

# Bosnia and Herzegovina Economy & European Integration

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# Economic Newsletter

**We can move forward.  
Reform can deliver.**



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## Economic Reform is about Raising Living Standards

Bosnia and Herzegovina began its transition to market democracy under unpromising circumstances; it has progressed slowly and fitfully; its people have yet to enjoy the benefits of prosperity.

These are facts, and when we consider the pace and outcome of economic reform we must face these facts.

The object of reform is to raise living standards – simple as that. And this object hasn't yet been met, at least not on the sustained and substantial scale that is both necessary and possible for BiH.

The desired results – poverty eradication, massive investment and job creation – have not been achieved because years were wasted on political in-fighting, while the mass of citizens continued to struggle with day-to-day hardship. Also, the desired results have not been achieved because transition takes time – BiH is not the only country in Southeast Europe where things have got worse before getting better.

What we must be very, very clear about now is that things *can* get better, quickly and significantly. We *can* move forward. Reform *can* deliver.

Because many of the building blocks are in place, much of the work that has been done in the last few years can now pay dividends. But only if the authorities follow through. *Enacting* laws doesn't change lives – that only happens when laws are *implemented*.

There is now a clear and durable political consensus in support of the reforms required for EU integration and the reforms laid out in the BiH Development Strategy. At the same time, some of the reforms now being implemented, after long and often exhausting debate, are producing tangible results – the effective functioning of the Indirect Taxation Authority is one example.

So, we are entering new territory, where instead of simply calling on the people of BiH to support reform with sacrifices, we can begin to point to the practical benefits that reform can bring; we can move onto an upward trajectory, where political and administrative change brings tangible improvements in living standards.

The reports in this quarter's Newsletter make it clear that political shortcomings, institutional limitations and the burden of excessive bureaucracy lie between the people of BiH and a better life.

There is a clear and pressing need for the BiH Government to establish efficient institutions that are able to manage closer relations with the European Union. To do this, the complex and expensive multi-tier government system must be rationalized. BiH cannot afford duplication of functions – it costs too much and it reduces efficiency. The three Finance Ministers have appointed a Working Group to recommend ways of reducing the cost and increasing the efficiency of government. The vast majority of citizens will cheer on this initiative.

I will work with the Governments to make sure that BiH *does* move forward and that reforms *do* deliver.

Ambassador Lawrence Butler  
Principal Deputy High Representative

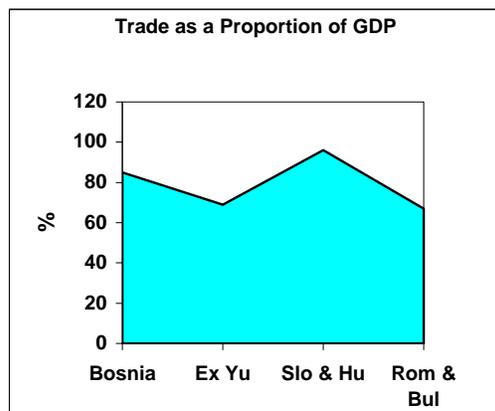


## Transition is About Long Term Benefits

Reform fatigue in BiH is becoming almost palpable. Most transition countries have, at times, experienced this, and BiH is not unusual, but BiH cannot afford to succumb to fatigue because it started its transition later than the other Southeast European countries, and its starting point in terms of economic activity and institutional development was less favourable. Compounding the fatigue is the fact that BiH's transition has, at times, faltered and, on occasion, has broken down completely. This stop-go syndrome has reflected an absence of policy drive and has resulted in a debilitating loss of reform impetus. As the EBRD's *Transition Report* noted: "Bosnia and Herzegovina and Serbia and Montenegro need to accelerate the pace of reforms if they are not to be left further behind."<sup>1</sup>

In some respects, BiH's economic performance figures are comparable with the average for the other countries of former Yugoslavia. There are even areas where it is doing significantly better than its neighbours. But there are as many cases where it is doing significantly worse.

If we look at the comparisons in the table below (bringing together statistics for Slovakia, Hungary, Rumania and Bulgaria as well as



<sup>1</sup> The European Bank for Reconstruction and Development, *Transition Report 2004*

former Yugoslavia) we see that all these countries are open economies with trade accounting for 60 to 90 percent of GDP.

Similarly, they all have significant current account deficits. The main differences among these economies are in their levels of foreign indebtedness and foreign direct investment. These comparisons primarily indicate that BiH is by no means an exception and that the BiH economy is broadly comparable to other transition economies in the region.

Although the link between reform and economic development is not straightforward, there is substantial evidence to show that a sustained commitment to reform and sound fiscal management brings considerable benefits to the economy over the long run. In BiH, reforms in the business environment and fiscal areas are particularly conspicuous because of the benefits they potentially bring in terms of economic transition as a whole and in fulfilling EU integration criteria. Concretely, the recent re-design of the fiscal system and the ongoing efforts of local experts to identify short- and medium-term options for reducing the cost of government will all have positive consequences. Rules pertaining to fiscal equilibrium, public expenditure and debt levels are often a critical factor in meeting investors' expectations and creating positive investment patterns. Thus, making public sector requirements and rules more predictable will reduce the potential for macroeconomic uncertainty. Small businesses and recent market entrants as well as foreign investors are particularly susceptible to macroeconomic uncertainty. That is why the reforms that have already been set in motion in order to put BiH on a more secure macroeconomic footing will probably matter more in the years to come than is apparent at present.

Business-environment reforms have, for example, included new laws on bankruptcy and liquidation and new laws on insurance. Since the rules governing bankruptcy and liquidation procedures are about more than simply writing off or recovering business debts, reform in this area will help redistribute assets from less

efficient to more efficient enterprises ensuring that assets are used more productively for the benefit of the whole economy.

The more efficient and transparent a country's business environment is, the more investment it attracts, the more competitive it is, the more its entrepreneurs begin to benefit from cheap credit. One important benefit arising from BiH's improving business environment could be the generation of new momentum in the faltering privatisation process.

While the BiH banking sector is stable and well developed, the insurance sector appears to be exactly the opposite. Recently enacted insurance legislation is designed to boost harmonisation, regulation and capitalisation of the market. Weakness in each of these three areas has contributed to the poor performance of the BiH insurance market to date – which has had a major negative impact on the economy as a whole because of the huge capital sums that are involved in this market and because of the importance of the market to a broad range of other economic activities. As economies grow, so too does the importance of managing risk; if the insurance sector is undercapitalised, atomised and relatively corrupt – as it has been in BiH – then the whole economy stands to suffer, directly and indirectly. Conversely, a vibrant insurance sector will aid in the development of capital markets, and increase public savings and private sector investment. In BiH, much work remains to be done before the insurance sector achieves a footing comparable to that of the banking sector, but, importantly, the foundations have been laid.

### 31 Chapters of Acquis Communautaire

Free movement of goods	Statistics	Consumers and health protection
Free movement of persons	Social policy and employment	Justice and home affairs
Free movement of services	Energy	Customs union
Free movement of capital	Industrial policy	External relations

Company Law	Small and medium enterprises	Common foreign and security policy
Competition Policy	Science and research	Financial control
Agriculture	Education and training	Budget
Fisheries	IT and telecoms	Institutions
Transport Policy	Culture and audio visual policy	Miscellaneous
Taxation	Regional policy	
Econ. & Monetary Union	Environment	

Of course, apart from benefiting individual sectors of the economy, reforms that have been undertaken so far in BiH have also aimed at harmonising the business environment and the commercial legal framework with the requirements of the EU's *Acquis Communautaire*. Specifically, they have sought to meet the economic criteria contained in the sixteen points of the European Commission's Feasibility Study. A glance at some of the chapters of *Acquis Communautaire* is enough to place in context the recent efforts to establish the Competition Council, introduce VAT, and set up a reliable statistical reporting structure. These steps can all be viewed in the context of BiH's efforts to align its economy with EU requirements. However, it should be emphasised that the adoption of rules and regulations contained in the *Acquis* is not an end in itself – these measures are aimed at attracting investment, creating jobs and improving living standards. As the elements of the *Acquis* are put in place systematically in the course of the accession process, the practical benefits of these measures will begin to be felt.

Before accession talks can begin, BiH has to satisfy three fundamental criteria:

- It must be a stable democracy, respecting human rights, the rule of the law and protection of minorities;
- It must have a functioning market economy; and



- It must adopt the common rules, standards and policies that make up EU Law.

Adopting the rules and regulations contained in the *Acquis* will clearly be the determining factor in BiH achieving these three objectives. Following the conclusion of a Stabilisation and Association Agreement, the integration process will be long and difficult – it will demand sustained and deep reserves of political will to push ahead with the introduction and implementation of comprehensive reforms.

EU accession has already become the focal point of BiH's reform programme, and the impact of this is beginning to be felt. Future accession talks will act as an incentive to the BiH authorities to consolidate the reforms that have already been introduced and ensure that they are fully and properly implemented. When the accession process reaches a point of no return this will buttress the country's political stability and economic momentum. This ought to reduce BiH's country-risk assessment, which could in turn bring a range of benefits, from cheaper airline tickets to cheaper loans and more foreign investment. So, although BiH's ability to attract foreign direct investment has been poor until now, as soon as it reaches the point where reforms are irreversible it should pass a critical threshold in its development.

EU entry will not make BiH rich overnight. The Economist Intelligence Unit calculates that if the 15 countries that were members of the EU before 2004 were to maintain economic growth of two percent a year, and the countries joining in 2004 and 2007 (including Bulgaria and Romania) were to grow by four percent a year, it would take the new members, on average, more than 50 years to draw level with the old ones. If the new members managed just three percent growth, it would take them 90 years to catch up. The Economist also notes that if the growth performance of any of the new member states should falter, "[that] country will be saddled with the rules and expenses of a club meant for rich people, while its income per person remains far below the average and may even decline in

relative terms."<sup>2</sup> If we consider the size of BiH's annual per capita GDP (around US\$ 2,000) as well as the recent rates of annual growth, it becomes clear that BiH must grow at faster rates or for a much longer period of time than its neighbours in Central and Eastern Europe before it can begin to reach EU wealth averages.

But this is an upward curve – in terms of business environment, inward investment, trade volumes and values, and (most important of all) standards of living. The EU integration process represents a blueprint for far-reaching reform that will deliver systematic benefits if the pace is maintained and the political will is mustered to move forward with initially difficult but, in the long term, beneficial changes.

<b>The long hard path to prosperity</b>		
Time needed for new members to reach average income per person in EU15 countries		
Countries	Average annual GDP growth per person, %	Years to catch up*
Bulgaria	3.8	63
Czech Republic	3.7	39
Estonia	4.8	31
Hungary	4.0	34
Latvia	3.9	58
Lithuania	3.8	53
Poland	3.8	59
Romania	3.8	80
Slovakia	4.0	38
Slovenia	3.2	31
Weighted average	3.8	56
Cyprus	3.4	21
Malta	4.1	29

\* Reaching EU15 average GDP per person assuming average EU15 GDP per person growth of 2% per year  
Source: EIU "Europe Enlarged: Understanding the Impact"

<sup>2</sup>Quotes & table: "Survey of EU Enlargement" *The Economist*, 2004



### Northwest

#### *ARDA NW Developments*

The EU RED project and the Northwest Regional Development Agency (ARDA) organized an "Open Day" Conference for the Northwest Economic Region, in Banja Luka on 22 March 2005, to inform all interested parties about the third EU RED Call for Project Proposals to be financed from a grant scheme worth € 3 million (the EU CARDS 2002/EU RED Programme Support for Regional Economic Development in BiH). The EU RED funding is focused on developing the business infrastructure to support SMEs, and on developing tourism activities. Business infrastructure development projects are oriented towards attracting foreign direct investment (FDI), reducing unemployment, supporting exports, and improving the application of science, technology, and innovation in business. Tourism development projects are oriented towards improving quality of service and the tourism market as a whole, and increasing the number of tourist destinations. The maximum grant amount for a single project is € 200,000. Submitted project proposals must be consistent with the NW BiH regional development strategy. The deadline for applications is 17 May 2005.

More on the application package is available at <http://www.delbih.cec.eu.int/>.

#### *Vitaminka, Banja Luka*

Vitaminka was founded in 1947 as a small workshop, which went on to become one of the best-known fruit and vegetable processing companies in ex-Yugoslavia. The company produces all types of fruit and vegetable products, including marmalade, *ajvar*, pickled vegetables and juices. Fruits and berries produced in the Banja Luka region have always enjoyed a reputation in the region and further afield for their high quality and distinctive aroma. The use of chemical fertilizer in the region is

below the average in Western Europe and elsewhere.

Vitaminka was sold to the Swiss company "Kreis Industriehandel Basel" in January 2002 (KM 250,000 in cash, plus investment worth KM 10 million). Significantly, the new owner has fulfilled all obligations contained in the privatization contract.

In 2005, Vitaminka plans to increase production from 10,500 tons to 15,000 tons, whereby the company will buy 6,800 tons of fruit and vegetables, mostly from domestic producers. Before the war, Vitaminka had reached a production level of 24,000 tons. The company exports to neighbouring countries (Croatia and Serbia), as well as to the countries of the EU.

More on Vitaminka is available at <http://www.vitaminka-kreis.com/>.

#### *Golden Metro, Banja Luka – Licensing agreement signed with Kolinska, Slovenia*

Golden Metro, Banja Luka was established in 1994. The company produces plastic bottles and beverages. It currently employs 68 people. The company recently introduced the internationally recognized ISO 9001:2000 and HACCAP quality standards. Golden Metro exports more than 50 percent of its production to Croatia, Serbia, Slovenia and Sweden.

A Licensing agreement with Kolinska, worth € 4 Million was signed on 25 February 2005 and bottling operations, with planned production of 10 million litres, began in March. It is expected, in the course of the next few years, that the overall turnover could reach between € 7 million and € 10 million.

### Northeast

In the first three months of this year, NERDA focused its activities on preparing the third call for proposals for applications for EU RED funds. For this purpose, EU RED and NERDA presented the application conditions in Tuzla and Modrica. NERDA also presented the Northeast

development strategy and an overview of its activities, to Bijeljina Municipality, where the municipal authorities expressed interest in future cooperation and indicated their support for regional development projects and activities.

NERDA hosted a delegation of the Czech Government; among possible projects discussed was the transfer of certification techniques to Northeast Region and BiH.

On 30 March 2005, NERDA held a seminar for potential applicants for municipal tenders, on public procurement rules and application procedures.

Currently, NERDA members are working on a dynamic plan to formulate the regional strategy over the next three years.

In terms of investment, the "Strolit" Metal Processing Company from Odzak, which was privatized in February 2005 by the EMPK Company of Slovenia, is a promising example. EMPK has decided to establish a modern production operation in Odzak. The contract envisages investment worth KM 4.45 million over a three-year period. In the first year this is likely to create 100 jobs, with an additional 100 jobs in the second year, and the intention is to maintain this employment level.

The FBiH Government has given its approval for the expansion of the Visoko Free Zone. The impetus for this expansion was provided by the Prevent Company, which is to initiate two export-oriented production facilities, which are projected to employ 230 workers.

On 3 February 2005, the Turkish Hayat Holding, Kastamonu Entegre, entered a joint venture with Natron Company from Maglaj. The Turkish partner will invest 14 million KM. The project initially expects to create 760 jobs, while an additional 150 workers are expected to be employed over the next two years. The project calls for 21 million Euros to be invested in the modernization of production equipment.

According to an agreement with the Srebrenica Municipality, the Slovenian company, CIMOS, will initiate the construction of a vehicle parts factory in Potocari. Work began in April, and the factory should begin production in May.

Although these positive examples show that recent economic reforms undertaken in BiH are starting to produce concrete results, prospective investors still have to contend with legal insecurity, enormous corporate debt liability, and a slow and excessively complex bureaucracy.

Many companies in BiH could be competitive and profitable, but need a credible investor that can provide access to regional and global markets. However, the issue of accumulated company debts deters investors. One classic example is the Fabrika Sode Lukavac, which is of enormous importance for the development of the mining and chemical industries in the Tuzla Canton. Despite a genuine interest in the company on the part of foreign investors, the firm's accumulated debts have prevented any investment agreements. The BiH authorities have yet to formulate a systematic approach to this problem.

It is also clear that many state-owned companies are accumulating debts that will prevent any investment in these companies in the future. Inconsistent application of the bankruptcy laws will drive these companies into liquidation, after which they will lose any possibility of restructuring.

The experience of Unico Filteri from Tesanj provides a textbook example of the damage that can be done by bureaucratic barriers and inadequate implementation of procedures. When the potential investor sought to buy UNICO Filteri and boost its turnover, it was caught up in court procedures caused by initial tendering flaws.

Progress in the fight against illegal and unrestrained deforestation cannot be made until the issue of competence over management and exploitation of forests is resolved. Concrete examples are Krivaja Zavidovici and Stupcanica in Olovo, both in Canton Four. Unfortunately, neither the management of these companies nor



the Canton Four Government has taken the necessary steps to implement the FBiH Forestry Law. Their lack of action is preventing privatization, investment, and the development of these companies. In addition, it has also left the door open for abuses, illegality and corruption in the forestry sector - one of the key sectors for economic development in BiH.

Business in BiH needs proactive, efficient and accountable authorities with the courage to stand by reforms, and in all phases to initiate, adopt and implement these reforms.

### Southeast

Developing tourism, promoting the growth of business infrastructure, stimulating exports, reducing unemployment, attracting foreign direct investment and facilitating business registration procedures are the main themes for the disbursement of € 3 million in EU RED assistance for regional economic development projects in BiH. A Call for Proposals seeking potential projects for financing was issued on 17 February with a three-month deadline for the receipt of applications and a maximum grant amount of € 200,000 per project.

In February, an MoU was signed between the Italian Region of Tuscany, the Italian NGO UCODEP, and REDAH regulating modalities for the joint promotion of REDAH's projects and initiatives as well as the implementation of economic development projects of common interest. A programme currently being promoted by the Tuscany Region encourages local governments to become a driving force of economic development in order to contribute to the creation of stable social growth. Local partners in this programme are the Herzegovina-Neretva Canton, the City of Mostar and the municipalities of Livno, Trebinje and Nevesinje. Within the Program each of these partners will be supported with the amount of € 80,000 for the implementation of projects ranging from tourism development (Mostar), the promotion of the *Hutovo Blato* nature resort (HNC), construction of a regional waste dump (Trebinje), and reconstruction of a sewage system (Livno) to

upgrading the quality of the water supply system (Nevesinje). The MoU will be in force until July 2006 when the program will end.

A roundtable on cross border cooperation in tourism was held in Tivat, Montenegro, organized by the East-West Institute's Dubrovnik Office, on 24 Feb 2005. Participants came from Dubrovnik, Tivat, Kotor, Herceg Novi, Trebinje, Mostar (REDAH) and Sarajevo (USAID). Participants emphasized the need for cooperation, underlining the mutual importance of Dubrovnik and Montenegro, and adding that day trips from Dubrovnik to Herzegovina, Mostar and back had traditionally been part of the tourism offer of Dubrovnik and should be included in future offers as well. There was a twofold idea behind this roundtable: to ensure face-to-face meetings among tourism specialists in the Dubrovnik-Trebinje-Tivat triangle and to help re-establish proper relations among the main regional urban centres of Trebinje, Herceg Novi, Mostar and Dubrovnik. This and similar events should serve as a valuable tool in overcoming past disagreements and introducing a new basis for dialogue, which will benefit the residents of the triangle formed by Dubrovnik County and Western and Eastern Herzegovina. Moreover, enhanced regional cooperation is one of the basic principles promoted by and within the European Union.

With the aim of reducing the unemployment rate in the region and promoting the development of the SME sector, a five-day training course under the slogan "*Start Your Own Business*" was organized in March, sponsored by the FBiH Ministry for Development, Entrepreneurship and Craft. The course was given by the Association of Entrepreneurs and Service Centre LiNK, at no charge. It brought together participants who are currently unemployed, students and young entrepreneurs from the Herzegovina region and presented basic information about business plans, registration of companies, marketing, tax policy and other elements in successful company management. LiNK has also implemented another pilot project in the SME sector – the Loan Guarantee Scheme. With an initial fund of KM 600,000, this project has supported 28



companies so far, creating 36 new jobs and helping to preserve 96 existing ones. The Association is currently seeking new funding partners in order to increase the Loan Fund.

In February *Violeta* Company, a producer of sanitary tissue from Grude, signed an exclusive three-year contract with the Iranian Company *Hidrophil Zanjan* for the distribution of five products from the “wet wipes” line to the Iranian market. A similar agreement has just been concluded with a company from Jordan, while negotiations related to the Saudi Arabian market are underway. Apart from the countries of former Yugoslavia, *Violeta* had already been exporting its products to Switzerland, Germany, Sweden and Libya. At the same time, the company is planning to put into operation a new nappies production line, which is expected to create 35 new jobs.

Last year, the Trebinje Tools Factory exported goods worth KM 22 million and thus became the fourth biggest exporter in the RS. The company plans to increase the value of its exports to KM 25 million next year. It has recently invested € 250,000 in the purchase of modern machinery. This represents the first serious investment in the modernization of equipment in 16 years. The privatisation of this company has been delayed for at least four years. In June last year, the RS Government adopted an action plan for the reorganization and privatisation of the Tools Factory. The plan anticipates that a new holding company will be established after the re-registration of the Tools Factory as a stock company and the re-registration of the sub-units as separate stock companies. The RS Government has tasked the RS Privatisation Agency to prepare, in cooperation with the Tools Factory management, stockholding assemblies for the newly registered companies. Most of the activities needed for the convocation of these assemblies have now been completed and the next moves are eagerly awaited. On completion of this step, the privatisation call will be issued.

Under the sponsorship of the BiH Presidency, USAID and Austrian Ambassador to BiH, the Herzegovina Association of Wine Producers

organized a *Night of Herzegovinian Wines* to present the BiH potential for wine production and especially the tradition and importance of this activity for the entire Herzegovina region, where almost 98 percent of all BiH vineyards are located. Although this sector has started to recover, the Wine Association argues that more support from the relevant authorities is required in order to reach the pre-war level of production and to prepare this sector for EU integration.

## Sarajevo

Since 7 February SERDA has been located at new premises, in Čemerlića 2/11. The “SERDA-in” business incubator is at the same address. The incubator offers clients premises that can be rented at reasonable rates, and the use of resources and services, including consulting, legal assistance, and accounting, and training programmes. The business incubator premises of around 2,000 m<sup>2</sup> have been allocated on the basis of public tenders issued since the beginning of this year. The first allocations were made in March, and currently around 62 percent of total capacity has been taken.

In the Business Development Sector, submission and processing of farmers' applications continues for loans approved by the partner bank.

Among projects in which SERDA portfolio managers have participated since the beginning of this year has been the “Cycle Management” training seminar on implementing integrated return projects. This was organised jointly by SERDA and ASB of Germany.

EU RED experts on industrial zones from Ireland, Tom Kelliher and Caimin Jones, have, together with the Development of Commercial Infrastructure Portfolio Manager, visited a dozen locations for potential industrial zones in the region. EU RED consultants, together with the members of the SERDA Assembly and Supervisory Board and numerous guests, made a presentation on a pre-feasibility study and preliminary proposals for the development of industrial zones in the Sarajevo region on 23 March.



The 2005 Operation and Financial Plans were adopted at the 10th Assembly session of 23 March 2005. At the same session the decision was taken on the accession of Olovo and Vares Municipalities to SERDA membership, so that the number of founders was increased to 24.

At the invitation of Conseil Regional d'Auvergne and the Union Europeenne en Auvergne, the SERDA director visited the French province of Auvergne from 28 March to 1 April. The purpose of this visit was to get to know the activities of the Auvergne DA and establish cooperation between the two regions.

### Central

The Regional Development Agency of Central BiH (REZ) is focusing on two clusters: wood processing and metal.

Over 100 companies from the wood-processing sector represent an excellent starting point for the development of a regional wood-processing strategy. Since February 2005 representatives of educational and science institutions, ministries, chambers of commerce, vocational associations, and other institutions directly or indirectly connected with the sector have been working on a regional strategy in close cooperation with USAID.

Problems experienced by producers have been identified and prioritized. In the course of the next few months, solutions will be prepared regarding better access to capital, application of new technologies, development of quality systems, education of staff and development of marketing capacity in the wood-processing sector.

In addition, visits are being organized for producers to wood-processing fairs and to one of the largest wood-processing clusters in Italy.

With regard to the metal cluster, REZ has facilitated a survey of the preconditions for establishing a metal-processing cluster in the region. The Survey is funded by the Federal Ministry for Development, Entrepreneurship and Craft. During the first phase of the project, all

necessary data about metal processing in the region was collected. There are 160 companies related to metal processing in the region.



## FISCAL SECTOR

### *Fiscal Challenges Ahead*

The complex system of government in Bosnia and Herzegovina presents a challenge for those responsible for public finance. During the recent consultations between the government of BiH and the International Monetary Fund, the IMF recommended measures to strengthen fiscal coordination between the State and the two Entity governments and enable BiH to assume full fiscal sovereignty.

Demands on public budgets are increasing at a time when government costs already consume half of the national income. State institutions must be created and expanded to enable BiH to negotiate and implement a Stabilisation and Association Agreement with the European Union. There is a backlog of infrastructure needs that require public investment. The costs of payouts to cover domestic claims for war damages and frozen foreign currency accounts are potentially huge. For all of these reasons, BiH must urgently find ways to reduce the cost of governance significantly, while increasing the efficiency of government services.

To increase inter-governmental fiscal coordination and address these issues, the finance ministers for the State of BiH, the Republika Srpska, and the Federation of BiH formed the Fiscal Sustainability Working Group on 11 February. They named a panel of government and academic experts on public finance to advise them on ways to economize on government costs at all levels, while increasing government effectiveness.

The most urgent task of the Fiscal Sustainability Working Group is to tackle the problem of State salaries and benefits. As agreed with the IMF, average compensation packages for 2005 must be quickly reduced by 10 percent to stay within

the State budget limits. Moreover, salaries vary wildly between different State agencies and are on average much higher than those at other levels of government. Salaries for employees of BiH institutions should be made more flexible and applied similarly across all State-level institutions and ministries. An expert sub-group is currently analysing the personnel costs of all State budget users and drafting a new State law on wages based on modern principles that can be applied in the drafting of the laws regulating salaries at lower levels of authority.

Over the next several months, the Fiscal Sustainability Working Group plans to develop a wide menu of cost-cutting options based on analyses of the optimal allocation of government functions and corresponding revenue assignments. The Working Group's goal is to produce recommendations by September on which the finance ministers can act on this year and which can be used to prepare sustainable State and Entity budgets for 2006 and beyond.



## AGRICULTURE

### *Forestry*

The recent audit reports on Srpske Sume highlighted patterns of gross mismanagement and potential criminal activity. While the RS judicial authorities are following up on the potential criminal activity, the Ministry of Agriculture, Forestry and Water Management, together with RS Sume (Srpske Sume's new name), have started to improve the corporate structure of the company. To what extent they are serious in this endeavour remains to be seen.

However, it is clear that a systematic approach to establishing sustainable forestry management must be inaugurated.

As much as two years ago a group of academics and experts from BiH's forestry sector began to prepare solutions. In the context of Bulldozer Phase Two the idea of sustainable forestry management was advanced (for the first time in BiH) by relevant industry associations. With the

support of the OHR a draft proposal on this idea was submitted to the BiH Ministry of Foreign Trade and Economic Relations in March 2005.

The core problem is that a substantial volume of wood is leaving BiH without any value-added processing. The urgent challenge is to retain the value of this resource within BiH. Or, in an export context, to *return* the value of this resource to BiH.

The underlying idea is as follows: The major actors in logging are the publicly owned forestry companies. They are monopolistic and generally lack transparency in their dealings. The forestry companies are well organized and networked, in contrast to the wood-processing sector, which is weak and rather disoriented. The forestry companies dictate prices and control the customer base. In the absence of even superficial oversight, they are free to act opportunistically. If blame for illegal logging can be attributed to any sectoral actor, it can be attributed to the publicly owned forestry companies. Illegal sawmills would shrivel away if they were not continually supplied by cash-strapped forestry companies. Although they control the product flow, the publicly owned forestry companies claim no responsibility for "who buys the product or what they do with it".

This draft Law is an attempt to reach into the mechanics, the daily business operations of the publicly owned forestry companies and ensure that they begin to function on the basis of acceptable corporate practice. The companies themselves are lobbying for the law to be applied on the basis of self-policing, on the grounds that the government, which has so far singularly failed to regulate the forestry sector, cannot be expected to "do everything". Not all publicly owned forestry enterprises are corrupt, but the level of corruption in the industry is endemic – self-policing won't work.

Change management and a turn-around strategy for the forestry sector are desperately needed. Today, foreign buyers are very interested in Bosnian wood, but they are not interested in Bosnian processing. One strategy is to harness

the power of all actors in the sector so that they can begin to protect their own long-term interests by ensuring that all transactions are based on sustainable forestry management. The draft Law provides the industry with viable tools to do this.

The law addresses an economically and ecologically untenable situation in which illegal loggers are obtaining quick profits while the country's forestry reserves are being depleted and thousands of skilled workers are being put out of work. It would set in place a legal framework within which the BiH wood industry could be placed on a sound long-term footing and provide sustainable exploitation of limited natural resources. Its enactment and implementation are therefore crucial for the future of the sector and of the BiH economy as a whole.

#### *Institutional capacity*

The EC Sectoral review recommended steps to be taken in order to establish a functioning legal and institutional framework. Despite clear recommendations and support from various members of the Council of Ministers, however, the FBiH Government submitted to the Federation Parliament a draft Law on Agriculture without any consultation with the State.

This initiative to promote Entity legislation unilaterally is not only out of step with the recently published EC recommendations but also prevents the forthcoming implementation of € 1 million worth of EC technical assistance to strengthen the State-level agricultural administration.

Furthermore, it goes against the interests of stakeholders in the agricultural sector. BiH farmers and agro-processing companies have for some time been lobbying for the establishment of a State Ministry for Agriculture as an institution that can bring about positive changes in agricultural trade and income policy for the benefit of farmers.

After the EU Ambassador's and High Representative sent a letter to the Federation Parliament this initiative was stopped and now

we hope that the FBiH and RS Governments will start lobbying for agricultural reform in a coordinated way at all levels of government. Setting up a working group under the chairmanship of MoFTER would be the next positive step in this direction.

#### *Veterinary*

Four months after the establishment of the State Veterinary Border Inspection this service is on the road to becoming effectively organised and equipped. With the support of Partner for Development, a USA NGO, the State Veterinary Office has begun the process of strengthening capacity at veterinary border crossings. This and similar projects in the veterinary sector are improving service and introducing European standards in BiH.

However State veterinary border inspection is only one aspect of the complex veterinary system, in the reliability of which the EU has expressed a particular interest.

The animal health surveillance system covers several functions and cannot operate properly if any of these functions is run inefficiently. And in the final instance the efficiency of the whole system depends on the degree of cooperation among various levels of the public administration. This cooperation includes elements such as gathering, sharing, processing and responding to information. At the moment, cooperation varies between Entities, cantons, municipalities and the State administration.

#### *Plant Health Protection and Food Safety*

Since November 2004 the CoM has been delaying the appointment of the managerial staff in the BiH Agency for Plant Health Protection, while positions in the BiH Agency for Food Safety have not yet been advertised.

The Agency for Food Safety and the Phytosanitary Agency have been allocated funds for the last quarter of 2004 and for 2005, but funds have remained unused because those bodies were not established.



Clearly, BiH can only make further progress towards Europe if ministries implement the laws and decisions they have taken.

The problems with the legislative and institutional framework and incentives policy have been highlighted at the round table hosted by BiH's association of plant and food processing producers and USAID LAMP (Project on Linking Agriculture Producers with the Markets). The problems of seed and seedlings smuggling, disharmonized subsidies policy, lack of certifying institutions and import controls, have been identified as major obstacles to development of this industry and as major threats to the consumers' health. A specific problem for processing companies is access to local distribution market chains.

The round table called again for the establishment of a BiH Ministry for Agriculture as a top priority.



## STATISTICS

### *Mission Possible?*

Ensuring the provision of reliable statistics is one of the 16 EC Feasibility Study preconditions for negotiating a Stabilization and Association Agreement. With this in mind, attention should be focused on implementing the BiH Law on Statistics, with the aim of creating a functional statistical system with clear responsibilities and efficient coordination mechanisms.

The central problem continues to be the production of State-level statistics. Some major macroeconomic indicators are still missing; these include price statistics (consumer price index, producer price index), industry statistics (index of industrial production), and national accounts statistics (calculation of GDP using expenditure approach, level of non observed economy).

The BiH statistical system consists of one State office created in 1998 (BHAS: Bosnia and Herzegovina Agency for Statistics, with a field office in Brcko) and two Entity offices (RSIS: The

Republika Srpska Institute of Statistics, FBHOS: The Federation of Bosnia and Herzegovina Office of Statistics).

Coordination and harmonization of activities among statistics stakeholders remains problematic. The level of statistics gathering in BiH has been influenced by both statistical and non-statistical (mainly political) factors, which in the present circumstances has hindered most potential progress in this area. Among the negative factors are the complex political organization of the state, the different levels of statistics gathering (State & Entity) with different sources of financing of statistical activities and often unsuitable external data sources, a constant problem with the statistical resources available (mostly placed within the Entity statistical institutes), and the fact that the CBBH is not officially included in the BH statistical system.

At this point, it is of crucial importance to reach agreement on a clear procedure of subordination of the Entity statistical institutes to the BHAS, to establish a proper source of financing of State-level statistics activity, and to improve the capacity of the BHAS so that it can successfully coordinate all activities related to State-level statistics production. The issue of subordination of the Entity statistical institutes, as well as the issue of financing State-level statistics, should be partially solved through the preparation of a Memorandum on creating a single BiH statistical system (initial document to be prepared by RSIS), and an official statistics action plan (to be prepared by BHAS). Addressing the issue of BHAS staffing will be time consuming. In view of the limited statistical resources within Bosnia and Herzegovina, deploying the resources of the Entity institutes to produce State-level statistics may be the best choice in the short-run.

It is obvious that the lack of reliable statistics has a negative impact on the quality of economic planning in the country. It is not easy to think about investing in a country where nobody knows exactly how many inhabitants there are, what the real rate of inflation is, or how big the workforce is. However, improving the BiH statistics system

is a continuous process. For the moment, the national statistics pillars should focus on establishing a single system that can produce reliable statistics for both domestic and international users.



## UTILITIES SECTOR

### Transport

A Working Group to prepare the BiH Law on Railways was established in the autumn of 2003. After a positive beginning, problems were encountered, threatening to undermine the whole project.

The Law on Railways is a part of a larger process of transformation of the railway sector in BiH. For BiH, the recovery of this sector is of considerable importance bearing in mind the country's economic potential. The pre-war economy largely depended on the heavy and extractive industries. In 1990, coal, coke, iron ore, and steel accounted for more than 60 percent of the total tonnage of freight carried by the railways in BiH. In 2003, total freight amounted to 5.91 million tons. In 1990, this was 25,900 million tons - in other words there has been a contraction of almost 80 percent. However, in the aftermath of the recent privatisation of Zenica steel works and the associated mines and coke plant, it is estimated that in the next few years, the railway lines to and from Zenica will be required to carry some 6.2 million tons of goods.

Recovery of the railway sector and heavy industry (on which whole towns and communities depend in some parts of the country) are substantially interlinked. Success will depend on the ability of the railway sector to transform itself into a demand-driven and profit-oriented supplier of affordable transport services and on the heavy industries' ability to attract sufficient fresh investment capital. Thus, EBRD and EIB plan to invest between € 120 million and € 160 million in this sector starting from this year, provided that certain conditions are met. The crucial condition is the passage of the Railway Law, along with progress on later stages of the reform process.

Although the law does not compromise on prevailing European standards, during the drafting process it became apparent that for the law to become fully functional and constitutionally acceptable the original inter-Entity agreement on railway transport (signed in 1998 under the auspices of Annexe 9 of the DPA) will have to be revised. So, the law itself will deal with railway-sector regulation, licensing and compliance, while a revised inter-Entity agreement is envisaged to cover aspects such as management of railway infrastructure. So, the Law on Railways is the first stage in a long process; the second stage is the revised inter-Entity agreement, and the third stage will be the advent of a comprehensive railway financing structure. Of course, these stages will probably not move in a linear progression since each will have a life of its own even though they are interlinked to a considerable extent.

Passage of the Law on Railways and comprehensive implementation of the further stages in this process will be crucial for the future development of the railway sector in BiH and for the country's overall economic development. In view of the importance of this reform and in view of the conditionality for the disbursement of EBRD/EIB funds, the BiH Parliament should address this issue as soon as possible.



## ECONOMIC TRANSITION

### Privatisation

Recent developments in the area of privatisation give reason for cautious optimism. Governments in both Entities seem to have recognised the benefits of privatisation. Potential successes include the privatisation of Jelsingrad, Banja Luka, which has attracted Slovene regional market leader Livar, while the privatisation of Energopetrol, Sarajevo, has reached the final stages. Energoinvest, Agrokomerc, and KTK in FBH, and Banja Luka Brewery are some of the high profile companies to be privatised over the next three to six months.

There is an emerging trend that should give reason for concern, however. An ever increasing number of enterprises, not just those in the pre-privatisation stage but also some in the post-privatisation stage, are facing legal disputes and other contractual challenges. The list includes companies such as Hidrogradnja, UnicoFilter, Feroelektro, Energopetrol, and Energoinvest. The number of disputes affecting strategic companies suggests that this is a systemic problem. Potential remedies may include mediation, arbitration and developing a more expeditious judicial system.

## Business Environment

### *Obligations*

The basis for modern economic activity is a legal framework that establishes legal certainty throughout the country. The existing legislation regulating contractual relations in BiH, however, does not provide for this certainty.

The ex-SFRY Law on Obligation Relations dates back to 1978; it represents the most complete and comprehensive legal text regulating contractual relations. Although this legislation was taken over by the Entities and Brcko District, subsequent amendments resulted in the evolution of three different laws regulating such relations in BiH. A source of particular concern is the fact that the application of the three different current versions of the obligation relations laws requires the adoption of several more laws, to mediate when the laws conflict, as in inter-Entity or international transactions.

Besides being illogical for a country of the size of BiH, such a complex legal system cannot ensure consistent legal treatment, protection of private property, and legal certainty on the territory of BiH. Moreover, it is contrary to the aim of achieving a Single Economic Space. This further exerts a chilling effect on inter-Entity and foreign direct investment and thus on the promotion of a market economy and BiH's economic takeoff in general. Needless to say, the regulation of contractual relations in BiH does not reflect the prevailing trend in the European Union, which

aims to draft uniform EU-wide contractual relations legislation.

Given the risks that the existing system poses to BiH's economy and given the absence of any guarantee that, even if harmonized, the Entity- and Brcko-level laws would not be subsequently amended or applied differently, it is imperative to adopt a single Law on Obligation Relations for the entire territory of BiH. Such a state-level law - the application of which would remain within the exclusive competence of the existing courts and would not require the establishment of any new State-level institution - would ensure uniform regulation of contractual relations and uniform judicial and legal praxis. This would further lead to the improvement of legal certainty and business predictability in contractual transactions, it would contribute to the creation of a Single Economic Space, and it would make BiH's business environment more conducive to investment.

The opportunity that this legislation presents for BiH's economic development is clear and must not be lost. Representatives of BiH's business community and legal profession are aware of this, but it is up to their elected representatives to seize the opportunity to move forward. Their path is clear.

### *Business Registration*

Aiming to introduce uniformity and promptness in the manner of registering a business in BiH, the BiH Parliamentary Assembly adopted the State Framework Law on Business Registration on 29 July 2004 (*BiH Official Gazette*, No. 42/04 of 10 September 2004).

Following the law's entry into force, the Entities and Brcko District were expected to adopt corresponding laws that would give effect to the provisions of the State Law and that would ensure uniform application of its principles. While the Brcko District Law is yet to be presented to the respective legislative authorities, the Entities' legislative procedures have been successfully completed. The FBiH Parliament adopted the FBiH Business Registration Law at its sessions



of 29 and 30 March 2005, while the RS Business Registration Law was adopted by the RS National Assembly on 6 April 2005. Both Laws are currently in the process of being gazetted.

Despite being behind schedule, the adoption of the new Business Registration Laws represents a major contribution to creating a business friendly environment in BiH. The procedure for registering a business will now be identical throughout the country and applicable to all businesses that are to be established in BiH by either local or foreign physical and legal persons. Uniformity will also apply to business registration application forms and certificates, which will be identical for all businesses and throughout BiH. Apart from achieving uniformity, the time needed to register a business will be significantly reduced, which is another incentive for business development and investment.

The new Business Registration Laws establish a single business registry/business registration system, which will keep data on all registered business entities in BiH and which will be accessible to all registration courts in the country. Of particular importance is the fact that the new Laws will provide for thorough checks by, and flow of information among, various governmental bodies, such as tax and customs authorities, municipalities, statistical institutions, institutions for pension and disability insurance, and relevant regulatory bodies.

In addition to providing the necessary legal basis for introducing a business friendly registration system, the adoption of the Business Registration Laws marks the successful completion of the first phase of business registration reform, which was implemented with the assistance of the UK Department for International Development. Moreover, it represents a significant step toward the realization of the World Bank's Business Enabling Environment Structural Adjustment Credit.

The new Business Registration Laws must now be implemented consistently. Implementation is scheduled to begin within 60 days of the laws'

entry into force. Responsibility for this stage of the process rests firmly with the BiH, Entity and Brcko District authorities. It will, therefore, be their will, consistency and promptness that will determine the actual establishment of the new business registration system and thus the realization of expected benefits for the country and its citizens.

#### *Accounting and Auditing*

The State Law on Accounting and Auditing was adopted by the BiH Parliamentary Assembly on 29 June 2004 ("BiH Official Gazette", No. 42/04 of 10 September 2004). Besides establishing mandatory accounting and auditing standards and a professional code of ethics for the whole of BiH, this piece of legislation defines uniform requirements for obtaining professional accountancy and auditing qualifications, as well as for training, testing, certification and licensing. Moreover, it regulates mutual recognition of qualifications, ensures the undisturbed conduct of audits throughout BiH, and establishes a State Commission for Accounting and Auditing to monitor the application of accounting and auditing standards in BiH.

Following the entry into force of the State Law, the Entities and Brcko District were obliged to adopt corresponding laws that would give effect to and be consistent with the provisions of the State Law. While the Brcko District Law has yet to be put into legislative procedure, the Entity Laws are currently awaiting their second reading by the respective legislative authorities and their adoption was expected by the end of April.

Provided that the Laws are adopted in a form that does not contradict the aims of the accounting and auditing sector reform, they will create a system ensuring the independence, integrity and self-regulation of the accounting and auditing profession, the protection of the public and a continuous improvement of standards. The system based on these principles is expected to modernize and revitalize the accounting and auditing profession in BiH and thus to address severe criticisms of BiH's accounting and auditing practices. Moreover, it should bring BiH



into line with internationally recognized practice and contribute to its attempts to align itself to the *Acquis Communautaire*.

## Trade

### *BiH Must Become a Trading Country*

With an economy that generates around € 9 billion annually, Bosnia and Herzegovina is a relatively small market. However, the country as a whole (let alone its constituent Entities) cannot expect to supply domestic demand only from local production. Nor can it rely on domestic consumers to buy enough locally produced goods to keep everyone fully employed.

Thus, BiH must be a trading country.

A trading country needs a modern, coherent trade policy that includes implementation of international standards and adherence to international trade rules. Such a policy is slowly taking shape, but BiH still has a long way to go. A crucial first step was accomplished with the establishment of a single customs zone administered by the inter-governmental Indirect Taxation Authority (ITA). Today a unified customs service for Bosnia and Herzegovina is inspecting all imported goods and applying a single tariff schedule.

In recent years, BiH has joined with its neighbours to promote regional trade liberalisation. Free trade agreements (FTAs) have been negotiated with eight other countries, mostly under the auspices of the Stability Pact for Southeastern Europe. The phase-in of the FTAs with Croatia and Serbia-Montenegro, by far BiH's largest regional trade partners, began in 2002, with trade officially becoming duty-free, albeit with some delays, at the start of 2004. Implementation of the FTAs with Macedonia and Turkey began in July 2002 and January 2003 respectively, but have not yet reached the duty-free target. Turkish goods will not receive duty-free treatment until 2007. Implementation of FTAs with Rumania, Bulgaria, Albania and Moldova began during 2004.

These agreements have generated controversy, as the relaxation of barriers to trade has produced some painful economic adjustments. In the long run, however, a trading country must be open to imports from other lands if it is to maintain free access to foreign markets for its exports. Furthermore, export competitiveness often depends on domestic producers having free access to low-cost inputs, whether imported or local.

These steps to improve the BiH trade regime are starting to pay dividends. The following table shows the recent trend:

	2003 (Jan.- Dec.)	2004 (Jan.- Dec.)	2005 (Jan.- Mar.)
Exports	up 11.5%	up 28.7%	up 23.6%
Imports	up 6.0%	up 7.6%	up 12.3%
Exports/Imports	26.2%	31.3%	37.4%

Source: Data compiled by the Central Bank of Bosnia and Herzegovina

The data shows that overall trade is growing rapidly and that exports are growing much faster than imports. The data for the first quarter of this year suggests the continuation of a sustained export boom. This is good news for the economic future of BiH. Today exports are generating enough revenue to cover well over a third of the country's import bill, up from a quarter in 2003.

Government revenue from imports tells a similar story. The ITA reports that customs receipts, now flowing to the single treasury account, increased by 4.8 percent for the first quarter of 2005, compared to the same period in 2004, even after the implementation of the FTAs. Moreover, excise and sales taxes on imported goods increased 9.9 percent and 20.5 percent respectively during the same period. Thus, trade growth is helping to strengthen the fiscal sustainability of government.

The next step is for BiH, led by the Ministry of Foreign Trade and Economic Relations



(MoFTER), to redouble efforts to join the World Trade Organisation (WTO). Joining the WTO would be a major milestone in the integration of Bosnia and Herzegovina in the world economic community.

WTO membership will bring practical benefits by ensuring that BiH does not suffer from discrimination from its trade partners, providing access to dispute resolution procedures, and giving this country a voice in the ongoing discussions to liberalise the global trading system further. Moreover, the reforms to BiH's trade regime required for WTO membership will contribute to the country's economic development and complement the reforms needed to join the European Union.

A WTO Working Group for BiH was established in 1999 and met most recently last December. BiH and its negotiating partners hope to hold another round of multilateral and bilateral negotiations later this year. In the meantime, BiH must make progress in implementing WTO-related legislation. Key issues include non-customs charges, import quotas, import licensing, customs valuation, rules of origin, patents, sanitary and phytosanitary measures. WTO members will expect BiH generally to bind its import tariffs at currently applied levels, avoid subsidies for agricultural exports, and allow branches of foreign companies to do business in all areas of the country. BiH also needs to establish trade measures regimes covering safeguards, anti-dumping, and countervailing duties that conform to WTO agreements.

As negotiations move forward for BiH accession to the WTO, to revise or expand the scope of FTAs, and eventually to join the European Union customs zone, the BiH authorities should consult closely with business, labour, and civic representatives. Trade agreements are concluded between countries, not just governments. It is important that the citizens of Bosnia and Herzegovina play a vital role in turning BiH into a prosperous trading country.



## BiH Economic Data January – April 2005

Source: CBBH, FBiH and RS Statistical Offices

Indicator	BIH (CBBH estimate)
GDP nominal 2000 GDP nominal 2004 ( <i>projection</i> ) Nominal increase 2000-2003	10,050 (Million KM) 12,911 (Million KM) + 28.5%
Consumer Price Index	0.6% (year end 2003)
Average Net Monthly Salary (in KM)	500.17
Number of Registered Unemployed (02/05) Number of Registered Employed (02/05)	478,299 628,056
Number of Pensioners Average Pension (in KM)	464,180 197
Imports 01/04 - 12/04 (Million KM) Exports 01/04 - 12/04 (Million KM) Balance	9,582,115 2,923,515 (- 6,658,600)