

Proposal for a Council Decision providing further macro-financial assistance to Bosnia and Herzegovina

(2002/C 291 E/20)

COM(2002) 437 *final* — 2002/0193(CNS)*(Submitted by the Commission on 31 July 2002)***EXPLANATORY MEMORANDUM****1. Introduction**

To consolidate the Dayton peace agreement that was signed in 1995, the international community endorsed a medium-term Priority Reconstruction and Recovery Programme amounting to USD 5,1 billion for the period 1996-1999. In 1998, at the fourth Donors' Pledging Conference for Bosnia and Herzegovina (BiH), the international community unanimously welcomed the agreements with the Bretton Woods institutions, which paved the way for more self-sustainable economic growth, and agreed to continue to strongly support the economic reform and reconstruction programmes of BiH.

Much has been achieved since the signing of the Dayton Agreement. The economy is beginning to recover, democratic institutions are being built, ethnic tensions have been significantly reduced and refugees are returning. The constitution of BiH only attributes limited competencies to the State government. The complex arrangements whereby the Entities, Repulika Srpska (RS) and the Federation (FbiH), and Brcko enjoy a great deal of autonomy, including over fiscal policy, has often made it difficult to identify a single national policy agenda. It is these complex constitutional arrangements, including an important role for the High Representative, which play a major role with regard to the development of the economic framework.

The Community has supported the process of economic reforms in BiH through Community macro-financial assistance. In May 1999, the Council decided to provide BiH with macro-financial assistance comprising a loan facility of up to EUR 20 million and a grant facility of up to EUR 40 million (Decision 1999/325/EC), in the context of an IMF programme (three-year stand by arrangement) that was agreed in May 1998. Following the completion of the first review under the IMF programme in June 1999 and the full clearance by BiH of its outstanding obligations to the Community and the EIB, the Commission disbursed in December 1999 a first tranche totalling EUR 25 million (EUR 15 million grant and a EUR 10 million loan). Following satisfactory progress under the IMF programme, including the completion of the fourth and fifth reviews, and the satisfactory fulfilment of the specific conditions attached to the Community assistance, the second tranche, amounting to EUR 20 million, was disbursed at the end of 2000. After the delayed completion by the IMF Board of the sixth and seventh (final) review of the SBA and, following two Commission staff missions, the respect of the specific economic policy conditions of the EC assistance were considered to be broadly met and the third (final) tranche of Community assistance (EUR 15 million grant) was subsequently disbursed at the end of 2001.

The EC has also supported the country's reforms with OBNOVA and, since 2001, with CARDS assistance. CARDS current assistance focuses, in accordance with the Country Strategy Paper 2002-2006, adopted by the Commission in December 2001, on support for the reforms and institution-building necessary to implement the obligations of a future Stabilisation and Association Agreement. The 2002 CARDS annual programme adopted by the Commission in May 2002 foresees commitments of EUR 71,9 million. The Multi-annual Indicative Programme foresees EUR 63 million for 2003. Additionally, ECHO has provided over EUR 1 billion of humanitarian assistance since 1991 (phased out in 2000), and the EIB has signed loans worth over EUR 160 million. Member States have also provided large amounts of grant funds for humanitarian aid, and for rehabilitation of transport, communications and utilities infrastructure.

Although much has been achieved to date many challenges remain. The key issues facing the authorities are the deepening economic reform and creating the conditions for self-sustaining market-driven economic growth, accelerating the return of displaced persons and refugees with particular emphasis on enabling citizens to exercise their property rights and fostering functional and democratically accountable common institutions supported by an effective merit-based civil service and a sound financial basis based on the rule of law.

The post war period has been characterised by extensive reconstruction, financed and directed by the international community. Although the country has recorded high levels of growth since the end of the war, GDP is still well below pre-war levels and the second lowest in the region. Reconstruction assistance is expected to decrease in the coming years and this will reduce externally driven growth. Reforms need to be continued to lay the foundation for internally driven, self-sustaining growth and job creation. The authorities in BiH intend to address these issues in the context of the forthcoming IMF programme.

The new IMF Stand-by arrangement, to be approved by the IMF board shortly, focuses on policies to achieve post-reconstruction growth through a continued commitment to the currency board arrangement and further significant fiscal consolidation. In addition, the programme foresees structural reforms in the areas of tax policy, privatisation, trade policy and improvements to the business environment.

The external sustainability of the BiH economy also remains challenging in the context of large current account deficits and weak private sector inflows. The balance of payments will therefore continue to rely upon official financing to meet the country's financing requirements over the medium term.

In these circumstances, and following the consultation of the Economic and Financial Committee, the Commission is now proposing to the Council to adopt a Decision providing further macro-financial assistance to BiH.

2. Recent Economic Performance

Recent macroeconomic data indicate that the high GDP growth rates, which accompanied BiH's reconstruction, have steadily fallen, reaching one-digit figures in 2000 for the first time since the end of the war. The growth rate for 2001 has been revised downwards, from around 5 % to 2,3 %, due to the slowdown in the Federation of BiH (FBiH) and the recession in Republika Srpska (RS). Official figures point to extremely high levels of unemployment (at 40 % of the labour force in 2001), although the World Bank estimates suggest the rate is one half of the official figure. Part of the 'officially' unemployed are likely to work in the informal sector, although limited survey data suggest that the poverty rates of the unemployed are three to five times higher than for the employed.

BiH achieved a major fiscal consolidation last year, despite weakening growth, with net arrears accumulation substantially reduced due to arrears clearance and better administration. Nevertheless, fiscal performance remains unstable. The revenue base of the Entities derives mostly from indirect taxes (sales, excises and customs) while the State budget, lacking own revenues, depends largely upon Entity transfers to meet one of its main responsibilities, foreign debt service. In 2001, general government expenditure was high at about 56 % of GDP. As in 2000, when budget ceilings were not respected, corrective measures had to be taken in 2001, when re-balancing exercises have been carried out in FBiH and the State.

Strict adherence to the rules of the currency board arrangement, established in mid-1997, has helped to moderate inflationary pressures and led to the almost general acceptance of the common currency, the convertible marka (KM), initially pegged on a 1:1 basis against the Deutsche Mark and now to the Euro. The previously significant inflation differential between the two Entities is converging to a low level: in the Federation of Bosnia and Herzegovina (FBiH) inflation has been well below 2 % in the past three years, while it has constantly decelerated in the Republika Srpska (RS), reaching single-digits in 2001. Increased economic integration between the two Entities has been a determinant factor in this convergence. The country-wide inflation rate was estimated at 3 % in 2001, reflecting the stabilising effect of the currency board.

The CPI-based real effective exchange rate depreciated by about 5 % in 2001, reflecting the sharp appreciation of the Yugoslav dinar; this provided some room for unit labour costs increases, which will have to be closely monitored in the future to avoid harming BiH competitiveness.

On the external side, in 2001 the balance of payments profited somewhat by an export recovery initiated in 2000 (partly due to reopening of the Yugoslav market) and a decline of imports (mainly due to reductions in donor finance for reconstruction). The current account deficit (excluding transfers) declined slightly in 2001 to around 20 % of GDP, from 22,2 % in 2000, but remained high. Net foreign direct investment (FDI) per capita was estimated at around USD 33 in 2001, but remains one of the lowest of the region. Gross official reserves increased to over five months of import cover in 2001, due to the increasing shift towards the use of the national currency.

External debt stood at 58 % of GDP at the end of 2001. Debt service as a percentage of export of goods is relatively low, reflecting the concessional nature of much of the debt and favourable debt rescheduling. However, total external debt service will increase substantially in the medium term, from USD 81 million in 2001 to USD 134 million in 2002 and USD 200 million in 2004 (a debt service ratio of 7 %).

3. Medium Term Economic Policy Framework

The new Stand-by arrangement (SBA) in the amount of about USD 89 million to be approved by the Board shortly will last for 15 months and sets the framework for policy from 2002-2003. The real GDP growth objective of the authorities is an increase from 2½ % in 2002 to 4 % in 2003, with a medium term growth target of broadly 5-6 % per year. The other main objectives are the reduction in current account deficit, maintaining strong international reserves and keeping inflation at current low levels. The policy is based on three central elements: prudent fiscal policies, strict adherence to the currency board arrangement and further structural reforms.

Fiscal consolidation is envisaged with the authorities committed to reducing the consolidated fiscal deficit (accruals basis) from 6,3 % of GDP of 2001 to 3 % in 2003. The reduction is driven by expenditure savings from the military demobilisation in 2002 and other expenditure reduction measures include freezing wages and hiring. Expenditure to GDP is expected to decline from broadly 61 % in 2001 to 55 % in 2003. On the revenue side, efforts will be made to strengthen the tax and customs administration, including through the implementation of the Tax Identification Number and the 'ASYCUDA++' customs information system. Tax revenues are expected to increase by 1 percentage point of GDP over the period although the overall revenue to GDP ratio falls by 3 percentage points of GDP to 52 % in 2003 due to lower grant revenues. Other fiscal measures include continued harmonisation of fiscal systems between Entities, the completion of a review of public expenditures with the assistance of the World Bank, and the full implementation, in each Entity, of the Treasury system at the central level, with plans to extend it to other levels also. Moreover, a second World Bank Public Finance Structural Adjustment Credit (PFSAC II) is being implemented which aims to improve inter-entity coordination, priority setting for expenditure, and budget and debt management.

The public debt stock, including domestic arrears (of some 9 % of GDP), is expected to rise from 68 % of GDP at the end of 2001 to 71 % of GDP at the end of 2003. However, including frozen foreign currency accounts (30 % of GDP) and potential war claims (50 % of GDP) the total stock of public debt could be over 150 % of GDP. The authorities will therefore revise the privatisation legislation to ensure that all privatisation revenues and succession monies are placed in an escrow account to be used for settlement of this debt.

Concerning monetary and exchange rate policy, the currency board, one of the most credible and successful BiH institutions, will remain, at least until mid-2003, as formally required by the Dayton agreement. Beyond mid-2003 changes are subject to State Parliament approval. However, the authorities have indicated a long-term commitment to the arrangement, in particular, because of its independence and insulation from the complex political environment.

Two main administrative changes are foreseen in the near future: the KM is already de facto pegged to the Euro and the necessary amendments to the Central Bank law will now be made. Also, the permissible reserve requirement range for commercial banks will be widened, from 10-15 % to 10-20 %, to allow for increased monetary policy flexibility. However, the reserve requirement will remain at 10 % over the stand-by arrangement. Moreover, the Central Bank will make no dividend payments to the government until its capital exceeds 10 % of its monetary liabilities (currently at around 5 %).

In terms of structural policies further strengthening is needed if BiH is to realise its growth potential. Policies will concentrate on the five main areas.

Firstly, the authorities will seek to improve the business environment, by facilitating both entry and exit of firms, by lowering administrative costs and by strengthening the legal framework for foreign direct investment. A World Bank operation (Business Environment Credit) aimed at improving and enabling the business environment was also recently agreed. Greater harmonisation of State and Entity laws is targeted, including in the area of bankruptcy. In the Federation at least 8 large strategic enterprises will be privatised in 2002, and further privatisation of medium-scale enterprises is expected in the RS.

In order to support trade liberalisation and trade promotion, efforts will be made to increase BiH's market access and regional integration. The authorities will seek to provide certification of inspection based on EU phyto-sanitary standards, and, by mid-2002 free trade agreements should be in place with all of the former Yugoslav republics, while bilateral agreements with Bulgaria and Turkey will be negotiated during 2002. WTO accession is expected for early 2003.

Strengthening of the financial system is also a priority with the completion of banking sector privatisation and by enforcing prudential banking regulations. Banks unable to be privatised by the deadline set by law will undergo bank resolution procedure. Similarly, by the end of 2002 all commercial banks will have to reach the minimum capital requirements of KM 15 million, or be liquidated. The authorities also intend to create a country-wide Deposit Insurance Agency which will supersede the current Entity arrangements. A World Bank Enterprise and Bank Privatisation Adjustment Credit (EBPAC) has also just been completed in this area.

The quality of statistical data is very poor with no official estimates for GDP, balance of payments or consolidated general government data being published. Therefore, major efforts will be directed towards improving the quality of statistics; these will entail improving coordination between the three statistical institutes and the Central Bank, initiating a household budgetary survey (with the support of the Customs and Fiscal Assistance Office (CAFAO), a programme funded by the European Commission), and producing real GDP estimates for 1998-2002; a first population census will be also launched, together with regular business and consumer surveys.

4. External Financing Requirements of BiH in 2002 and 2003

The new 15-month Stand-by Arrangement seeks to build on earlier achievements while facilitating stronger growth and a reduction in the current account balance. Nevertheless, even with continued good progress with reforms and continued macro-stabilisation it is clear that BiH will remain dependent upon official external financial support — including macro-financial assistance — in the foreseeable future.

The IMF balance of payments projections foresee current account deficits (before grants) of USD 1 015 million and USD 947 million in 2002 and 2003, respectively (21,3 % and 18,7 % of GDP). In addition, gross foreign reserves are planned to increase by USD 319 million in 2002, assuming among other things, continued conversion of DEM/EUR into convertible marka under benign external and domestic conditions, with a planned increase of USD 50 million in 2003. Taking into account amortisation payments on medium and long term debts (excluding the IMF) of USD 46 million in 2002 and USD 43 million in 2003, as well as minor changes in arrears, commercial banks net foreign assets, and London Club rescheduling and debt relief, the gross financing requirements are USD 1 281 million and USD 945 million in 2002 and 2003 respectively.

This financing need is expected to be only partly covered by foreign direct investment of USD 240 million in 2002 and USD 320 million in 2003, official capital transfers and loans for reconstruction (although this source of financing is declining), as well as other capital inflows, including the conversion of DEM/EUR into KM. After also taking into account other rescheduling and debt relief in 2002 the resulting financing gaps are USD 140 million and USD 60 million in 2002 and 2003 respectively.

Including expected IFI financing, overall residual external macro-financing gaps of some USD 75 million in 2002 and some USD 41 million in 2003 have been identified, i.e. a total of USD 116 million until end-2003. The IMF has assumed that Community macro-financial and other donor assistance would be provided during this period in order to close these gaps in 2002 and 2003.

5. Possible Further Community Macro-Financial Assistance and main Characteristics of This Assistance

The Commission is proposing that the Community makes available to BiH further macro-financial assistance in the amount of up to EUR 60 million as a complement of the new IMF 15-month Stand-by arrangement.

Given that the stock of public debt to GDP stands at nearly 70 % before taking into account frozen foreign currency deposits (30 % of GDP) and potential war claims (about 50 % of GDP) a cautious approach to new sovereign lending would be advisable. Thus, it is considered appropriate to provide a larger part of this assistance in the form of a grant, i.e. around EUR 40 million. Such a substantial grant element, which is completely in line with the first assistance package, would support increased external sustainability over the medium term.

The proposed grant amount would be financed from budget line B7-548 (Macro-economic assistance in favour of Western Balkan countries). Also in view of the BiH's external constraints, the loan would carry a maturity of 15 years with a 10 years grace period, comparable to the last macro-financial assistance package for BiH and to those for other Western Balkan countries. The adoption of this assistance would require an additional provisioning of the Guarantee Fund for some EUR 1,8 million which is possible due to sufficient margins in the reserve for the Guarantee Fund.

The Council is therefore requested to adopt the attached proposal for a Decision providing further macro-financial assistance to the BiH.

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 308 thereof,

Having regard to the proposal of the Commission,

Having regard to the opinion of the European Parliament,

Whereas:

- (1) The Commission consulted the Economic and Financial Committee before submitting its proposal.
- (2) The BIH authorities re-established links with international organisations and in particular made progress towards normalising the country's financial relations with multi-lateral creditors, including the European Investment Bank, and with official bilateral creditors.
- (3) Since October 2000, Bosnia and Herzegovina has achieved substantial progress in economic stabilisation and reform and has made important steps towards a well-functioning market economy.
- (4) Within the Stabilisation and Association process, the framework for EU relations with the region, it is desirable to support efforts to sustain political and economic stabilisation in Bosnia and Herzegovina, with a view to evolving towards the development of a full cooperation relationship with the Community.
- (5) Financial assistance from the Community shall be instrumental in bringing Bosnia and Herzegovina closer to the Community; the Community already provided macro-financial assistance to Bosnia and Herzegovina.
- (6) [The International Monetary Fund (IMF) approved on [...] a 15-month 'Stand-by Arrangement' for Bosnia and Herzegovina of about USD 89 million to support the authorities' economic programme in 2002-2003.]
- (7) The World Bank Group has committed broadly USD 900 million in support of 42 IDA credits/Trust Funds, and has disbursed broadly USD 670 million since 1996. In addition broadly USD 45 million of IFC loans have been committed with USD 37 million disbursed, as of February 2002. A second Public Finance Structural Adjustment Credit (PFSAC II) is being implemented and Enterprise and Bank Privatisation Adjustment Credit (EBPAC) has just been completed and a labour market reform and social protection operation was completed last year. An operation aimed at improving and enabling the business environment was also recently agreed.
- (8) The Members of the Paris Club agreed in October 1998 on debt relief in favour of Bosnia and Herzegovina, already alleviating the balance of payments situation.
- (9) The authorities of Bosnia and Herzegovina have requested financial assistance from the international financial institutions, the Community, and other bilateral donors.
- (10) Over and above the estimated financing which could be provided by the IMF and the World Bank, an important residual financing gap remains to be covered to support the policy objectives attached to the authorities' reform efforts.
- (11) Community macro-financial assistance to Bosnia and Herzegovina is an appropriate measure to help ease the country's external financial constraints, supporting the balance of payments and securing the reserve position.
- (12) Financial assistance from the Community in the form of a combination of a long-term loan and a straight grant is an appropriate measure to support the sustainability of Bosnia and Herzegovina's external financial position, given its limited borrowing capacity.
- (13) The inclusion of a grant component in this assistance is without prejudice to the powers of the budgetary authority.
- (14) This assistance should be managed by the Commission in consultation with the Economic and Financial Committee.
- (15) The EC Treaty does not provide, for the adoption of this Decision, powers other than those of Article 308,

HAS DECIDED AS FOLLOWS:

Article 1

1. The Community shall make available to Bosnia and Herzegovina a further macro-financial assistance in the form of a long-term loan and a straight grant with a view to ensuring a sustainable balance-of-payments situation and securing the country's reserve position.
2. The loan component of this assistance shall amount to a maximum principal of EUR 20 million with a maximum maturity of 15 years. To this end, the Commission is empowered to borrow, on behalf of the European Community, the necessary resources that will be placed at the disposal of Bosnia and Herzegovina in the form of a loan.
3. The grant component of this assistance shall amount to a maximum of EUR 40 million.

4. This Community financial assistance shall be managed by the Commission in close consultation with the Economic and Financial Committee and in a manner consistent with the agreements reached between the IMF and Bosnia and Herzegovina.

Article 2

1. The Commission is empowered to agree with the authorities of Bosnia and Herzegovina, after consultation with the Economic and Financial Committee, the economic policy conditions attached to this assistance. These conditions shall be consistent with the agreements referred to in Article 1(4).

2. The Commission shall verify at regular intervals, in collaboration with the Economic and Financial Committee and in co-ordination with the IMF, that economic policies in Bosnia and Herzegovina are in accordance with the objectives of this assistance and that its conditions are being fulfilled.

Article 3

1. The loan and grant components of this assistance shall be made available to Bosnia and Herzegovina in at least two instalments. Subject to the provisions of Article 2, the first instalment is to be released on the basis of an agreement between Bosnia and Herzegovina and the IMF on Stand-by arrangement.

2. Subject to the provisions of Article 2, the second and any further instalments shall be released on the basis of a satisfactory track record on Bosnia and Herzegovina's adjustment and reform programme, and not before one quarter after the release of the previous instalment.

3. The funds shall be paid to the Central Bank of Bosnia and Herzegovina.

Article 4

1. The borrowing and lending operations referred to in Article 1 shall be carried out using the same value date and

must not involve the Community in the transformation of maturities, in any exchange or interest rate risks, or in any other commercial risk.

2. The Commission shall take the necessary steps, if Bosnia and Herzegovina so requests, to ensure that an early repayment clause is included in the loan terms and conditions and that it may be exercised.

3. At the request of Bosnia and Herzegovina, and where circumstances permit an improvement in the interest rate of the loan, the Commission may refinance all or part of its initial borrowings or restructure the corresponding financial conditions. Refinancing or restructuring operations shall be carried out in accordance with the conditions set out in paragraph 1 and shall not have the effect of extending the average maturity of the borrowing concerned or increasing the amount, expressed at the current exchange rate, of capital outstanding at the date of the refinancing or restructuring.

4. All related costs incurred by the Community in concluding and carrying out the operation under this Decision shall be borne by Bosnia and Herzegovina, if appropriate.

5. The Economic and Financial Committee shall be kept informed of developments in the operations referred to in paragraph 2 and 3.

Article 5

At least once a year, and before September, the Commission shall address to the European Parliament and to the Council a report, which will include an evaluation on the implementation of this Decision in the previous year.

Article 6

This Decision shall take effect on the day of its publication in the *Official Journal of the European Communities*. It shall expire two years after the date of its publication.

ANNEX

**BUDGETARY RESOURCES NECESSARY FOR THE PROVISIONING OF THE GUARANTEE FUND IN 2002
AND MARGIN UNDER THE RESERVE FOR LOANS AND LOAN GUARANTEES IN FAVOUR OF THIRD
COUNTRIES**

(in euro million)

Operations	Basis of the calculation ⁽¹⁾	Provisioning of the Fund ⁽²⁾	Reserve Margin
Decided for project related assistance			
EIB			213,00 ⁽³⁾
Mediterranean Basin 1997-2000	35,00 (a)	2,36	210,64
2000-2007 general lending mandate	2 747,70 (b)	160,74	49,90
Special Turkey Reconstruction Facility (Terra)	225,00 (b)	13,17	36,73
Baltic Sea/Russia special action	25,00 (c)	2,25	34,48
Corrections			
EIB			
Cancellation of the 2001 provisioning for Baltic Sea/Russia ⁽⁴⁾	(100) (c)	- 9,00	43,48
Macrofinancial assistance (d)			
<i>Suspended operation</i>			
Albania: estimated carry over	(20) (e)	- 2,80	46,28
<i>Decided operations</i>			
Ukraine Supplementary macro-financial assistance	(92) (e) + 110,00	- 2,98	49,26
<i>Proposed operations</i>			
Bosnia and Herzegovina further macro-financial assistance	20,00	1,80	47,46
FRY further macro-financial assistance	55,00	4,95	42,51
Residual Lending and Guarantee capacity ⁽⁵⁾			472,33

⁽¹⁾ The basis of calculation represents 75 % (a), 65 % (b) or 100 % (c) of the nominal amount of the EIB loans and 100 % (d) of the macro-financial assistance loans.

⁽²⁾ According to the provisioning rules provided in the Council regulation (EC, Euratom) No 2728/94 of 31 October 1994. Since 2000, the provisioning rate has been fixed to 9 %. Operations which were decided before 2000 (e) have been provisioned at a rate of 14 % and reprovioned at a rate of 9 %.

⁽³⁾ Reserve amount in 2002 under the financial perspective.

⁽⁴⁾ Instead of 100 in 2001, the new schedule for disbursement is 25 in 2002, 40 in 2003 and 35 in 2004.

⁽⁵⁾ For 100 % guarantee loans.