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December 8, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Republic of Bosnia and Herzegovina - Use of Fund Resources -  
Emergency Post-Conflict Assistance

Attached for consideration by the Executive Directors is a paper on the use of Fund resources for emergency post-conflict assistance for the Republic of Bosnia and Herzegovina, which is scheduled for discussion on Wednesday, December 20, 1995.

This subject, for which this paper provides background information, will be for discussion at an informal session on Thursday, December 14, 1995. A separate report will be provided to the Executive Board on issues related to succession to membership for the Republic of Bosnia and Herzegovina.

Mr. Thomsen (ext. 38808) or Mr. O'Callaghan (ext. 38219) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF BOSNIA AND HERZEGOVINA

Staff Report for Use of Fund Resources--  
Emergency Post-Conflict Assistance

Prepared by the European I and  
the Policy Development and Review Departments

(In consultation with other Departments)

Approved by Massimo Russo and Michael Edo

December 8, 1995

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## I. Introduction

A staff mission has been in Sarajevo since November 13, 1995 to advance work on a plan for Fund assistance to Bosnia and Herzegovina in the aftermath of the conflict that has raged since 1992. 1/ The mission has focused on diagnosing technical assistance and external financing needs, establishing a coherent economic policy framework for the remainder of 1995 and 1996 building on the recent Peace Agreement, and discussing a set of economic measures that could warrant support under the Fund policy for involvement in post-conflict countries as laid out in Buff/95/98 (9/19/95). Upon membership in the Fund, the authorities intend to request such support on the basis of the Statement on Economic Policies contained in Appendix I. 2/

When the Republic of Bosnia and Herzegovina declared independence from the former Socialist Federal Republic of Yugoslavia (SFRY) in March 1992, it was recognized by the United Nations and most of its members in the following months. The General Framework Agreement for Peace in Bosnia and Herzegovina, which was initialed in Dayton, Ohio, on November 21, 1995, and which is tentatively scheduled to be signed in Paris on December 14, 1995, confirms the continued existence of the country under the name "Bosnia and Herzegovina", within its existing internationally recognized boundaries. It also confirms, for an interim period until elections can be held in six to nine months, the authority of existing government offices and institutions. All existing laws and regulations will remain in effect during the interim period, provided they are consistent with the constitution. The constitution provides for the establishment of a collective presidency and a new bi-cameral parliamentary system. The proposed political institutions are summarized in Appendix IV.

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1/ The mission is comprised of Messrs. S. B. Brown (Head), Marrese, Odenius (all EU1), Brooks (PDR), Krellove (FAD) and McAlister (STA). Messrs. Brooks, Krellove, and McAlister have since returned to headquarters. As far as the Central Government and Federation of Bosnia and Herzegovina are concerned, the mission met with President Izetbegović, Prime Minister Silajdžić, Foreign Minister Šaćirbegović, Governor Omičević of the National Bank of Bosnia and Herzegovina, Minister of Finance Tomić, Minister of Industry and Energy Smajilbegović, Deputy Minister of Finance Kesetović, Minister of Transport and Communications Koluder, Mr. Kreso, Director of the Agency for Reconstruction, and other ministers and senior officials. As far as the Republika Srpska is concerned, the mission met with Mr. Stanišić, Vice President of the State Committee for Collaboration with the United Nations and International Humanitarian Organizations, and with Dr. Mulojović, Director of the Direction for Privatization and Development. Mr. Schilthuis, Assistant to the Executive Director for the Netherlands, attended some of the meetings. A mission consisting of Messrs. Byrne (TRE), Hagan (LEG), and Miller (SEC) visited Sarajevo in December to assist the authorities with membership-related issues.

2/ A separate report will be made to the Executive Board on membership-related issues.

During the course of the civil war, two independent political entities were formed on the territory of Bosnia and Herzegovina, the Federation of Bosnia and Herzegovina (henceforth "the Federation"), consisting of the Bosniac-majority area and the Croat-majority area, and the Republika Srpska, the Serb-majority area. The Federation and Republika Srpska have been recognized as legitimate entities of Bosnia and Herzegovina under the new constitution and granted considerable autonomy at the discretion of their individual parliaments. The Federation will comprise 51 percent of the territory of Bosnia and Herzegovina with Republika Srpska comprising 49 percent. The population still residing within the country's boundaries is put at 3.2 million, with 65 percent living in the Bosniac-majority area, 13 percent in the Croat-majority area, and 22 percent in the Serb-majority area. 1/ The constitution requires the entities to allow free movement of persons, goods, services and capital throughout the whole of the country.

The Federation was established by the Washington Agreements of March 1994 when a year-long armed conflict between Bosniac and Croatian forces ended. The Federation constitution, which linked the Croat- and Bosniac-majority regions, provided for the establishment of a parliament, which has since been achieved. However, although legislation has been passed in a number of key areas, few steps have been taken to establish Federation institutions. There are still two armies, two budgets, two tax and customs authorities, two banking systems, two payments systems, and two currency arrangements. In Republika Srpska, a National Assembly has also passed key legislation and established a separate administrative structure.

Fund staff have conducted extensive discussions with officials of the internationally recognized Government of Bosnia and Herzegovina in recent months and with officials of the Federation. More limited discussions have also been possible with officials of Republika Srpska.

On December 14, 1992, the Fund found: (i) that the Republic of Bosnia and Herzegovina is one of the successor states to the assets and liabilities of the former SFRY in the Fund; and (ii) that, as such, it may succeed to the SFRY's membership in the Fund in accordance with the terms and conditions provided in the Executive Board's decision on the succession of the republics of the former SFRY of December 14, 1992 (EBS/92/207). However, the authorities had not so far been able to fulfill all the requirements of membership. The authorities have now indicated their ability and willingness to fulfill such requirements, and have indicated their willingness to accept a Fund quota of SDR 121.2 million and all related rights and obligations of that quota, including the acceptance of outstanding obligations to the Fund of SDR 27.2 million, of which

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1/ The total pre-war population of 4.4 million was 44 percent ethnic-Bosniac, 31 percent ethnic-Serb, 17 percent ethnic-Croatian, with 8 percent of others. Some 3 million people were displaced in the course of the conflict--1.2 million abroad and 1.8 million internally.

SDR 25.1 million are in arrears. 1/ For the purposes of this staff report, it has been assumed that all the necessary conditions for Bosnia and Herzegovina to succeed to membership have been met, namely: (i) that it has notified the Fund that it agrees, with accordance with its laws, to succeed to the former SFRY's membership to the Fund and has taken all the necessary steps to do so; (ii) that it has cleared all its overdue financial obligations to the Fund; and (iii) that the Fund made the necessary finding that Bosnia and Herzegovina was able to meet its obligations under the Articles of Agreement.

The conflict has seriously disrupted procedures for the collection and processing of statistics. Data on economic developments since 1992 are extremely limited and subject to very large margins of error, and available information is often of an anecdotal nature. The description of recent developments is, therefore, incomplete and tentative; quantitative estimates and projections should be regarded as being highly conjectural.

## II. Background

The Republic of Bosnia and Herzegovina was among the lowest income republics in the former SFRY, with per capita GDP estimated at US\$1,900 in 1990, compared to US\$6,500 for Slovenia, the most affluent of the republics, and an average of US\$2,530 for the SFRY. Per capita GDP in 1995 is estimated at US\$500. 2/ Domestic economic developments in the three ethnic majority areas have, however, been quite different.

### 1. The Bosniac-majority area

Total measured industrial production has fallen to 5 percent of its 1991 level, with capital goods production halted. Consumer price inflation reached over 73,000 percent in 1992, 44,000 percent in 1993, and 780 percent in 1994. The hyperinflation of 1992-94 was mainly fueled by central bank financing of sizeable budget deficits. Such deficits emerged when military expenditures surged while the tax base deteriorated sharply, reflecting migration, military mobilization, and the destruction of productive capacity.

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1/ Relations with the Fund and the World Bank Group are summarized in Appendices II and III, respectively.

2/ Many of those residing in the country rely on packages of food aid to provide for minimum subsistence needs. Reportedly about 90 percent of those living in the Bosniac-majority area and 30 percent of those living in the Croat-majority area regularly receive such food packages.

Significant financial stability was achieved in mid-1994 when the budget was balanced on a cash basis, often at the expense of incurring wage and pension arrears. 1/ At the same time, under an extensive currency reform program, the official exchange rate of the new Bosnia and Herzegovina dinar (BH dinar) was fixed at BH dinar 100 per deutsche mark. 2/ The National Bank of Bosnia and Herzegovina virtually terminated the extension of credits, and has essentially acted as a currency board, mainly issuing BH dinars against purchases of hard currency. The stock of currency in circulation is fully backed by hard currency reserves, and the exchange rate premium in the parallel market has been small. Large amounts of foreign currency, notably deutsche mark, are also in circulation. 3/

## 2. The Croat-majority area

Close economic links with neighboring Croatia, and the preservation of much of the area's infrastructure, have meant that economic decline and financial instability have been limited in this area. Industrial production is estimated to have fallen to about 85 percent of its pre-war level. Wages in the Croat-majority area are estimated at about seven times higher than in the Bosniac-majority area, even though the cost of basic consumer goods and services is virtually the same in both areas. There has been no indigenous currency in circulation, and the Croatian kuna and the deutsche mark have been used for payments. The inflation rate has probably mirrored the rate experienced in Croatia, although data for 1992-1995 are unavailable. 4/

## 3. The Serb-majority area

Few data are available on economic developments in the Serb-majority area. There is no accurate indication of declines in production or output. A central bank was established in early 1992 and issued its own currency, the Republika Srpska dinar. All credit was oriented toward supporting large military-induced budget deficits and, by the end of 1993, the value of the

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1/ Pensions due in April 1995 were paid only in November 1995. As regards arrears in the economy generally, only about 50 percent of those recorded as being employed received wages in October 1995.

2/ The BH dinar was first introduced as legal tender for Bosnia and Herzegovina on August 18, 1992. The BH dinar and special coupons issued for Sarajevo circulated as domestic currency. On August 14, 1994, the BH dinar was redenominated and new banknotes were introduced later in the autumn to substitute for all forms of circulating domestic paper money.

3/ By law, all employee wages must be paid in BH dinars. Many goods, including bread and electricity, can only be bought with BH dinars. Customs duties must also be paid in BH dinars, except for those on oil, tobacco, coffee, and alcohol.

4/ Inflation in Croatia gradually rose to 40 percent per month by the last quarter of 1993 when prices abruptly stabilized. Prices have remained virtually constant since then.



currency had been virtually eroded through hyper-inflation. 1/ The Serb-majority area maintained close economic ties with the Federal Republic of Yugoslavia (Serbia/Montenegro) and, when a stabilization program fixed the value of the Yugoslav dinar at par with the deutsche mark in mid-1994, the Republika Srpska adopted the Yugoslav dinar as its currency. However, no official exchange rate for the Yugoslav dinar was maintained, in the absence of resources to support the currency, and the exchange rate was allowed to move freely with no restrictions on holdings of widely-circulating foreign currency. After a period of relative price stability, inflation (of about 30 percent) re-emerged in the past 6 months. 2/ The budget has been largely balanced on a cash basis since mid-1994, although some bank financing is thought to have taken place. 3/

With regard to foreign trade by Bosnia and Herzegovina as a whole, merchandise exports fell dramatically, from over US\$2 billion in 1991 to less than US\$0.2 billion in 1994. Merchandise imports also fell sharply, from about US\$1.7 billion in 1991 to an estimated US\$0.7 billion in 1994. 4/ Imports consist primarily of goods to meet basic human needs, either provided as humanitarian aid or financed from cash remittances from abroad.

As to external debt obligations, all three ethnic-majority areas suspended debt servicing in April 1992. Substantial arrears have accumulated since then, and are expected to reach around US\$2 billion by end-1995, accounting for roughly two-thirds of total estimated external debt (Table 2).

### III. Policies for the Future

#### 1. Macroeconomic policies and prospects

The economic reconstruction of Bosnia and Herzegovina will be associated with complex stabilization problems as a result of foreign exchange shortages and supply and transportation bottlenecks. These problems are likely to be exacerbated by inherited weaknesses in the

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1/ By end-1993 there had been substantial issues of Republika Srpska dinar notes in denominations up to ten billion. The notes had originally been issued in standard denominations.

2/ In November 1995, the Yugoslav dinar was devalued to 3.3 per deutsche mark, largely closing the gap with the unofficial foreign exchange market.

3/ Substantial arrears have accumulated in respect of wages and pensions. Wage payments for June were being made in December.

4/ Trade data for 1991 and 1994 are not strictly comparable because the earlier data exclude trade with other republics of former SFRY. The 1994 data are rough estimates for the Bosniac- and Croat-majority areas based on limited customs and banking figures.

enterprise and banking sectors. The authorities expect to launch a comprehensive stabilization-cum-reform program to deal with such problems before mid-1996, once firmer assessments of war damages and external assistance are available and the capacity to implement and coordinate policies has been sufficiently developed. They plan to seek Fund support for such a comprehensive program under an upper credit tranche arrangement or under the Enhanced Structural Adjustment Facility (ESAF).

During the interim period, until such a comprehensive program can be launched, the monetary and fiscal authorities will operate under extreme uncertainties. In addition to a lack of information on the extent of war damages and the size and timing of external assistance, there are also uncertainties relating to the capacity to overcome supply and transportation bottlenecks, the flow of returning refugees and the pace of demobilization and the attendant reorientation of productive capacities toward non-military uses. Under these circumstances, projections of inflation and output are subject to margins of error that make the adoption of a quantified economic program for the interim period extremely difficult. In particular, any projection of the availability of budgetary resources is highly speculative. Economic policies will need to be continuously adjusted to rapidly changing circumstances, severely challenging the capacities of what are still rudimentary policy-making institutions, especially since effective procedures for coordinating economic policies among regions remain to be developed.

In light of these uncertainties, and the limited capacity to undertake discretionary policy changes, financial policies will be subordinated to a tight set of policy rules until a comprehensive program can be launched. There will be two key features: (i) the central bank will operate as a de facto currency board, abstaining from any extension of credit and issuing domestic currency only against purchases of foreign exchange; and (ii) the Central Government and the Federation will refrain from borrowing from the domestic banking system, forcing the fiscal authorities to continuously reassess spending priorities in order to match cash expenditures to available resources. <sup>1/</sup> In addition, the operation of the payments system through the Social Accounting Office (SDK), if implemented effectively,

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<sup>1/</sup> There has been no official undertaking from representatives of Republika Srpska to refrain from borrowing from the domestic banking system, but the scope for such borrowing is, in any event, likely to be limited, as discussed in section 5 below.

would ensure that inter-enterprise arrears do not accumulate on a large scale. 1/

On the strength of these rules and institutional features, the authorities expect to prevent a sharp resurgence of inflationary pressures during the coming months. In this regard, it should be noted that similar features, especially the SDK and the injunction against public sector borrowing from the domestic banking system, have been instrumental in enabling other republics of the former SFRY to maintain restrictive monetary policies and achieve a notable financial stabilization under extremely volatile conditions originating from the regional crisis.

a. Monetary policy

The new constitution calls for the establishment of a single central bank for Bosnia and Herzegovina, which will issue a new currency that will be legal tender in both the Federation and Republika Srpska; the two constituent entities will not issue their own currencies. The new central bank will, at least for the first six years of its existence, operate as a currency board, issuing currency only when there is full foreign exchange backing. 2/ The expected remonetization of the economy will, therefore, require that the attendant increase in the demand for money be largely accompanied by a similar balance of payments surplus. The new central bank is expected to become operational in about six to nine months. 3/

The existing central bank in Sarajevo will be the sole monetary authority until the new central bank can be established. It will continue to issue the existing BH dinar, but will operate as a de facto currency

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1/ The accounts of enterprises are maintained with the SDK, which operates the payments system, and an enterprise is precluded from making wage payments (above a subsistence level) and other sundry payments if it has outstanding obligations to another enterprise. In this way, an enterprise with claims on another enterprise effectively becomes a preferential creditor. It might also be noted that a payment cannot be made in the absence of the enterprise having sufficient funds in its account and that, in this way, the SDK prevents the automatic extension of credit by overdraft.

2/ A new central bank law and new regulations for bank licensing are in the process of being drafted with assistance from the Fund. The exact modalities of the new monetary system remain to be worked out, including the establishment of an institution that will act as lender of last resort, a function that will require this institution to hold foreign exchange reserves or have access to foreign lines of credit.

3/ The new central bank will be headed by a Governor who cannot be a national of any republic of the former SFRY and whose appointment will be based on the recommendation of Fund Management. The first governing board of the central bank will consist of the Governor and three members appointed by the Presidency, all for a six-year term.

board during the interim period. 1/ The BH dinar is likely to continue to circulate primarily in the Bosniac-majority area for some time. During this period, the Croatian kuna and the deutsche mark are likely to continue to dominate transactions in the Croat-majority area, and the Yugoslav dinar and the deutsche mark to dominate transactions in the Serb-majority area. Thus, even though the three regions might only gradually acquire the characteristics of a common currency area, an increase in money in circulation in any of these regions will require a balance of payments surplus in that region.

b. Fiscal policy

Fiscal policy will be conducted at three levels: the central government, accounting for an estimated 5 percent of total public sector expenditures; the entities of the Federation and Republika Srpska, accounting for 25 percent; and the cantons or municipalities, accounting for 70 percent of expenditures. The prerogatives of each level and their sources of financing, including revenue-sharing formulas, have been set out in the constitution, with any residual (unspecified) powers residing with the entities. The main responsibilities and revenue sources of the three levels of government are summarized in Chart 1.

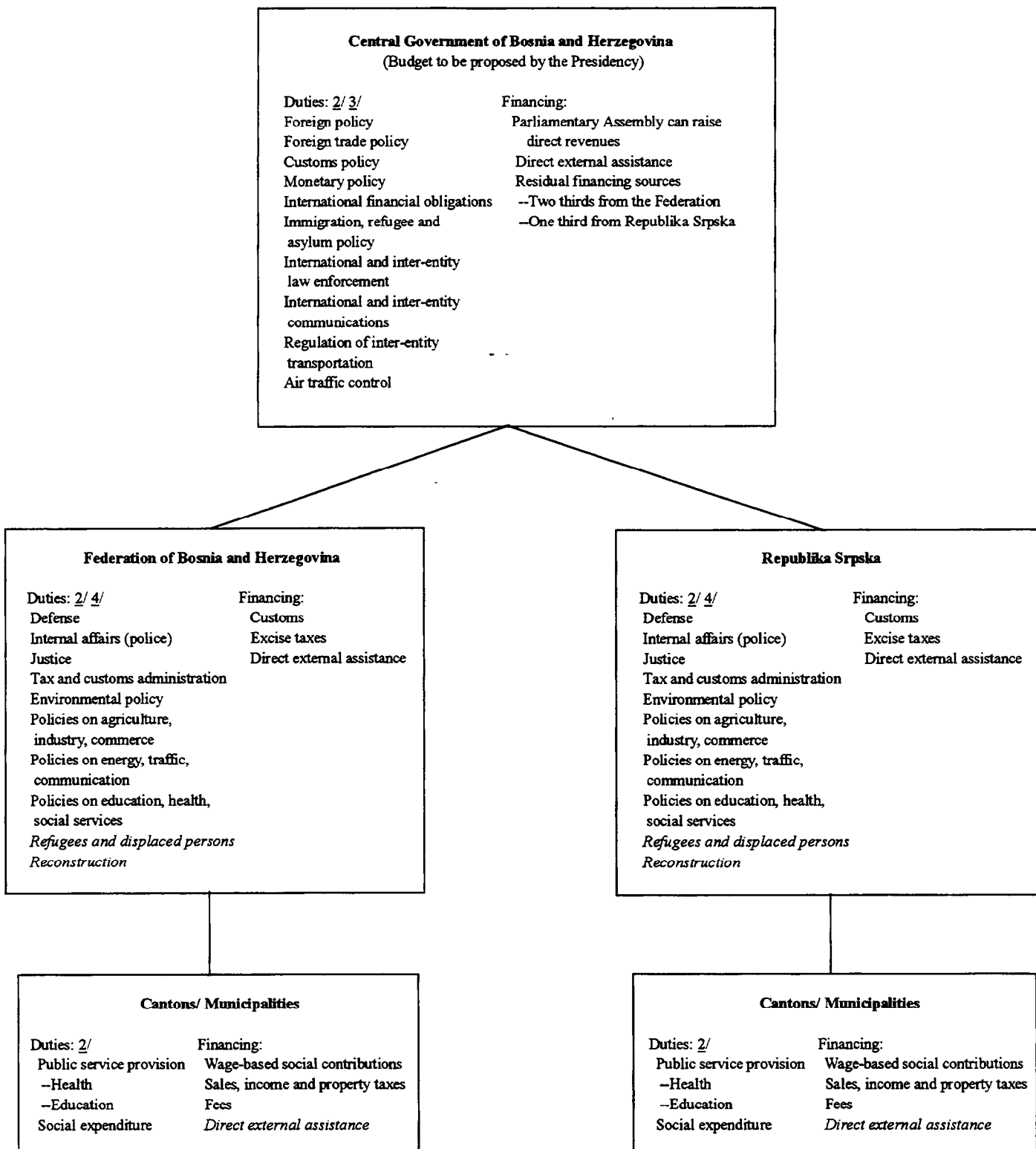
Uncertainty about the availability of fiscal resources, and injunctions and limitations on borrowing from the domestic banking system, will require all levels of government to continuously review spending priorities in light of the availability of tax revenues and foreign financing. While an accumulation of domestic arrears cannot be precluded, experience from other republics of the former SFRY suggests that the scope for arrears in respect of purchases of goods and non-factor services is limited. Arrears in respect of public sector wages, transfers and subsidies could arise as the authorities are unlikely to adjust existing entitlements before they have a clearer picture of resource availability over the medium term. As to foreign borrowing, there is, at present, no mechanism for ensuring that the Federation and Republika Srpska do not engage in borrowing that exceeds their long-term capacity to generate fiscal resources to service such loans, potentially jeopardizing the functioning of the fiscal system, including the revenue-sharing formulas. The development of adequate safeguards in this regard is an immediate and important policy objective.

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2/ As noted above, the existing stock of BH dinars in circulation is fully backed by foreign reserves. The central bank will continue to abstain from extending domestic credit, and will issue currency only to the extent that it is fully backed by foreign reserves. The new central bank, which will take over the foreign reserves of the present central bank, will thus be able to convert the existing BH dinars into the new currency at the prevailing market exchange rate between the existing BH dinar and the deutsche mark.

## Chart 1

### Fiscal Structure of Bosnia and Herzegovina <sup>1/</sup>



<sup>1/</sup> *Italicized letters indicate transitional arrangements.*

<sup>2/</sup> Each level of government is responsible for its own administrative costs.

<sup>3/</sup> In six months, the entities will begin negotiations on other responsibilities for the central government.

<sup>4/</sup> Residual unspecified responsibilities reside at the entity level.



(i) The central government of Bosnia and Herzegovina

The role of the central government will be very limited. Its financing responsibilities will be to conduct foreign policy, customs policy and international financial relations (including the servicing of foreign debt inherited from the former SFRY), and its spending will mainly consist of administrative expenditures and salaries. For 1996, domestic expenditure of the central government is projected at about DM 40 million, and the central government's administration is expected to have about 750 employees, of which 450 will work in the diplomatic service. As specified in the new constitution, any excess revenue needs, over and above the central government's own revenue (which is expected to be small and largely consists of consular fees), are to be financed in the proportions of two thirds by the Federation and one third by Republika Srpska.

(ii) The governments of the Federation and Republika Srpska

Each of the two constituent entities--the Federation and Republika Srpska--will be responsible for their own defense, internal affairs, justice system, industrial and agricultural policy, and tax and customs administration. In addition, these entities will oversee reconstruction and the resettlement of refugees and displaced persons, with most funds for this purpose emanating from the donor community. The main source of revenue for the two constituent entities' governments is expected to be customs and excise taxes.

In the Federation, expenditures on administration and salaries during 1996 are expected to amount to about DM 40 million, including a planned expense for about 2,250 employees, with an average gross monthly wage of DM 800. <sup>1/</sup> No information is available on the budget for 1996 for Republika Srpska, but government salaries are currently about DM 150 per month.

Given the importance of customs revenue to both constituent entities and to the central government, and given that most excise tax revenue will be raised on imports, the authorities of the Federation have undertaken to move quickly to seek to establish a unified customs administration. This will involve setting up an effective collection organization (including its management and headquarters structure); agreeing on the number and location of customs houses and customs stations and on staffing requirements and standardized payment arrangements; and unifying information systems and procedures. The Federation authorities are considering suggesting a 5 percent import duty on reconstruction-related imports paid by donor assistance.

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<sup>1/</sup> In 1996, all military expenditure, including for demobilization, is expected to be financed directly by the international defense and donor communities.

It should be noted that the Federation Government still operates as two distinct, parallel units, one for each of the ethnic-majority areas of the Federation. Taxes, including customs duties, are collected separately, expenditures are separately administered, and each area's expenditures are based on the revenues each area collects. 1/

(iii) Local government

The remaining fiscal responsibilities, including the provision of most public services and social expenditures, lie with the cantonal and local governments. 2/ The cantons' revenue base will consist mainly of wage-based social contributions and sales and income taxes, but also of fees and property taxes. It is, however, expected that these revenues will be inadequate to fulfill budgetary needs during the transition period and that external assistance to help cover recurring expenditures in certain social sectors, in particular in the areas of health and education, will be required. The Federation agreement calls for the finalization of cantonal budgets for calendar 1996, by March 31.

Some form of income support for retired persons has to be revived in the short term. The Federation authorities believe that the minimum acceptable pension for 1996 is DM 100 per month. 3/ Given the currently eligible population in the Federation, the annual cost of the pension system under these circumstances is estimated at DM 250 million. Only about one-third of this can reasonably be expected to be financed by wage-based contributions at existing rates. It is unlikely that donor assistance would be available at a sufficient level to cover the resulting deficit of the Pension Fund. There is clearly a need for the Federation authorities to adjust payment levels, and to more precisely target payments to the most needy. The problem of outstanding arrears in pension payments also needs to be resolved.

2. Structural reform agenda

The authorities are still in the process of developing an agenda for structural reforms. Such reforms came to a virtual standstill during the war and the institutional and structural features of the economy of Bosnia and Herzegovina are largely similar to those of the former SFRY. In this

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1/ While there is a single Ministry of Finance in the Federation, the Minister of Finance--a Bosnian Croat--administers the Croat-majority area and the Deputy Minister of Finance--a Bosniac--administers the Bosniac-majority area.

2/ Only one of the eight cantons to be established under the Federation agreement is operational. In Republika Srpska, a canton system has yet to be devised.

3/ Current pension payments have been DM 11.5 in the Bosniac-majority area and about DM 50 in both the Croat-majority area and the Serb-majority area.



regard, the authorities are aware that the high rates of inflation and the perennial cycle of stop and go policies that characterized the economy of the former SFRY reflected deep-seated structural problems that have their roots in the self-management system, a Yugoslav idiosyncrasy that was introduced in an attempt to preserve social ownership while introducing the decentralized decision-making characteristics of capitalistic economies. Under the self-management system, elected workers' councils made all key decisions of enterprises, including wage and employment determination. There was a strong tendency to protect employment and real wages, at the expense of investment and profitability, and this led to a gradual depletion of the social capital and increasing losses. The losses of enterprises were, in turn, covered by commercial banks, which were owned and controlled by enterprises, especially the larger conglomerates. The National Bank for its part passively rediscounted commercial bank credits to the enterprise sector, culminating in the automatic monetization of enterprise losses. This monetization was the main source of inflationary pressure in the former SFRY, as all levels of government were prohibited from borrowing from the banking system.

The experience from the former SFRY suggests that bank rehabilitation and enterprise restructuring and privatization should be given priority, in addition to the introduction of a commercial code and a comprehensive legal and regulatory framework for private sector development.

As to privatization, Federation authorities have begun the process of drafting the necessary legislation and have also begun to develop a privatization strategy, in consultation with the IBRD, which is set for completion by end-March 1996. However, a number of obstacles will need to be overcome before the privatization process can begin. At present, enterprises and households have been paying little for energy and public services. Moreover, many enterprises have continued to operate by building up arrears to the government, employees, and suppliers. In addition, products have often been given to the army without payment and enterprise accounts are, therefore, likely to be of little use in determining the market value of an enterprise.

In addition to being saddled with old bank loans and arrears to the government and suppliers, most enterprises are likely to be severely overstaffed and will be faced with substantial compensation claims from employees for back wages in the process of restructuring. Under legislation that prevailed in the former SFRY, it was virtually impossible to shed excess labor. The adoption of new labor market legislation and the mobilization of budgetary reserves for unemployment compensation will need to be given priority.

Turning to bank rehabilitation, of the 36 banks operating in the Federation, 12 of the largest are "old" banks, still owned by social

enterprises. 1/ On the basis of recent estimates regarding the (28) banks that operate in the Bosniac-majority area, the largest bank accounts for about 40 percent of the assets of the banking system, with the next two largest accounting for about 20 percent each. On the basis of the same estimates, potential bad loans at these banks are eight times larger than bank capital. 2/ A comprehensive bank rehabilitation program will be required and the authorities have undertaken to agree on a bank reform strategy with the IBRD by end-March 1996.

All banks will need to have their balance sheets cleared of liabilities pertaining to frozen household foreign currency deposits, for which there is still a claim on the former National Bank of Yugoslavia, the ultimate recipient of such deposits. The authorities realize that, given the magnitude of these claims (in excess of DM 1.3 billion in the Bosniac-majority area alone), they are unlikely to be in a position to make compensation for them. However, they foresee being able to write down such claims in the process of the privatization and sale of state assets. Banks may also need to be relieved of most of the obligations to foreign creditors for loans on-lent to social enterprises, which are generally expected to be unable to service such loans.

The decentralized decision-making characteristic of the self-management system means that Bosnia and Herzegovina will avoid some of the problems experienced by other former socialist economies during the process of transition to a market economy when liberalizing prices and abolishing budgetary subsidies. 3/ More generally, the traditional openness of the economy and the decentralization of economic decision-making mean that enterprises have well-established links with Western European markets and that the goods being produced have often already withstood the test of such markets.

While the legislative institutions of Bosnia and Herzegovina will be new, it is worth noting that much of the organizational structure of Bosnia and Herzegovina will resemble that which was inherited from the former SFRY in 1992. The fact that both entities have the same institutional heritage may be even more important at lower levels of policy implementation and in the operation of those agencies crucial to the functioning of a market economy. Although the existing institutional links were severed in the course of the war, the similarity between the parallel institutions will mean that such links can quickly be restored. In particular, SDK offices existed across all of the territories of the former SFRY, with extensive

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1/ This section relies heavily on material from Bosnia and Herzegovina: Economic Issues and Priorities, World Bank discussion paper, September 29, 1995.

2/ In the banking sector as a whole, bad loans exceed capital by a factor of four.

3/ The Federation authorities have indicated that they intend to remove the price controls imposed during the war by end-January 1996.

power and expertise in managing the payments system and acting as a clearing house for banks. It should be possible for the SDK to speedily resume these functions, and to quickly re-establish links between banks that have been clearing transactions through international banks for the past number of years. No prudential risks are incurred by allowing these relations because prudential regulations are similar in all areas. Moreover, the Federation has already adopted a commercial banking law which will cover the whole of Bosnia and Herzegovina, and it should be possible to quickly establish a bank regulatory agency.

### 3. External financing and balance of payments projections

An early and robust recovery of the economy will require a large infusion of capital and this, in turn, will require the normalization of relations with foreign creditors, both official and private. Thus, the external financing requirement has two main components:

First, based on what still is a highly rudimentary assessment of war damages, projections suggest that post-war priority reconstruction of industrial capacity, infrastructure and social services will require external financing of around US\$4.9 billion, of which US\$4.5 billion is for imports of goods and services, over the next four years. 1/

Second, in order to normalize relations with creditors, Bosnia and Herzegovina will have to reach agreement on the clearance of an estimated US\$2 billion of outstanding arrears at end-1995 and payments of current debt-servicing obligations of US\$1.6 billion through the year 2000 on debt existing at end-1995 (Table 2).

As to 1996, highly tentative staff projections suggest an external financing requirement of US\$3.2 billion, and a financing gap of US\$1.2 billion. This projection, which is detailed in Tables 3 and 4, assumes that: (i) exports will reach 30 percent of the pre-war level in 1996, twice the level estimated for 1995 (Table 1); (ii) imports will more than double to US\$2.5 billion as a result of imports of goods and services of US\$0.9 billion to be used in reconstruction; (iii) grants and loans on concessional terms for reconstruction needs will amount to US\$1.0 billion; 2/ (iv) a substantial portion of cash merchandise imports will be financed from private transfers; (v) all payments to commercial creditors will be rolled

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1/ This figure reflects an updating of the preliminary assessment for the reconstruction needs presented in Volume II of the World Bank report on Bosnia and Herzegovina entitled "Rebuilding Bosnia and Herzegovina: A Program for Recovery and Growth", September 1995, Washington, D.C. The updated estimate, which remains highly preliminary, refers to the whole of Bosnia and Herzegovina.

2/ No firm commitments in this regard have been received so far.

over; 1/ and (vi) an estimated US\$1.0 billion of arrears to Paris Club and multilateral creditors will be cleared.

A Paris Club rescheduling of pre-cut-off date arrears and debt service falling due in 1996 would provide debt relief of around US\$400 million, leaving a residual financing gap of about US\$0.8 billion. 2/ Potential sources for closure of this gap include debt relief from the Paris Club on very concessional terms, additional support from official bilateral donors, assistance from the World Bank and other multilateral institutions, and use of Fund resources. An initial donor group meeting is scheduled to take place in Brussels on December 20-21, 1995. 3/

To unlock foreign assistance, efforts are under way to clear outstanding arrears of about SDR 25 million to the Fund and about US\$450 million to the World Bank. It is expected that the use of Fund resources soon after Bosnia and Herzegovina becomes a member would largely match arrears to the Fund. Bridge financing is being arranged so as to facilitate the process of clearing such arrears. The authorities and the World Bank are in the process of discussing a plan for the clearance of arrears to the World Bank.

Looking to the medium term, the total financing requirement--on account of debt service, arrears clearance, reserve accumulation, and reconstruction needs--is projected to amount to US\$1.9 billion a year on average in 1997-2000 and US\$0.8 billion a year on average in 2001-2005 (Table 4). The projections are particularly sensitive to changes in assumptions regarding export growth, imports for reconstruction needs and the concessionality of external assistance. For instance, if exports recover to only 50 percent of the pre-war level by the turn of the century, rather than to two thirds of this level as assumed in the baseline scenario (see Table 5), the average annual financing gap would be about US\$200 million higher for the period 1997-2000, and the average debt-service ratio would be around 6 percentage points higher for the same period. If external financial support is provided on less concessional terms (see Table 5), the average annual financing gap for the period 1996-2000 would be about US\$100 million higher.

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1/ Includes London Club, other creditors (supplier and trade credits) and nonconvertible currency debt.

2/ A possible Paris Club rescheduling would be linked to a successor Fund arrangement subject to upper credit tranche conditionality.

3/ A flow rescheduling from Paris Club creditors on Naples terms, once Bosnia and Herzegovina becomes eligible, along with deferral of post-cut-off date debt, would provide additional debt relief of around US\$100 million in 1996, over and above the debt relief on non-concessional terms. This comprises about US\$80 million from deferral of post-cut-off date arrears, with the remainder coming from lower moratorium interest stemming from Naples terms.

The existence of large financing gaps in the base-line scenario and the sensitivity to changes in key assumptions illustrate the need for international assistance to be on terms that are consistent with Bosnia and Herzegovina's capacity to service debt. Projected debt service ratios are relatively high until the turn of the century, but would fall to moderate levels thereafter (under the baseline scenario). Although concessional financing would be most appropriate, some non-concessional financing would not be inappropriate as long as the grace and repayment periods are such as to avoid repayments in the next five to six years.

The authorities have committed themselves to take urgent steps to further liberalize the trade and exchange system prior to a request for support under the upper credit tranches or the ESAF. Such liberalization would include the removal of import restrictions, the easing of restrictions on the availability of foreign exchange, and the removal of existing surrender requirements on foreign exchange.

#### 4. Technical assistance needs

At the request of the authorities, the Fund is to take a lead role in technical assistance in the areas of strengthening economic statistics and developing the capacity to formulate and implement fiscal and monetary policies. The IBRD is expected to play a similar lead role in developing reform strategies for the banking and enterprise sectors. Given the limited capacity to absorb such assistance, there would need to be clear coordination between the institutions providing such assistance.

A final evaluation of technical assistance needs will have to await more extensive diagnostic work, but a preliminary assessment is possible on the basis of some early missions and experience with the other republics of the former SFRY: 1/

##### a. Fiscal affairs

The most productive areas for immediate Fund technical assistance are likely to be:

- (i) Customs administration--in particular the establishment of the federal customs service;
- (ii) The establishment of an effective tax administration, including advice on its management and structure;
- (iii) The reform of direct and indirect taxation, including an assessment of the desirability of an early introduction of a VAT;

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1/ Staff members from STA and FAD have already been in the field, and diagnostic and other missions from MAE, STA and FAD are planned for December 1995 and January 1996.

(iv) The design of treasury and budgetary systems which will recognize the new constitutional arrangements, including the determination of a new organizational structure for the Ministry of Finance, based on the two main functional departments of Budget Preparation and Treasury; and

(v) A precise assessment of the assignment of revenue and expenditure responsibilities among the Federation Government, the entities and the cantons, with the goal of enhancing efficiency in government.

b. Statistics

In the State Institute of Statistics, which currently compiles production, price and trade statistics for the Bosniac-majority area, only about one-third of the ante-bellum staff are still in place and are dependent upon a central six year-old IBM system. 1/ There are only a few personal computers and software is lacking. 2/ The central bank in Sarajevo compiles balance of payments and monetary statistics, while the Ministry of Finance looks after government finance statistics. In both cases, staff and data processing technology are chronically lacking.

Given the limited absorptive capacity of the authorities, a STA multi-sector mission would not be the most effective means for delivery of technical assistance at this time. Instead, STA would undertake topical missions, in the following order of priority (as the statistical infrastructure deepens and counterpart staff become available):

(i) Monetary statistics, where guidelines have been issued to commercial banks but reporting has been intermittent and the guidelines need to be refined;

(ii) Price statistics, where the weighting patterns for both the broad index and the survival index are based on a household expenditure survey conducted before the outbreak of war;

(iii) Balance of payments statistics, where there is no understanding of basic concepts;

(iv) Government finance statistics on an accruals basis; and

(v) National accounts statistics, where production estimates can be built up on a value-added basis and compared and reconciled with GDP estimates using national income concepts.

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1/ In both the Croat-majority and Serb-majority areas the compilation of statistics is similar in type, coverage, and methodology to procedures in the Bosniac-majority area.

2/ There may be a role for BCS to review the situation and propose appropriate solutions which could be coordinated with the efforts of bilateral and multilateral donors.

c. Monetary and exchange affairs

The National Bank of Bosnia and Herzegovina is in need of technical assistance in virtually all areas of central banking. Immediate assistance is needed in the areas of central bank legislation and general banking legislation. Priority issues for this assistance are the operation of the currency board and the status of responsibility for the payments system and for prudential supervision. Present legislation may be deficient in these areas. Technical assistance in the actual functioning of the payments system and prudential supervision is also urgently required, as is assistance with the introduction of a new currency. Additional assistance will also be needed in the areas of central bank accounting, monetary analysis and central bank organization. MAE will, in December 1995, field a diagnostic mission to address these issues and to agree with the authorities on an extensive plan of technical assistance to the central bank.

d. Training

Information has been provided to the authorities about INS courses offered in both Washington and Vienna, but staff availability and language constraints are likely to be major limiting factors--many of the existing counterparts have no knowledge of either English or Russian.

5. Capacity to control and implement policies and safeguards of financial objectives

The request from the Government of Bosnia and Herzegovina for Fund support involves some exceptional issues stemming from the authorities' limited capacity to control and implement policies.

Even after the constitution enters into force, the central government does not, in practice, have full control over all relevant policies within the entire territory. In particular, the constitution delegates very considerable control over public sector activities from the central government to the Federation and Republika Srpska, but no procedures have yet been developed and made operational for coordinating policies in Republika Srpska with those in the remainder of the country. Moreover, despite having been in existence for well over a year, the Federation still appears to be operating two parallel fiscal systems in the Croat- and Bosniac-majority areas. Under these circumstances, the central government's control over policies is limited, as is its capacity to present a comprehensive program. Moreover, Fund staff's contacts with officials of Republika Srpska have been of a preliminary nature, with no substantive commitments obtained, giving the Fund only limited prior assurances about the political resolve to implement policies in line with those described above.

The main policy assurances stem from the undertaking that the only indigenous central bank will operate under currency board rules, and that parts of the country that do not use the BH dinar will, instead, only use

foreign currencies. Thus, even if Bosnia and Herzegovina might de facto function as three distinct currency areas during a transition period, the source of an increase in money in circulation in any of these areas would have to be an external surplus in that area. The undertakings in this regard are embodied in the constitution that comes into effect with the signing of the Peace Agreement in Paris. The constitution stipulates that there will be only one central bank. Neither the Croat- nor the Serb-majority areas currently have their own central banks or currencies, a fact that lends additional credibility to this undertaking.

A further concern arises from the fact that the currencies of some neighboring countries are circulating freely in some parts of the country but not in others. Financial instability in either of these countries would likely lead to inflation in the relevant area of Bosnia and Herzegovina, in terms of the currency in use. However, this would not lead to inflation in terms of the BH dinar and movements in the exchange rate between the BH dinar and the affected currency should preserve relative real prices in all parts of the country.

The possibility of foreign financing of fiscal deficits in some parts of the country does pose a potential problem. A government entity could incur debt servicing obligations that would exceed the potential for the future availability of fiscal resources, jeopardizing the revenue sharing formula and the operations of the central government. However, the relevance of these concerns must be viewed in the perspective of the likely constraints on availability of such foreign financing.

The Republika Srpska has not provided firm assurances that it will avoid recourse by its fiscal entities to its banking system. Given the limited liquidity available to domestic banks, this concern raises mostly the same issues as the possibility of foreign borrowing because banks will have to borrow abroad to finance such fiscal support.

#### IV. Staff Appraisal

The Government of Bosnia and Herzegovina is faced with the very difficult and urgent task of rebuilding the country after the devastations of war without losing control over financial policies. This task is complicated by physical bottlenecks, a weak and fragmented administration, severe foreign exchange shortages, and deep-rooted structural problems in the enterprise and banking sectors that make the economy highly inflation-prone.

Reconstruction and stabilization are further complicated by a high degree of decentralization of economic policy-making. Moreover, at this early stage of implementation of the Peace Agreement, procedures for consultations between the central government authorities and Republika Srpska on policy coordination have yet to be developed. The staff welcome,



therefore, two key decisions that, under the circumstances, lend considerable assurance as to the authorities' capacity to maintain control over financial policies, notwithstanding their inability to prepare a quantified policy framework at this stage.

First, the authorities have decided to forego the possibility of a discretionary monetary policy by conducting such policy according to the rules of a currency board. These rules will apply in practice even in those parts of the country that might not initially use the BH dinar. This decision shows an important appreciation of the potential risks to monetary policy that would have arisen had the Central Bank been given wide discretionary powers in a situation where the various constituent parts of the country have yet to develop mutual confidence and in particular a common understanding of the proper role of monetary policy.

Second, additional safeguards to financial policies arise from the decision by the central government and by public sector entities in the Federation to refrain from domestic bank financing of fiscal expenditures. The central authorities are seeking a similar undertaking as soon as possible from government entities in Republika Srpska. However, even without such an undertaking, the staff do not believe that fiscal laxity in Republika Srpska could seriously threaten financial stability in the country as a whole. With no currency of its own, borrowing by Republika Srpska from its banking system would have to be funded through a balance of payments surplus, except to the extent that banks already have excess liquidity. Moreover, if there are large-scale external inflows denominated in the currency of the Federal Republic of Yugoslavia (Serbia/Montenegro), this currency would start to depreciate vis-à-vis the BH dinar, and inflation in Bosnia and Herzegovina in terms of the BH dinar would not be affected.

While posing limited threats to financial stability, the fiscal situation will clearly remain very difficult for some time. Tax revenues and foreign financing are subject to large uncertainty but are in any event likely to fall short of the demands arising from the need to restore essential public services and infrastructure, to care for displaced persons, to maintain minimum levels of social expenditures, and to facilitate the demobilization of the armies. The authorities are facing extremely difficult spending choices and must, given the constraints on domestic financing, stand ready to continuously review their priorities in light of available tax revenues and foreign financing. Under these circumstances, some accumulation of domestic arrears cannot be precluded, especially in respect of wages and social transfers, which can be seen as a de facto curtailment of such benefits. Moreover, given the experience in other republics of the former SFRY, the staff believe that the policy and institutional constraints that will be in effect in the coming months will be sufficient to prevent a significant increase in arrears in respect of goods and non-factor services. Thus, such arrears will not represent a serious threat to financial stability in the coming months, provided that the authorities take steps to ensure that existing mechanisms to enforce financial discipline operate as intended.

The staff understand that a customary quantified budgetary framework for public sector policies cannot be prepared for 1996 at this stage due to extreme uncertainties. The authorities should adopt such a framework as soon as possible. Moreover, while excessive foreign borrowing by public sector entities might not be an immediate problem, the authorities should develop adequate safeguards to prevent borrowing at an inappropriate level in the future.

The war has severely disrupted the functioning of key administrative institutions in the economic sphere and the new institutions that will be required to co-ordinate and implement policies under the constitution have not yet become operational. The authorities should give high priority in the coming months to building the basic administrative and institutional structures necessary to strengthen their ability to control and implement policies. A large-scale technical assistance program, including from the Fund, is already well under way. In light of the prospects for early progress in this area, and taking into account the aforementioned constraints on economic policies, the staff believe that there are sufficient assurances regarding the authorities' capacity to carry out their policy intentions in the coming months.

Looking beyond the immediate future, the normalization of the security situation could be associated with pressures to restore wages to pre-crisis levels. Such demands would be inconsistent with financial stability as it will take many years to rebuild the productive capacity destroyed during the war. The authorities should develop an affective incomes policy so as to be able to withstand such pressures. Demands are also likely to arise for an early restoration of social benefits and entitlements and for the elimination of the arrears that have accumulated in recent years in respect of such payments. When formulating the budget for 1996, and determining public sector wages, social entitlements, and other recurrent expenditures, the authorities should be aware that the tax base is likely to remain weak for the foreseeable future.

As to the agenda for structural reform, the authorities should be mindful of the inherent tendency of social enterprises to give priority to wages at the expense of investments, a vestige of the self-management system of the former SFRY. Priority should be given to the early privatization of social enterprises, and the rehabilitation and privatization of banks controlled by such enterprises. This will be key to preserving financial stability while ensuring an efficient allocation of resources.

There is clearly a need for the international community to assist the reconstruction process with large-scale financial and technical support. Financial support must be on highly concessional terms considering the very limited debt-servicing capacity of the country and it must be received urgently in order to help overcome acute bottlenecks in key sectors. To unlock broad-based foreign assistance, the authorities should seek an early normalization of relations with external creditors, starting with the

problem of arrears to multilateral institutions. Also, they would need to accept responsibility for a part of the unallocated debt of the former SFRY.

On the strength of the aforementioned policy constraints, and the progress being made to strengthen the authorities' ability to implement policies, the staff consider Bosnia and Herzegovina to be fully deserving of Fund support under the policy for Fund involvement in post-conflict countries. While it would be unwise to ignore the considerable risk to Bosnia and Herzegovina's capacity to repay foreign debt in the event that the peace effort fails, the staff believe that the risk to the Fund is relatively modest. The outstanding use of Fund resources is low and will only increase marginally. Moreover, the balance of payments outlook suggests that repurchases and interest due the Fund would amount to less than 2 percent of projected exports of goods and services when repurchases start falling due, which is equivalent to about 7 percent of total debt service due or about 5-6 percent of gross official reserves (see Table 6).

The staff have taken note of the authorities' intention to work towards a program that could warrant support under the upper credit tranches or the ESAF. In the staff's view, the implementation of such a program will require the existence of effective procedures for policy co-ordination, especially between the central government and Republika Srpska, and the urgent establishment of an adequate administrative infrastructure. Substantial external support, in the context of a concerted effort by the international community, will also be essential.

Table 1. Bosnia and Herzegovina: Economic and Financial Indicators 1/

	1990	1991	1992	1993	1994 est.	1995 est.	1996 proj.
GDP (millions of U.S. dollars)	8,299	8,199	...	...	...	2,200	3,080-3,520
Population (millions) 2/	4.37	4.38	4.24	4.11	4.14	4.12	...
Per capita GDP	1,909	3,676	...	...	...	486	...
Industrial production 3/ (index 1991 = 100)	132	100	...	...	...	5	...
(Percent change, annual average)							
Real GDP	-9.0	-20.0	...	...	...	...	40-60
CPI 3/	394	114	73,100	44,000	780	-10	10-20
(Percent change, end-of-period)							
M2 3/ 4/	...	...	...	...	1,240	326	100-200
Currency 3/	...	...	...	1,900	3,445	237	...
Demand deposits 3/	...	...	...	...	607	100	...
Time and savings deposits 3/	...	...	...	...	4,634	-14	...
(In millions of DM)							
Central Government							
Revenues							62
Expenditures							140
Deficit 5/							78
Domestic financing							...
(In millions of U.S. dollars)							
External current account balance 5/	...	...	...	...	-745	-564	-1,579
Exports 6/	1,990	2,120	495	7	164	295	608
Imports 6/	1,953	1,673	429	60	889	759	1,875
Net invisibles 5/	...	...	...	...	-20	-100	-312
Gross official international reserves	...	..	...	...	4	22	172
Memorandum items:							
Exchange rate							
Dinars per deutsche mark	...	...	...	...	...	100	...
Gross official reserves 7/	...	...	...	...	--	0.3	1.1

Sources: National Statistics Institute, National Bank of BH, Ministry of Finance, and staff estimates.

1/ Data for 1992-95 refer to the territory of the Federation of Bosnia and Herzegovina, unless otherwise indicated.

2/ Data from 1993 on include refugees overseas.

3/ Data for only the Bosniac-majority area.

4/ M2 is defined as domestic currency, plus all demand deposits and all time and savings deposits (whether in Bosnian dinars or foreign currency).

5/ Excluding official transfers.

6/ Data for 1992-93 are based on limited customs data for the Bosniac-majority area. 1994 and 1995 data are rough estimates for the whole territory of Bosnia and Herzegovina.

7/ In months of merchandise imports.

Table 2. Bosnia and Herzegovina: Debt and debt service payments, by creditor, 1995–2000 <sup>1/ 2/</sup>

(In millions of U.S. dollars)

	<u>Debt outstanding end–1995</u>		<u>Scheduled payments <sup>3/</sup></u>	
	<u>Arrears</u>	<u>Total</u>	<u>1996</u>	<u>1997–2000</u> Annual Average
Total	1,979	3,229	344	305
Multilateral	508	703	73	42
IMF <sup>4/</sup>	38	41	4	2
IBRD	446	625	66	37
Other	24	37	4	3
Paris Club	486	571	29	15
Pre cutoff date	404	481	26	13
Post cutoff date	83	90	2	1
London Club <sup>5/</sup>	384	1,112	132	149
Other creditors <sup>5/ 6/</sup>	388	605	77	72
Non–convertible currency debt <sup>5/</sup>	212	237	34	27

Sources: Data supplied by the Bosnian authorities; and staff estimates.

<sup>1/</sup> Excludes US\$100 million of payments arrears for gas supplied from the Russian Federation, which is in dispute. Also, excludes around US\$200 of claims on Bosnian banks relating to guarantees provided for construction work not completed, which is in dispute. Includes non–allocated debt of the former SFRY, allocated on the basis of the Fund key of 13.2 percent of non–allocated debt of the former SFRY; the authorities have not yet agreed on the allocation.

<sup>2/</sup> The authorities reported that Bosnia and Herzegovina had claims amounting to around US\$1.2 billion at end–1991 on other countries (excluding states of the former SFRY) mainly in the Middle East and North Africa. In addition, Bosnia and Herzegovina has a potential claim on the former SFRY's foreign exchange reserves.

<sup>3/</sup> Based on debt existing at end–1995 only.

<sup>4/</sup> Before clearance of arrears to the Fund; includes SDR charges.

<sup>5/</sup> Includes late interest on principal and interest payments in arrears.

<sup>6/</sup> Mainly commercial creditors (i.e., suppliers' and trade credits).

Table 3. Bosnia and Herzegovina: Balance of Payments, 1994-2005

(In millions of US dollars)

	1994 Est.	1995 Est.	1996 Proj.	1997-2000 Annual Average	2001-2005 Annual Average
Trade balance	-725	-464	-1,267	-1,083	-332
Exports, f.o.b.	164	295	608	1,386	2,447
Imports, f.o.b.	-889	-759	-1,875	-2,469	-2,779
Reconstruction	--	--	-765	-742	--
Humanitarian (in-kind)	-498	-203	-297	-75	--
Other	-391	-556	-813	-1,727	-2,779
Services, net	-405	-287	-485	-338	-70
Receipts	98	100	165	338	597
Expenditure	-503	-387	-650	-676	-667
of which: reconstruction related	--	--	-153	-148	--
Income, net	-218	-207	-153	-194	-263
Interest due 1/	-218	-207	-153	-194	-263
Unrequited transfers, net	1,147	737	749	304	154
Receipts	1,163	759	771	326	176
Official	544	343	422	157	26
Private	619	416	348	169	150
Expenditure	-16	-22	-22	-22	-22
Current account balance	-201	-221	-1,156	-1,311	-510
Excl. official transfers	-745	-564	-1,579	-1,468	-536
Capital transfers 2/	--	--	700	679	--
Foreign investment	--	--	--	125	200
Multilateral and Paris Club creditors	-110	-130	219	240	-25
Disbursements 2/	--	--	300	291	--
Amortization	-110	-130	-81	-51	-25
Other creditors	-139	-120	130	156	215
Disbursements 3/	--	7	243	248	274
Amortization	-139	-127	-112	-93	-59
Capital account balance	-248	-250	1,050	1,200	390
Errors and omissions	-48	40	...	...	...
Overall Balance	-497	-431	-107	-111	-121
Financing	497	431	107	111	121
Gross reserves (increase, -)	31	-42	-150	-85	-50
Central bank	--	-18	-150	-85	-50
Commercial banks	31	-24	--	--	--
Net use of Fund resources	-4	43	-2	-12	--
Purchases/loans	--	45	--	--	--
Repurchases/repayments	-4	-3	-2	-12	--
Short-term liabilities (reduction, -)	--	5	--	--	--
Arrears (reduction, -)	470	425	-956	...	...
Multilateral creditors 4/	...	...	-470	...	...
Paris Club creditors 4/	...	...	-486	...	...
Total financing gap	--	--	1,215	208	171

Sources: Data provided by the Bosnian authorities; and staff estimates.

1/ Includes late interest.

2/ Financing of the reconstruction program only.

3/ Assumes a rollover of debt service (including late interest) from January 1, 1996.

4/ Assumes clearance of arrears in early 1996.

Table 4. Bosnia and Herzegovina: Financing Requirement, 1994-2005

(In millions of U.S. dollars)

	1994 Est.	1995 Est.	1996 Proj.	1997-2000 Annual Average	2001-2005 Annual Average
Total Financing Requirements	1,569	1,298	3,206	1,855	799
Current account deficit excluding interest and transfers	1,130	751	1,752	1,421	402
Interest 1/	110	85	22	38	48
Existing debt	110	85	20	10	2
Multilaterals	65	44	17	9	2
IMF	3	3	3	3	2
World Bank	60	39	13	5	0
Other multilaterals	2	2	1	0	0
Paris Club	45	40	4	1	0
New debt	--	--	1	27	45
Amortization 1/	114	133	83	63	25
Existing debt	114	133	83	59	1
Multilaterals	49	63	58	46	--
IMF	4	3	2	12	--
World Bank	41	57	53	32	--
Other multilaterals	4	3	3	3	--
Paris Club	64	70	25	14	1
New debt	--	--	--	4	24
Clearance of arrears	--	39	956	--	--
IMF	--	39	...	...	...
World Bank 2/	...	...	446	...	...
Other multilaterals 2/	...	...	24	...	...
Paris Club 2/	...	...	486	...	...
Debt service to other creditors	247	249	243	248	274
Change in gross reserves	-31	42	150	85	50
Sources of financing	1,569	1,298	1,992	1,647	628
Unrequited transfers, net	1,147	737	749	304	154
Official	544	343	422	157	26
Private	603	394	326	147	128
Capital transfers (for reconstruction)	--	--	700	679	--
Loans from multilateral and bilateral creditors (for reconstruction)	--	--	300	291	--
Foreign direct investment	--	--	--	125	200
Use of Fund Resources	--	45	--	--	--
Errors and omissions and other sources	-48	52	...	...	...
Rollover of debt service to other creditors 3/	...	...	243	248	274
Exceptional financing	470	464	...	...	...
Financing gap	--	--	1,215	208	171

Sources: Data provided by the Bosnian authorities; and staff estimates.

1/ Includes only obligations to multilateral and Paris Club creditors.

2/ Assumes clearance of arrears in early 1996.

3/ Assumes rollover of debt service to other creditors from January 1, 1996.

Table 5. Bosnia and Herzegovina: Balance of Payments Sensitivity Analysis, 1995–2005

(In millions of U.S. dollars, unless otherwise stated)

	1995 Est.	1996 Proj.	1997–2000 Annual Average	2001–2005 Annual Average
Baseline Scenario				
Exports	295	608	1,386	2,447
Real rate of growth (in percent)	77	100	28	6
Imports	759	1,875	2,469	2,779
Current account balance (ex. official transfers) as a percent of GDP	–26	–52	–31	–6
External debt as a percent of GDP	147	119	94	66
Scheduled debt service (before relief)	466	348	349	347
Scheduled debt service as a percent of exports of GNFS	118	45	22	11
Financing gap	--	1,215	208	171
Lower export growth scenario 1/				
Exports	295	547	1,064	1,801
Real rate of growth (in percent)	77	80	22	6
Imports	759	1,836	2,310	2,416
Current account balance (ex. official transfers) as a percent of GDP	–26	–54	–37	–11
External debt as a percent of GDP	147	123	109	89
Scheduled debt service (before relief)	466	348	355	385
Scheduled debt service as a percent of exports of GNFS	118	50	28	17
Financing gap	--	1,251	413	836
Lower concessional assistance scenario 2/				
Exports	295	608	1,386	2,447
Real rate of growth (in percent)	77	100	28	6
Imports	759	1,875	2,469	2,779
Current account balance (ex. official transfers) as a percent of GDP	–26	–52	–32	–7
External debt as a percent of GDP	147	132	127	91
Scheduled debt service (before relief)	466	350	450	741
Scheduled debt service as a percent of exports of GNFS	118	45	27	24
Financing gap	--	1,217	309	564

Sources: Data provided by the Bosnian authorities; and staff estimates.

1/ Assumes recovery of exports (in real terms) to one-half of pre-war level by 2000 compared with a recovery to two-thirds of pre-war level in the baseline scenario.

2/ Assumes that 70 percent of the reconstruction is financed by loans, of which 70 percent are on non-concessional terms. This compares with the assumption in the baseline scenario that all financing for reconstruction is on concessional terms, with 70 percent in the form of grants. Also assumes that 70 percent of the remaining financing gap is filled on non-concessional terms, compared with 30 percent in the baseline scenario.



Table 6. Bosnia and Herzegovina: Indicators of Use of Fund Resources, 1996–2000

(In millions of U.S. dollars)

	1996 Proj.	1997 Proj.	1998 Proj.	1999 Proj.	2000 Proj.
Baseline scenario					
Debt service to the Fund	6.2	4.7	3.6	26.0	25.0
Repurchases/repayments <sup>1/</sup>	2.2	1.1	0.0	22.7	22.7
Charges	4.1	3.6	3.6	3.3	2.3
In percent of exports of goods and services	1.0	0.5	0.3	1.7	1.4
In percent of total debt service due <sup>2/</sup>	1.8	1.3	1.0	7.2	7.4
In percent of gross official reserves	3.6	1.5	0.9	5.6	4.9
In percent of quota	3.4	2.6	2.0	14.3	13.7
Fund credit outstanding <sup>1/</sup>					
In millions of U.S.dollars	46.5	45.5	45.5	22.7	0.0
In percent of quota	25.6	25.0	25.0	12.5	0.0
In percent of total debt	1.3	1.1	1.0	0.4	0.0
In percent of GDP	0.8	0.6	0.5	0.2	0.0
Lower export growth scenario <sup>3/</sup>					
Debt service to the Fund	6.2	4.7	3.6	26.0	25.0
In percent of exports of goods and services	1.1	0.6	0.4	2.2	1.9
In percent of total debt service due <sup>2/</sup>	1.8	1.3	1.0	7.1	7.1
Lower concessional assistance scenario <sup>4/</sup>					
Debt service to the Fund	6.2	4.7	3.6	26.0	25.0
In percent of exports of goods and services	1.0	0.5	0.3	1.7	1.4
In percent of total debt service due <sup>2/</sup>	1.8	1.2	0.9	5.3	4.6

Source: Data provided by the Bosnian authorities; and staff estimates.

<sup>1/</sup> Assumes an emergency assistance drawing for post–conflict situations of 25 percent of ninth review quota.

<sup>2/</sup> Before debt relief.

<sup>3/</sup> Assumes recovery of exports (in real terms) to one–half of pre–war level by 2000 compared with a recovery to two–thirds of pre–war level in the baseline scenario.

<sup>4/</sup> Assumes that 70 percent of the reconstruction is financed by loans, of which 70 percent are on non–concessional terms. This compares with the assumption in the baseline scenario that all financing for reconstruction is on concessional terms, with 70 percent in the form of grants. Also assumes that 70 percent of the remaining financing gap is filled on non–concessional terms, compared with 30 percent in the baseline scenario.

Sarajevo  
Bosnia and Herzegovina  
December --, 1995

Statement of Economic Policies

Introduction

1. The Republic of Bosnia and Herzegovina declared its independence from the former Socialist Federal Republic of Yugoslavia (SFRY) in March 1992. While the Republic of Bosnia and Herzegovina was recognized internationally by the United Nations and most of its members in the following months, its independence and territorial integrity were challenged. The conflict which followed lasted until the cease-fire agreement of October 10, 1995. In late November 1995, agreement was reached on a comprehensive peace accord and principles for a new constitution, initiating the process of reintegration of the multi-ethnic state.

2. Under the new constitution, the Republic of Bosnia and Herzegovina continues in existence under the name "Bosnia and Herzegovina." It consists of two Entities--the Federation of Bosnia and Herzegovina, and the Republika Srpska. In the interim period before new central institutions of Bosnia and Herzegovina are put into place with the participation of both Entities, existing economic institutions will remain operational so as to ensure sufficient capacity to implement policies.

3. Bosnia and Herzegovina has also embarked on a process of economic reconstruction and development--a task that is greatly complicated by the devastation that occurred during the 3 1/2 years of conflict, and by the economic system inherited from the former SFRY. An essential part of this process will be putting in place a market economy that can help generate sustainable growth. The transition to a market economy was delayed by mobilization for the war, which intensified the centralist tendencies of the previous system, but initial steps are being taken in some regions. We intend to continue and deepen this structural transformation, through our own efforts and with the assistance of the international community.

4. In this statement, we describe recent economic developments in Bosnia and Herzegovina, outline our economic strategy and policies for the coming year, and summarize requirements for external financial and technical assistance. We expect this statement to help form a basis for a purchase from the IMF under its policy on emergency assistance, following the succession to membership in the IMF. We intend to move as quickly as possible thereafter, in step with the establishment of country-wide economic

institutions and policies, to design a comprehensive medium-term economic program that could be supported by the Fund under a stand-by arrangement or a program under the ESAF.

Economic developments in 1992-95

5. The economic situation since the outbreak of the war has been extremely difficult. Disruption of industry, housing, transportation and other public infrastructure brought economic activity to a virtual standstill in large parts of the country. Implementation capacity for economic management was undermined by the destruction of government offices and equipment, the difficulty of movement and communication, and the death or migration of many skilled professionals. Shortages and the monetization of budget and enterprise deficits led to hyperinflation. Fiscal and monetary arrangements were fragmented, with multiple fiscal systems and, at times, multiple currencies in various regions.

6. The war also inflicted severe social costs. Hundreds of thousands of citizens were killed or severely wounded, and three million people have become either refugees abroad or displaced persons within the country. Damage to water and sewer networks poses a major public health hazard. More than 2.15 million people (about half of the pre-war population) are currently receiving food aid from the Government and the international donor community. Three to four years of schooling have been lost by children in the most severely affected regions. In addition, most of the extremely large segment of the population presently under arms will need to be demobilized as peace is consolidated.

7. Since mid-1994, there have been attempts to restore financial stability, with differing strategies and results in the two Entities. Within the Federation, two separate fiscal and monetary arrangements have existed, operating on similar principles. Fiscal revenues and expenditures have been balanced on a cash basis, mainly through expenditure compression. Inflation fell to low levels in the second half of 1994 and the retail price index declined by 30 percent in the first ten months of 1995. In addition, there have been modest gains in international reserves. Real wages and economic activity have strengthened during 1995 in areas where the military situation was relatively stable; however, industrial production is still estimated to be only about 5 percent of its 1991 level.

8. A currency reform in July 1994 fixed the official exchange rate of the new Bosnia and Herzegovina dinar (BH dinar) at BH 100 per DM (the deutsche mark is widely used in domestic transactions, and the Croatian kuna also serves as a currency in the Croat-majority area). The National Bank of Bosnia and Herzegovina has supported this exchange arrangement by avoiding virtually any extension of central bank credit, and relying on the purchase of foreign exchange reserves as the source of monetary expansion. At current exchange rates, reserves amount to over 100 percent of reserve money. There are foreign exchange surrender requirements, and the availability of foreign exchange through the banking system has been

restricted at times. There is little or no exchange rate differential in the parallel market at present. Until very recently, there were no linkages between the banking and payments systems in the two areas of the Federation, and transactions between them took place indirectly (in DM) through banks in foreign countries.

9. In the Republika Srpska, recent financial developments have reflected monetary policy in the Federal Republic of Yugoslavia (Serbia/Montenegro). In mid-1994 the FR Yugoslavia adopted a new economic program and currency, the Yugoslav dinar, whose exchange rate was fixed at YUD 1.0 per DM. The Republika Srpska also adopted the new Yugoslav dinar as its currency and sought to follow a consistent fiscal policy, an approach that led to a moderation of inflation. Financial imbalances and inflationary pressures re-emerged in 1995, however, in both the FR Yugoslavia and Republika Srpska. In November, the FR Yugoslavia initiated a new stabilization program, including a 67 percent depreciation of the Yugoslav dinar, that can be expected to have like effects on Republika Srpska and the FR Yugoslavia. The Republika Srpska has maintained foreign exchange surrender requirements and exchange restrictions; the DM is widely used in this region, as in the rest of Bosnia and Herzegovina.

#### Economic policies for 1996

10. In order to bring about rapid improvement in the economic well-being of the population and the prospects for political stability, the Government intends to orient economic policies toward promoting financial stability and sustainable growth and accelerating the transition to a market economy. A key element will be the establishment of institutional arrangements for a single country-wide monetary policy with consistent fiscal arrangements. Specifically:

a. The objective, as specified in the new constitution, calls for the establishment of a single central bank for Bosnia and Herzegovina, which will issue a new currency that will be legal tender in both the Federation and Republika Srpska; the two constituent Entities will not issue their own currencies. The new central bank will, at least for the first six years of its existence, operate as a currency board, issuing currency only when there is full foreign exchange backing. Its Governor will be appointed on the basis of a nomination by the management of the IMF.

b. In the interim, until the new central bank can be established, the National Bank of Bosnia and Herzegovina will be the sole monetary authority. The supply of BH dinars will continue to be fully backed by foreign reserves. Thus in the interim period, the existing central bank will operate as a de facto currency board.

11. While maintaining monetary discipline, the Government will seek to use the budget as a vehicle to support the Program for Recovery and Growth

("Reconstruction Program") and begin addressing urgent social needs. <sup>1/</sup> Given the very low level of tax revenues, however, the establishment of even remotely satisfactory levels of expenditure in these areas will rely on the mobilization of external assistance on a large scale. The Government intends to make progress in the normalization of relations with the international financial community, which will help establish access to such assistance from a wide range of organizations.

12. With the cessation of conflict, renewed possibilities for travel and transportation, and the initiation of reconstruction programs, we anticipate an upturn in real GDP on the order of 40-60 percent in the coming year. Because of the use of different currencies, regional disparities in inflation performance are likely to persist during the early months of 1996; reflecting in the first instance differences in the policies of the corresponding monetary authorities, but also because of regional transportation bottlenecks and variations in the phased reintroduction of charges for public services that have been provided free in parts of the country during the war. With the establishment of the central bank and currency board, we expect inflation will recede to uniformly low levels.

#### Monetary and exchange rate policy

13. The Government intends to orient monetary policy toward safeguarding financial stability. During the coming year, the Central Bank of Bosnia and Herzegovina will be established as the monetary authority for the entire country at the level of the Republic and will have the sole authority for issuing currency and monetary policy throughout the country.

14. During a transition period prior to the establishment of the new Central Bank, the present monetary policy and exchange rate arrangements will be preserved. A Federation agency for licensing and supervision of banks will also be established during this transition period. The National Bank will discontinue even the extremely modest credit operations that it engaged in during 1995. It will maintain the value of the BH dinar by keeping sufficient foreign exchange reserves to back the currency and transferring those reserves to the Central Bank, upon its establishment. Once the Central Bank of Bosnia and Herzegovina has been established, the stock of BH dinars will be redeemed in the new currency.

15. Linking the payments systems of the different parts of the country is essential to economic efficiency and growth. In late November, the payments systems of the two areas of the Federation were linked, using the DM as the common transactions currency; a unified Federation payments system is to be established by end-December 1995. We would intend for the social accounting

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<sup>1/</sup> During 1996, longer-term dimensions of the reconstruction effort will be defined in cooperation with the World Bank, the EU, and other international organizations.

offices in the Republika Srpska to be converted into payments bureaus, thereby ceasing to be a potential source of creation of high-powered money, with the objective of permitting their linkage to the Federation payments bureau system before end-June 1996.

Fiscal policy

16. Fiscal policy will need to be supportive of the monetary arrangements, while addressing social and development needs. Under the systems now in place in the Federation, there has been no domestic financing of the fiscal deficit during the past year (through bank credit, the payments system, or Government securities). The Government will maintain this policy, and intends that it be extended to the Republika Srpska prior to the establishment of the Central Bank of Bosnia and Herzegovina. In addition, we believe that existing institutional arrangements will make it unlikely that there will be a significant increase in arrears for the purchase of goods and non-factor services.

17. As specified in the constitutional elements arising from the Dayton agreements, fiscal policy will entail a considerable degree of decentralization. All powers are reserved for the two Entities and their subunits, except for those specifically granted to the central government of Bosnia and Herzegovina. The latter include: (i) foreign policy; (ii) foreign trade policy; (iii) customs policy; (iv) monetary policy; (v) the finances of central government institutions and the international obligations of the country; (vi) immigration, refugee, and asylum policy; (vii) international and inter-Entity law enforcement; (viii) establishment and operation of common and international communications facilities; (ix) regulation of inter-Entity transportation; and (x) air traffic control. The constitution also provides that following the establishment of the Parliamentary Assembly, two thirds of the revenues for the budget of the central government of Bosnia and Herzegovina are to be provided by the Federation, and one third by the Republika Srpska, except insofar as revenues are raised as specified by the Parliamentary Assembly. For 1996, it is expected that the major sources of revenues will be international financial assistance and a share of customs tariff revenues. The expenditures of the central government will consist of its administrative expenditures and the servicing of the international obligations of the country.

18. Other expenditures (including, among other things, all social expenditure and the domestic contribution to the financing of the Reconstruction Program) will be the responsibility of the Entities and their subunits. The corresponding revenue base will consist of a share of customs tariff revenues, plus all other taxes. In view of the low level of economic activity, the extremely large dependent population, and the special needs arising from the war, these revenues will be inadequate to their responsibilities for the initial years. Accordingly, with the assistance of the EU, EBRD, World Bank, and IMF, we are seeking to mobilize the remainder from the international community in the form of grants or highly

concessional loans. Such assistance would be directed, in particular to financing the Reconstruction Program: and, on an interim basis, to support salaries and recurring costs in the central governments of the two Entities, including for social programs. We are also seeking technical and financial assistance in rebuilding the pension system, and continued humanitarian assistance to deal with the transitional needs of displaced persons and the most vulnerable segments of the population.

19. Wage policy in the central government institutions of Bosnia and Herzegovina will need to be oriented toward providing some scope to attract and retain highly qualified personnel, in the face of very attractive alternative opportunities in the construction sector and the international donor community. Accordingly, average net salaries in the central institutions (including the Presidency, the Parliament, the Ministries, and the Central Bank) will be set at about DM 400-500 a month, provided that sufficient funds are available. Initially, these will be financed on the basis of grants presently being arranged from donors. Similarly, salaries at lower levels will depend on local conditions and financial capacity.

20. The fiscal structure of Bosnia and Herzegovina will not become fully operational until the new organizations of the customs administrations, the structures of the political subunits, and the new tax systems of the two Entities have been put in place. The Government is therefore pursuing these tasks on an urgent basis, with assistance from the IMF and other institutions. This effort is focusing initially on the Federation, where understanding in principle on these matters have existed since early 1994.

21. One of the largest items of fiscal expenditure in the coming year is the modernization and demobilization of the armed forces. The Government is expecting to receive the support of the international defense and donor communities in addressing these issues and their social effects.

#### Structural transformation of the economy

22. We intend to take full advantage of the opportunity to accelerate the implementation of market-oriented structural reforms under peaceful conditions. The restoration of mobility and communications is an essential building block in this process. In the immediate future we are putting particular emphasis on the following:

(1) Pricing reforms, designed to eliminate the remaining vestiges of price controls and rationing, and to adopt pricing principles for public utilities that will be consistent with economic efficiency and financial viability. Their government intends to remove all remaining price controls on sales by the private sector (other than possible future activities in regulated utilities sectors); as a first step, this will be done in the territory of the Federation, as from January 1996.

(2) Liberalization of the exchange and trade systems, including the removal of import restrictions and restrictions at internal borders (as

called for in the new constitution) and, in the near future, the convertibility of the domestic currency. It is expected that substantive progress on these issues will take place prior to requesting an upper credit tranche arrangement with the Fund.

(3) Banking and enterprise reforms, which are being developed in close consultation with the World Bank. In the banking sector, this will include the linking of the financial systems of all areas of the country; privatization of the remaining publicly-owned banks and promoting the entry of additional private institutions; the segregation of banks' old portfolios of nonperforming assets and associated liabilities from their current operations; and the strengthening of prudential supervision and regulation. Policies for the enterprise sector will focus on defining ownership; the establishment of hard budget constraints in conjunction with a comprehensive cleaning up of enterprises' balance sheets; and rapid privatization of most firms in ways designed to mobilize the remaining productive assets and improve governance. The Government intends to prepare the legal framework and overall strategy for bank reform and privatization, in consultation with the World Bank, by March 31, 1996. Hard budget constraints will be central to any program dealing with bank and enterprise restructuring.

23. We intend to set aside claims arising from old assets and liabilities in the banking and enterprise sector. Given the urgency of supporting the reconstruction process and addressing the problems of the most vulnerable groups of society, there will be no access to budgetary resources or bank credit for the settlement of these liabilities. Resources for this purpose will be derived from the servicing and sale of assets. In addition, as the privatization process evolves, consideration will be given to utilizing enterprise assets or shares in the process of addressing these and other issues.

24. As part of the basis for a market economy, we also intend to initiate a thorough review and revision of labor market regulations, the structure of the social funds and related expenditures, and the legal and institutional framework in areas such as the private ownership of property, contracts, foreign investment, bankruptcy, accounting and auditing.

#### External financial and technical assistance

25. As described above, Bosnia and Herzegovina faces very substantial requirements for external assistance to support the establishment of viable economic structures and institutions, the Reconstruction Program, urgent social needs, and the modernization and demobilization of the armed forces.

26. This will require extensive external financial assistance on concessional terms. In addition, we are confronted by a large external debt, most of which is in arrears and inherited from the former SFRY. We are relying on the advice and assistance of the international financial community in addressing the debt problem in ways that are consistent with



our economic situation. We will meet fully our obligations to the Fund in a timely manner.

27. In view of the disruption of most government functions and the depletion of the previous cadre of skilled professionals in recent years, we are also requesting external technical assistance in the design and implementation of all aspects of our macroeconomic policy, structural reform, and legal development. There is a need to balance the needs for rapid improvements with the difficulty of coordinating assistance from diverse sources, and we will be working with the international community to establish mechanisms for the effective coordination of these efforts. In the immediate future we would intend to rely on the IMF to take a lead role in the development of technical assistance strategies in the core areas of fiscal and monetary policy and the strengthening of economic statistics. Diagnostic and other missions from the Fund are planned in these areas for December 1995-January 1996. We have requested that the World Bank play a similar lead role in developing strategies for the banking and enterprise sectors. Given the large needs for technical assistance at all levels of government, expertise from a broad spectrum of the international community will undoubtedly be needed in the implementation of these strategies.

Neven Tomić  
Minister of Finance  
Republic of Bosnia and Herzegovina

Kasim Omičević  
Governor  
National Bank of  
Bosnia and Herzegovina

Bosnia and Herzegovina: Fund Relations  
(As of November 30, 1995)

I. Membership Status:

Bosnia and Herzegovina has not fulfilled the conditions of succession to the membership of the former Socialist Federal Republic of Yugoslavia in the Fund. Upon succession to membership and payment of its increase under the Ninth General Review, the quota of Bosnia and Herzegovina would amount to SDR 121.2 million.

II. General Resources Account SDR Million    % Quota

III. SDR Department SDR Million    % Allocation

Net cumulative allocation 20.48    100.0

IV. Outstanding Purchase and Loans SDR Million    % Quota

Stand-by arrangements 20.54    ...

V. Financial Arrangements None

VI. Projected Obligations to the Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	<u>Overdue</u> (11/30/95)	<u>Forthcoming</u>				
		<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>
Principal	18.4	--	1.4	0.7	--	--
Charges/Interest	6.7	--	1.1	0.9	0.9	0.9
Total	<u>25.1</u>	<u>--</u>	<u>2.5</u>	<u>1.6</u>	<u>0.9</u>	<u>0.9</u>

VII. Exchange Arrangement

The currency of Bosnia and Herzegovina is the Bosnia and Herzegovina dinar (BHD). Bosnia and Herzegovina maintains a fixed exchange rate at BHD 100 = deutsche mark 1. Access to foreign exchange is restricted, and enterprises and banks are subject to surrender requirements for foreign exchange.

VIII. Article IV Consultations

No consultation discussions have yet been held with Bosnia and Herzegovina.

IX. Technical Assistance

November 1995:	STA -- Diagnostic participation in EU1 mission
December 1995:	FAD -- Diagnostic Mission

Relations with the World Bank Group

1. Bosnia and Herzegovina is not currently a member of the World Bank Group. As conditions of Bank membership, Bosnia and Herzegovina must become a member of the Fund; and, as a successor republic to the former Socialist Federal Republic of Yugoslavia (SFRY) must also: (i) accept the terms and conditions and carry out obligations regarding SFRY's capital stock subscription in the World Bank; (ii) make necessary payments with respect to the shares of the Bank's capital stock; (iii) assume its share of the loans made by the Bank to, or with the guarantee of, the SFRY; 1/ and (v) eliminate, or agree with the Bank on a plan to eliminate, arrears on these loans. As of end-December 1995, Bosnia and Herzegovina's arrears to the Bank will be on the order of US\$450 million. None of these conditions have been fully satisfied. Active preparations for Bosnia and Herzegovina to be able to meet the conditions of Bank membership are under way.

2. In parallel with efforts towards membership, the Bank has initiated, in collaboration with the IMF and international donors, preparatory efforts for a program of post-war reconstruction. Priority reconstruction needs for the whole of the territory of Bosnia and Herzegovina have been estimated to be US\$5.1 billion over the next three to four years, of which about US\$2.0 billion would be required in the first year. 2/ These figures include rehabilitation and repair of essential physical infrastructure, such as major transport facilities (roads, bridges, railways), power generation, distribution and transmission, telecommunications networks, water and sewerage networks, as well as critical social infrastructure including repair and reconstruction of schools, hospitals, and other health facilities. Also included are estimates for supplies and necessary recurrent expenses for operation of education and health facilities, support for a cash-benefit system for vulnerable populations (principally the elderly and the very poor), as well as working capital financing to jump-start small- and medium-sized enterprises, salary support to key government institutions, and technical assistance and training.

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1/ Allocation of these loans among the successor republics of the SFRY is based on project benefits located within the internationally recognized territory of each republic. An apportionment formula has been used for unallocated debt, i.e., debt relating to balance of payments support where single republics could not be identified as a beneficiary.

2/ See the World Bank Report "Bosnia and Herzegovina: Priorities for Recovery and Growth."

3. In the near term, pending resolution of issues related to membership, the Bank will support initiatives in the above-mentioned areas through donor trust funds. The first such fund, supported by the Government of the Netherlands in an amount of US\$25 million, will focus on strengthening key government institutions; financing a line of credit for small- and medium-sized enterprises; and critical preparatory work for reconstruction investments in infrastructure and the social sectors.

Legislative and Policy-Making Institutions

The existing legislative and policy making institutions of Bosnia and Herzegovina will be subject to radical change under a new constitution which will take effect upon the signing of the General Framework Agreement for Peace in Bosnia and Herzegovina, scheduled for December 14, 1995, in Paris. Transitional arrangements have been established until such institutions as provided for in the constitution can be put in place. 1/

As specified in the Peace Agreement, the state of Bosnia and Herzegovina will have two constituent entities, the Federation of Bosnia and Herzegovina and Republika Srpska. These entities will, in turn, be subdivided into cantons or municipalities which will have responsibility for local government. All powers are reserved for the two entities and their subunits, except for those powers specifically granted in the constitution to the central government. 2/

The central government institutions will consist of:

- \* A Presidency composed of three people;
- \* A Parliamentary Assembly with two chambers--a House of Peoples and a House of Representatives;
- \* A Council of Ministers;
- \* A constitutional court; and
- \* A central bank.

The Presidency will be composed of two people elected from the Federation and one person elected from Republika Srpska. The Presidency may make decisions by majority if it fails to reach consensus. However, one member of the Presidency may veto a decision of the Presidency if the member is supported by two thirds of the delegates to the National Assembly or House of Peoples of the territory that member comes from. In addition to

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1/ The transitional arrangements refer to the governance of Bosnia and Herzegovina prior to the 1996 election of a Presidency and Parliamentary Assembly. A High Representative has been selected to coordinate the activities of the organizations and agencies involved in the civilian aspects of the peace settlement. The High Representative will also chair a Joint Interim Commission, composed of eight local people, which will coordinate many of the practical aspects of establishing new institutions in Bosnia and Herzegovina.

2/ The division of powers is set out in Chart 1 of the main text. Six months after the constitution comes into effect, however, the entities may begin negotiations on assigning additional duties to the central government.

conducting foreign policy and representing the country abroad, the Presidency will have responsibility for nominating a Chair of the Council of Ministers who will take office upon approval of the House of Representatives. The Chair of the Council of Ministers will, in turn, nominate members of the Council of Ministers who will also take office upon approval of the House of Representatives. <sup>1/</sup> The Presidency will propose, on the recommendation of the Council of Ministers, an annual budget to the Parliamentary Assembly.

The House of Peoples will be comprised of ten delegates selected by the House of Peoples of the Federation and five delegates selected by the National Assembly of Republika Srpska. The House of Representatives will be comprised of 42 members, two thirds elected from the territory of the Federation and one third elected from the territory of Republika Srpska. All legislation will require the approval of both chambers by majority vote, subject to some provisions for delay if at least one third of the delegates from each entity are not in favor of the proposal.

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<sup>1/</sup> No more than two-thirds of the Council of Ministers may be appointed from the territory of the Federation.

