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REPORT FROM THE COMMISSION TO COUNCIL

**THE POSSIBILITY OF THE EUROPEAN INVESTMENT BANK
LENDING IN BOSNIA-HERZEGOVINA**

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LENDING IN BOSNIA-HERZEGOVINA

1. Introduction

In the light of recent developments in Bosnia-Herzegovina (BiH), ECOFIN requested the Commission on February 16 to examine, in collaboration with the European Investment Bank (EIB), the possibility of the Bank providing loans in this country.

Besides humanitarian aid, BiH together with other ex-Yugoslav republics, receives reconstruction aid under the Council Regulation No 1628/96 of 25 July 1996 and under the PHARE Regulation. In view of the urgent needs for reconstruction in BiH however, the Commission is in favour of inviting the EIB to extend its lending activities to BiH, while taking into account the particularities of the political economic and financial environment of the country. The possibility of mobilising Bank loans in this country must be seen as a *special and exceptional action* whose main objective would be to contribute to the speedy reconstruction of the country and, in the process, to facilitate the communication and the integration of the different communities living in the area.

The EIB has expressed its willingness in principle to start operations in BiH provided there is a formal Council Decision granting a Community Budget guarantee for these operations and subject to a positive decision of its Board of Governors. The EIB indicated having undertaken preparatory work to identify the areas of possible Bank intervention within the framework of the Reconstruction Programme agreed by the International Community at successive Donors' Pledging Conferences sponsored by the Commission and the World Bank.

2. Political, economic and financial background

2.1. Political background

According to the Dayton/Paris peace agreement signed on December 14, 1995, BiH was to remain a single state being composed of two Entities, the Federation of Bosnia-Herzegovina and the Republika Srpska (RS). The implementation of Dayton involves military and civilian aspects contributing in parallel to regenerate confidence and stability, which are monitored annually by the Peace Implementation Council (PIC). The military aspects have been dealt successfully. However, a military presence will remain necessary for some time. Civilian implementation has been much slower. It is coordinated by the High Representative whose mandate was reinforced at the last PIC conference in Bonn on December 9-10, 1997. The appointment of a pro-Dayton government in the RS has paved the way for an improved cooperation by this entity with the international community, making the political and economic outlook more favourable for the country as a whole.

In the absence of a Protocol on Financial Cooperation between BiH and the Community, which usually provides with the framework (objectives and conditions) of the EU financial cooperation with third countries, the involvement of the EIB in BiH should be consistent with the policy of the Union in this country and supportive of the objectives of the Dayton/Paris agreement and subsequent obligations.

2.2. Economic developments

By 1995, GDP in BiH had shrunk to less than a third of its pre-war level and per capita GDP had fallen to US\$500. The population was 23% smaller than in 1991, over 50 % of the population had been displaced, and more than 1.2 million inhabitants were forced to flee abroad, mainly to the EU. Physical capital and infrastructure had been devastated. With the end of the war, the economy recovered strongly, fuelled by external assistance, mainly in the Federation. Real GDP growth reached 50% in 1996 for the country as a whole, but decelerated to about 30% in 1997 owing to a slower pace of financial assistance. In particular, the RS has suffered self-imposed isolation from the internationally-sponsored Reconstruction programme and has benefited only from humanitarian aid. Unemployment is reported high in both the Federation and RS (up to 50%) and represents a serious threat to social stability and peace. Considering the deficit of the trade balance (estimated at about US\$ 2 billion in 1997 by the IMF with imports as high as US\$ 2.7 billion), the recovery of economic activity and employment will continue to heavily rely on the availability of official financial flows.

In 1995, the international community endorsed a medium-term programme for reconstruction and peace implementation activities in BiH amounting to US\$ 5.1 billion for the period 1996-99 which included the following areas among its priorities: basic infrastructure, housing, energy, telecommunications, transport, and water and waste management. Following three Donors' Pledging conferences, US\$ 1.6 billion of aid had been donated to BiH by the end of 1997¹, of which 45% originated from the Community and the Member States. In January 1998, the Council welcomed the formation of the new government in the RS and decided to immediately support it in the form an initial emergency budgetary grant in the amount of up to ECU 6 million and to examine the possibilities for further assistance. Moreover, in view of weak implementation capacities in both Entities, the Council is presently discussing a Commission proposal aiming at streamlining the financial regulation governing its financial assistance to BiH.

2.3. External financial situation and prospects

The external debt of BiH was estimated at US\$4.6 billion at end-1996, equivalent to over 160 % of GDP. Against an accumulation of external arrears of some US\$ 2 billion, the authorities have tried to normalise relations with external creditors. Arrears to the IMF and the World Bank were cleared in

¹ See Bosnia and Herzegovina: Implementation of the Priority Reconstruction Program, Status Report to the Donor Community, November 1997.

December 1995 and June 1996, respectively. An agreement with the London Club creditors was reached in July 1997 on the restructuring of over US\$1 billion debt. Negotiations with Paris club creditors are expected to be concluded soon after the authorities reach agreement on an IMF-supported programme. Clearance of arrears to the EIB, which amounted to approximately ECU 6 million (including penalties) at end-1997, will also have to be dealt within the framework of the IMF-supported programme as a precondition for an effective involvement of the EIB in BiH.

Prospect for the early conclusion of an IMF-supported programme have recently improved, pending the adoption of satisfactory and mutually-consistent State and Entity budgets for 1998, including the establishment of automatic mechanisms for external debt service payments. In particular, a number of essential legislation establishing common foreign trade and debt policies was adopted in June 1997. The new Central Bank of BiH launched its operations in August 1997 and the design of the new common currency (the convertible markā) was imposed on all parties in January 1998. Despite these achievements, much more needs to be done to effectively implement open and market-oriented economic policies and ensuring good governance, transparency, and accountability in the use of donor fund.

3. Prospects for Bank operations

- 3.1 As a rule, the EIB intervenes outside the Community in the framework of protocols, co-operation or association agreements signed between the Community and a particular country. In the absence of a Financial Protocol or Agreement between BiH and the Community, the involvement of the EIB in BiH should be consistent with the policy of the Union in this country.
- 3.2 The Bank's involvement in BiH would require a **Council Decision**, on the basis of a Commission proposal, under Article 235 with consultation of the European Parliament, indicating the Community guarantee arrangements as well as the amount for the new commitment. The Council Decision would indicate that the new lending mandate is in addition to that defined in Council Decision 97/256/EC of 14 April 1997.

The EIB operation in BiH would be of exceptional nature. An amount of about ECU 100 million could be envisaged on EIB lending on own resources. This amount could be reconsidered on the basis of the experience. Towards this end, the Commission and the EIB will present to Council a report with the evaluation of the situation no later than one year after the entry into force of the eventual Council Decision.

- 3.3 The conclusion and implementation of a Stand-By IMF programme and subsequent arrangements will be crucial for ensuring BiH's capacity to repay the EIB, including through the mobilization of large scale external assistance, with a high degree of concessionality.

- 3.4 In view of the low income and BiH's eligibility to IDA, EIB loans would need to be combined with a substantial grant element from the Community Budget for the Bank to intervene effectively. This could take the form of **interest subsidy** and/or **cofinancing** on a case-by-case basis. Moreover, the Bank could consider granting longer than the usual grace period.
- 3.5 Further to a decision on a specific mandate and the appropriate guarantee arrangements, the Bank's intervention in BiH is also subject to the previous clearance of all **arrears** (see section 2.3).
- 3.6 The Bank would operate, within the framework of the Reconstruction programme agreed at the various Donors' conferences, in **sectors** where its contribution and expertise can play a meaningful role and with its intervention aim to the regional integration of the area. The sectors that could benefit from possible Bank financing are general infrastructure including transport (in particular the reconstruction of roads and bridges), energy, telecommunications, environment (with focus on the water, waste water and sanitation projects). At a later state, when structural reforms are implemented, the industrial sector could also be considered.
- 3.7 Projects to be supported by the Bank would have to meet the Bank's **lending criteria** notably those concerning economic, technical and financial viability and be in line with the relevant Community legislation. The Bank's usual lending conditions will apply.
- 3.8 As for other lending mandates, the possible EIB loans in BiH would be subject to the arrangements set out in the Guarantee Fund Regulation.

4. **Conclusion**

In the light of the above, should the Council be favourable to the EIB carrying out its operations in Bosnia-Herzegovina, the Commission would prepare a proposal for a decision granting the Community Budget guarantee to the EIB for its operations in this country.

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