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acting as Administrator of the Interim Trust Fund

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Report No. P - 7147 -BIH

MEMORANDUM AND RECOMMENDATION
OF THE
MANAGING DIRECTOR
TO THE
PRESIDENT OF THE
INTERNATIONAL DEVELOPMENT ASSOCIATION
ON A
PROPOSED INTERIM FUND CREDIT
IN AN AMOUNT OF SDR 28.2 MILLION
TO
BOSNIA AND HERZEGOVINA
FOR A
SECOND EMERGENCY TRANSPORT RECONSTRUCTION PROJECT

August 8, 1997

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CURRENCY EQUIVALENT

(as of July 31, 1997)

Currency Unit: Bosnia and Herzegovina Dinar (BHD)

BHD100 = DM1 = US\$0.55

WEIGHTS AND MEASURES

Metric System

ACRONYMS

ANS	Air Navigation System
DC	Direct Contracting
ERR	Economic Rate of Return
ETRP	Emergency Transport Reconstruction Project
EU	European Union
FRY	Federal Republic of Yugoslavia
GDP	Gross Domestic Product
GPN	General Procurement Notice
HDM	Highway Design and Maintenance Standards Model
ICAO	International Civil Aviation Organization
ICB	International Competitive Bidding
IDA (ITF)	International Development Association (Interim Trust Fund)
IFC	International Finance Corporation
IFOR	Implementation Force
IMF	International Monetary Fund
IS	International Shopping
LIB	Limited International Bidding
NS	National Shopping
MAC	Mine Action Center
MPRA	Mine Protection and Removal Agency
NBBH	National Bank of Bosnia and Herzegovina
NCB	National Competitive Bidding
NPV	Net Present Value
PHRD	Private Human Resource Development, Japanese Grant Fund
PID	Project Implementation Directorate
PMA	Project Management Advisor
RS	Republika Srpska
SETRP	Second Emergency Transport Reconstruction Project
SOE	Statement of Expenditure
SWPP	Small Works Procurement Procedure
TRP	Transport Reconstruction Program

FISCAL YEAR

January 1 - December 31

Vice President:	Johannes Linn, ECAVP
Country Director, Bosnia and Herzegovina:	Christiaan Poortman, ECC04
Sector Director:	Ricardo Halperin, ECSIN
Staff Members:	Enn Vasur, Saumya Mitra ECCBA, Jacques Bure, Aymeric-Albin Meyer, ECSIN

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BOSNIA AND HERZEGOVINA

SECOND EMERGENCY TRANSPORT RECONSTRUCTION PROJECT

Credit and Project Summary

Borrower:	Bosnia and Herzegovina	
Beneficiaries:	Federation of Bosnia and Herzegovina, and Republika Srpska	
Credit Amount:	SDR28.2 million	
Terms:	Standard IDA terms, with a 35 year maturity and a 10 year grace period	
Onlending Terms:	Identical to the IDA terms to the Borrower	
Financing Plan:	Borrower/Government	US\$ 2.9
	IDA (ITF)	US\$ 39.0
	EC	US\$ 52.0
	Japan	US\$ 0.4
	Netherlands	US\$ 0.2
	Financing gap	<u>US\$ 89.5</u>
	Total	US\$ 184.0
Economic Rate of Return:	30% (on the road portion of the investment component)	
Poverty Category:	Not applicable	
Staff Appraisal Report:	Not applicable. A Technical Annex is attached.	
Project ID:	BA-PA-45484	
Map:	IBRD 28612	

This report is based on the findings of missions which visited Bosnia and Herzegovina in January and June 1997. The transport component was prepared by Messrs. Enn Vasur (Task Manager), Jacques Bure (Highway Engineer), and Aymeric-Albin Meyer (Highway Engineer). The adjustment component of the project was prepared by Mr. Saumya Mitra (Task Manager) with the assistance of Mr. Pedro Rodriguez (Economist). Dino Bicciato of the International Management Group (IMG) provided valuable information essential for the preparation of the transport part of the project. Legal support was provided by Maurizio Ragazzi and Barbara Santos, and advice on procurement was provided by Naushad Khan. The peer-reviewers of the project were Ms. Melody Mason, EC3IV and Graham Smith, EMTIE. The Director for Bosnia and Herzegovina is Mr. Christiaan Poortman, and the Infrastructure Sector Director is Mr. Ricardo Halperin.

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**MEMORANDUM AND RECOMMENDATION OF THE MANAGING DIRECTOR TO
THE PRESIDENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION (THE
ASSOCIATION ACTING AS ADMINISTRATOR OF THE INTERIM TRUST FUND)
ON A PROPOSED INTERIM TRUST FUND CREDIT
TO BOSNIA AND HERZEGOVINA FOR A SECOND EMERGENCY TRANSPORT
RECONSTRUCTION PROJECT**

INTRODUCTION

1. I submit for your approval the following memorandum and recommendation on a proposed IDA (ITF) Credit in the amount of SDR28.2 million (US\$39 million equivalent) to Bosnia and Herzegovina to support a Second Emergency Transport Reconstruction Project. The proposed Credit will be on standard IDA terms, with a maturity of 35 years, including a grace period of 10 years. The Credit consists of an adjustment component of SDR6.5 million (US\$9 million equivalent) and a transport investment component of SDR21.7 million (US\$30 million equivalent).

2. The proceeds of the Credit for the adjustment component would be onlent to Republika Srpska. The proceeds of the Credit for the transport investment component would be onlent to both the Federation of Bosnia and Herzegovina and Republika Srpska. No cofinancing is being sought for the adjustment component. Cofinancing for the transport investment component in the amount of US\$55.5 million equivalent has already been identified and an additional US\$89.5 million equivalent is being sought from various donors to ensure the full financing of the proposed Project.

Part I - Background and the Assistance Strategy

A. Introduction

3. The declaration of independence of Bosnia and Herzegovina at the end of 1991 was quickly followed by an exhausting war that lasted three and a half years. The war completely shattered the economy and left extensive human and physical devastation. By 1995, Bosnia and Herzegovina's GDP had shrunk by 80 percent from its pre-war level, and its per-capita GDP had declined to US\$500. Separate economic management systems within the country developed during the war. Republika Srpska adopted the Federal Republic of Yugoslavia (FRY) dinar as well as its tax, trade, and banking legislation. Within the Federation of Bosnia and Herzegovina, separate fiscal and financial policies and management were implemented in the majority Bosniak and Croat areas.

4. In the Federation, post-war economic recovery is well underway. Industrial production increased by 90 percent during 1996, reflecting the limited production base before the recovery started and the large scale of international assistance. In 1996, about 80% of donor resources were committed to the Federation territory, and the vast majority of them are under implementation. In Republika Srpska, economic recovery has lagged behind and began only gradually after the lifting of international sanctions in February 1996. In large part resulting from sanctions, donors provided just 3-4% of resources in Republika Srpska. Following the lifting of sanctions, trade and supply of basic commodities have improved to a certain extent.

Nevertheless, the difficult post-war situation in supply and production, particularly in non-agricultural sectors, remains largely unchanged. Current estimates place Republika Srpska production in late 1996 at 8-10 percent of its pre-war level. Because of the very low level of economic activity and tax rate reductions early in the year, 1996 tax revenues of Republika Srpska fell below their 1995 level, which forced further expenditure restraint in order to maintain the budget balance. Credit and monetary expansion were also limited under FRY's tight monetary program.

5. War damage and resulting urgent reconstruction needs are large and widespread across all economic sectors of both Entities. However, destruction did not occur uniformly and did not have the same effects on the economy in all parts of the country. Output fell most in the Bosniak majority areas due to the destruction of large segments of the transport and communications networks, water and energy supplies, and productive assets, as well as loss of human life. In the Serb majority areas, the decline was also severe in terms of destruction and damage of basic infrastructure, exacerbated by the economic sanctions on Republika Srpska, and difficulties of access to and communication with Republika Srpska. In the Croat majority areas economic activity has continued relatively less affected, at about 60 percent of the prewar level. This is the framework within which the proposed Project has been prepared.

B. Background for the Adjustment Component of the Project

6. As noted above, Republika Srpska economy continues to be severely afflicted by the effects of the war, recovery has been much slower than that in the Federation of Bosnia and Herzegovina and both production and income levels are much lower than those in the Federation. Though Republika Srpska's GDP is estimated to have expanded by 28 percent in real terms in 1996 from a severely depressed base, and industrial output to have grown by nearly 30 percent, the sustainability of growth is highly questionable in view of a paucity of domestic savings and external assistance. The growth seen in 1996 was achieved primarily through a restart of industry and other activities that did not require fresh investments or significant working capital. Dearth of working capital and funds for investment are now projected to be the major constraints to sustained growth in 1997 and beyond.

7. Republika Srpska labor force has not benefited significantly from the expansion in output; thus, the rate of unemployment is estimated at nearly 70 percent. Real wages have, however, registered a strong rise from the severely depressed immediate post-war level and at end-1996 the monthly wage stood at DM73, which represents a rise of three-fold in the course of 1996. Prices were roughly stable during 1996, albeit with high month to month fluctuations. Given that Republika Srpska interim currency is that of FRY, the tightness of monetary policies reflected the intention of the authorities of the FRY to maintain a fixed exchange rate for the Yugoslav dinar.

8. With respect to macroeconomic policies, Republika Srpska authorities maintained a balance in the cash budget in 1996, with domestic revenues and external financing covering total public expenditures. Thus, no reliance was placed on borrowing from the domestic banking system or from the non-bank public; in large part this outcome reflected a lack of loanable funds within the banking system and the lack of savings by the general public that could be used to finance a possible budgetary deficit. In accrual terms, however, the budget was in significant deficit as arrears were run up in relation to debt service, wage and pension payments -- estimates

of the volume of arrears are, however, not available. Hence, Republika Srpska's budget was clearly not on a sustainable basis in 1996.

9. Republika Srpska has adopted an economic program for 1997, which has been endorsed by the State, that is described in a letter of development policy (Appendix I). This program -- within the context of the overall economic program for the State -- is expected to be supported by a standby arrangement with the IMF, currently being negotiated. The overall economic program for Bosnia and Herzegovina is based on the continuation of sound macroeconomic policies, the rebuilding of public administration, market oriented structural reforms, and the reconstruction of critical physical assets. The strategy has three macroeconomic pillars: (i) the use of a fixed exchange rate as a nominal anchor through the currency board arrangement; (ii) fiscal discipline, aimed initially at the avoidance of domestic borrowing by all levels of government; and (iii) large scale external assistance on concessional terms.

10. In 1997, the monetary regime will be gradually transformed with the institution of the Bosnia and Herzegovina Central Bank that will function strictly as a currency board. The passage of the legislation on the central bank in mid-1997, after prolonged negotiations between the two Entities, signified unification of monetary policies at the State level. A domestic currency -- the convertible mark -- will be introduced and will be maintained at a fixed rate vis-a-vis the Deutsche mark. In the meantime, the Yugoslav dinar and the Deutsche mark will continue to circulate freely within Republika Srpska, as will the Croatian kuna and the Deutsche mark in the Federation. They will continue to be acceptable as the means of payment even beyond the introduction of the convertible mark. Monetary conditions in 1997 are expected to continue to be such that low inflation could be maintained.

11. As for fiscal management, the Republika Srpska budget for 1997 has been approved by Parliament. The budget focuses both on ways to strengthen the revenue base and on the prioritization of expenditures. Revenue increases are expected to stem mainly from a strengthening of economic activity and improvements in tax and customs administrations. Tax policy will be guided by the principle of applying relatively low rates to a broad base. Excise and sales taxes are projected to rise significantly, but the growth in customs revenues will be relatively modest as it will be affected by the introduction of the new trade and customs regime from the second half of 1997. The full year effects of the changes in the trade and customs regime are expected to be substantial, but will be felt in their entirety only in 1998. Until this time, there is a clear need for fiscal resources to support essential social expenditures and external debt servicing obligations. Budgetary expenditures have been limited to projected revenues and the likely level of external assistance through donor financing, including quick disbursing support from the Bank. The budget execution law permits reductions in all categories of expenditure (other than wages, benefits for war invalids and survivors and transfers to the State of Bosnia and Herzegovina) as necessary to ensure that no recourse to domestic borrowing becomes necessary. Payments on external debt (principally to the Bank) are fully provided for within Republika Srpska's budget.

12. Republika Srpska authorities will take steps to strengthen budget planning, formulation and execution through improvements in systems and personnel. These efforts will be supported by technical assistance from the Bank and by a proposed Public Finance Reform Credit that is being prepared.

13. Fiscal discipline is reinforced by the current monetary arrangements. Republika Srpska authorities lack independence as the major currency circulating in Republika Srpska continued to be the Yugoslav dinar, and in the absence of availability of credit to the Entity authorities or private sector (beyond donor financing), increases in the demand for currency could be satisfied only by running current account surpluses. In effect, the firm monetary policies being followed by the FRY authorities in 1996 created the conditions for the virtual absence of inflation in Republika Srpska.

14. As for external assistance, considerable external financing will be needed to normalize Bosnia and Herzegovina's relations with external creditors, as well as to meet the requirements of the reconstruction program. Timely availability of international support will be of crucial importance in advancing economic recovery and transition.

15. Since the beginning of the hostilities, Republika Srpska maintained a free trade regime with the FRY; thus, the two Entities -- with the Federation enjoying a free trade regime with Croatia -- had differing trade policies. In addition, the customs tariffs regime and rates, other import regulations, including restrictions, differed between the Entities. Three pieces of key legislation have been passed by the State legislature in 1997-- the trade policy law, the customs policy law and the customs tariffs law. These laws will ensure common policies in all these areas and will constitute an important step towards the formation of common economic institutions at the level of the State. The legislation will go into effect once published in the official Bosnia and Herzegovina Gazette. Republika Srpska authorities are now required to take steps to implement this legislation, inter alia, by revising the tariff code, removing quantitative and value restrictions on trade, and revising the free trade area agreements. They will also participate in a tariff commission with Federation partners in order to rationalize and liberalize the trade and customs regime further.

16. With respect to structural reforms and the promotion of a market-based economy, Republika Srpska authorities have passed an amended privatization law in spring 1996 which provides for rapid privatization using a variety of methods. Steps are being taken to reform the company law, develop a commercial code, strengthen collateral laws, and establish the framework for a capital market, with significant progress expected in the second half of 1997. Republika Srpska authorities intend to restructure the banking system with a view to rapid privatization of banks and to encourage foreign participation in both bank and enterprise privatization.

C. Background for the Transport Investment Component of the Project

17. Large-scale damage occurred as a result of the hostilities. Transport links leading to or near confrontation lines suffered the most extensive destruction. Over 2,000 km of the main road network were in need of immediate repair. Seventy bridges were damaged; all bridges connecting Bosnia and Herzegovina to Croatia were destroyed; no infrastructure maintenance had been carried out during four years; most of the railway lines were inoperable; Sarajevo Airport was partly destroyed and closed to regular civilian traffic; public transport vehicles and installations were damaged or run down. Transport institutions lost premises, records, staff, funds and, in many instances, did not have access to those parts of the system which remained operable. Moreover, the sector institutions were forcibly fragmented and communication was severed among them.

18. Since the end of hostilities, the condition of the transport infrastructure has significantly improved, mainly through the implementation of the Emergency Transport Reconstruction Project (ETRP)¹ and IFOR/SFOR activities to restore strategic infrastructure. Road and railway links have been gradually restored in much of the country. Road traffic on part of the main network has already reached prewar levels. The Sarajevo-Ploce and the Bosanski Novi/Novi Grad - Tuzla railway lines have been reopened to minimal standards but no commercial trains are yet running. A few civilian charter flights are now available at Sarajevo Airport, and public transportation companies are progressively resuming their activities.

19. Major transportation bottlenecks remain, however. In the road sector, more than half of the main network still needs to be rehabilitated. Road maintenance needs to be undertaken urgently to avoid further rapid deterioration of infrastructure and maintenance organizations need to be organized and equipped. In the railway sector, the economically important part of the network has been restored to minimal standards, but operating agreements (paragraph 28) and further rehabilitation is needed before commercial trains can run regularly; notably signaling and telecommunications systems have to be restored to ensure safety. Extensive work is still required on Sarajevo Airport to accommodate regular traffic. Public transport systems will continue to require a considerable level of assistance in the years to come.

Transport Reconstruction Program and 1996 Achievements

20. As part of the overall reconstruction program (paragraph 30), a Transport Reconstruction Program (TRP) was prepared in December 1995. The TRP was then estimated at US\$698 million with first year requirements of US\$301 million, of which US\$192 million was, in the end, committed. While remaining valid as an overall framework, the TRP has been continuously updated. It has been reduced to US\$583 million to take into account the changing reconstruction needs and IFOR/SFOR activities: large-scale patching of roads, installation of many "temporary" bridges, and railway repairs. In addition, the time horizon for the rehabilitation of the secondary and tertiary road networks has been extended, since repair to these networks is not of major economic significance. It is currently estimated that US\$175 million will be required for the 1997 program and US\$216 million for 1998-99.

21. The main achievements in the reconstruction of the transport sector in 1996 have been carried out in the frame of the ETRP. Some 90 km of roads were rehabilitated with IDA funding, making it possible to use approximately 300 km of the main network. Thirteen bridges are being reconstructed, including most bridges on the main road between Sarajevo and the port of Ploce and two bridges on the Sava River connecting Bosnia and Herzegovina to Croatia (the contract for the Orasje bridge has been awarded in July 1997, and works on the Brcko railway bridge started with USAID financing). The EC, the Japanese Government, and the IDA supplied construction, maintenance, and quarry equipment, as well as asphalt plants. The EBRD approved a US\$19.9 million loan for the repair of some 300 km of roads and several bridges in both Entities.²

¹ The ETRP secured funding of about US\$145 million, from over 20 donors, including IDA which provided a credit of US\$35 million, of which 68% has been disbursed so far.

² The loan was ratified at the end of June 1997.

22. The railway line linking Sarajevo to the port of Ploce on the Adriatic Coast reopened on July 30, 1996. Further upgrading is expected by end-1997. Works were carried out with parallel funding from members of the European Union. Although technical conditions would allow the operation of two pairs of trains a day at an average speed of 60 km an hour, persisting tension within the Federation has prevented the regular operation of commercial trains. In addition, IFOR/SFOR rehabilitated the East-West line (Bosanski Novi/Novi Grad - Tuzla). The resumption of civilian traffic is, however, impeded by political difficulties. Thus restoring an effective transport network will require not only donor financing but also a real commitment by the authorities to overcoming political difficulties.

23. On August 15, 1996, Sarajevo Airport was reopened to limited civilian traffic, thanks to the efforts of IFOR, the French military detachment at the airport, the newly formed Sarajevo Airport Authority, and the United States (U.S.) Government. The airport has not yet been reopened to regular air traffic, which will require meeting the standards set by ICAO. Concurrently, a financial package of US\$12.8 million (in addition to the US\$19.9 million mentioned above) was assembled by EBRD to implement a year-long program of facility rehabilitation, including upgrading the air traffic control system and the terminal.³

24. Many governments and local authorities in Europe helped to restore minimal public transportation in the main cities of Bosnia and Herzegovina, focusing their efforts on Sarajevo. About fifty buses and twenty minibuses, including spare parts and workshop equipment, were delivered through both the EC Essential Aid Program and bilateral donations. Spain provided twenty used buses and Norway ten. In addition, about a hundred new and used buses were donated by European cities to the main urban transport companies in Bosnia and Herzegovina. And two new trams with spare parts donated by the Czech Government are on their way to Sarajevo.

25. Technical assistance was required mainly for project design, project management, and supervision of works. About 350 person months of technical assistance were provided, mainly to the State and Federation Ministries of Transport. Because the foreign assistance is designed to complement local capacity, not substitute for it, local consultants have been fully involved and consulting organizations strengthened.

Transport Sector Issues

26. Road Maintenance Administration: A gradual increase in road maintenance to an acceptable level is of prime concern in Bosnia and Herzegovina. Improvements are required in both management and financing structures. To assist with this task, a working paper on the organization of road maintenance was prepared by the Bank and submitted to both Entity Ministries of Transport and was generally well accepted. Within the Federation Ministry of Transport and Communications, an embryo current maintenance unit⁴ has been set up and a declaration of intent concerning the set up of a Road Administration at the Federation level has

³ Aside from a US\$12.83 million EBRD loan, funds have been provided by nearly all the countries from the European Union and by the EC. Technical assistance is also being provided by the U.S.

⁴ This unit has so far managed the 1996-97 winter maintenance program and has prepared a current maintenance program for 1997.

been sent to the Association. In Republika Srpska, the Road Administration is presently operational but its management capacity needs to be strengthened.

27. Road Maintenance Financing: The Bank has required that the Entities' Governments guarantee that about US\$15 million in each Entity will be allocated to road maintenance in 1997. This would constitute a first step towards sustainability. However, estimated needs for adequate road maintenance in Bosnia and Herzegovina exceed US\$100 million per year.

28. Railway Operations: The railway network has been rehabilitated so that operations are possible on practically the whole network. However, as long as railway operations are impeded by political difficulties, it is not recommended to include financing in the 1997 program for the railways. Only once it has been demonstrated over a certain period of time that trains can run across the network on a reasonable technical and commercial basis, would donors be encouraged to provide further assistance to upgrade the infrastructure to acceptable standards and restore maintenance capacities, with a special focus on international access.

D. World Bank Strategy and Programs in Bosnia and Herzegovina

29. On April 1, 1996, Bosnia and Herzegovina fulfilled the conditions of succession to the former Socialist Federal Republic of Yugoslavia's membership in the Bank, IDA and IFC. Membership is retroactive to February 25, 1993. The resolution of Bosnia's arrears with the World Bank, through consolidation of its IBRD debt, allowed regular Bank lending to begin in June 1996. With a war-devastated economy, low post-war per capita GDP and lack of creditworthiness, Bosnia was declared IDA eligible.

30. Since early 1995, the Bank Group has been deeply involved in developing, with the Bosnia and Herzegovina authorities, a blueprint for reconstruction of the country's economy. A three- to four-year Priority Reconstruction Program totaling some \$5.1 billion was presented to and endorsed by a donors' conference co-sponsored by the Bank and the EU, following signing of the Dayton-Paris Peace Accords in December 1995. This conference, and a second one in April 1996, led to 1996 commitments of about US\$1.8 billion from some sixty bilateral and multilateral donors for immediate and priority reconstruction activities. A third donors' conference in July 1997 mobilized additional pledges of US\$1.1 billion for reconstruction.

31. During 1996, the Bank followed an assistance strategy aimed at jump-starting economic activity through support of a broad range of economic sectors. Leveraging Bank resources with significant funding from donors was an important element of this strategy. Before arrears resolution, the Bank supported a series of immediate assistance programs through a special US\$150 million Trust Fund for Bosnia and Herzegovina (TFBH). Seven emergency operations were approved under the TFBH, included rebuilding of government institutions and funding of a line of credit to small business, as well as support for rehabilitation in the agriculture, water and sanitation, transport, health, education and heating sectors. Since the start of regular Bank lending in mid-1996, US\$207.6 million in IDA resources have been committed, supporting an additional nine operations focused on clearing of landmines, reconstruction of electric power, housing, hospitals and schools, establishment of a guarantee facility for industry, and three programs to support recovery of employment through public works, re-training and loans to microbusinesses. The Bank's assistance program also supported the initial phase of the

government's macroeconomic and institutional reforms: a Transition Assistance Credit (CR-2914-BOS), approved by the Board in September 1996, was the first operation focusing on institution-building in the Federation and a series of structural reforms needed for advancing the transition to a market-economy. The International Finance Corporation (IFC) has also committed US\$2 million to an equity fund and US\$0.7 million for a microbusiness project.

32. While emphasis during the first post-war year was on moving quickly with emergency reconstruction across a range of sectors, the Bank's assistance strategy in 1997 and beyond will shift to focus on sustainability and ensuring the medium- to long- term viability of policies and investments. Significant donor resources will be needed for the next several years; however, Bosnia and Herzegovina must increasingly become more self-reliant in preparation for the time when these inflows are no longer available. This will mean viable government institutions, sustainable government budgets, improved cost-recovery policies and mechanisms and structural reforms that stimulate private investment. Three overarching objectives will guide Bank Group strategy: (i) further development of the basic institutional and policies for macroeconomic management; (ii) transition to a market economy through deepening of major structural reforms; and (iii) continued, selective support of physical reconstruction.

33. Further policy-enhancing investment or adjustment operations are envisaged to support institution-building at the State and Entity level, as well as key reforms in the areas of public finance, banking, privatization and trade liberalization. In the area of reconstruction, future Bank operations will support key areas such as the network infrastructure sectors of energy and transport, as well as education, agriculture and other sectors essential to economic recovery. Limited IDA resources will continue to make partnerships with other donors essential: mobilizing co-funding for future operations, and coordinating strategies -- e.g., eventual exit from those sectors where other donors are more fully engaged or have greater comparative advantage -- will be important elements of this partnership.

Part II - The Project

A. Project Objectives

34. The **adjustment component** supports Republika Srpska fiscal and trade reforms, by creating the conditions for efficient budget formulation and execution and for the effective implementation of the recently approved trade and customs policy reforms. It is expected that the counterpart funds would be used to undertake urgently needed social expenditures and finance the external debt service requirements of Republika Srpska in 1997. By supporting policy implementation and the budget, these resources will help attaining fiscal stability and enhance the prospects for the overall sustainability of policies.

35. The objective of the transport **investment component** is the rehabilitation of the primary transport network countrywide, and the reconstruction of the remaining key transport links with the rest of Europe. The investment component will continue the reconstruction activities initiated under the ETRP and will: (i) remove critical infrastructure bottlenecks; (ii) resume operation of major transport networks; (iii) ensure sustainable development of the transport sector and related institutions; and (iv) rebuild the local contracting and consulting industry. The specific objective of the IDA (ITF) financed part of this component of the Project is to assist the Borrower in

further rehabilitating the main road network while supporting the progressive re-establishment of adequate road maintenance activities countrywide.

B. Project Description

36. The Project would consist of the following two components:

(i) the **adjustment component** will provide US\$9 million to Republika Srpska to support key macroeconomic policy reforms. The proceeds will support the approved 1997 budget in line with agreed budget priorities that include essential social expenditures and debt servicing obligations. This component provides needed fiscal resources that help alleviate the acute needs of 1997; and

(ii) the transport **investment component** amounts to US\$175 million to: (i) carry out maintenance and reconstruction on the most critical parts of the networks; (ii) supply equipment to restart transport operations; and (iii) ensure the sustainability of reconstruction activities by strengthening local institutions and taking proper organizational measures to ensure operations' efficiency. The component total cost includes a notional allocation of US\$38 million for railways, which may not materialize (paragraph 28). The investment component of the Project will include the subcomponents necessary to overcome in a balanced manner the most serious transport system constraints not taken into account by the ongoing ETRP, as follows:

- **State of Bosnia and Herzegovina:** items of an international nature, including the rehabilitation of the Sava/Una rivers bridges (12% of the total SETRP cost) and of Sarajevo Airport (4%);
- **Federation of Bosnia and Herzegovina:** rehabilitation of roads and bridges (16%), rehabilitation of Mostar Airport (3%), procurement of railway (16%) and urban transport (2%) equipment, including safety equipment (1%), and technical assistance (3%); and
- **Republika Srpska:** road and bridge rehabilitation (23%), supply of construction/maintenance equipment (6%), procurement of railway (6%), urban transport (6%) and navigation equipment for Banja Luka Airport (1%), and technical assistance (3%).

37. Under the Project, the Bank would finance, out of an IDA Interim Trust Fund (ITF) Credit, the total cost of the adjustment component and part of the transport investment component. For the transport investment component, IDA (ITF) resources will focus on: (i) rehabilitation of roads, reconstruction of bridges and related mine clearing and technical assistance, within the Federation and Republika Srpska; (ii) supply of maintenance equipment to Republika Srpska; and (iii) support to the establishment, within the Federation, and the strengthening, within Republika Srpska, of road administrations.

38. The **adjustment component** of the Project will be totally financed by IDA (ITF), for an amount of SDR6.5 million (US\$9 million equivalent). For the transport **investment component**, presently identified financing includes IDA (ITF), SDR21.7 million (US\$30 million equivalent), Netherlands, US\$0.2 million; and Japan US\$0.4 million (specifically for preparatory activities). In addition, the EC is expected to commit about US\$52 million. Furthermore, the Entities of Bosnia and Herzegovina would contribute about US\$2.9 million. The remainder (US\$89.5 million) would be sought from donors' pledges made during the Third Donors' Conference held on July

24, 1997, in Brussels. A financing plan is presented in Schedule A. The Project is fully modular in design and its scope can be adjusted to match available resources.

C. Project Implementation

39. The State of Bosnia and Herzegovina would be the Borrower of the IDA (ITF) Credit. The Borrower will onlend the proceeds of the **adjustment component** to Republika Srpska. For the transport **investment component**, the Borrower will onlend their respective portions to both the Federation and Republika Srpska. The onlending from the Borrower to the Entities will be made on the same terms and conditions as the ones on which the Borrower shall repay the Credit to the Association.

40. The IDA (ITF) Credit in support of the **adjustment component** of the project will be implemented by the Republika Srpska Ministry of Finance, with the Credit proceeds flowing to the Republika Srpska budget account. The portion of the Credit supporting the **investment component** of the project would be implemented through Project Implementation Directorates (PIDs), already established at the Entities levels. After agreement with the relevant Entity Government, cofinanciers would be able to use the PIDs to implement their respective parts of the Project, in exchange for a contribution toward the PID's operating costs. The PIDs would be responsible to coordinate and provide assistance in the overall implementation of the Project. At the level of Bosnia and Herzegovina, a State PID has been created under the ETRP to implement those components of an international nature (paragraph 36). In addition, the Program Management Advisor, (as defined under the ETRP) as well as his two deputies (one in each entity) would assist the respective ministries in their relations with the donor community and the PIDs in implementing their tasks.

D. Project Sustainability

41. The reforms supported by the **adjustment component** of the Project are based on the economic program of the Republika Srpska authorities (paragraph 9). The authorities implementation of the fiscal, trade and customs reforms set out in this program, as well as reform measures aimed at moving toward a market economy, including privatization of banks and enterprises, underpins the sustainability of this component. Strong policy dialogue between the authorities and the Bank, including technical assistance in critical areas of economic reform, help to further strengthen the sustainability of the component.

42. With reference to the **investment component** of the Project, considerable attention will be paid to the development of the transport sector's financial sustainability, by seeking agreement on: (i) adequate budgets for road maintenance both in the Federation and Republika Srpska; (ii) appropriate counterpart funds to undertake road maintenance on the most damaged parts of the main network; (iii) improvements in the financial and operating conditions of the railway companies; and (iv) reopening Sarajevo Airport fully to regular civilian traffic and enabling Bosnia and Herzegovina to play its part in the air traffic control of Europe's main air routes which crossed the country prior to the hostilities. The Project will build on what has been achieved during the ETRP. Institutions, including the Road Directorates, will be further strengthened through the provision of advisory services, supply of equipment and training.

E. Lessons Learned from Previous Bank Involvement

43. A multitude of important lessons has been learned from Bank-supported emergency projects in Bosnia and Herzegovina during 1996, covering adjustment and investment operations. At a cross-sectoral level, the Bank has learned important lessons as to the institutional framework necessary to allow timely and sustainable reconstruction investments to take place in Bosnia and Herzegovina.

44. Regarding the **adjustment component**, a recent Country Portfolio Performance Review highlighted that close attention must be placed on implementation of underlying reforms and the execution of the budget as planned. The experience from the previous adjustment operation, the Transition Assistance Credit, suggests that specific arrangements should be made to ensure that counterpart funds finance agreed priority expenditures. This lesson has been taken into account in the design of the proposed adjustment component, which would help to support agreed priority social expenditures and debt servicing obligations set out in the Republika Srpska's approved 1997 budget.

45. As for the **investment component**, lessons learned while implementing the ETRP have been taken into account as follows: (i) the fast-track civil works procurement approach used under the ETRP has been successful, allowing for quick award and implementation start of the contracts. This approach will also be used under the Project; (ii) foreign technical support has been crucial in 1996, and the Bank recommends that it be maintained at a reduced level in 1997, in order to gradually increase the technical responsibilities of local authorities and consultants; (iii) rehabilitation requires not only repairs but also maintenance. Thus far, IFOR/SFOR has assisted in most critical maintenance works but this will not continue. Entity authorities have to assume these responsibilities -- and need to be supported to that effect. Under the institution building component of the Project, assistance in maintenance organization, supply of basic equipment to undertake maintenance, and staff training will be provided to both Entities' Roads Administrations; and (iv) the institutions involved in the transport sector should receive the funding necessary to fulfill their mandate. Both Entities' Governments have been requested to allocate adequate budgets to road maintenance.

F. Rationale for Bank Involvement

46. The **adjustment component** of the Credit provides the Bank with a vehicle to support fiscal and trade reforms in Republika Srpska, which have been prominent elements in the economic dialogue with the authorities over the last year. The policy decisions taken by Republika Srpska authorities and enacted into law in the trade and customs areas, the adoption of a sound budget for 1997, the measures to be taken in cooperation with the Bank in implementing the budget as well as the trade and customs laws constitute important first steps toward ensuring sustainability of macroeconomic policies. Also, the authorities are putting in place an overall reform framework with the purpose of developing a market based economy rapidly. Meanwhile, a clear need exists for fiscal resources to support urgent social expenditures and external debt servicing obligations. During 1996, IDA's Board approved eight projects providing financial support to both Entities. However, none of them provided adjustment assistance to Republika Srpska in support of macroeconomic reforms. Such support was provided to the Federation of Bosnia and Herzegovina through the IDA-supported Transition Assistance Credit. The

adjustment component supported by this project should be seen as the first element in a program of envisaged adjustment lending from which Republika Srpska will benefit. Further adjustment credits could be considered in late 1997 and beyond in support of further reform of public finances, as well as privatization of enterprises and banks -- but the timing of the support will depend crucially on reform measures being adopted.

47. For the transport **investment component**, the restoration of an effective transport system is a precondition for economy recovery: restart of industry and development of commerce are contingent upon the removal of infrastructure bottlenecks. The main road network, in particular, is of critical importance. Good results were achieved in 1996 but much remain to be done. The leadership role that the Bank assumed through the ETRP was seen from the onset not as a single isolated operation, which would only begin addressing the problems, but as something that had to be continued through a follow-up project. This was also spelled out to the donor Community, which recognized IDA's catalytic role in resource mobilization. The proposed Project constitutes this planned and necessary follow up project.

G. Agreed Actions

48. During negotiations, the following principal agreements were reached between IDA and the Government on the implementation of the investment part of the Project: (i) the creation of a Federation Road Directorate; (ii) each Entity Government has committed itself to allocate in 1997 about US\$15 million to road maintenance activities; (iii) the PIDs' Terms of Reference and staffing; (iv) the procurement arrangements; and (v) the financial and audit arrangements.

49. Conditions of effectiveness and disbursement would be: (i) execution of the Project Agreement on behalf of the Administrator and an Entity; (ii) execution of the Subsidiary Credit Agreement on behalf of the Borrower and the Entity; and (iii) receipt of legal opinions that both the Project Agreement and the Subsidiary Credit Agreement have been dully executed and are legally binding upon the parties.

H. Environmental Aspects

50. The Project is expected to include the rehabilitation and maintenance of existing infrastructure and as such will not require any land acquisition. The relative small scale of works would not require the opening of new quarries or asphalt plants sites. Furthermore, by improving badly damaged road surface, shoulders and drainage, and removing downed bridge decks from rivers and their banks, the Project would have a positive impact on the environment. Therefore and as an emergency operation, the Project has not been assigned an environmental category. However, any subcomponents which present an opportunity for environmental enhancement will be designed accordingly, and all subcomponents will be monitored during supervision to ensure that there is no degradation to the environment.

I. Program Objective Categories

51. In general terms the Project will support: (i) poverty reduction through employment generation; (ii) the restart of industry by re-establishment of transport links; and (iii) facilitate the return of refugees and displaced persons and community revival.

J. Project Benefits

52. For the **adjustment component**, major project benefits would include: support for Republika Srpska's promotion of critical fiscal, customs and trade reforms necessary for economic recovery and sustainable growth under market conditions; the laying of foundations for further structural reforms in other areas; and support for undertaking high priority public expenditures under circumstances of severe budgetary constraints resulting in part from highly depressed economic conditions in a post-war economy.

53. For the **investment component**, the economic benefits from restoring critical links in the road network are major. Downed bridges are critical bottlenecks in the transport system and their reconstruction will eliminate lengthy and/or dangerous detours. For roads, vehicle running costs will be lowered on improved road surfaces and, with the maintenance equipment, road pavement service life will be extended through timely major maintenance. The technical assistance component will support project implementation and, with institutions sorely affected by the hostilities, will promote the re-establishment and modernization of transport institutions. Moreover, since a part of the contracts to be let under the Project will be awarded to local industry, jobs will be created directly in the local construction and consultants' industries through the road and bridges reconstruction and maintenance program. As a serviceable transport system is essential to the economy, the project will also indirectly support the creation of jobs throughout the country.

K. Economic Justification

54. For the road subcomponent of the investment component, the ERR has been calculated at more than 30%, using the Highway Design and Maintenance Standards Model (HDM) III model. Part of the data used in the economic evaluation are best estimates, in the absence of precise information and the still highly changing traffic patterns. Traffic growth has been estimated at about 3 to 4% per annum, and vehicle operating costs were calculated using input data from the Albania-adapted HDM III model. For other civil works subcomponents of the investment component, including mainly reconstruction or rehabilitation of bridges and rehabilitation of landslides all located on the principal network, the rates of return are expected to be high since: (i) downed bridges are critical bottlenecks causing, at certain locations, long waiting times. Furthermore, damaged bridges are being used, despite the constant risk of collapse; and (ii) rehabilitation of landslides will avoid further degradation of the road sections.

L. Risks

55. There is the political risk of a resumption of hostilities in the region; it is hoped that rapid reconstruction, in both Entities, would help cement the peace process. The main project-specific risks in the **adjustment component** stem from possible weaknesses of the Republika Srpska authorities in the implementation of the 1997 budget, and in the implementation of planned reforms in the fiscal, customs and trade areas, and possible slippage in policy planning and execution of further reforms, in particular, enterprise and bank privatization, and less than whole-hearted engagement in the pursuit of market oriented reforms. The risks in the policy areas would be addressed by the Bank continuing to maintain its strong policy dialogue with the authorities and by a concerted program of technical assistance by the Bank and by other donors in all the

reform areas -- this wider program of technical assistance is being coordinated by the Bank. The Republika Srpska authorities have shown increasing responsiveness to the policy dialogue with the Bank. The Bank intends to maintain this intensive policy dialogue with the aim of ensuring that reform policies in line with the Dayton/Paris Accord are adopted. Risks are mitigated also by the planned program of adjustment lending currently under discussion with the authorities covering public finance reform and support of enterprise and bank privatization within the context of promoting a market-based economy.

56. Regarding the **investment component**, both the Governments and the Bank are better prepared, thanks to the implementation of the ETRP, to handle project related risks. Assuming that peace will be maintained, project risks for this component include: (i) overextending the local construction capacity (not less than five infrastructure projects will be implemented this year). To mitigate this risk, local contractors will be advised to form joint ventures with foreign companies and NCB as well as ICB would be broadly used; (ii) delays in implementation due to the fragility of institutions. However, the implementation of the ETRP has already strengthened the institutions and the technical assistance to be provided under the Project will ensure adequate institutional capacity; (iii) delays in program progress due to a slow implementation of the mine clearing component. So far, however, under the ETRP, mine clearing activities have not constituted an obstacle to works progress; (iv) failure to close the financing gap. If participation from the Donors' Community partly fails to materialize, the scope of the project will be adjusted downwards to match available resources. As the bulk of the project is made up of small subcomponents providing flexibility in implementation such that the project can be easily adjusted; and (v) failure in providing counterpart funds, mainly for maintenance. Clear targets and vigorous supervision will be needed to manage this risk.

Part III - Recommendation

57. I am satisfied that the proposed Interim Fund Credit would comply with Resolution No. 184, adopted by the Board of Governors on June 26, 1996, establishing the Interim Trust Fund and I recommend that the President approve it.

Caio Koch-Weser
Managing Director
Washington, D.C.
August 8, 1997

Attachments

BOSNIA AND HERZEGOVINA
Ministry of Foreign Trade and Economic Relations
M i n i s t e r

Appendix I
Page 1 of 8

No. 01-91- ²⁷¹ /97
Sarajevo, 04 August 1997

Mr. James Wolfenson
President
The World Bank
1818 H St., NW
Washington, DC 20433

Re: Second Emergency Transport Reconstruction Project
Economic Program of Republika Srpska

Dear Mr. Wolfenson,

This is to inform you of the support of Bosnia and Herzegovina of the economic program of Republika Srpska submitted to you in conjunction with the request for an adjustment component for the benefit of Republika Srpska in a proposed Second Emergency Transport Reconstruction Project to be financed by the International Development Association (the Association) pursuant to an Interim Fund Development Credit Agreement.

The statement of the economic program is set forth in the annex to the letter to you from Republika Srpska, dated August __, 1997, a copy of which is attached hereto. This statement should be seen in the context of the overall economic program for Bosnia and Herzegovina that is expected to be supported by a standby arrangement with the International Monetary Fund.

On behalf of Bosnia and Herzegovina, I would like to express my appreciation for the assistance to be made available by the Association under the proposed Credit.

Sincerely,



Minister
Dr. Hasan Muratović

St. Musala 9, Sarajevo,
tel. (387 71) 473 123, fax. (387 71) 445 911

REPUBLIKA SRPSKA

Office of the Prime Minister

June 30, 1997

Mr James Wolfensohn,
President,
The World Bank Group
Washington DC, USA

Dear Mr Wolfensohn,

Re: Economic Programme of Republika Srpska

I attach a statement of the economic programme of Republika Srpska in support of our request for a quick disbursing component of US\$9 million equivalent in the proposed reconstruction assistance credit for Bosnia and Hercegovina (Republika Srpska). This statement should be seen in the context of the overall economic programme for Bosnia and Hercegovina that is expected to be supported by a standby arrangement with the Fund.

I wish to highlight three aspects of our programme

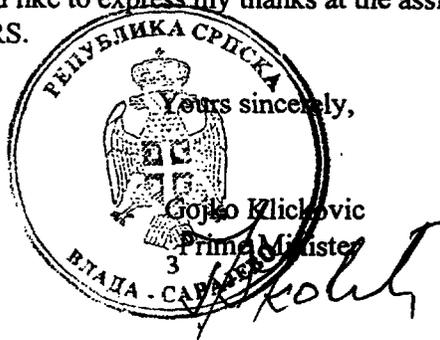
* the RS government will maintain economic and financial stability and take all measures towards the development of a market based economy. In particular, the privatisation programme will be pursued vigorously, and the banking system will also be privatised

* the RS government will implement the budget for 1997 as passed by parliament; in particular, there will be no recourse to domestic financing of the budget, nor to a rise in arrears in payments. Furthermore, expenditures on external debt service obligations of the RS will be fully provided for and funded

* the RS government will implement rapidly the laws passed at the state level on trade policy, customs policy, customs tariffs, external debt service and the establishment of the central bank. To this end, it will cooperate with the state and federation authorities and with external partners, in particular, the World Bank, in establishing the necessary institutions and policies.

On behalf of the RS government, I would like to express my thanks at the assistance that is now being made available to the RS.

Yours sincerely,
Gojko Klicicovic
Prime Minister
3



REPUBLIKA SRPSKA

POLICY STATEMENT

OBJECTIVES AND PRIORITIES

1. The basic objective of the strategy and policies for Republika Srpska development is economic reconstruction as the first phase, and economic revitalization as the second phase, which entails halting the recession and creating conditions necessary for sustainable growth. Having in mind the nature of the present economic system and enterprises, the RS economy is in the process of transition to a market economy. This process had already been initiated, though the armed conflict and related negative impact had slowed it down considerably. The second part of this process is the implementation of structural adjustments, thus entailing an open economic strategy with export promotion on the macro-economic level, while on the microeconomic level it entails the structural adjustment of existing enterprises and banks and economic expansion so as to enable sustainable growth.
2. Institutional reform implies the adjustment of the economic system to a market oriented economy. Systemic changes should contribute to the development of a market for the goods and services, the capital and labor markets, as well as to adapt role of the government to the needs of the market economy.
3. The aim of openness and export promotion is the integration and the inclusion of Republika Srpska into the world economy, thus making it essential to achieve the compatibility of the system and development compatibility. Openness calls for production for the export and the domestic markets on an equal footing, as well as doing away with incentives for the domestic market production only. Key measures for implementing an open policy are: a stable domestic currency exchange policy; an open policy attracting foreign direct investment, an antidumping policy and a policy of realistic/positive interest rates.
4. Macro-economic stabilization is a prerequisite for achieving lasting and sustainable growth, steps for which have already been undertaken. Macro-economic stabilization and liberalization complete the macroeconomic environment and create the incentives needed for export promotion. Sectoral policies create the basis for changes in the economic structure, leading to a higher participation of small and medium size enterprises in the structure of the economy. To secure a consistent approach to the transition process, it is necessary to implement complex restructuring of enterprises as well. This entails privatization and ownership transformation, as well as a restructuring of existing enterprises in their organizational, financial and production aspects. The purpose of microeconomic restructuring - the most difficult phase of transition - is the creation of enterprises successfully functioning within the framework of hard budget constraint.
5. Implementation of macro-economic policies would serve stabilization, this, at once, providing an initial step in the economic transition of Republika Srpska. This phase would be followed by institutional reform, the restructuring of enterprises and banks, the liberalization of foreign commercial relations and, as part of the last phase, the liberalization of capital flows.

MACRO-ECONOMIC POLICIES

MONETARY POLICY

1. With an economy entering a transitional phase, a healthy currency policy must prevail. Strict financial discipline policy would lead to hard budget constraints, beginning with enterprises and ending with the budgets. The Bosnia and Herzegovina central bank shall have full monetary authority, i.e., it should faithfully and independently execute a hard monetary policy, based on the currency board approach.
2. The creation of money should be founded only on hard currency transactions. Balanced budgets are essential in this regard.
3. The key to banking transformation is the creation of banking and other financial organizations as profit-oriented money institutions. With necessary modifications, the present institutions can serve in the future period as well. Encumbering the financial system at present are past losses: frozen forex savings, non-performing assets and unredeemable demands, loss of capital due to hyper-inflation, as well as doing business in the old manner where the role of the governments and mayor debtors were instrumental in making business decisions.
4. Having in mind the dubiousness of the former decision-making process, the reform of banking and financing as a whole shall be conducted on the macroeconomic level. It should be kept in mind that the consolidation of the financial sector is closely linked to the restructuring of enterprises and that both processes should be conducted simultaneously.

FISCAL POLICY

5. In planning budget expenditures, the pertinent principle is the balance with revenues. This would prevent fiscal deficits. This issue is of key importance to an economy in transition, since it has been empirically proved that a fiscal deficit is the basic cause of internal and external imbalances among numerous development countries. Management of public expenditures should lead to unified economic conditions. Additional revenues could be expected from privatization. An expansion of the taxation base will gain in importance as shall more efficient tax collection which should be facilitated by the formation of professional financial police and the strict enforcement of the law.
6. The initial task of implementing fiscal stabilization policies is the elimination or minimalization of fiscal deficits which, in the past were the main generator of hyper-inflation, since the budget deficit was covered by printing money. This is possible by limiting the budget at a level commensurate with the decreased GNP during the civil war and recession. Income should be adapted to increased needs. Having in mind the difficulties caused by the decreased expenditures, the increase in primary budget revenues has all the greater significance.
7. An increase in the taxation level would be counterproductive since, in a recession, it may lead to further decrease of production, which would not lead to increased tax revenue. That is why the strategy of increasing the taxation base and decreasing rates of taxation is an approach ensuring increased income through the revitalization of production. Widening the taxation base largely entails a larger degree of participation by the present "gray economy" in the normal economy which allows the taxation of this group as well. Changes in the system conducted since the beginning of the programme in Republika Srpska are a good basis for changes to taxation law aimed at stabilization.

8. Having in mind the aims of taxation reform in an economy in transition (securing the neutrality and efficiency in allocation, transparency, simplicity, justice in the division of taxation burden), which should be in the next phase transformed by the value added taxation system.
9. Continuing the phase of restructuring, individual funds in this field - pensions, disability insurance and unemployment insurance - shall be formed and thus be institutional investors, contributing to their long-term stability and on the other hand contributing to financial markets. Efficiency in the public sector could also be secured by the increased participation of consumer services by contracting, while the dispersion of institutions would enable the development of various levels of quality depending on the level of participants. Privatization of health care and education institutions will reduce the pressure on welfare funds.

FOREIGN ECONOMIC RELATIONS POLICY

10. A crucial factor in revitalizing production to levels above what is possible in a closed economy is the renewal of transportation, scientific/technical and foreign trade exchange. This includes the renewal of cooperation with the former Yugoslav republics. However, it is realized that cooperation will be on a level lower than desirable, in consideration of the overall situation. In the initial stages, the renewal of relations will be regulated through bilateral agreements, while steps towards higher forms of multilateral cooperation can only be expected later. In the near future, a free trade zone could be created as a maximum level of integration within the former Yugoslavia region, while payments could be made through private clearing houses. As far as multilateral economic cooperation is concerned, it is necessary to develop projects for integration within the whole Balkans region.
11. Bosnia and Herzegovina Quick Start Package Laws adopted in June represent a legal framework in support of implementation of Foreign trade policy, Customs policy, and Monetary policy, thus enabling the Government to implement the full scale macro-economic policies as described here.
12. The basic implication regarding economic development is export stimulation. The strategy of openness of our markets creates conditions for halting the drop in production in exports, followed by their lasting growth under stable conditions. The use of lowest cost resources, regardless of their source, enables the improvement of efficiency of utilization and the creation of conditions for competitiveness on international markets.
13. An open market strategy is secured through a realistic currency exchange policy, openness respecting foreign investment, and through appropriate anti-dumping policies. A realistic currency exchange policy creates conditions for revitalizing the foreign exchange market and restoring confidence in the financial system. Opening up the economy is accomplished through incremental introduction of a high degree of commercial liberalization in the first phase., while the second phase will also deal with the liberalization of capital. Liberalization is accompanied by the creation of appropriate anti-dumping measures, in accordance with a commitment to development and international trade norms. Restrictive measures and import limits, as well as customs barriers, will not be introduced without a detailed assessment of domestic costs and resources and effective protection levels. The existing legislation is amenable to foreign investment. Therefore, a relatively attractive foreign investment environment already exists compared to those of the neighboring countries so that foreign inflow may be expected during the first stages of economic renewal. By Constitution amendment LII full safeguards to foreign investments are provided.

PRICING POLICY

14. One of the basic tasks of the transition economy is the liberalization of the market for goods and services. The creation of suitable market institutions - laws dealing with monopolies - the organization of commodity reserves and the liberalization of foreign trade would create conditions enabling unhindered market supply and demand and the free determination of prices without the generation of unwarranted inflation. A stabilizing macro-economic framework - a necessary and first step in the transition phase - will be secured through a restrictive monetary policy, a restrictive fiscal policy, the appropriate revenue policy and a fixed foreign exchange. Thus, prices are formed freely in response to market conditions. Policies dealing with monopolies and free imports will prevent the occurrence of monopoly market positions.

15. Of great importance, especially in the period of the renewal and rehabilitation of Republika Srpska's economy and because of decreased supply, will be the creation of a temporary commodity reserves programme. The essential aim here is to secure the stability of markets, production and export, hand-in-hand with the decreased participation of capital for these ends. A new concept regarding commodity reserves implies financial reserves from the budget, but, such reserves will by their participation in the market also secure primary revenue. Of special significance for inclusion in international trade, is the use of commodity reserves for reaching planned export goals. Replenishing commodity reserves would be accomplished through domestic and foreign markets and contractual production. They would be in the form of goods and money and would contain - in addition to industrial raw materials, production materials, fuel, medicine and sanitary supplies - essential agricultural products.

16. In those sectors of the economy with limited market participation because of natural and lasting monopolies, prices would be determined according to criteria developed by Republika Srpska Government.

17. In the sector of the economy with majority State ownership (State enterprises), the government will determine prices. The essential principle governing is "cost plus", which, in this phase of stabilization, encompasses only production costs, and not development cost. One should keep in mind that the essential principle governing the determination of prices must be modified, but in such a way so as not to be detrimental to the functioning of the large systems as well as not to lower living standards. Therefore, the determination of prices for State enterprises entails the efficient functioning of all State enterprises. The government should take into account that some State enterprises, by the nature of their enterprise, will for sometime continue to generate losses, while on the other hand there are enterprises which can generate an income. The role of the government is to "iron out" losses and income between State enterprises.

18. An important part of pricing policy is the formulation of protective prices for agricultural products of interest to Republika Srpska - wheat, maize, sugar beets, oil-bearing plants, meat, and milk.

INCOMES POLICY

19. For the unhindered functioning of the labor market it is necessary to establish all market institutions and elements accompanied by deregulation of contractual agreements as regards the welfare aspects of enterprises. Thus, income should be the result of supply and demand through the contract mechanism, while at the same time not creating inflationary pressure.

20. The incomes policy has three essential goals: establishing a competitive labor market which implies low unemployment and negligible differences in the prices of labor of the same kind and intensity throughout, the elimination of indexed incomes under generally stable production conditions and the removal of existing disadvantages (protection of employment and limitations to contractual arrangements).

Together with the above it is necessary to create temporary welfare mechanisms so that the government would take upon itself welfare concerns and remove this obligation from the enterprises themselves. First of all, a minimum level of protection would be determined - that is, the rights of the vulnerable population in accordance with the ability of the government to care for the unemployed and others. While developing a welfare protection system, work would also be undertaken on the development of a new concept for private and public financial institutions within which the problem of providing more than the minimum care provided by law would be dealt with. A separate segment of welfare policy during the economic recovery and transition will be welfare programs in support of structural adjustments in the economy.

DEVELOPMENT POLICIES

INVESTMENT POLICY

21. Because of the economic crisis and the structural inadequacies, Republika Srpska's economy found itself financially impoverished and technologically backward even during the war and at the time the blockade was imposed. The result of the war and blockade pushed the situation to one of extreme impoverishment. Therefore development policies have to be realistic. Such policies shall provide incentives to development to the extent possible, primarily in those areas which support the restructuring of the economy. Investment policy is aimed at:

- (a) structural adaptation and incentives provision for enterprise;
- (b) analyzing on more realistic basis natural and human resources and available capital stock;
- (c) offering incentives for exports.

22. In a situation with extreme shortages on the one hand, and enormous needs on the other, the revitalization of the war-devastated economy requires the determination of potential sources of available funds and channel them towards development. Healthy commercial enterprises are in possession of such funds - largely private and mixed ownership - as are emigrants and foreign capital interested in Republika Srpska.

23. Primary leverage for the stimulation of investment is to be found in the rehabilitation of enterprises and the banking system. Only secondary would be the engagement of the government through the provision of initial funding for direct investment. A policy of openness respecting foreign capital - especially direct investment - will have an enhanced importance.

INDUSTRIAL POLICY

24. Industrial development should tend towards restructuring. With this in mind, the macro-economy should be gauged towards increasing supply, keeping in mind that revitalization should be achieved in a restructured economy. At the sector level it is necessary to revitalize, redirect industrial development which in most of the cases would do away with traditional, centralized and pointless production, on the one hand, while on the other hand it is necessary to support production and create the appropriate infrastructure for new, expansive, decentralized sectors (proactive restructuring). With existing enterprises, the tendency will be towards restructuring which will achieve greater utilization of facilities, decreased energy and resources consumption per unit of output. This entails investment aimed at enlarging production facilities or redirecting them, investment in improving management and organization.

25. A second and parallel development, which should be dominant, is the foundation of new small and medium sized enterprises, for which an attractive business climate should be created.

26. As regards essential and strategic products for Republika Srpska it will be necessary to secure investment. To decrease energy and raw materials consumption per unit of output, it is necessary to develop long-term energy saving programs as well as the conversion of energy sources. One of the bases for renewal will be the construction industry.

AGRICULTURAL DEVELOPMENT POLICY

27. Agricultural production in Republika Srpska will be developed along lines which will provide, as far as circumstances allow, food supply security for the population, an appropriate living standard in rural areas, a stable market for agricultural products at reasonable prices.

28. Republika Srpska must enable agricultural producers to secure an income which will provide them with an acceptable living standard. This will maintain a healthy population on the land, will maintain the village as a vital social component, while the production of food will be maintained.

29. One may suppose that Republika Srpska will not in the next few years have the necessary funds for the large-scale, direct financing of agricultural policies. This makes it necessary to use other means to secure favorable conditions for the development of agriculture.

30. Government intervention through direct monetary grants may only be resorted to in undeveloped areas where conditions for agricultural production are unable without such support to move towards their true potential.

31. The state of agriculture as inherited, must be changed. There is enough room for improvement through a strictly applied long-term agricultural policy. In earlier periods, village house holds derived only 13 percent of their income from their agricultural activities, which bespeaks the lack of development prevailing and the derivation of income through other means. Through an increase in productivity, with an emphasis on the utilization of relative advantages, the income derived must be increased so as to fully satisfy the requirements of all members of the household. The government can help with direct financial grants (through subsidies and the like), through the education of agricultural producers, familiarizing them with new techniques, through the provision of veterinary clinics, the provision of credit, as well as the use of other ways aimed at increasing production. Regional development policy for agriculture will be developed in the light of appropriate analysis of the production potential in relation to markets.

Bosnia and Herzegovina

Second Emergency Transport Reconstruction Project

Estimated Project Cost and Financing Plan
(US\$ million)

Items	Cost	IDA (ITF)	Entities	EC ¹	Nether lands	Japan	Total financing	Financing gap
Adjustment Component	9.0	9.0					9.0	0.0
TOTAL	9.0	9.0	0.0	0.0	0.0	0.0	9.0	0.0
Transport Component								
A) Road								
Road rehabilitation	50.5	22.3	2.5	10.0			34.8	15.7
Sava River bridges	20.0	0.0		20.0			20.0	0.0
Bridge rehabilitation	16.1	3.7	0.4				4.1	12.0
Tunnel rehabilitation	1.1	0.0	0.0				0.0	1.1
Land slips	2.2	0.0	0.0				0.0	2.2
Construction and Maintenance Equipment	9.0	1.2					1.2	7.8
Road Safety (Signalization)	1.0				0.2		0.2	0.8
Tires	1.9	0.0					0.0	1.9
<i>Sub-total</i>	101.9	27.2	2.9	30.0	0.2	0.0	60.3	41.6
B) Railways								
Civil works	9.0			9.0			9.0	0.0
Signaling/Telecom	6.5						0.0	6.5
Electrification equipment	12.7						0.0	12.7
Maintenance	10.2						0.0	10.2
<i>Sub-total</i>	38.4			9.0	0.0	0.0	9.0	29.4
C) Civil aviation								
	11.1			10.0			10.0	1.1
D) Buses, trams, spare parts and workshop equipment								
	12.7						0.0	12.7
E) Institution building								
	2.5	0.3					0.3	2.2
F) Technical Assistance								
	7.3	2.4		3.0		0.4	5.8	1.5
G) Mine clearing								
	1.1	0.1					0.1	1.0
TOTAL	175.0	30.0	2.9	52.0	0.2	0.4	85.5	89.5
GRAND TOTAL	184.0	39.0	2.9	52.0	0.2	0.4	94.5	89.5

¹ The amount and breakdown of the EC contribution are tentative and will be confirmed by the EC in due course.

Bosnia and Herzegovina

Second Emergency Transport Reconstruction Project

Summary of Proposed Procurement Arrangements ^{1 2}
(US\$ million, including contingencies)

Items	ICB	NCB	Other ^a	NBF ^b	Total
Works					
Road rehabilitation	10.2 (9.3)	13 (11.4)	1.6 (1.5)	25.7	50.5 (22.2)
Sava River bridges				20.0	20.0
Bridge rehabilitation			4.1 (3.7)	12.0	16.1 (3.7)
Tunnel/ land slips rehabilitation				3.4	3.4
Railway Civil Works				9.0	9.0
Civil Aviation Works				3.0	3.0
Mine clearing		0.1 (0.1)		1.0	1.1 (0.1)
<i>Sub-total</i>	10.2 (9.3)	13.1 (11.5)	5.7 (5.2)	74.1	103.1 (26.0)
Goods					
Construction & Maintenance Equipment	1.2 (1.2)			7.8	9.0 (1.2)
Tires				1.9	1.9
Railway electrification equipment				12.7	12.7
Railway Signaling/Telecommunications				6.5	6.5
Railway Maintenance				10.2	10.2
Civil aviation equipment				8.1	8.1
Buses, trams, spare parts and workshop equipment				12.7	12.7
Road Safety (Signalization)				1.0	1.0
<i>Sub-total</i>				60.9	62.1 (1.2)
Services					
Institution building			0.3 (0.3)	2.2	2.5 (0.3)
Design & Supervision			2.5 (2.5)	4.8	7.3 (2.5)
<i>Sub-total</i>			2.8 (2.8)	7.0	9.8 (2.8)
TOTAL	11.4 (10.5)	13.1 (11.5)	8.5 (8.0)	142.0	175.0 (30.0)

^a Includes: Direct Contracting for works (DC, for US\$1.5 million) Small Works Procurement Procedure (SWPP, for US\$4.0 million), International Shopping (IS, for US\$0.1 million), National Shopping (NS, for US\$0.1 million), Selection Based on Consultants' Qualification (SBCQ, for US\$1.3 million), Least-Cost (LC, for US\$0.7 million).

^b Not Bank Financed

¹ The procurement arrangements table might be modified in accordance with pledges from donors committed through World Bank administered funds. The figures in parentheses indicate the part financed out of the IDA (ITF) Credit.

² Excludes the adjustment component

Bosnia and Herzegovina

Second Emergency Transport Reconstruction Project

Disbursement Categories and Estimated Schedule
(US\$ million)

Disbursement Categories

Categories	IDA (ITF)-financed	% of expenditures to be financed under IDA (ITF) Credit
A) Adjustment Component	9.0	100%
B) Investment Component		
Civil Works:		
• Roads/bridges	23.2	90%
Goods:		
• Trucks	1.2	100% of foreign expenditures 100% of local expenditures (ex-factory cost) and 85% of local expenditures for other items procured locally
Consultants Services:		
• Project implementation, including audit	2.0	100%
Incremental Operating Costs (PIDs)	0.3	100%
Unallocated	3.3	
Sub-Total Investment Component (including contingencies)	30.0	
Grand Total (A + B)	39.0	

Estimated Disbursement Schedule

Bank FY	FY98 Q2	FY98 Q3	FY98 Q4	FY99 Q1	FY99 Q2	FY99 Q3	FY99 Q4	FY00 Q1	FY00 Q2
Quarterly Amount	11.4	2.2	4.5	5.2	6.2	2.0	3.0	3.0	1.5
%	29.3	5.6	11.5	13.3	15.9	5.2	7.7	7.7	3.8
Cumulative Amount	11.4	13.6	18.1	23.3	29.5	31.5	34.5	37.5	39.0
%	29.3	34.8	46.4	59.7	75.6	80.7	88.4	96.1	100.0

Bosnia and Herzegovina

Second Emergency Transport Reconstruction Project

Timetable of Key Processing Events

- | | |
|--------------------------------------|--|
| (a) Time taken to prepare: | 9 months |
| (b) Prepared by: | Government, with World Bank assistance |
| (c) Appraisal mission: | January 13, 1997 and June 25, 1997 |
| (d) Negotiations: | April 7, 1997 and July 5, 1997 |
| (e) ITF Committee Discussion: | August 28, 1997 |
| (f) Planned date of Effectiveness: | September 10, 1997 |
| (g) List of relevant PCRs and PPARs: | Not applicable |

STATUS OF BANK GROUP OPERATIONS IN BOSNIA-HERZEGOVINA

A. STATEMENT OF BANK LOANS ^{a/}
(As of July 31, 1997)

Loan No.	Fiscal Year	Borrower	Project	US\$ Million	
				Loan	(Less Cancellations) Undisbursed
<u>Loans/Credits/Grants</u>					
<u>IBRD</u> ^{b/}					
4038-BOS	1996	Bosnia and Herzegovina	Consolidation Loan A	28.6	0.0
4039-BOS	1996	Bosnia and Herzegovina	Consolidation Loan B	284.9	0.0
4040-BOS	1996	Bosnia and Herzegovina	Consolidation Loan C	307.1	0.0
Total				<u>620.6</u>	<u>0.0</u>
Of Which: Repaid				<u>24.9</u>	
Total Now Held by the Bank:				<u>595.7</u>	
<u>TFBH</u> ^{c/} (Under Disbursement)					
TF-024030	1996	Bosnia and Herzegovina	Emergency Recovery Credit	45.0	4.3
TF-024031	1996	Bosnia and Herzegovina	Emergency Farm Reconstruction	20.0	0.6
TF-024032	1996	Bosnia and Herzegovina	Emergency Water Supply	20.0	1.6
TF-024033	1996	Bosnia and Herzegovina	Emergency Transport	35.0	11.2
TF-024034	1996	Bosnia and Herzegovina	Emergency District Heating ^{d/}	20.0	7.2
TF-024035	1996	Bosnia and Herzegovina	Emergency War Victims Rehabilitation	5.0	1.1
TF-024040	1996	Bosnia and Herzegovina	Emergency Education Reconstruction	5.0	0.0
Total				<u>150.0</u>	<u>26.0</u>
<u>IDA</u>					
2897-BOS	1996	Bosnia and Herzegovina	Emergency Education Reconstruction	5.0	0.4
2896-BOS	1996	Bosnia and Herzegovina	Emergency War Victims Rehabilitation	5.0	5.0
2902-BOS	1996	Bosnia and Herzegovina	Emergency Housing Repair	15.0	2.9
2903-BOS	1997	Bosnia and Herzegovina	Emergency Power Reconstruction	35.6	18.0
2904-BOS	1997	Bosnia and Herzegovina	Emergency Public Works and Employment	10.0	3.1
2905-BOS	1997	Bosnia and Herzegovina	Emergency Landmines Clearance	7.5	5.8
2906-BOS	1997	Bosnia and Herzegovina	Emergency Demobilization and Reintegration	7.5	5.1
2914-BOS	1997	Bosnia and Herzegovina	Transition Assistance Credit	90.0	0.0
N001-BOS	1997	Bosnia and Herzegovina	Emergency Industry Re-Start Guarantee	10.0	10.0
N002-BOS	1997	Bosnia and Herzegovina	Emergency Microenterprise/Local Initiatives	7.0	3.6
N003-BOS	1997	Bosnia and Herzegovina	Essential Hospital Services	15.0	11.0
Total				<u>207.6</u>	<u>64.9</u>

^{a/} The status of these projects is described in a separate report on all Bank/IDA financed projects in execution, which is updated twice yearly and circulated to the Executive Directors on April 30 and October 31.

^{b/} Consolidation Loans A, B, and C were approved on June 13, 1996 and became effective on June 14, 1996.

^{c/} Trust Fund for Bosnia and Herzegovina.

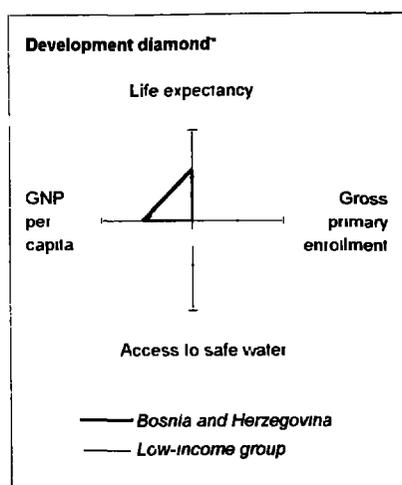
^{d/} Disbursements to date are from the Project Start-Up Advance (of which US\$2 million is disbursed for Gas).

B. STATEMENT OF IFC INVESTMENTS
(As of June 30, 1997)

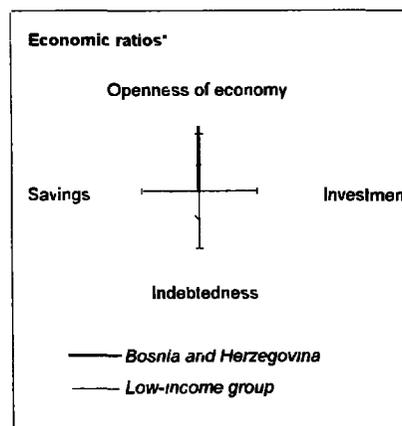
Fiscal Year	Obligor	Type of Business	Gross Commitments		
			-----US\$ Million-----		
			Loan	Equity	Total
1977	Tvornica Kartona I Ambalaze Cazin	Timber, Pulp and Paper	4.28	0.0	4.28
1985	Sour Energoinvest	Industrial Equipment and Machinery	9.80	0.0	9.80
1997	Horizante BiH Enterprise Fund	SME Investment	2.00	--	2.00
1997	Microentreprise	Microcredit	0.60	--	0.60
1997	Sarajevska Pivara	Brewery	--	8.20	8.20
		Total Gross Commitments	<u>16.68</u>	<u>8.20</u>	<u>24.88</u>
		Less: Participations, Cancellations, Terminations, Exchange Adjustments, Repayments, Write-offs and Sales	<u>23.50</u>	<u>2.60</u>	<u>26.10</u>
		Total Commitments Now Held by IFC	<u>16.68</u>	<u>8.20</u>	<u>24.88</u>
		Total Undisbursed	2.60	8.20	24.88
		Total Outstanding	<u>14.08</u>	--	<u>14.08</u>

Bosnia and Herzegovina at a glance

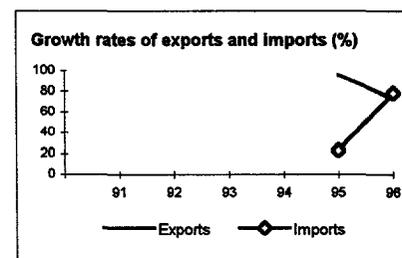
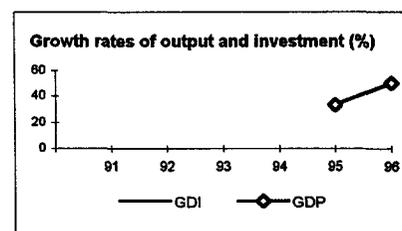
	Bosnia and Herzegovina	Europe & Central Asia	Low-income
POVERTY and SOCIAL			
Population mid-1995 (millions)	4.1	488	3,180
GNP per capita 1995 (US\$)1/		2,220	430
GNP 1995 (billions US\$)1/		1,084	1,382
Average annual growth, 1990-95			
Population (%)		0.3	1.7
Labor force (%)		0.5	1.7
Most recent estimate (latest year available since 1989)			
Poverty: headcount index (% of population)			
Urban population (% of total population)	49	65	29
Life expectancy at birth (years)	71	68	63
Infant mortality (per 1,000 live births)	19	26	69
Child malnutrition (% of children under 5)			
Access to safe water (% of population)			53
Illiteracy (% of population age 15+)			34
Gross primary enrollment (% of school-age population)		97	105
Male		97	112
Female		97	98



	1975	1985	1995	1996
KEY ECONOMIC RATIOS and LONG-TERM TRENDS				
GDP (billions US\$)			2.1	3.3
Gross domestic investment/GDP				
Exports of goods and services/GDP			19.0	20.3
Gross domestic savings/GDP				
Gross national savings/GDP				
Current account balance/GDP			-27.0	-43.0
Interest payments/GDP				
Total debt/GDP			167.0	116.0
Total debt service/exports			118.0	72.0
Present value of debt/GDP				
Present value of debt/exports				
	1975-85	1986-96	1995	1996
<i>(average annual growth)</i>				
GDP	33.0	50.0
GNP per capita				59.0
Exports of goods and services				74.0



	1975	1991	1995	1996
STRUCTURE of the ECONOMY				
<i>(% of GDP)</i>				
Agriculture	..	9.5	..	19.0
Industry	..	43.0	..	23.0
Manufacturing
Services	..	47.5	..	58.0
Private consumption
General government consumption
Imports of goods and services	63.0	73.0
	1975-85	1986-96	1995	1996
<i>(average annual growth)</i>				
Agriculture
Industry
Manufacturing
Services
Private consumption
General government consumption
Gross domestic investment
Imports of goods and services	23.0	78.0
Gross national product



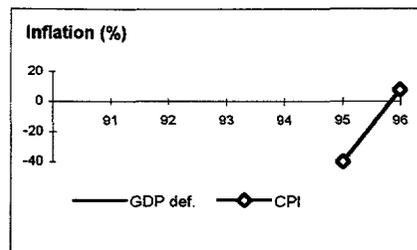
Note: 1996 data are preliminary estimates.
Many of the above statistics are unavailable due to scant and partial data in post-war Bosnia and Herzegovina.

1/ Due to poor data in post-war Bosnia and Herzegovina, 1995 GNP figure is not available; GDP per capita is estimated to be US\$ 501.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

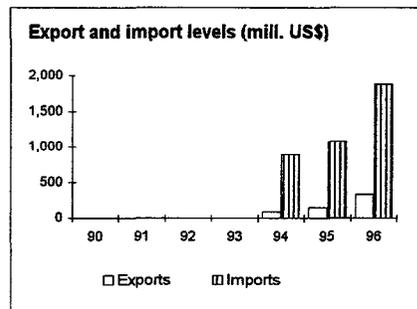
PRICES and GOVERNMENT FINANCE

	1975	1985	1995	1996
Domestic prices 2/ (% change)				
Consumer prices	-40.0	7.7
Implicit GDP deflator
Government finance (% of GDP)				
Current revenue	35.0	62.0
Current budget balance	0.0	-7.0
Overall surplus/deficit



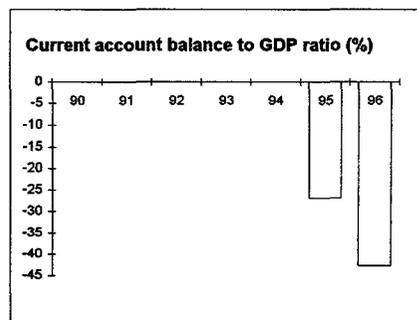
TRADE

	1975	1985	1995	1996
(millions US\$)				
Total exports (fob)	152	336
n.a.
Manufactures
Total imports (cif)	1,082	1,882
Food
Fuel and energy
Capital goods
Export price index (1987=100)
Import price index (1987=100)
Terms of trade (1987=100)



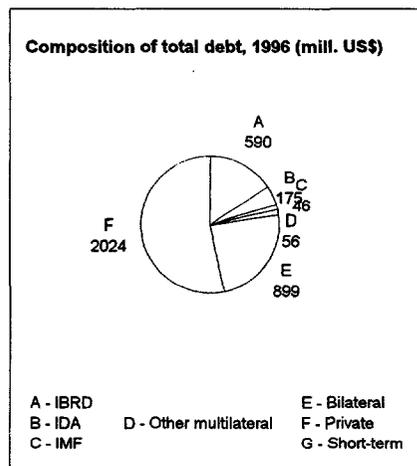
BALANCE of PAYMENTS

	1975	1985	1995	1996
(millions US\$)				
Exports of goods and services	381	658
Imports of goods and services	1,334	2,379
Resource balance	-953	-1,721
Net factor income	-242	-220
Net current transfers	625	536
Current account balance, before official capital transfers	-570	-1,405
Financing items (net)	708	1,803
Changes in net reserves	-138	-398
Memo:				
Reserves including gold (mill. US\$)
Conversion rate (local/US\$)



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1995	1996
(millions US\$)				
Total debt outstanding and disbursed	3,518	3,790
IBRD	625	590
IDA	0	175
Total debt service	451	476
IBRD	12
IDA	1
Composition of net resource flows				
Official grants
Official creditors
Private creditors
Foreign direct investment
Portfolio equity
World Bank program				
Commitments
Disbursements
Principal repayments
Net flows
Interest payments
Net transfers



2/ Data refers only to the Federation of BiH. In Republika Srpska, annual percentage change in CPI was 204.4 in 1995 and -8.5 in 1996.
International Economics Department



IMAGING

**Report No.: P
Type: MOND**

7147 BIH