-off. Statistics gathering and tax collection are woefully inadequate; currency management, by contrast, is superb and delivering impressive results. Inflation is not a problem and will only become so when the other scourge of economic planners, unemployment, ceases to be a problem.

We will be in a significantly better position when we are able to answer the simple question: Where have all the tourists gone?



REGIONAL DEVELOPMENT

Northwest

Since the early 1990's, the EC has increasingly promoted the development and delivery of support measures at regional level; one third of the total EU Budget (Euro 30 billion) is now devoted to regional economic development.

An initial Euro 2.8 million has been already allocated to the BiH RED Fund, and the EC has made available an additional Euro 3 million to be spent later on regional economic development projects

The Northwest RDA was established on 25 March 2004 by thirty-five development organisations.

A Draft Regional Economic Development Strategy, presented in Banja Luka on 30 July 2004, identifies improving the business environment and developing human resources as two key priorities. It also highlights the European orientation of the region, and stresses the importance of inter-regional (inter-municipal) cooperation.

The Northwest economic region covers thirty-four municipalities, of which twenty-one are in the RS, two are in Srednjobosanski Canton, three are in Hercegbosanski Canton, and eight are in Una-Sana Canton, with an area of 17,077 square kilometers, and an estimated population of 1,101,704. There are 11,281 registered enterprises in the region and the official unemployment rate is 37.11 percent.

A new Business Incubator was opened in Nova Topola, during August. The Nova Topola Business incubator is funded by the EC through the EU QIF project, and is the first incubator in BiH targeting the agricultural sector. In September, Klas, the Sarajevo-based food

processing company, opened Klas Centre in Banja Luka. This is a modern, 2,200-square metre complex with a bakery, a confectionary plant, a wholesale store and a discount store. More than five million KM has been invested in Klas Centre, which now employs 35 workers. The centre will sell more than 360 products made by Klas, as well as products made by other producers, mostly from BiH.

The Klas example suggests a viable way of reducing unemployment in the Northwest region, which has substantial capacity in the production and processing of crops, meat and meat products, eggs, and vegetables.

Banja Luka Brewery has invested 24 Million KM in the last three years and a bottling facility with a capacity to process 60,000 bottles per hour was opened on 21 September 2004, thus increasing production capacity to one million hectolitres of beer per year.

The northwest economic region has a competitive geo-strategic position, being located near the main Western Europe-Mediterranean-Middle East traffic corridors. This enhances the region's development opportunities.

The most important project in the region is the construction of the Banja Luka –Gradiska Highway (connected to the Zagreb-Belgrade highway), which began recently. Total investment for this project is projected at 350 Million KM. The EBRD has expressed interest in supporting this project with a 50-million KM loan.

The total length of major roads in Northwest region is 1,207 kilometers (507 km in FBiH, and the remaining 700 km in the RS); there are 1,466 km of regional roads (681 km in FBiH, and 785 in the RS). The regional railway network encompasses four different routes with a total length of 399 km (261 km in the RS, and 138 km in FBiH). Banja Luka International Airport has good prospects for further development, with a focus on connections with neighbouring countries and Southeast Europe.

Northeast

Contrary to pre-election media rumors involving KIL (Coke Industry Lukavac), Tuzla Canton PM Jasarevic and the Director of KIL, Busevac Faik, have explained that the foreign investor, ISPAT, has exceeded its contracted 10-million KM investment in the company and has invested 13.5 million KM. In addition, over the past three months the company has reemployed 150 workers.

In addition to coke production, KIL is also restarting complementary facilities for industrial processing of coke byproducts, such as nitrogen-based fertilizers, tar, benzene (used in the manufacture of medicines, dyes and solvents), and wood preservatives.

Investments such as this, (including the successful privatization of the Lukavac cement factory by the Austrians companies Alas International and Asamer Hufnagl) have helped improve living standards for local residents employed by KIL (1260 employees) and have provided work for local companies that were subcontracted to repair these facilities. Indeed, this has produced a significant jobs boost in Lukavac Municipality, where the economy has been stagnant since 1991.

With the financial assistance of the EU's Quick Impact Facility the Northeast Regional Development Agency set up an information centre in September, that will serve as a reliable database for all business related information in Tuzla Canton.

This means that the Northeast region now has two information centers (the other is in Brcko District) as well as a Business Service Centre, in Zenica. This is in line with the EU's Regional Economic Development Strategy's development roadmap for Northeast BiH.

The EU RED identified health/recreational tourism and agriculture development as Northeast Region priority activities.



In regard to health tourism, respective ministries of the Tuzla Canton and three municipalities - Kladanj, Zivinice and Banovici -- are working together on an initiative aimed at having Konjuh Mountain declared a National Park. The protected zone will be used for the development of health and recreational tourism. The area's celebrated mineral water springs and its established skiing capacities provide a promising basis for development, and construction of purpose-built facilities will be approved in order to create conditions for better utilization of existing capacity. The entire park will cover an area of 8,500 ha and the law classifying the area as a natural park will be placed on the agenda of the cantonal government soon.

Agriculture development has started picking up momentum. The USAID-funded LAMP (Linking Agricultural Markets to Producers) continues to promote faster growth in the Northeast farming sector, with a programme aimed at increasing the income of local farmers. Through a series of Sub-sector Networking Meetings, and Grant and Loan Schemes, LAMP is working to strengthen market linkages among producers, producer associations, food processors, and consumers. The programme has brought together farmers from Petrovo and Tesanj and Gradacac and Samac, and from Srebrenica and Zvornik and Kalesija and Bijeljina.

LAMP has also provided a 500-litre lacto-freezer to the Tesanj Agricultural Women's Association, which resulted in the signing of a 250,000-KM contract with the Tuzla Dairy, thus encouraging other donors and municipal authorities to donate more such equipment. In addition, the programme has organized a milk processors' meeting on EU Laws on Quality. This is especially important in view of the fact that only 35 percent of BiH demand for dairy products is met by domestic production and only 22 percent of milk produced is actually being collected. There is obviously a window of opportunity for the BiH dairy sector to compete with foreign products producing quality domestic products at a competitive price.

Berry fruit farming is also expanding. The Swedish company, Olle Svensson AB, which specializes in berry fruit processing, has been purchasing berries from the Bratunac and Gorazde areas since 2000. Last year the company built a 450-ton cooling facility in Potocari, Srebrenica. The company has been attracted, among other things, by an integrated approach to this type of farming, involving Lutheran World Federation grant projects, SIDA credit lines, and organic certification through ECON NGO. Olle Svensson plans to boost capacity to 1500 tons by 2006, bringing an additional 100 acres under organic berry fruit production. Currently, Bos Agro Food (Olle Svensson AB) employs 32 workers and cooperates with 150 farmers. When the production reaches its optimal target, in 2006, the Bos Agro Food cooling facility will employ 50 full-time employees, 30 to 40 seasonal workers, and will cooperate with four to five hundred berry farmers. This represents a significant contribution to job creation in the local community and is likely to have a positive knock-on effect in terms of encouraging complementary agricultural projects in the return areas of the eastern part of the Northeast Region.

Southeast

In August ZU&RIC, a trade and manufacturing firm from Citluk, opened a new factory producing plastic cutlery, adding 14 jobs to the company's 48-strong workforce. This kind of incremental job creation, particularly in the manufacturing sector (jobs in public administration constitute too high a proportion of total employment in Herzegovina) represents a viable model for addressing the region's 34-percent unemployment rate.

There have been other, similarly modest but positive, cases of job creation in the last quarter, including a 5.2-million KM investment by Sarajevo Klas in a new Mostar plant, which is expected to create 50 new jobs, and the August opening by the Konjic firm, Prominvest, of a new granite processing plant.

This shows that the Small and Medium Enterprise sector – identified as the key strategic



source of new employment in the Herzegovina Regional Development Agency's medium-term development plan, is generating new jobs—but it is not doing this nearly fast enough. We continue to see a debilitating migration out of the region as those of working age seek employment opportunities elsewhere. The total population of Herzegovina has fallen by a third since the beginning of the war, and economic migration has left the region with a disproportionate number of non-working inhabitants, placing considerable pressure on education and welfare services.

In order to boost the SME sector, particularly in manufacturing (currently, the region imports five times as many products as it exports), we have to address the problems of an underdeveloped traffic infrastructure – the region has just 124 km of highway (as opposed to secondary roads). Improvements in this respect will depend on an effective BiH infrastructure policy: Corridor 5C, for example, will have a positive impact on the region's overall development, but that won't come into play for another decade and in the meantime we have to push for incremental improvements.

An area where countrywide reforms have had a positive impact is the banking sector, now offering more reasonable interest rates, but banks remain dispiritingly reluctant to lend money to entrepreneurs (a big idea and a small cash balance – does not appear to find favour with most banks in BiH).

One major infrastructural improvement was set in place in September, when the *Pec Mlini* hydroelectric plant was opened, in Grude Municipality. This 60-million KM project was financed by Elektroprivreda HZ HB and will supply power to the greater part of Herzegovina.

The development of tourism, a sector in which Herzegovina enjoys comparative advantages over other parts of the country, continues to be hampered by the lack of an efficient BiH-wide tourism administration. For example, Neum is estimated to have attracted between 250,000 and 300,000 tourists during the summer, but the

official figure – used for purposes of assessing tourism tax – is 30,000. The disparity between truth and fiction with regard to Medjugorje is even greater. Around 150,000 visitors were in Mostar in the period of the re-opening of the Old Bridge, but this sudden influx could not be optimized due to the absence of a coherent tourism development strategy for the region. This is something that the RDA will address directly when it publishes its draft tourism strategy in mid November. The RDA also plans to set up a tourism training centre, with assistance from international donors.

While we can do a great deal ourselves, we must rely on the BiH authorities to take the necessary sensible steps to relax tourist visa requirements for, for example, Central European visitors to the Croatian coast who might be tempted to spend a day or two in BiH.

Sarajevo

In the third quarter of 2004, the Sarajevo Economic Region Development Agency worked on establishing business development centres and industrial zones in the region, and took forward a project that aims to develop family farms.

The business development centre project follows a concept deriving from the Activa Development Agency in Barcelona. The centres are designed, among other things, to simplify the complicated and time-consuming process of registering a new company. As such they can have a very positive impact on the small- and medium-enterprise sector.

Business development supervisors at existing business development centres in Kiseljak, Ilidza and Pale have collected all the necessary information regarding mandatory reporting to financial institutions, and other basic registration procedures that go with setting up a new company. In September, SERDA began the process of establishing business development centres in all the municipalities in Sarajevo Economic Region. Kresevo, Fojnica, Sokolac and Iljas have all expressed a willingness to



cooperate. Currently, equipment is being sought for the new centres.

The Family Farm project aims to create 165 new jobs in the food production sector. The project is divided into two phases, the first, dealing with milk production, to be completed by the end of this year. The deadline for farmers to apply for participation in the project was 15 August 2004. A total of 550 applications were received, and in September and October the Portfolio Manager of SERDA's Business Development Department visited all the applicants.

The dairy farm-partners for the Project were selected in September based on a tender published in the press in July, and a partnership contract was signed with the Teleoptic dairy farm from Sarajevo and the Dramon dairy farm from Mokro-Pale, on 14 September 2004.

These dairy farms will take a contracted quantity of milk at an agreed price from each of the participating farmers, and will also guarantee loans for the farmers. Initial production under this Project is planned for the first quarter of 2005. One of the basic problems faced by all domestic and foreign companies in the region (and in BiH) is finding suitable locations for production facilities. Entrepreneurs are routinely placed in a position where they may inadvertently risk violating construction regulations. The lack of transparent and coherent regulations governing industrial and commercial premises gives BiH a bad image and deters investors. In addition, investors are often obliged to develop green-field sites because of administrative complications in adapting existing premises. This adds to start-up costs. The Industrial Zone project is designed to address these problems, with a view to attracting more investment and creating more jobs.

In September, a field trip of potential locations was organized with a Slovenian consultant; a pilot study is now being drafted and preparatory work on establishing several zones is now underway.

Central

In July, Foreign Direct Investment Magazine, part of the Financial Times group, classified Central Region as a "European Region of the Future" A one-page article on Central Region appeared in the magazine's August / September issue. This was distributed to 45,000 readers and will be distributed at this October's World Bank/IMF annual conference.

In September, REZ RDA issued a call for economic development project proposals, which will be eligible for a total of 100,000 EUR in support funding, provided by the Swedish International Development Cooperation Agency). The money will be disbursed to agriculture and business associations, cooperatives, and local development agencies. Individual projects will be eligible to received from 5,000 EUR to 15,000 EUR.

New RDA Network

On 30 September, the Network of Regional Development Agencies was established, with a joint meeting of the five directors of the five RDAs -- ARDA (Northwest), NERDA (Northeast) REZ (Central), SERDA (Sarajevo), and REDAH (South). Supported by EU RED the RDAs have established a network that will help them to become more recognizable in public, among BiH economic stakeholders and foreign and domestic investors. This Network will in future serve as a platform for exchanging information and expertise among the agencies.

FINANCE & FISCAL SECTOR

Tax Reform

A great deal has happened during this quarter. In the public domain, VAT has dominated the media in what has been perhaps the first countrywide entirely non-ethnocentric debate since Dayton. Paradoxically, some traditional

antagonists have been drawn together by their opposition to VAT.

On 23 September, the Budget and Finance Committee of the BiH Parliament considered a range of arguments about the validity of a single- or multiple-rate VAT system. The debate was at times heated, and the Committee agreed to delay its decision until after the local elections.

The law on the single account continues to make progress and is set for adoption under semi urgent procedure.

Significant steps were taken towards achieving the first effective State-level laws for taxation when the ITA Governing Board on 22 September adopted the State-level Sales Tax and Excise Tax Laws. These draft laws will soon be discussed at the Council of Ministers and will then be submitted to the BiH Parliament.

The enactment of these laws will mean that 15 Entity and District-level laws will be replaced by two State-level laws - adding to transparency and cleaning up the indirect tax system. Businesses will find it much easier to deal with one law for excise tax across the whole of BiH.

The adoption of these laws, together with the single account law will allow for the much hated excise allocation mechanism to be finally abolished. A major barrier to inter-Entity trading will have been removed.

It should be noted that significant progress has also been made in other areas over this quarter:

- In July, the regional structure of the four regional centres of the ITA, its staffing plan, its 2004 budget via the State and the revenue allocation formula between the Entities and the Brcko District were agreed;
- In August, the Federation Parliament passed and gazetted sales and excise tax changes which had not been approved by the Governing Board. Prime Minister Terzic took this case to the Constitutional Court and the

Constitutional Court revoked these illegal changes pending a final review.

Budget

The third quarter of the year is the period when budget execution reports of the current year are scrutinized and when activities for budget policy in the next fiscal year are formulated.

The BiH Joint Institutions budget is being executed in accordance with the adopted budget and currently there are activities in preparation for the 2005 budget. The greatest uncertainty regarding the 2005 budget is related to the dynamics of establishing new State institutions required by the Euro-integration process. In addition, the urgent need to achieve the full functionality of existing State-level institutions has budgetary consequences.

Given the heavy dependence of the BiH Joint Institutions budget on transfers from the Entity budgets (two thirds being provided by FBiH and one third by the RS), it is critical to monitor the situation at the Entity level.

In FBiH, despite slightly higher revenue on a year-to-year basis, a budget rebalance had to be prepared since realized revenue did not match planned revenue. However, the administrative tiers below that of the FBiH government are experiencing substantially higher revenue. The immediate consequence of this trend in FBiH revenues – ie falling customs revenue for the FBiH government and rising sales tax revenue for the Cantons -- is that the FBiH government has a diminishing share of total public revenue, as shown in Table 1.

Government tier	Jan-Aug 2003	Jan-Aug 2004	Share in total 2003	Share in total 2004
FBiH	636,478,965	694,008,934	41.8%	40%
Cantons	712,105,703	841,778,065	46.9%	48.6
Municipalities	170,325,782	191,622,370	11.3%	11.4
Total	1,518,910,450	1,727,409,369	100	100

Table 1: Revenues in FBiH

While it appears that enough public revenue is collected in the territory of BiH, the success of



the state-building effort may ultimately depend on an ability to reorganize the country's fiscal architecture, particularly in the more complicated three-tier fiscal system of BiH.

The situation in the RS budget is better, the execution being slightly below the plan.



AGRICULTURE

Modernising and restructuring agriculture is one of the 16 steps listed in the Feasibility Study. In the context of forging a coherent and consistent BiH trade policy (another Feasibility Study requirement) the following priorities for the agriculture sector in 2004 have been identified: establishing EU-compatible State-level certification and other procedures for the export of animal products, and making the BiH Phytosanitary Office operational. The object is to promote exports while enhancing standards and consolidating BiH's Single Economic Space. However these priorities for 2004 are short-term; in order to meet the challenges of the SAA process, BiH will have to initiate and maintain a more progressive reform of its agriculture sector. A structural adjustment programme based on a coherent and prioritized agricultural policy is essential.

Since the publication of the Feasibility Study, the State Veterinary Office has been made operational, the Phytosanitary Office has been set up, and some certification procedures, together with an accompanying legal framework, have been established.

Veterinary

The State Veterinary Office is now operational and co-operation mechanisms between the Entities are under development. In cooperation with international experts, the State Veterinary Office has taken steps to establish a State-level Animal Health Control Program (State Epidemiological Unit), a Network of Reference

Laboratories, and a single State-level border inspection. From the animal health protection perspective a State-level Animal Health Control Program will enable a single and harmonized approach for the control, prevention and eradication of animal diseases. After development of this program by the end of this year, funds for its implementation in 2005 will have to be found.

BiH authorities funding has already been provided for continuation of an animal identification scheme (a project sponsored by the EC), and a large-scale animal identification effort was scheduled to begin in the autumn of 2004. However, funding has still to be provided for the implementation of the national programme for control of biological residues, by the end of 2004 if BiH wants to comply with the recommendation of the EC Food and Veterinary Office and create the preconditions for the export of animal-origin products to the EU.

Phytosanitary

Since the adoption of the BiH Law on Plant Health Protection (framework law) in September 2003, there has not been significant progress in implementing phytosanitary legislation. The legal framework has been strengthened by the adoption of the Law on Mineral Fertilizer, the Law on Plant Variety Rights, the Law on Seed and Seedlings and the Law on Phyto Pharmaceuticals, in September 2004. Adoption of these laws and their implementation will facilitate the consolidation of the Single Economic Space and will meet EC recommendations. The BiH Phytosanitary Office, which will replace the current system of divided Entity jurisdiction in the sector of plant health protection, is being established.

- The charts below show the progress achieved in the phytosanitary, veterinary and food-safety sectors in the context of forging a coherent BiH trade policy.



Chart on establishing the necessary legal framework for establishing an operational institutional framework for the Veterinary, Phytosanitary and Food Safety sectors

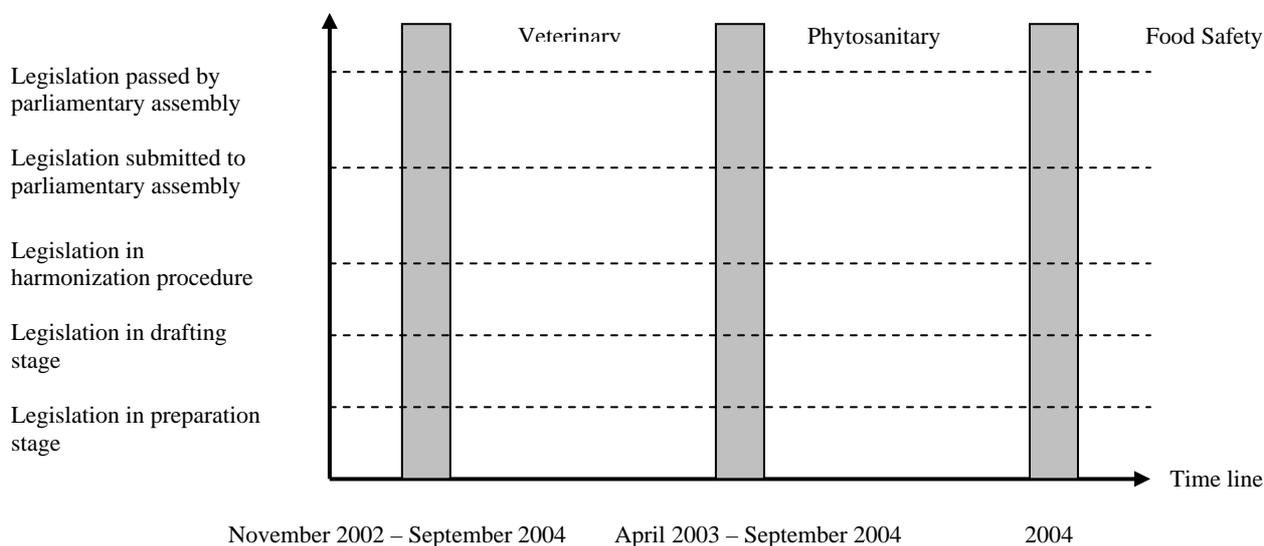
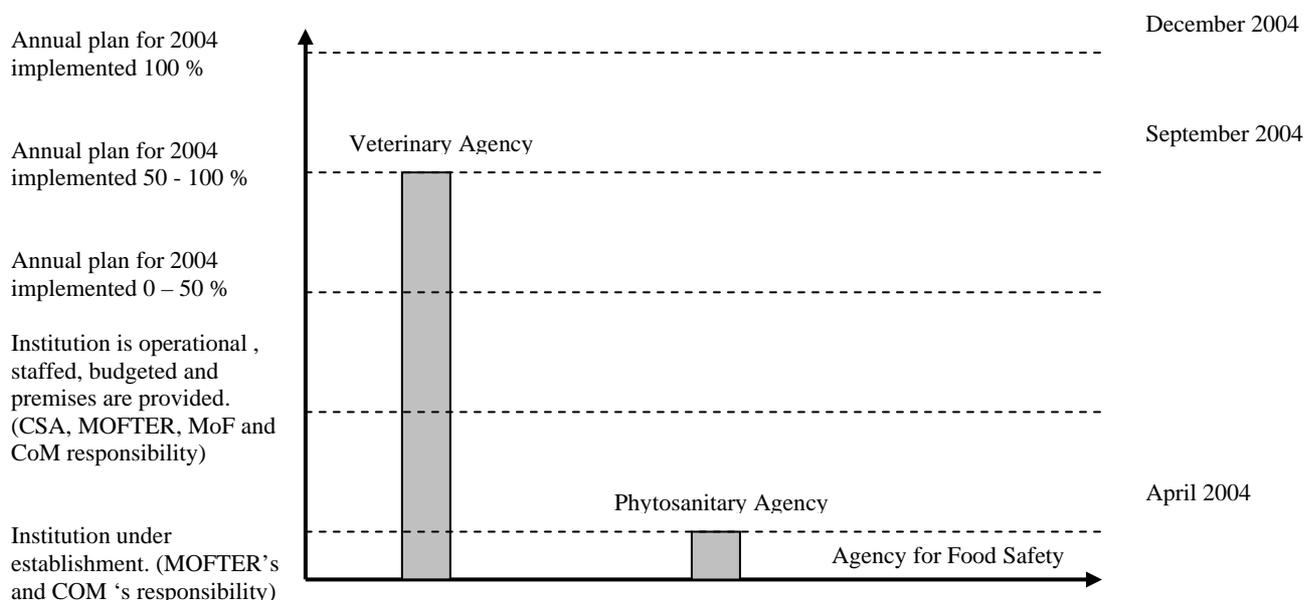


Chart on establishing institutional framework (with reference to efficiency and responsible authority, measured by fulfilment of the annual plan and by the steps undertaken, regarding institutional set-up, by various levels of the BiH authorities)





STATISTICS

Implementation of the Law on Statistics is aimed at creating a functioning system of statistics with clear lines of responsibility and the co-ordination mechanisms that are needed for a reliable statistics system. Establishing such a system is a Feasibility Study requirement.

Progress update

- Progress since November 2003 in developing a reliable statistics system and implementing BiH's Law on Statistics has been extremely limited.
- Clear lines of responsibility and co-ordination mechanisms have not been established.
- The Law on Statistics was imposed by the High Representative in 2002, adopted by the BiH Parliament on 26 April 2004, and published in the BiH official gazettes.
- Immediately after adopting the Law, the BiH Parliament amended it to introduce a second deputy director of the BiH Statistic Agency (BHAS).
- The posts of BHAS Director and Deputy Directors were advertised, but for ten months political disagreements prevented the appointments being made.
- Finally, on 16 September 2004 the CoM appointed a director and two deputies.
- The BHAS has not strengthened its staff capability according to its plans for 2004.
- The BiH Financial Audit Office report on the BHAS was very negative, making reference to poor budget planning, poor execution and management; insufficient staffing, and improper procurement procedures.
- If the newly appointed managerial staff of the BHAS do not take effective steps to implement the statistics legislation (i.e. establish the BiH Statistic's Council, strengthen the capacities of the BHAS, and start production of State-level

statistical data) BiH will face significant problems.



UTILITIES SECTOR

Energy

On 10 October a historic event for the European electricity sector took place: resynchronization, or reconnection, of the two UCTE zones.

The Union for the Co-ordination of Transmission of Electricity coordinates the operation and development of the electricity transmission grid from Portugal to Poland and from Belgium to Romania and Greece. The UCTE network ensures safe electricity supply for some 500 million people in one of the biggest electrical synchronous interconnections worldwide. The highly meshed system of 24 European countries consists of some 200,000 km of 400 and 220 kV lines.

Synchronous interconnection means that individual systems are connected and being run together, at the same frequency, and can assist each other if a disturbance occurs in a system.

In 1992, connections between the western and eastern part of former Yugoslavia were broken due to the war. This produced two UCTE synchronous zones, with the border going through BiH. The reconnection, so-called resynchronization, of the two UCTE zones after many years of preparation (which has included the rehabilitation of several high-voltage lines and substations in BiH) took place on 10 October 2004. In addition to "gluing" the two zones back together, this also involved bringing new countries under the UCTE umbrella, making this the largest synchronous zone in the world.

BiH energy sector reform is one of the key areas addressed in the European Commission's Feasibility Study and it is of critical importance for BiH to demonstrate progress in this important reform.

BiH signed the Athens MoU (2002 and 2003) on the establishment of a regional energy market with the goal of setting up an integrated regional electricity market and ensuring its integration in the EU Internal Electricity Market. Consequently, the incorporation of BiH in the EU Internal Energy Market can be viewed as the first practical step by BiH into the EU.

The Athens Memoranda, which establish political obligations, will be replaced by a legally binding document. The Negotiating Directive for the Legally Binding Agreement was adopted by the Council of the European Union on 17 May 2004. The European Commission prepared a draft treaty, which has been discussed with the MoU participating countries during the last several months. Based on those discussions, the Commission will prepare the treaty, which will be the starting point of formal negotiations between the participating countries and the European Commission.

Reform of the electricity sector currently being implemented in BiH follows the EU Electricity Directive and aims to ensure that the requirements for establishing the regional market are met. It is therefore crucial for BiH's EU integration prospects that successful and timely implementation of all aspects of this reform is achieved.

To that end, an important milestone was passed during the summer when the Law on Transmission Company and the Law on Independent System Operator were adopted and gazetted. These laws are now being implemented.



PUBLIC SECTOR & ECONOMIC TRANSITION

Health

Even with the reform efforts of the local authorities supported by several international organizations, the current situation in the health sector remains very complex. The health care

system is still incapable of meeting even the basic needs of the population. Most of the problems relate to health financing. Very low contribution collection rates, a significant number of uninsured citizens, high operational expenditures of health insurance funds-- especially in the Federation -- and a lack of transparency all impede the sustainability of the health financing system. The system is also characterized by low quality of health services, inaccessibility and inequity.

In the Federation, provision of insurance-covered services among the cantons is drastically different because of differences in health system revenues. These revenue differences between cantons are in some cases above 65percent.

Often even the simplest cases are sent for treatment in neighbouring countries, thus indirectly financing the diagnostic equipment in those countries, while the same equipment in BiH remains obsolete. Last year the RS Health Insurance Fund spent 28 million KM on health care provided to RS citizens in Serbia and Montenegro.

Taking into account the fact that the revenues for the health sector come mainly from collected health contributions, concrete steps towards establishing mechanisms for improving contribution collection rates are urgently required. In that sense the strengthening of the official economy must be regarded as a priority.

Reducing operational expenditures of the health insurance funds and controlling the expenditures on a macro-level by developing adequate contracting mechanisms, would also help to strengthen the health financing system.

Defining the basic package of health services covered by health insurance would to a great extent eliminate the inequity in service provision among different cantons in the Federation.

BiH maintains two totally separate health care systems, with no evidence of Entity collaboration on a unified health systems strategy. If such a



strategy were adopted, health care provision could be optimized throughout the country.

Privatization

The privatization process during the last quarter has shown modest progress in the FBiH. The situation with regard to the RS is more bleak.

Activities on the joint-venture agreement with the strategic investor and Zenica Steel Company were successfully completed. Other privatization contracts have also been signed, among them a contract to privatize the Milkos Sarajevo dairy company.

After two failed tenders, Natron Maglaj is another company that is seeking investment through a joint-venture arrangement. Discussions with interested investors are currently ongoing.

In the RS, there was no registered progress during the reporting period. On the contrary, selection of a new Director of the RS Directorate for Privatization, which has now lasted for six months, produced no results and was formally abandoned because of procedural reasons. This raises serious questions about the RS Government's interest in privatizing enterprises and attracting investment to the Entity.

Creating a Better Business Environment: Legislation

Framework Law on Business Registration

The BiH Parliament enacted the new Framework Law on Business Registration on 29 July 2004. The Entity governments must adopt legislation postulated by the adopted framework law within 90 days in order to simplify the business registration process. Quick adoption by the Entities will send a clear signal to international and domestic investors that the authorities are serious about establishing a competitive business environment in BiH.

The new framework law on business registration will help consolidate the Single Economic Space, and it will bring BiH closer to the EU by

establishing a uniform, faster, more efficient and transparent business registration system. The new registration system will operate countrywide and the certificates issued under this system will be valid throughout BiH.

The new system will significantly reduce the time required to register a company. This will have a double benefit. Companies will be able to start up faster and therefore create new jobs faster. In addition, the law will help to change the immensely damaging perception of BiH, common among prospective investors at home and abroad, as a place where bureaucracy is inefficient and indifferent to the needs of modern business.

Business registration reform is a part of the World Bank's Business Environment Adjustment Credit, supported by a soft loan worth USD 44 million. The first tranche of this loan, worth USD 19 million, was disbursed in 2002; the second tranche, worth USD 25 million, will be disbursed on successful implementation of the business registration and Inspectorate reform.

The UK Department for International Development participated in the reform effort by providing a business registration consultancy service.

The Entities and Brcko must now introduce legislation in accordance with the BiH Framework Law so that the new business registration system can be operational by 31 December 2004.

Framework Law on Accounting and Auditing

The BiH Parliament adopted the framework Law on Accounting and Auditing on 29 June 2004. The law is consistent with EU directives and practice and will put in place a uniform set of international accounting and reporting standards. This law is likely to provide a major boost to investor confidence.

The new law directs the Entities and Brcko to implement International Accounting Standards (IAS) and International Standards of Auditing (ISA). The framework law includes provisions



that the Entities and Brcko District must adopt in their own legislation. This legislation must now be passed as a matter of urgency.

For years, business in BiH has suffered because of a parochial, fractured, monopolistic, and poorly informed accounting and auditing profession. The new law offers an opportunity to those accountants and auditors who wish to become a part of the EU accounting and auditing community to improve their skills and the quality of their service. The law is designed to raise standards in the BiH accounting and auditing profession; as a by-product it is likely to expand the earning potential of effective accountants and auditors.

BiH Law on Public Procurement

The BiH Parliament passed the law on/ September 27th, 2004.

The Law on Public Procurement, in line with the EU Acquis and best international practice, provides uniform regulations across BiH for conducting public procurement. Responsibility for procurement remains with the contracting authorities.

The law establishes an effective and independent mechanism for public accountability and an information and monitoring system on public procurements that will encourage more effective supervision and better budgetary control. In addition, the law sets up an efficient remedies mechanism and comprehensive and coherent implementing regulations, and widens access to information on public tenders.

Inspectorate Reform

Reform of the BiH Inspectorate system was initiated in 2000. The main aim has been to tackle the corruption that thrives in the nexus between Ministries and the businesses that they regulate. The draft Entity Inspectorate Laws attempt to streamline Inspectorate procedures and harmonize practices in both Entities.

Till now, the inefficient and corruption-prone inspection system in BiH has been a major element in deterring investment. This is a core economic problem -- the integrity (or lack of integrity) of inspection systems affects a huge swathe of commercial life. If reform of the Inspectorates fails, this will have a disastrous knock-on effect on other reforms. Take for instance the agricultural sector: Forestry Inspectors and Environmental Inspectors currently have absolute authority. This means they can make or break businesses. The same is true of Market Inspectors. The predictable consequence of this arbitrary authority is that a huge number of businesses prefer to operate in the grey economy in an attempt to escape the attentions of Inspectors (among other reasons). This means that the present Inspection system is achieving the exact opposite of what it was intended to achieve: instead of promoting a business-friendly environment, inspectors are hindering companies' operating potential, which means they are hindering job creation.

Not only are Inspectors vested with an inappropriate amount of authority, there are altogether too many of them -- more than 2000 for the whole of BiH. This is because of overlapping jurisdictions. For instance, currently in the FBiH, there are Inspectors for Agriculture, Forestry/Hunting, Water, and Environmental Protection, all of whom have similar duties. The same can be seen with the Urban Development and Construction Inspectorates. The new law is meant to define the duties and procedures associated with many (but not all) of the Inspectorates in BiH. As it attempts to evaluate particular procedures and job descriptions, consolidation should come to be seen as the only reasonable way of addressing this issue. Consolidating Inspectorates would allow similar inspections to be carried out at the same time (rather than separately, imposing an unnecessarily large burden on companies), without eliminating necessary inspection functions.

The law, however, does not address all of these issues in an optimal way, and the Inspectorate reform project is encountering major obstacles,



which have prevented it from reaching Parliamentary procedure. The constitutionality of the FBiH draft Law on Inspectorates, for example, has been called into question. The Federation and the ten Cantons enjoy specific, and shared, competencies, allowing each to have primary control over certain areas of the economy. In view of this, individual Inspectorates are unable to carry out their duties (at the Federation-level), since they would be violating provisions in the FBiH Constitution. OHR is in the process of trying to find the best solution to reform the inspectorates in BiH.

The situation in BiH is unique. Inspectorate reform has been successfully implemented in Croatia and Serbia & Montenegro. The problem is that BiH's extensively devolved administrative system has produced a proliferation of Inspectorates, routinely overlapping and even competing with one another, to the clear and serious detriment of the business environment. This is an issue that will have to be tackled with urgency and an appropriate measure of political will – failure to reform the Inspectorate system will compromise BiH's reform process overall.

Bulldozer

Bulldozer phase III started on 7 July 2004. Its object is to harness the energy and consolidate the mechanisms that were developed in Phases I and II. During Phase III, the Bulldozer Committee has become increasingly locally driven. The international organizations, and the OHR in particular, now play only a technical assistance role.

Analysis of the structures that evolved in the second phase of the Bulldozer Initiative revealed a number of fields in which action should be undertaken in order to secure the continued success of the Initiative.



A key recommendation coming out of this analysis was that the Bulldozer's capacity to articulate the concerns and interests of the private sector should be institutionalized. The engagement of the private sector is therefore being enhanced by extending the Bulldozer's presence in the media and in the field. The aim is to build up a public-private dialogue so that this comes to be viewed (as it is in other countries) as a natural component of commercial policy debate. The core mechanism in maintaining this dialogue will be the BiH Association of Employers, which will take over responsibility for the Bulldozer Initiative at the end of this year.

The initiative to establish this association goes back two years, when the ILO brought together the FBiH Employers' Organization and the RS Employers' Organization to agree on the principles of creating a roof-level structure. At that time, informal contacts with the BiH Ministry of Justice suggested that a registration request would be met with insurmountable administrative resistance. A formal registration request was therefore never submitted.

Through the coordination of the OHR Bulldozer Unit, a number of meetings were initiated with the most significant Entity-based employers' organizations. The list of invitees for this meeting-cycle was compiled after consultation with international and domestic organizations, including the two main employers' organizations.

In a short timeframe, four of the five employers' organizations reached agreement on objectives, competencies, organizational structure and other statutory issues. This led to the founding assembly meeting on 7 July, coinciding with the formal start of Bulldozer Phase III. A registration request was formally and publicly submitted at that meeting to BiH Prime Minister Terzic. This led to the registration of the Association of Employers of BiH on 3 September.

The founding members of this organization are the FBiH Employers' Confederation, the RS Employers' Council, the Association of Private Employers of the RS, and the Chamber of Commerce of Brcko. The one employers'



organization that decided not to become a founding member of this association was the Union of Employers' Associations of the RS.

The BiH Association of Employers will carry on the work of the Bulldozer Initiative, promoting the establishment of dialogue between the public sector and the private sector. The more conventional forum for such dialogue is a social and economic council. These have been established in many modern economies. They also already exist in the FBiH and in the RS, but not yet at the BiH level. The logical successor of the Bulldozer Initiative, after the third phase, would therefore be the Social and Economic Council at the State level

The natural third partner in this Council, with the Association of Employers and the Government, are the trades union. Following a recent meeting between the ILO, the Bulldozer Unit and Minister for Civil Affairs Safet Halilovic, on establishing a BiH Social and Economic Council, the Ministry publicly called on the trades union to "complete the registration of their organization at the State level in order to have legitimate partners for this task". This indicates that the Ministry, like the Employers' Association, would prefer to develop a dialogue with one rather than several labour organizations. The Ministry has assured the OHR and the ILO that the Social and Economic Council will be included in its budget and work plan.

The trades union and the Employers' Association will need extensive support in order to develop their role as government interlocutors on BiH social and economic policy. An initiative is underway to assess the needs and possibly set up a support program for the Association of Employers of BiH. There currently appears to be a gap in upcoming support programs for the trades union at the BiH level.



TOURISM

In March, the High Representative identified three challenges that must be met by the relevant BiH authorities if the tourism sector – potentially

a major foreign-exchange earner – is to begin acting as a motor of economic growth. The High Representative called for the enactment of legislation to establish a single BiH tourism promotion organization with adequate funding, the launch of a single hotel classification system (so that three stars in one resort means the same as three stars in another), and the inauguration of a programme to step up the exchange of skills between other tourism markets and BiH.

Since then, tourism has been incorporated in the Medium Term Action Plan (PRSP), and the Ministry of Foreign Trade and Economic Relations has assumed a coordinating role in developing the tourism sector.

This reflects the growing consensus that tourism can be a major source of job growth and foreign exchange earnings for Bosnia and Herzegovina. Statistics from the World Tourism Organization and the World Tourism and Travel Council show that the global tourism industry is worth over 470 billion dollars per year and accounts for 67.4 million direct tourism sector jobs. Including linkages with other sectors, world tourism accounts for 194.5 million jobs, this is 7.6 percent of total employment. BiH obviously has a large potential in niche market tourism and tapping into the world tourism market could have huge benefits for the BiH economy, as these statistics show.

Until now, tourism, tourism promotion, and the hospitality and catering industry have been regulated at the Entity level. This has resulted in business-inhibiting differences in requirements for companies and individuals working in the sector, differences in the way funding for tourism promotion is collected and distributed, and differences in the way accommodation is classified.

These distinctions between the Entities are at odds with the reality of BiH tourism – there is a natural synergy in marketing destinations in both Entities with the same campaigns.

The Ministry of Foreign Trade and Economic Relations (MOFTER) has formed two working

groups to address the central issues affecting the sector:

The first group is working on State-level legislation covering tourism promotion, the harmonization of Entity legislation on hospitality and catering and the subsequent adoption of harmonized rulebooks on hotel classification. This group will also seek a permanent solution to financing Bosnia and Herzegovina's tourism promotion activities abroad. The working group consists of representatives from MoFTER, the Foreign Trade Chamber and members nominated by the Entity ministers responsible for tourism. The group is receiving legal support from OHR.

The second working group aims to draft a provisional, medium-term tourism-development strategy. This is likely to include an overview of bottlenecks in all policy sectors that are connected to tourism, such as accessibility (transport), availability of qualified workers (education), protection of natural tourism attractions (environment) protection of monuments (cultural heritage) and the need for policy development in these sectors that would support the tourism sector. The working group will consist of representatives from MoFTER, the Entity ministries of tourism and the tourism community (Federation of Bosnia and Herzegovina and Republika Srpska). In addition representatives from international organizations and NGOs that are working on tourism development will be invited to provide input.





BIH ECONOMIC UPDATE

BiH Economic Data January – October 2004

Source: CBBH, FBIH and RS Statistical Offices

Indicator	BIH (CBBH estimate)
GDP nominal 2000 (Million KM) GDP nominal 2003 (Million KM) Nominal increase 2000-2003	10,050 12,170 + 21%
Index of Industrial Production 05/04 compared to Ø 2003 05/04 compared to 05/03	N/A N/A
Consumer Price Index	0.6% (year end 2003)
Average Net Monthly Salary (in KM)	482.25
Number of Registered Unemployed	451.294
Number of Pensioners Average Pension (in KM)	474,480 180
Imports 01/04 - 08/04 (Million KM) Exports 01/04 - 08/04 (Million KM) Balance	6,507,037 1,937,654 (4,569,383)

