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May 1, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Bosnia and Herzegovina—Staff Report for the 1998 Article IV Consultation and Request for Stand-By Arrangement**

Attached for consideration by the Executive Directors is the staff report for the 1998 Article IV consultation with Bosnia and Herzegovina and Bosnia and Herzegovina's request for a Stand-By Arrangement in an amount equivalent to SDR 60.6 million. A draft decision appears on page 30. This subject, together with the letter of intent and memorandum of economic and financial policies for Bosnia and Herzegovina, is tentatively scheduled for discussion on Wednesday, May 20, 1998.

Mr. S.B. Brown (ext. 38431), Mr. Marciniak (ext. 36732), or Ms. Rehm (ext. 37492) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Bank for Reconstruction and Development (EBRD), following its consideration by the Executive Board.

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BOSNIA AND HERZEGOVINA

Staff Report for the 1998 Article IV Consultation and Request for Stand-By Arrangement

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

(In consultation with other departments)

Approved by Yusuke Horiguchi and John Hicklin

May 1, 1998

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Bosnia and Herzegovina: Executive Summary of Staff Report

Background: Under the Dayton peace treaty Bosnia and Herzegovina (BH) consists of two Entities—the Bosniac/Croat Federation and the Republika Srpska (RS). There is a small central government (State) with limited powers; its most significant functions are external borrowing and debt service, trade and customs tariff policy, and monetary policy—the latter under a new Central Bank operating as a currency board.

Economic activity has grown rapidly since 1995 in the Federation, but much less in the RS, due mainly to relative access to external financing. Inflation is low throughout the country. There have been serious difficulties in cooperation among the leaders of the three national groups and the record has been poor for the implementation of civilian aspects of the Dayton treaty, including return of refugees, respect for human rights, surrender of indicted war criminals, and development of common institutions. However, resolution of a political crisis in the RS in January 1998 brought about a much stronger level of cooperation on economic issues between the Entities and within the State institutions, making it possible to reach understandings on the proposed program.

Issues and Staff Recommendations: The program is based on the economic strategy endorsed by the Executive Board in the August 1996 Article IV consultation discussion, and involves policy commitments by both the State and the Entities. The key macroeconomic elements are: (1) a fixed exchange rate, under a currency board arrangement; (2) budgets that are as supportive as possible of reconstruction and social needs, while avoiding any domestic borrowing; and (3) external financial assistance, to help supplement the still-limited resources of governments in BH and promote economic recovery. Structural elements include reforms of the customs and tax administrations, budget systems, pension policies, and the banking sector; trade liberalization; and the strengthening of economic statistics. Access would be 50 percent of quota over a 12-month period, with 20 percent available upon approval; the front-loading would be intended mainly to provide support for the new Central Bank.

The Board meeting is tentatively scheduled for May 20; a donor meeting on May 7-8 will help to secure financing assurances. There are prior actions in three areas: (1) establishing the operations of the Central Bank in all regions of the country; (2) protecting the currency board arrangement from further extensions of credit to the National Bank of BH; and (3) submission of a new Federation pension law to Parliament, consistent with Fund/World Bank staff proposals.

The staff report highlights the difficulties posed by political and economic decentralization under the Dayton treaty, and other risks to the program. Governance issues are prominent. Nevertheless, the staff appraisal notes that the agreements that have been reached among the parties are a remarkable achievement in light of recent history, which is worth supporting as a stepping stone to further progress. It urges the authorities to show wholehearted support for the introduction of the new currency; develop further the new fiscal structures called for under the Dayton treaty along with mechanisms for cooperation among them; and accelerate the structural transformation of the economy. It also underscores the need for generous financial and technical assistance from the international community in support of strong efforts at economic cooperation and reform.

I. Introduction

1. Discussions for the 1998 Article IV consultation with Bosnia and Herzegovina were conducted during three staff missions in February, March, and April 1998. At the same time, the staff resumed discussions of a possible Fund-supported program, which had been interrupted by a political crisis that paralyzed most decision-making in the common institutions of Bosnia and Herzegovina between July 1997 and January 1998. The discussions involved senior officials of Bosnia and Herzegovina and both of its constituent Entities—the Federation of Bosnia and Herzegovina, and the Republika Srpska (RS).[1]

2. On April 27, 1998, Executive Directors received a copy of a letter to the Managing Director and accompanying memorandum of economic and financial policies, in which the authorities of Bosnia and Herzegovina and its constituent Entities requested a 12-month stand-by arrangement (SBA) in the amount of SDR 60.6 million (50 percent of quota) in support of a policy program through April 1999 (EBS/98/76, 4/27/98). The authorities also indicated their intention to request that the SBA be replaced by arrangements under the ESAF, once they have been able to establish a track record of policy implementation and specify more fully a broad range of structural reforms. The country purchased SDR 30.3 million (25 percent of quota) under the policy on post-conflict emergency assistance, in December 1995. Detailed information concerning the phasing of purchases under the proposed SBA and the projection of the Fund position is set out in Tables 1 and 2.

3. The first Article IV consultation with Bosnia and Herzegovina was concluded on August 26, 1996. Directors welcomed the early signs of economic recovery in response to the cessation of hostilities and the implementation of stabilization policies by the three separate public administrations. They urged the authorities to act quickly after the September 1996 elections, to establish cooperation among those administrations and put in place a country-wide economic program that could be supported by a Fund financial arrangement, in line with the strategy described in the staff report (SM/96/203, 8/5/96).

4. Bosnia and Herzegovina retained the Article XIV status of the former Socialist Federal Republic of Yugoslavia (SFRY) upon its succession to membership in the Fund in December 1995. However, since the SFRY did not maintain any exchange restrictions under Article XIV

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[1] Discussions were held with the three members of the Presidency of Bosnia and Herzegovina; the Council of Ministers; the Governor of the Central Bank; the Prime Ministers, Ministers of Finance, and many other key officials of the two Entities; leaders of a number of the opposition political parties; and representatives of the banking sector and non-governmental organizations. Mission activities took place mainly in Sarajevo, Banja Luka, Pale, and Mostar. The staff team comprised Messrs. Brown (Head), Marciniak, and Ms. Rehm (all EU1), Mr. Ebrahim-zadeh (PDR), and Ms. Akkaya (World Bank—ECPREM). The mission was assisted by Mr. Zanello, the Resident Representative in Bosnia and Herzegovina, and Ms. Mehmedbašić-Selimović (Economist, Resident Representative Office).

immediately prior to its dissolution, any restrictions presently maintained by Bosnia and Herzegovina would be subject to approval under Article VIII. Appendices I and II provide further information on relations with the Fund and World Bank, respectively. The World Bank has provided a high level of financial support to Bosnia and Herzegovina, beginning with assistance from a Trust Fund before the country succeeded to membership in the Bank. The country has experienced a number of episodes of overdue obligations to the Fund and Bank during the past year, owing both to fiscal revenue constraints and political differences within the country. Cooperation among the staffs of the Fund, World Bank, Office of the High Representative (OHR),[2] EU Commission, and other organizations and governments active in Bosnia and Herzegovina is very close.

5. The state of statistical information and reporting is summarized in Appendix III. The timeliness and quality of economic data are deficient in a number of respects. Statistical functions are organized on a regional basis and both the compilation of country-wide statistics and measures to improve the statistical base are hampered by difficulties in inter-regional cooperation. Nevertheless, since the last Article IV consultation there has been a significant strengthening of monetary statistics, mainly as a result of extensive technical assistance from the Fund. The authorities recently agreed to establish a State Statistical Office to liaise with international institutions and help coordinate the activities of the Entity statistical institutes.

II. BACKGROUND AND RECENT DEVELOPMENTS

6. War in Bosnia and Herzegovina began in April 1992, when the country's secession from the former SFRY was challenged by the Yugoslav National Army together with ethnic Serb militias. In addition, conflict took place between Croat defense forces (HVO) and the Army of the Republic of BiH in 1993 and early 1994. The peace process was established through two key treaties: the Washington Agreement of March 1994, which ended the war between the Republic and Croat forces and created the Federation of Bosnia and Herzegovina (a political union of the Bosniac- and Croat majority regions); and the **Dayton Treaty** of December 1995. Reflecting deep-seated mistrust among regions, the new Constitution enacted as part of the Dayton Treaty provides for a decentralized governmental structure. The central ("State") government has limited powers and a balanced ethnic composition, with consensus required for most decisions. Other functions are devolved to the two Entities (the Federation

[2] The Office of the High Representative was established in December 1995 to oversee the implementation of the Dayton treaty, under the terms of Annex 10 of the treaty. The High Representative is the final authority regarding the interpretation of the Dayton treaty in the area of civilian implementation. The High Representative maintains offices in Sarajevo, Mostar, Banja Luka, and Brčko in Bosnia and Herzegovina, and an international secretariat in Brussels. The Office of the High Representative employs about 150 international staff, mostly on secondment from other organizations, and 250 local staff. Coordination of economic issues within Bosnia and Herzegovina takes place mainly through the Economic Task Force of the OHR and several sectoral task forces.

and RS) or their sub-units.[3] The Federation in turn has a relatively decentralized system of government, in which substantial powers are devolved to the 10 cantons.

7. The Dayton Treaty also provided a timetable and procedures for the early stages of the peace process, including the deployment of an international peacekeeping force, the withdrawal of each Entity's armed forces behind the inter-Entity boundary line, partial demobilization of the armies, and elections. These events have generally proceeded on schedule. In contrast, the implementation of civilian aspects of the treaty, which is coordinated by OHR but depends on the voluntary compliance of the parties, has been slow, grudging, and incomplete. Since the 1996 Article IV consultation, the international community has given highest priority to the establishment of State institutions. Country-wide presidential and parliamentary elections were held in September 1996, and the State Council of Ministers was named in January 1997. In June 1997 the Parliament adopted the so-called "Quick-Start Package" (QSP) of key economic laws on the central bank, the 1997 budget, external debt, trade and customs tariff policies. However, the implementation of most of these laws did not begin until 1998. Mainly as a result of the slow pace of progress on the development of State institutions, return of refugees, freedom of movement and respect for minority rights, the mandate of international peacekeeping forces has been extended three times, most recently until at least mid-1999.

8. A major factor in the slow pace of change during the past year was the political crisis that emerged in late June, 1997 in the RS. At that time, with the Entity facing major shortfalls in customs tariff revenues, RS President Plavšić sought to dismiss the Minister of Interior on the charge of his complicity in organized smuggling activity. The President was subsequently detained but given protection by international military and police forces. In response to a threat of removal by the RS National Assembly, she then issued a decree dissolving the Assembly and called for new parliamentary elections. These elections were held in November 1997 and a new RS government, more supportive of the President's position, assumed office in late January, 1998. During the crisis, decision-making State bodies also came nearly to a standstill. To address this problem, the December 1997 Peace Implementation Conference (PIC) agreed that the mandate of the High Representative should be interpreted as giving him the authority to impose interim solutions for unresolved issues in State bodies. In subsequent months, the High Representative has taken decisions, *inter alia*, on the new State flag, the law on citizenship, currency designs, and a foreign investment law.

9. **Governance issues** have arisen in all regions of the country. During the war political and economic institutions of Bosnia and Herzegovina were severely disrupted and, even now, many public functions are carried out in an ad hoc manner inconsistent with existing laws.

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[3] The State's economic responsibilities are confined to monetary and exchange rate policy, external borrowing, and foreign trade and customs tariff policy. Functions not explicitly assigned to the State are reserved for the Entities or their sub-units. The Entities, by mutual consent, may agree to expand the powers of the State.

This is largely a consequence of the political and economic fragmentation of the country, which is being reversed only slowly, and the requirement for consensus decisions to establish new laws and institutions. A preoccupation of fiscal authorities in both Entities has been to recover control of the tax base from organized criminal groups that became particularly active during the war. In cooperation with the OHR and international peacekeeping forces, the EU's customs and fiscal advisory office (CAFAO) is spearheading efforts to help address these problems (see Text Box 1). The Entity authorities have made numerous changes in their tax and customs administrations in recent months, in response to internal investigations and CAFAO reports. Donors have expressed concern about the diversion of some assistance to purposes for which it was not intended, but neither international nor domestic investigators have found evidence of systematic corruption in the management of donor funds.

10. As described further below, **the new Central Bank** of Bosnia and Herzegovina (CBBH) began partial operations in August 1997, initially only in the Bosniac-majority area of the Federation. Prior to the establishment of the CBBH, monetary policy responsibilities were divided among three ethnically-based and completely distinct monetary authorities, all of which remain in existence with diminished functions. Only the Bosniac-majority area used a domestic currency—the Bosnia and Herzegovina dinar, at a fixed exchange rate to the DM—while monetary arrangements in the Croat- and Serb-majority areas were based on the use of foreign currencies (Croatian kuna and Yugoslav dinar, respectively) and close cooperation with the neighboring countries. The DM was widely used in all regions. All four currencies remain in use as of April 1998, along with the newly-introduced convertible marka (KM), which so far exists only as a unit of account in the banking system.

11. Mirroring these arrangements, monetary developments since 1995 have largely reflected developments in the balance of payments. In 1996, the broad money supply expanded by over 96 percent, in connection with a surge in foreign financing, but slowed to 25 percent in 1997, as aid inflows dried up (Table 3). As described in the forthcoming background information, the rapid expansion of net foreign assets and broad money in 1996 occurred mainly in the Bosniac-majority area of the Federation. Commercial bank interest rates are market-determined, but financial intermediation remains almost nonexistent. Lending rates in all parts of the country have declined significantly since the end of the war but remained highly positive in real terms while inflationary pressures moderated during 1996-97.

12. In support of the monetary arrangements, fiscal policy is based on avoiding domestic borrowing at all levels of government. Under the highly decentralized fiscal system mandated by the State and Federation constitutions, the State's expenditures are limited to modest administrative outlays and the servicing of external debt and are funded mainly by transfers from the Entities. Within the Federation the lower levels of government—cantons and municipalities—are responsible for more than half of all revenues and expenditures. The RS fiscal system is more centralized, with limited municipal budgets funded mainly through

Box 1. Bosnia and Herzegovina: Customs Administration Reform and EC-CAFAO

The European Commission Customs and Fiscal Assistance Office (EC-CAFAO) was established in January 1996 to assist the governments of Bosnia and Herzegovina and its constituent Entities (the Federation and the Republika Srpska (RS)) to implement the customs-related provisions of the Dayton peace treaty.

Under the Dayton treaty, trade and customs tariff policy are responsibilities of the State government, but customs administration is carried out by the Entities. This division of labor was complicated initially by the absence of State structures acceptable to all parties, and the existence of two separate customs administrations in the Federation. One of these administrations reported to the *de facto* government of the area under the control of the Croat defense forces (HVO) while the other reported to the Republic of Bosnia and Herzegovina. Customs control at the Federation borders--and hence most external trade and much of the revenue base--was in the hands of customs offices of the Croat-majority area.

As its first task, EC-CAFAO served as the focal point of the strategy, designed by the Fund staff in cooperation with the World Bank and the Office of the High Representative, to establish a unified Federation customs administration. CAFAO was well suited for this task since many of its personnel had extensive previous experience in the region monitoring wartime economic sanctions. CAFAO field teams began providing regular field inspection and audits of the performance of customs offices, in order to build confidence and overcome the initial security impediments to creating multi-ethnic border posts. Legislation establishing the unified Federation customs administration with a single, combined revenue account went into effect in April 1996. In the following months CAFAO helped to reduce discriminatory treatment, evasion, and other irregularities and, with the help of the international peace forces (IFOR) oversaw the dismantling of illegal border posts within the country. CAFAO also introduced programs of training and modernization, in cooperation with a number of bilateral donors.

During 1997 CAFAO participated in a task force, under the leadership of the Office of the High Representative, to help design the new State trade and customs tariff regimes. It also broadened its programs of training, modernization, and monitoring to include the RS customs administration and helped to promote initial steps in inter-Entity communication and cooperation in this area. The most noteworthy achievement was the February 1997 "Transit Agreement" on procedures for handling goods in transit through the Entities from abroad. As of early 1998, import and export goods transited unhindered through both Entities.

During the second half of 1997, CAFAO released a number of reports on customs fraud and evasion, which became a focal point of efforts by the international community to improve governance in Bosnia and Herzegovina. Customs fraud is, of course, present to some extent in all countries, through such techniques as smuggling, false valuation of goods, false certificates of origin, misrepresentation of transit status of goods actually being imported, and other abuses of duty free status and warehousing concessions. In Bosnia and Herzegovina, CAFAO has signaled the presence of more systematic abuses in most of these areas, with apparent knowledge or complicity of relatively senior officials, and the diversion of revenue within both Entities to parallel power structures. There have been numerous changes in the top and middle management of the Entity customs administrations in recent months to help address these problems, and investigations and enforcement actions are continuing.

At its December 1997 meeting, the Peace Implementation Council (PIC) endorsed an "Anti-Corruption Strategy Paper" prepared by the Office of the High Representative, in collaboration with other international organizations active in Bosnia and Herzegovina. This strategy assigns CAFAO the lead on most customs-related issues, including:

(1) improving organization and infrastructure in the customs administrations;
(2) customs and tax legislation, implementation and enforcement;
(3) computerization (in this area, CAFAO has offered to provide the Entities with a linked information system);
(4) training, conditions of work, and morale of customs administration staff;
(5) verification and audit; and
(6) cooperation between the Entities and with other national and international bodies.

downward sharing of centrally-collected revenues. The preparation of 1997 budgets for the ethnically-heterogenous State and Federation was difficult.

13. Both the State and Entity budgets were in balance on a cash basis during 1997 (Tables 4 to 7), but at the expense of transient external arrears and an accumulation of domestic arrears by the Entities and their pension funds. In the Federation, this reflected the failure to take measures, discussed with the Fund and World Bank staffs, to align statutory benefits for pensions, war invalids, and surviving families with the available resources. In the RS, the problem was exacerbated by a shortfall of 30 percent in revenues and the absence of external assistance.

14. Most of Bosnia and Herzegovina was devastated by the war and **economic recovery** is still in its early stages, especially in the RS. Following a surge in estimated real GDP growth from 30 percent in 1995 to 50 percent in 1996—reflecting increases in capital expenditures and net exports—growth slowed to about 30 percent in 1997, owing in part to delays in mobilizing external financing (Table 8). Despite these rapid growth rates, GDP in 1997 was estimated to be only half of its level in 1990. The unemployment rate in the Federation has dropped from 70-80 percent of the labor force to perhaps 30-40 percent since the end of the war, but there has been less progress in the RS; country-wide unemployment is still estimated at around 40 percent of the labor force. The unemployment problem is being exacerbated by demobilization and the return of refugees. Disparities in wages and social benefits between the Entities have widened since 1995.[4]

15. Inflation performance, measured in local-currency terms, has varied among regions, reflecting the use of different currencies as described above. In the Federation, the hyperinflation of 1992-94 was followed by a decline in prices during 1995-96, reflecting the improved access to imported consumer goods, a sharp tightening of fiscal and monetary policies, and the successful pegging of local currencies to the deutsche mark (DM). In the RS, inflation measured in Yugoslav dinars (YUD) was affected by movements in the YUD exchange rate and the ability to import and export normally. Thus, inflation moderated in 1996, despite further depreciation of the YUD, due to the removal of economic sanctions.[5] With currencies in both Entities largely stable in terms of the DM during 1997, increases in retail prices were moderate and largely reflected adjustment in official utility charges and rent

[4] For instance, in 1995 net wages in the Federation and RS averaged DM 43 per month and DM 21 per month, respectively, while in 1997 the comparable figures were DM 266 in the Federation and DM 90 in the RS.

[5] The RS authorities do not intervene to maintain the exchange rate of the YUD at the official rate determined in the FR Yugoslavia. As a result, the YUD/DM exchange rate and prices denominated in YUD have adjusted continuously to exchange market conditions in the FRY and the RS, attenuating the immediate effects of the devaluations of the official exchange rate of the YUD in December 1995 and March 1998.

(moderated in the RS by diversification of import sources following the agreement on transit trade through the Federation).[6]

16. With its export capacity largely inoperative and facing a need for substantial imported consumer and capital goods, Bosnia and Herzegovina has experienced large current account deficits in recent years, financed mostly through official transfers and private remittances (Table 9). Since the end of the war the emphasis in external financing has shifted from humanitarian assistance toward rebuilding infrastructure and jump-starting the economy. At the first donors' conference in December 1995, the authorities presented a priority Reconstruction Program, developed in cooperation with the World Bank, EU, EBRD, and Fund staffs, which called for US$5.1 billion of external assistance during 1996-99. During 1996-97 commitments were roughly consistent with this goal, at US$3.1 billion. A remarkable US$1.1 billion was actually disbursed in 1996 but disbursements for 1997 slowed to an estimated US$0.7 billion, owing mainly to donors' concerns about slow implementation of civilian aspects of the Dayton treaty and the absence of a Fund-supported program. The authorities concluded debt rescheduling negotiations with London Club creditors on favorable terms in December 1997 (Text Box 2) and have initiated contacts with the Paris Club secretariat.

III. The Program for 1998-99

A. Objectives and Strategy

17. In the MEFP (¶10) the authorities reiterate their commitment to the economic strategy that was developed during 1996 and summarized in the last Article IV staff report (SM/96/203).[7] That strategy has three macroeconomic pillars: (i) the use of a fixed exchange rate as a nominal anchor, through the currency board arrangement; (ii) fiscal discipline, aimed initially at the avoidance of domestic borrowing by all levels of government; and (iii) large-scale external assistance on concessional terms. The authorities also seek to rebuild public administration and infrastructure and continue the transition to a market economy. The highest priority structural measures for 1998-99 include banking reform; enterprise privatization and restructuring; pension and health system reform; implementation of the

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[6] Data limitations preclude a meaningful quantification of movements in the real effective exchange rate (REER). Based on official exchange rates for the BH dinar and KM, which have remained fixed since mid-1994 and August 1997, respectively, a rough measure of the REER based on relative consumer price inflation would appear to have depreciated strongly in 1995-96 (when the price level fell) and appreciated in 1997. However, it is possible that the results using market exchange rates for the BH dinar and other cost/price measures would show different results, if these were available.

[7] Paragraph references (¶) in this report refer to paragraph numbers in the memorandum of economic and financial policies (MEFP).

Box 2. Bosnia and Herzegovina: Rescheduling Agreement with Commercial Bank Creditors, December 1997

A delegation of Bosnia and Herzegovina met in June 1997 with the International Coordinating Committee (ICC) representing the commercial bank creditors, to reach agreement in principle for a comprehensive restructuring of the outstanding debt to these creditors. The final agreement was signed in December 1997 and became effective as of January 1, 1998.

All of the restructured obligations were inherited by Bosnia and Herzegovina from the former SFR Yugoslavia. They include obligations under the New Financing Agreement of 1988 (NFA); the alternative participation instruments (API's) issued under the exchange agreement (API Exchange Agreement) of September 30, 1988; and interest deposits under the Trade and Deposit Facility Agreement (TDFA) of September 20, 1988. As part of its early discussions with the ICC, Bosnia and Herzegovina received a waiver of the "joint and several liability" clause under the NFA, and this was reflected in the final restructuring agreement. The amounts to be restructured do not include debt that is held by connected persons, as a result of secondary market transactions.

The total amount consolidated is estimated at US$400.4 million and comprises US$367.8 million of NFA, US$8.5 million of API's, and US$24.1 million of TDFA. The amount of NFA to be restructured was computed by taking into account the debt already restructured under agreements with Croatia, Slovenia, and the FRY Macedonia in 1996, excluding debt held by connected persons, and canceling accrued interest and late interest. On this basis, the share of Bosnia and Herzegovina in NFA was estimated at 10.58 percent. This same share was applied to API, while a share of 11.49 percent was used for TDFA (in both cases, after cancellation of interest).

Under the agreement in principle, the consolidated amount is divided into two portions: a "basic amount" equivalent to 37.5 percent of the total, and a "performance amount" equivalent to the remaining 62.5 percent. In the restructuring of the basic amount, Bosnia and Herzegovina is to issue DM-denominated bonds equivalent to US$150.2 million, which may be listed on the Luxembourg Stock Exchange. These bonds will have a maturity of 20 years with 7 years grace and graduated amortization payments. The interest rate will also be graduated, starting at 2 percent per annum during the first four years, 3.5 percent per annum during the next three years, and LIBOR plus 13/16 thereafter. The performance amount of US$250.3 million would be added to the rescheduled amounts if per capita GDP reaches at least US$2,800 (measured at 1997 prices) in two consecutive years during the period commencing with the seventh year after the issue of the bonds and ending with the twentieth year. If so, the performance amount would be amortized over 12 years and would carry an interest rate of LIBOR plus 13/16. Under the medium-term scenario discussed in section IV, the performance amount would be triggered by 2008. On the basis, and assuming DM LIBOR interest rates are unchanged at current levels, the implied payments (measured in millions of US dollars) would be:

	Basic Amount		**Performance amount**		**Total restructured**		
	Interest	Amortization	Interest	Amortization	Interest	Amort.	Total
Annual average:							
1998-2001	3.0	0.0	0.0	0.0	3.0	0.0	3.0
2002-2004	4.6	0.0	0.0	0.0	4.6	0.0	4.6
2005-2007	5.2	4.0	0.0	0.0	5.2	4.0	9.2
2008-2017	10.4	13.8	11.1	20.8	21.5	34.6	56.1
2018-2019	0.0	0.0	1.9	20.8	1.9	20.8	22.7
Total	145.8	150.2	114.4	250.3	260.2	400.4	660.6

simplified customs tariff system; exchange and trade liberalization; and initial steps in the strengthening of economic statistics. In many fields the program incorporates unwieldy institutional structures dictated by the difficulties of the current political situation.

18. Inflation is expected to average 10 percent or less for the country as a whole during 1998, mainly as a result of changes in administered prices. The authorities hope to continue investment-led real GDP growth in the range of 20-30 percent a year during 1998-99, the remaining peak years of the Reconstruction Program. Medium-term prospects are discussed in Section IV.

19. Despite the improvements in recent months, governance issues still pose significant risks to the implementation of the program. However, it is not realistic to expect that all major governance problems can be resolved immediately. Early in the postwar period, the authorities have drawn upon the assistance of the Fund, World Bank, and US government to improve budgeting and treasury management techniques; the EU to improve and monitor the workings of the customs administrations; and these and other donors to begin reorienting the legal framework and improving statistical systems. Under the program, the authorities are to intensify these efforts and also take more direct measures to address some of the specific governance problems described above. In addition to changes in personnel, the latter include the elimination of discretionary tax and customs tariff exemptions, more even-handed and transparent approaches to payment of social benefits, technical improvements of customs and excise tax administration, and placing the customs administration and financial police of the RS under the authority of the Ministry of Finance. Both Entities have stepped up their efforts to detect and prosecute official corruption, with the assistance of the Anti-Fraud Unit recently established in the Office of the High Representative.

B. Monetary Policy Under the Currency Board Arrangement

20. The basic characteristics of the Central Bank of Bosnia and Herzegovina (CBBH) are described in the MEFP (¶25-29). As required under the Dayton Treaty, the CBBH is the sole authority in the country for monetary policy and issuing domestic currency, operating for at least its first six years as a currency board. The CBBH began partial operations on August 11, 1997, mainly in the Bosniac-majority area, and its operations are to be extended to the rest of the country prior to Executive Board consideration of the authorities' request for a stand-by arrangement (¶27).[8] Its functions are limited even in comparison with many other currency board arrangements, in that it has no direct role in bank supervision and regulation. The Central Bank's primary task is to issue the new domestic currency, the convertible marka, in exchange for convertible currency at a 1:1 exchange rate with the DM; at least 95 percent of

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[8] At the time of its establishment, the CBBH did not receive from the government the KM 25 million of initial capital required under the Central Bank Law. The authorities have indicated that they would intend to use for this purpose part of the funds derived from the first purchase under the proposed stand-by arrangement.

its foreign assets must be held in DM at all times.[9] The CBBH also levies reserve requirements on commercial banks' KM deposits (currently 10 percent, with a statutory maximum of 15 percent) and is the clearing agent for interbank transactions in KM, through banks' reserve accounts.[10] Other functions of the CBBH are to coordinate the activities of the Entity banking supervisory agencies; to advise on legislation and regulations concerning the payments system; and to compile country-wide monetary and balance of payments statistics. It serves as banker for the State, but is prohibited from doing so for either Entity government unless both agree to such an arrangement.

21. At the time of its establishment, the CBBH assumed the existing stock of BH dinar currency from the National Bank of BH (NBBH) and the required reserve deposits of commercial banks, along with a matching stock of DM assets (Table 10).[11] In order to begin the clearing function of the CBBH, all existing bank accounts in BH dinars were redenominated into KM. However, as part of this system the CBBH was exposed to the possibility of extending temporary credit to the banking system, through a settlement lag of 3-5 days for certain transactions involving the NBBH. To avoid such a violation of the currency board rule, the NBBH also provided a compensating deposit of DM 10 million that was expected to exceed any potential net credit exposure through the settlement lag and undertook to increase the deposit as necessary. In practice, neither the CBBH nor the NBBH monitored the system closely and numerous extensions of credit in excess of the compensating deposit occurred. This was a matter of concern for two reasons: first, because of the potential damage from even transient net extensions of credit to the NBBH to the credibility of the currency board arrangement; and second, because this arrangement was exposing the CBBH to the risk

[9] In the coming years the exchange rate peg and limit for reserve holdings will need to shift to the Euro.

[10] To protect banks in each Entity from interference by the State or the other Entity in their ability to use foreign exchange, the Central Bank law did not permit the Central Bank to impose reserve requirements on foreign currency deposits, which constitute the majority of bank deposits in all regions of the country. However, the Entity bank supervisory authorities impose high liquidity requirements on foreign currency deposits. This essentially continues the arrangements in place prior to the establishment of the CBBH. The staff has emphasized that, as financial and political integration become less fragile, the authorities should adopt legislation permitting a more uniform system of reserve requirements.

[11] The assets and liabilities assumed from the NBBH were held in a trust account. As the liabilities are converted into KM, those liabilities and the corresponding foreign exchange assets become part of the ordinary accounts of the CBBH; any remaining assets at the end of this process will be used in settlement of other NBBH liabilities.

of permanent loss from the insolvency of the NBBH.[12] The maximum daily extension of net credit through the mechanism (in excess of the compensating deposit) was KM 16.6 million at end-1997, equivalent to about 10 percent of the monetary liabilities of the CBBH. In addition, the authorities in the Croat- and Serb-majority areas cited this problem as a reason to delay the extension of CBBH operations into those regions.

22. Following protracted negotiations, in late April 1998 the authorities devised a strategy to address this issue by: (1) introducing arrangements that would block the settlement of payments by the NBBH unless it had first provided the necessary foreign exchange backing; (2) transferring most of the remaining foreign exchange assets of the NBBH to the compensating deposit; (3) appointing a liquidator for the NBBH (a foreign expert with substantial experience in commercial bank workouts); and (4) freezing the balances of official (cantonal and municipal) deposits in the NBBH in excess of its remaining foreign exchange assets.[13] In the judgment of the staff and the Governor of the CBBH, these steps—if fully implemented—should insulate the CBBH from the risk of further violations of the currency board rule; their implementation is a prior action for Executive Board consideration of the authorities' request for a stand-by arrangement. The liquidation of the NBBH is to be completed following the redemption of BH dinar notes in circulation for new KM notes, and in any event no later than August 1998; this will be a condition for completion of the first review under the proposed SBA. At the time of liquidation, the gap between the foreign exchange assets and liabilities of the NBBH is expected to be borne by the official depositors of the NBBH.

23. The CBBH is decentralized, with headquarters operations conducted at two sites (one in Sarajevo and the other in nearby Pale, in the RS). The bank also has major organizational subunits ("main units") located in Sarajevo, Mostar and Pale. As the initial stage of the strategy for extending CBBH operations throughout the country, a branch office will be opened shortly in Banja Luka and commercial banks in the Banja Luka, Pale, and Mostar areas will open KM reserve accounts with the CBBH.[14] Currency notes in KM, with slightly differing design elements for the two Entities, will be issued in early June and the existing BH dinar banknotes will be retired from circulation (¶26). The KM notes of both designs will serve as legal tender throughout the country. The use of KM is mandatory in transactions relating to the State budget, and the official accounts of the Entities and their public agencies

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[12] The gap, estimated provisionally by an international accounting firm at DM 20-25 million, arose from a loan extended by the NBBH to the former central government in May 1996, which was never repaid.

[13] The NBBH also held deposits from over 21,000 non-governmental entities, totaling about DM 5 million. These deposits are being shifted to commercial banks, along with a corresponding stock of foreign exchange assets.

[14] The Banja Luka office is expected to be redesignated as the main unit in the RS.

and enterprises must be denominated in KM (although they may be presented simultaneously in some other unit of account). Public officials of the Entities have undertaken to promote the wider use of the convertible marka in transactions by these institutions and the Presidency has an obligation to review these efforts every three months on the basis of analysis submitted by the IMF staff. During this process, the main foreign currencies now in circulation (the DM, Croatian kuna, and Yugoslav dinar) may still be used for public transactions in the Entities and their use will be permitted indefinitely, on a voluntary basis, in non-governmental transactions.

24. The decision of the authorities to leave certain foreign currencies in widespread use during the period immediately after the introduction of the KM represented a pragmatic response to the difficulties faced, in particular, by residents of the RS, who have significant asset holdings in nonconvertible Yugoslav dinars and more limited access to convertible foreign currencies. It is expected that this situation will improve as restrictions on the transit of goods to and from the RS through neighboring countries are removed and international financial relations become more diversified. An important step in this direction was taken at end-March 1998, when the RS government issued a decree permitting the unrestricted use of convertible foreign currencies in its payments system and in settlement of public or private obligations. For the present, only a modest reorganization of the existing payments systems, along with the establishment of a common linkage to the CBBH, was needed to accommodate the initiation of transactions in KM throughout the country. For the period ahead, the Fund staff will work with the authorities to develop plans for a more competitive, country-wide payments system reform.

25. The features of the new Central Bank pose a number of challenges for the conduct of economic policy. First, there is the possibility that difficulties in cooperation among the parties will continue to inhibit the development of the institution and public acceptance of the KM. In addition, there are the risks and rigidities associated with any currency board arrangement. For Bosnia and Herzegovina, these include potential volatility in interest rates stemming from the lack of an official instrument for intervening in the money market, and the risks to the very weak banking system when the central bank is unable to serve as a lender of last resort. The choice of a currency board arrangement for the immediate postwar period was motivated by the difficulties of restoring trust among former combatants, which militated against monetary arrangements requiring frequent decision-making on sensitive matters, as well as concerns over the lack of administrative capacity and recognition of the role that transparency could play in reinforcing fiscal discipline. Undertakings to strengthen the banking system and limit the risk of a systemic banking crisis are described in section E, below.

C. Exchange System

26. The Central Bank law stipulates that the convertible marka shall be freely convertible into DM, and that no restrictions shall be imposed on the making of payments and transfers

for international transactions (¶36).[15] This constitutes a considerable simplification of the previous exchange arrangements, maintained by the National Bank of BH and the National Bank of the RS, which entailed restrictions on payments for both current international transactions and capital transactions, as well as foreign exchange surrender requirements.[16] At present, the only remaining restrictions subject to Fund jurisdiction would be those relating to the maintenance of external payments arrears; since there is not complete information in this area and no definitive timetable for eliminating such arrears, the staff does not recommend approval of the restriction. At the time of the first review of the program, the staff will pursue again with the authorities the prospects for prompt acceptance the obligations of Article VIII, sections 2, 3 and 4.

D. Fiscal Policy for a Decentralized State[17]

27. The authorities' fiscal strategy (¶13) is designed to support as much as possible the reconstruction and social needs of the country and actively promote the transition to a market economy. Under the currency board arrangement, the monetary authorities are precluded from extending credit to the public sector; in addition the banking system has little capacity for financial intermediation and capital markets are non-existent. Therefore, budget plans are based on the avoidance of domestic borrowing at all levels of government, and cash-basis expenditures will not be able to exceed the total of revenues and external financing. Reflecting this cautious approach, total fiscal expenditures are expected to rise from an estimated 33 percent of GDP in 1997 to about 35 percent of GDP in 1998, mainly due to an increase in budgetary expenditures in the RS for the first time in several years.[18] In the past the authorities have sought to expand the possibilities for deficit spending by incurring domestic arrears. An *important part of the fiscal strategy is avoiding any further accumulation of domestic arrears*

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[15] The only exception is for restrictions that may be required, pursuant to internationally-mandated economic sanctions.

[16] The exchange regimes maintained by the two National Banks were summarized in SM/203/96 (page 11 and Table 5). Both Entities are preparing new exchange regulations consistent with the Central Bank law.

[17] Detailed descriptions of a number of institutional and policy reforms, designed as part of a coordinated effort by the staffs of the Fund, World Bank, and other international and bilateral agencies, can be found in the documentation for the World Bank's Public Finance Structural Adjustment Credit, released in late April, 1998.

[18] See Table 5. These figures reflect reported expenditures by the State and Entity governments, cantons and municipalities in the Federation, and the Entity social funds. They exclude municipal expenditure in the RS and all off-budget spending. The only known, significant category of off-budget spending has been military expenditure (see footnote 19 and Table 6).

and dealing transparently with existing obligations. Poor accounting systems and the early stage of organization of most cantonal administrations in the Federation make the timely monitoring of domestic arrears infeasible at present. Hence, as prior actions the Entity authorities have revised many existing laws and regulations (relating to pensions, wages, and benefits to invalids and survivors) to avoid further domestic arrears (see ¶17, 19, 22 and 23).

28. New fiscal structures are being created to reflect the preference for extensive fiscal decentralization. In general the Dayton treaty calls for a proliferation of State level commissions, Entity and lower-level governing bodies, and other structures entailing a much larger and more complex public administration than would normally be appropriate for a country of this size and stage of development. Moreover, the demanding timetable for initiating new fiscal structures has contributed to theoretically undesirable solutions. Decentralization under the Dayton treaty is reflected in the design of the State budget (¶14-15), which is dependent upon transfers from the two Entities for its operations and has no revenues of its own. This poses risks to the timeliness and reliability of State revenues, which contributed to the poor record of timely servicing of external debt during the last year. The authorities have addressed these risks: (i) by specifying a mechanism and schedule for monthly transfers from the Entities to the State and making the transfer mechanism operational; and (ii) by providing in the External Debt Law that the State may levy a tax, if transfers from the Entities are not forthcoming. The issue will be reviewed in the context of preparations for the 1999 budget.

29. Coping with decentralization is also the major challenge for fiscal policy in the Federation. Since late 1995 the international community has encouraged the formation of Federation institutions to replace the two separate administrations that existed at the end of the war, through substantial financial and technical assistance as well a political pressure (¶16). While this process is well advanced at the formal level, in practice the vestiges of these separate administrations are still present in the actual operation of the new Federation structures. Relations between the central Federation government and lower levels are also evolving. The assignment of customs and excise tax revenues to the Federation and all other taxes (including sales and income taxes) to lower levels of government has limited the resources available to the Federation; therefore, to match revenues with expenditure responsibilities, important social expenditures, such as health and education, were assigned to the cantons. The current arrangement is suboptimal in that it could lead to unreasonably large differentials in the provision of essential public services, such as health and education, across the cantons. In addition, there are risks in the early stages of under provision of services which have spillover effects across cantons, such as university education and large clinics, and a longer-run possibility (as revenue bases recover) of under-utilization of economies of scale, if each canton opts to have its own university or clinic. The authorities recognize that they may need to review the assignment of revenue and expenditure responsibilities and the possibilities for transfer of resources among jurisdictions in the coming years.

30. The most immediate challenge to fiscal policy in the RS is to restore the revenue base (¶18). Despite similarities in tax systems and in methods of collection, revenue performance in

the RS has been significantly worse than in the Federation, even controlling for the differences in economic activity and incomes. The staff advised the authorities to address this problem mainly by addressing compliance and governance issues in the customs and tax administration, as described above, while simplifying and reducing both indirect taxes and customs tariffs. The RS has introduced tax stamps for excisable goods , tightened enforcement for goods transiting the FR Yugoslavia, and plans to issue new tax identification numbers by June 1998. Revenue performance so far this year suggests that these measures are succeeding, but the authorities have nevertheless included provisions in the budget execution law that permit a reduction of expenditure allocations in the event of revenue shortfalls.

31. At the end of the war the tax systems in all regions were based either on legislation inherited from the former SFRY or wartime emergency taxes. The authorities are eager to put in place a system more suited to a market economy. As the State's responsibility for tax policy is limited to customs tariffs, tax reform is primarily a task for the Entities, but they have increasingly come to recognize the need for tax harmonization in view of the growing mobility of goods and factors of production (and, hence, the tax base). The recent improvement in cooperation between the Entities led to the formation of an inter-Entity task force in March 1998. The first concrete project in this area was the sales tax rate cut introduced by the RS in April 1998, designed to bring rates more into line with the Federation, reducing incentives for evasion and facilitate future inter-Entity cooperation in enforcement. Other efforts for the program period will focus on broadening the tax base and harmonizing rates for indirect taxes, selective increases in excise taxes to compensate for the possible revenue losses arising from the new customs tariff system, and income tax reform (¶20).

32. The amendments to legislation and assignments of responsibility for social expenditures have concentrated on altering social expenditure policies to fit the overall budgetary envelope, while improving targeting, in preparation for more fundamental reforms. This strategy has implicitly acknowledged the economic and political dangers of a continuation of wartime policies of accumulation of arrears on key social benefits. In the case of benefits for war invalids and survivors, one of the largest expenditure items in both Entities, this has entailed bringing benefits more clearly into the Entity budgets and raising the overall allocation for this purpose, while revising existing legislation providing for benefits several times larger.[19] New pension laws in both Entities are designed to bring pension obligations

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[19] The largest expenditure item in each Entity's 1998 budget is for the **military**, with a combined total of DM 429 million (about 4 percent of GDP). While these figures reflect efforts to bring such expenditures more fully on-budget in 1997 and 1998, the budgeted figures are only slightly higher than the projected wage bill for the armed forces, suggesting that there is still a large off-budget component (financed from local revenues and external assistance) (see also SM/96/203, page 14). In 1995, the last year of the war, reported military expenditures were about DM 500 million (16 percent of GDP) and actual expenditures were estimated to be at least twice that size. During the Dayton Peace Conference, it was agreed

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into line with contributions and, in the case of the Federation, also embody initial steps toward a more equitable and sustainable pension system over the medium term. The submission to Parliament of the proposed Federation legislation, developed in cooperation with the staffs of the World Bank and Fund, is a prior action for Executive Board consideration of the request for a stand-by arrangement (¶22).

E. Institutional and Legal Reforms for a Market Economy [20]

33. The war in Bosnia and Herzegovina began at a time when many other countries in Central and Eastern Europe had embarked on a decisive transition to a market economy. While more than four years were lost, the fact that so many existing institutions ceased to function normally could facilitate the introduction of more appropriate replacements. To take maximum advantage, it will be important for the authorities to resist temptations to resuscitate the former Yugoslav system of social ownership and the associated legal and regulatory frameworks. The MEFP reflects the authorities' initial plans and orientations in the areas of social assistance and labor market reform (¶21-24), commercial banks (¶30-32), enterprise reform and privatization (¶33), pricing (¶34), and the external trade regime (¶35). This section provides additional information in three areas: the financial sector, enterprise reform and privatization, and foreign trade and investment policies.

Strengthening the financial sector

34. In both Entities, the banking system is burdened by the prewar legal, regulatory, and ownership structures; the financial consequences of imprudent lending and hyperinflation; and damages from the war period. The assets of the 25 publicly-owned banks are largely nonperforming and prewar foreign-currency liabilities cannot be serviced. The 39 private banks are mostly small and inexperienced, and subsist mainly on fee income. As a consequence, the banking sector is in no position to contribute significantly to the financing needs of the recovering economy and, indeed, constitutes a potential threat to financial stability as the recovery unfolds.[21] Banking sector issues are being handled at the level of the

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[19](...continued)
that military expenditures in the Federation for 1996 would not be reflected in the central Federation budget, in view of the uncertainties associated with the withdrawal and demobilization of forces and the gradual integration of the Army of the Republic of BH and the Croat defense forces (HVO).

[20] An excellent source for further information on the broad strategy for structural reform is the World Bank country study prepared in May 1997, ***Bosnia and Herzegovina—From Recovery to Sustainable Growth.***

[21] The seriousness of this threat and the need to further strengthen both the legal framework
(continued...)

Entities, under parallel approaches and with coordinated technical assistance from the World Bank, US government, Fund, and other sources. The authorities' strategy emphasizes the conclusion of independent audits; the development of action plans for restructuring and privatization or closure of all publicly-owned banks; an early focus on strengthening bank supervision; and the development of a more adequate legal framework. New banking legislation, developed with the assistance of the Fund, US government, and World Bank staffs, is to be introduced in a parallel fashion in both Entities during the coming months. Efforts are also underway to develop new legislation in the areas of bankruptcy, accounting standards, mortgages, collateral, insurance, and capital markets (¶31). The staff has emphasized that there should be a very cautious approach toward any expansion of financial intermediation under the present circumstances and a number of donors are providing lines of credit, either directly or through the better-managed commercial banks, to help meet the needs of small and medium-sized enterprises, until the banking sector is in a better position to do so.

35. Restructuring of publicly-owned banks will involve severing ownership linkages between banks and their major enterprise customers and cleaning up their balance sheets, including the transfer of nonperforming assets and corresponding liabilities (including frozen prewar foreign-currency deposits) to government agencies. There is not yet an estimate of the direct budgetary cost, but it is expected to be minimal as most such liabilities would be compensated through voucher privatization schemes. This strategy will result in the closure of nonviable institutions and merger of some of the salvageable ones, and the ultimate goal is to place all banks under majority private ownership. The authorities do not have any plans to compensate depositors of private institutions that have recently failed. For the future, the World Bank is coordinating the introduction of a deposit insurance system, which would be restricted to sound private and foreign institutions and capitalized with the assistance of foreign donors (¶32).

Enterprise reform and privatization

36. The authorities intend to begin the privatization of public enterprises (and, in the Federation, public housing) as soon as possible, as a means of enhancing efficiency over the medium-term and as a vehicle for settling a wide range of claims on government (¶33).

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[21](...continued)
and the resources of the supervisory authorities were underscored in recent months by the failure of three private commercial banks in the Federation and the apparent insolvency of a newly-created public institution in the RS. In both Entities scarce (albeit competent) supervisory capacity has been targeted mainly on the large, unsound publicly-owned banks; accounting standards are inadequate; and changes in the legal framework permitting supervisory intervention in private institutions has not yet been adopted. It is considered likely that governance issues contributed to the most recent bank problem in the RS. The staff has also alerted the authorities to the possible dangers of pyramid schemes, and the authorities are planning both legal and public education efforts in this field.

Efficiency gains are likely to be modest in the initial stages, as most enterprises will be included in mass-privatization schemes that may not lead to immediate improvements in corporate governance. Moreover, the legal environment for rapid privatization is far from ideal. Separate approaches were initially devised in the two Entities during 1996-97, while some State officials contended that the ownership of assets inherited from the SFRY had been inherited by the State.[22] There are important issues involved in conducting separate privatization processes in the two Entities. Most important, following the war and the associated large-scale migration, establishing ownership will be a difficult and protracted process and, in the case of housing, any solution will have important consequences for return of refugees. The staff has joined in the concerted view of the international community that, for matters other than housing, the difficulty of reaching a final legal resolution may be so great that it is better to implement a pragmatic, Entity-based solution that gets the assets quickly out of public hands. The State Council of Ministers is now considering an "umbrella" law that would provide a more uniform legal setting for Entity-based privatization.

Foreign trade and investment policy

37. Promoting a sustained expansion of exports under the fixed exchange rate regime will require a policy environment that avoids the imposition of unnecessary costs on productive sectors and is conducive to economic efficiency. Macroeconomic discipline, holding tax rates to reasonable levels, development of human capital, restoration of infrastructure, and elimination of barriers to movement and communications within the country are all elements of that environment, which will need to be reinforced by labor market flexibility and open policies toward foreign trade and investment. The latter are already reflected in the legislation underlying the new State customs tariff system (see below) and the State foreign investment law that was adopted in early 1998. Businessmen will now be looking to the consistency of implementation, as well as a further elaboration of the framework for and environment facing foreign investment.[23]

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[22] In the Federation, privatization would be mainly through vouchers, partly through a mass distribution but primarily to holders of claims on government (including frozen foreign exchange deposits). The estimated face value of claims to be compensated in this manner is about DM 10 billion. The Federation privatization program was to have begun in the spring of 1998; however, while most of the necessary legislation is in place, complementary regulations and administrative procedures are still being finalized. The RS initiated a voucher privatization program during 1997, under which majority foreign ownership of any enterprise was prohibited and the largest bloc of shares was reserved for distribution to the social funds (which include *inter alia* the pension and health funds). The RS program is being reviewed by the new government and actions already taken may be unwound.

[23] The Law on Foreign Investment Policy established a relatively liberal environment for foreign equity participation in domestic enterprises: the approval process is largely automatic

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38. Inter-Entity technical discussions on a liberal, country-wide foreign trade and customs tariff regime, which had been underway since mid-1996, were short-circuited in mid-1997 in an effort to produce a compromise that would be acceptable to Entities with widely differing existing systems. The resulting customs tariff law, adopted in June 1997, included 21 different tariff rate categories and was never implemented in either Entity.[24] It was superseded at end-1997 by a simpler tariff system, with an unweighted average rate of about 7 percent and only four rate categories (0, 5, 10, and 15 percent) (¶35). The State customs law eliminates nearly all customs tariff exemptions. In April 1998 the RS adopted this system for most merchandise transactions, but still retains preferential tariff arrangements with the FR Yugoslavia for some goods. In the Federation, the authorities indicated initially that they intended to retain both their existing free-trade agreement with Croatia and a number of tariff surcharges. The reluctance of the Entities to fully implement the new State tariff regime has been challenged forcefully by the State government and the Office of the High Representative, and the program envisages that the new system will be applied uniformly by June 1998 (one of the topics to be addressed in the first program review). The State trade and tariff laws would also eliminate most quantitative restrictions on imports and exports (in practice there are almost no QR's on imports in either Entity at present, while the RS maintains QR's on exports of certain agricultural products and unprocessed lumber).

IV. External Financing Requirements, Medium-Term Scenario, and Capacity to Repay the Fund

39. Tables 9, 11 and 12 provide details on the medium-term balance of payments outlook and its implications for external debt. In the near term, the size of the external current account deficit is limited mainly by the real resource transfer that the donor community is willing to provide. The scenario reflected in these tables illustrates the possible consequences of a sustained improvement in inter-Entity cooperation and policy implementation, leading to further successful aid mobilization. This scenario suggests that the external current account deficit (excluding official transfers) would widen from US$1.5 billion (33 percent of GDP) in 1997 to US$2.0 billion (34 percent of GDP) in 1998, moderating to US$1.6 billion (21 percent of GDP) in 1999. The increase in the deficit would reflect in part an unwinding of the delays in some donor disbursements that occurred in 1997, in response to difficulties in establishing the post-election common institutions and the political crisis in the RS.

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[23](...continued)
for most areas of investment, and enterprises with foreign participation are guaranteed the same rights and responsibilities as those wholly owned by domestic residents. The rights and obligations of foreign-owned enterprises are to be covered under separate legislation.

[24] This complex system of rates was determined by averaging the existing rates for individual categories of goods in the two Entities.

40. The authorities would seek to eliminate an estimated US$1.6 billion of arrears to Paris Club, London Club, and multilateral official creditors during 1998 and another US$0.7 million of arrears to other bilateral and commercial creditors no later than 1999. They are targeting an increase in gross official reserves of US$175 million in 1998 (in large part, the counterpart of remonetization of the economy under a currency board arrangement, following the issue of new KM notes) and US$75 million in 1999. Taking all of these goals plus external debt service obligations into account, the gross external financing requirements would be about US$3.8 billion in 1998 and US$2.4 billion in 1999 (Table 10). After deducting projected nonofficial and humanitarian grants, foreign direct investment, and targeted disbursements of project assistance under the Reconstruction Program, the residual financing requirement to be covered by debt rescheduling and balance of payments assistance would be US$1.9 billion in 1998 and US$0.9 billion in 1999 (¶37).

41. Possible sources for this residual financing requirement include debt relief from the London Club, Paris Club, other bilateral, and commercial creditors; balance of payments assistance from the World Bank, EU Commission, and bilateral donors; and use of Fund resources. Debt relief from the London Club under the December 1997 rescheduling agreement is about US$0.8 billion. Assuming a comprehensive rescheduling on Naples terms from Paris Club creditors and comparable treatment from other official bilateral and commercial creditors, the need for balance of payments assistance might be on the order of US$250 million in 1998 and US$160 million in 1999.[25] Projected purchases under the proposed stand-by arrangement plus disbursements under World Bank adjustment loans already under discussion with the authorities would total about US$125 million in 1998 and US$70 million in 1999, leaving a residual balance of payments financing requirement of US$125 million to be met from other sources this year and a smaller amount in 1999. The staff has collaborated with the EU Commission to present these financing requirements to G-24 representatives, and will be seeking financing assurances for at least the remainder of 1998 during the May 7-8 donor meeting, chaired by the World Bank and EU Commission. If the Executive Board approves the authorities' request for a stand-by arrangement, they expect to request a Paris Club rescheduling shortly thereafter.

42. The prospects for economic growth over the medium term will depend on the normalization of the political situation in the country and a further deepening of cooperation between the two Entities, including the reopening of the domestic and international transportation routes. Table 13 illustrates the type of outcome that might prevail under favorable circumstances, with consistent implementation of stabilization policies and rapid structural reform supported strongly by the international community, mainly on highly

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[25] The assumed terms of relief from Paris Club creditors are: (i) Naples terms with 67 percent NPV reduction for all pre-cutoff date obligations, covering both arrears and current maturities; and (ii) a concessional deferral of arrears on post-cutoff and short-term debt, with a six-year maturity and three-year grace period. The cutoff date is December 2, 1982. Relief from other bilateral and commercial creditors is assumed to be on at least comparable terms.

concessional terms. Growth would still be led by public sector investment during the remaining peak years of the Reconstruction Program, 1998-99, and is envisaged under the scenario in the range of 20-30 percent a year. Private consumption would also be rising significantly in real terms, albeit not as a share of GDP. Thereafter growth would taper off to more sustainable rates, with rapid progress toward balance of payments viability. While foreign financing is crucial to the initial phase, throughout the scenario continued macroeconomic stability and reforms of the tax system, financial sector, and legal framework affecting domestic business activity and foreign investment are assumed to help promote domestic saving and investment. In addition, growth would be supported by the supply-side effects of structural measures. The external current account deficit would contract sharply to about 3 percent of GDP annually during the period 2001-2005, due to a drop in reconstruction-related imports together with a recovery of exports, as domestic output expands and transportation facilities improve.

43. With debt relief on favorable terms, this scenario would imply a reduction in external debt to less than 50 percent of GDP by the year 2000 and a debt service ratio of under 10 percent of exports of goods and services. Nevertheless, there would be significant risks to the Fund and other external creditors in the event that the favorable circumstances assumed in the scenario failed to materialize. The authorities' poor track record of timely debt service during the past year underscores the fragility of the existing administrative mechanisms and political consensus in this area, and recent events elsewhere in the region are a reminder of the ever-present possibilities of broader political disruption or even armed conflict. Thus, the capacity of Bosnia and Herzegovina to repay the Fund and the operation of mechanisms for the transfer of resources from the Entities to the State to service external debt require continuous review. The authorities would intend to hold a portion of the proceeds from the proposed stand-by arrangement in the SDR account, to facilitate timely discharge of obligations to the Fund. Under the proposed purchase schedule, obligations to the Fund would peak at about 2 percent of export of goods and services by 2001. The authorities should be able to meet these obligations readily in the future, provided that the political will to do so continues to exist.

44. Because a number of measures (including currency designs and the foreign investment law) were imposed by the High Representative, while others were adopted under strong international pressure, there would appear to be reason to question the authorities' ownership of the program. In recent months the State and Entity authorities have acquiesced in the measures imposed by the High Representative, professed to be committed to the program strategy, and have taken other measures (especially in the areas of fiscal policy and bank supervision) to strengthen the chances for success of the program. Nevertheless, there is a risk that the present political equilibrium in support of the program could come undone in the future. Support and encouragement from the international community for the rapid implementation of the program, with the attendant economic benefits, would appear to be the best way to minimize this risk.

V. Features of the Proposed Stand-By Arrangement

45. In view of the obvious difficulty of decision-making under current circumstances, the proposed stand-by arrangement has relied heavily on prior actions (see Text Box 3). A number of actions taken over the past year were considered preconditions for finalizing program discussions, relating to the enactment of laws establishing the basic economic institutions of the State, initial steps in the implementation of many of those laws, and the formulation of appropriate Entity budgets. These in turn built upon an earlier stage of institutional development in the Federation. As noted above, there are a few remaining prior actions for Executive Board consideration of the authorities' request, including: (i) extension of Central Bank operations into the Croat- and Serb-majority areas of the country; (ii) measures to safeguard the integrity of the currency board arrangement from financial linkages between the Central Bank and the National Bank of BH; and (iii) submission to the Federation Parliament of pension reform legislation in line with understandings with the World Bank and Fund staffs.

46. Quarterly quantitative performance criteria under the program would comprise: (i) ceilings on domestic borrowing by the consolidated general government, with separate sub-ceilings for the State and Entity governments—all such ceilings will be set at zero, except for the State where a surplus is targeted;[26] (ii) a floor on "free" international reserves of the Central Bank;[27] (iii) ceilings on nonconcessional external borrowing set at a positive level (mainly to accommodate planned lending by the EBRD); and (iv) a floor for the reduction in external payments arrears. The maintenance of at least 100 percent foreign exchange cover for the domestic liabilities of the Central Bank and the avoidance of new external payments arrears except for amounts subject to rescheduling—as well as the normal undertakings relating to exchange restrictions—will constitute continuous performance criteria (¶40). The program includes structural benchmarks and performance criteria relating to the strengthening

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[26] As part of the strict currency board arrangement, the Central Bank is not permitted to borrow abroad or to lend the proceeds of external borrowing to other sectors. Thus, the State Ministry of Foreign Trade and Economic Relations, which is responsible for administering policy on external borrowing, has been designated as the fiscal agent of Bosnia and Herzegovina. To provide a cushion against adverse contingencies and to facilitate timely servicing of external obligations, the authorities intend to set aside a portion of the proceeds of purchases under the arrangement in the SDR account.

[27] As the Central Bank is precluded by law from onlending its assets to the banking sector, as is envisaged by the Banking Departments of some other currency boards (e.g., Bulgaria and Estonia), this target for maintaining a stock of foreign exchange reserve assets in excess of the minimum needed for full coverage of the Central Bank's monetary liabilities would serve primarily to ensure that the initial capital of the Central Bank is not depleted to meet operating expenses.

Box 3. Bosnia and Herzegovina: Prior Actions

Establishment of new Central Bank

1. Adoption of Central Bank (CBBH) Law (June 1997)
2. CBBH begins operations (August 1997)
3. **CBBH operations extended to Croat- and Serb-majority areas (before Executive Board meeting)**
4. Currency designs agreed and timetable for issuing new currency (January-February 1998)
5. Actions to safeguard currency board arrangement from further extension of credit to the National Bank of Bosnia and Herzegovina:
   - Appointment of liquidator for NBBH (April 1998)
   - **Revision of clearing arrangements to avoid credit to NBBH (before Executive Board meeting)**

Financial system

6. Establishment of unified Federation Payments Bureau (April 1996)
7. Establishment of Federation Banking Agency (June-September 1996)
8. Linkages between the Federation and Republika Srpska (RS) payments bureaus (early 1997)
9. Separation of RS payments bureau from operations of Serb State Bank (April 1998)

Fiscal policy

10. Approval of 1998 State budget and budget execution law (March 1998)
11. Approval of Entity budgets consistent with State budget and entailing no domestic financing requirement (March 1998 in RS, April 1998 in Federation)
12. Establishment of unified Federation customs and tax administrations (1996)
13. Assignment of revenue and expenditure responsibilities within Federation (1997)
14. Placement of RS customs and financial police under control of Finance Ministry (March 1998)
15. Other RS revenue measures: use of tax stamps for excisable goods, shifting collection of sales tax on excisable goods to wholesale level, revision of sales and excise tax rates (April 1998)
16. Measures to avoid accumulation of domestic arrears by Entities:
    - Provisions of budget execution laws adjusting expenditure allocations to revenues (March 1998)
    - Matching policies on invalid and survivor benefits to available revenues (March 1998)
    - **Submission of revised Federation pension law to Parliament (before Executive Board meeting)**
17. Adoption of State trade and customs tariff laws (June 1997)
18. Simplification of customs tariff regime (January 1998)

External debt management

19. Adoption of State External Debt Law and allocation of debt service to Entities (June 1997)
20. Establishment of automatic transfer mechanism for resources from Entities for debt service (May 1998)
    - Establishment of accounts and beginning of Federation transfers (April 1998)
    - Initiation of transfers by RS (May 1998)
    - Broadening to more creditor groups (June 1998)
21. Establishment of State External Debt Management Office (April 1998)

of economic statistics (¶43). In addition, any change in reserve requirements on commercial banks would be effected only after consultation with the IMF staff.

47. Program reviews would be associated with each purchase under the arrangement (¶41-42). The first review, to be completed by September 15, 1998, would ensure that external financing assurances have materialized, that the program remains on track (including whether there has been any increase in domestic arrears), that the National Bank of BH has been liquidated, and that progress has been made in implementing key structural measures. In addition, it would assess the introduction of convertible marka notes and the efforts to promote the use of the new currency in public sector transactions in all parts of Bosnia and Herzegovina. The second review would again cover financing assurances, the progress in structural reform, and the efforts to promote the use of the convertible marka. As the authorities intend to request that the proposed SBA be replaced by arrangements under the ESAF in early 1999, and in view of the uncertainties about a number of key issues at present, the quantitative performance criteria have been established only through end-September 1998. The performance criteria associated with the remaining purchases under the stand-by arrangement will be specified in the context of the first program review.

VI. Staff Appraisal

48. Some 2½ years after the signing of the Dayton treaty, cooperation among the three major national groups in Bosnia and Herzegovina has reached a level at which it is possible to reach understandings on a country-wide economic program. The most difficult element has been the development of the basic economic institutions of the State—the Central Bank, State budget, and laws on external debt, trade, and customs tariffs. The arrangements under which these institutions will operate involve many unwieldy compromises and may need to evolve over time. Nevertheless, in light of the recent history of this country, they represent a remarkable achievement which is worthy of support as a stepping stone to further progress.

49. The authorities' economic strategy is based on four elements: (i) use of a fixed exchange rate as a nominal anchor, through the currency board arrangement; (ii) a fiscal policy that avoids domestic borrowing while being as supportive as possible of reconstruction and social needs; (iii) mobilization of large-scale external assistance on concessional terms; and (iv) acceleration of the transition to a market economy through structural reforms. In view of the difficulties in decision-making under the present circumstances, the staff has judged that such a program is much more likely to succeed if it is launched by action in the most critical areas; this is reflected in the large number of prior actions. While successful implementation of the program policies is by no means assured, by now the authorities have demonstrated a more pragmatic approach to issues of common interest and a willingness to make difficult choices in the interest of financial stability, factors which bode well for the future.

50. The new Central Bank and domestic currency should play a major role in political and economic reintegration, and help to establish an environment more conducive to economic

recovery. Conversely, half-hearted support for the institution could damage the credibility of the program and the peace process. The staff will monitor closely the progress in this undertaking, including the efforts of the authorities to promote the use of the new domestic currency throughout the country. At the same time, the adoption of a currency board arrangement places a high premium on the maintenance of fiscal discipline, wage moderation and labor market flexibility, and additional structural reforms to promote sustainable growth. As envisaged under the program, the latter will need to encompass, inter alia, tax policy, the trade regime, the financial and enterprise sectors, and other legal and institutional underpinnings of a market economy.

51. Unfortunately, the structural bases for sustained, successful economic policy under a currency board are not yet fully in place. Both to help forestall further difficulties in the banking sector and to ensure that commercial banks are put in a position as soon as possible to serve as important financial intermediaries, it is crucial that the implementation of the strategy for bank reform and the strengthening of supervision be deepened quickly in both Entities—in part through the timely adoption of the new banking laws. It will also be important to hasten the implementation of a complementary framework for enterprise reform and privatization. In the coming years, a more fundamental restructuring of the payments system will also be an important element of the transition. To have their maximum effectiveness, actions in these and other structural areas will need to be implemented as soon as possible, on a consistent basis in all areas of the country. As part of this process, it will be important for the authorities to resist temptations to resurrect elements of the economic system of the former SFR Yugoslavia. A comprehensive approach and rapid progress on the structural reform agenda will be essential for moving to an ESAF-supported program at an early date.

52. The efforts of the authorities and the international community to put in place the new fiscal arrangements called for under the Washington and Dayton treaties have borne considerable fruit, but the arrangements remain incomplete. There is still a need to develop fully the common institutions of Bosnia and Herzegovina, within the decentralized framework of the treaties, and eliminate the vestiges of temporary wartime administrations. A further strengthening of State institutions, within the agreed framework of the Dayton treaty, and more agile, institutionalized means of inter-Entity cooperation on fiscal matters will be needed for the present economic strategy to succeed. In order to promote sustainability, it will be important to follow through on initiatives to reform the pension and health systems, develop a more effective and targeted social safety net, avoid further domestic arrears and eliminate existing obligations, mainly in conjunction with the privatization process.

53. The recent efforts of the authorities in all regions to put aside their previous restrictive exchange and trade systems are very encouraging signs for the future. The staff would urge the Entity authorities to move quickly to implement the common customs tariff regime and abolish inconsistent surcharges and preferential trade agreements with neighboring countries. It would encourage the authorities to eliminate any remaining restrictions on international

transactions and urge them to accept the obligations of Article VIII, Sections 2, 3, and 4, before the end of this year.

54. Bosnia and Herzegovina faces substantial balance of payments financing requirements in the coming years, associated with the depressed export capacity, urgent reconstruction projects, and the need to reconstitute foreign exchange reserves and normalize relations with external creditors. Filling this gap in a way that does not create an unsustainable debt burden will require large scale and highly concessional support over a number of years from the international community, through grant assistance, concessional loans, and debt relief. While the situation in the country during 1997 led to a slowdown in external assistance, the international community should stand ready now to respond generously to renewed efforts at political and economic integration and the implementation of the economic adjustment strategy. The use of Fund resources under an upper-credit tranche stand-by arrangement would play an important catalytic role in this process. The staff thus supports the authorities' request for a stand-by arrangement.

55. It is recommended that the next Article IV consultation with Bosnia and Herzegovina take place on the standard 12-month cycle.

VII. PROPOSED DECISION

The following draft decision is proposed for adoption by the Executive Board:

1. The government of Bosnia and Herzegovina has requested a stand-by arrangement for a period of 12 months from May--, 1998 to May--, 1999 in an amount equivalent to SDR 60.6 million.

2. The Fund approves the stand-by arrangement set forth in EBS/98/78 .

Table 1. Bosnia and Herzegovina: Schedule of Purchases
Under the Proposed Stand-By Arrangement 1/

Amount of Purchase	Availability Date	Conditions Include:
1. SDR 24.24 million	May 1998	Board approval
2. SDR 12.12 million	August 15, 1998	Completion of first review and observance of end-June performance criteria
3. SDR 6.06 million	November 15, 1998	Completion of second review and observance of end-September performance criteria 2/
4. SDR 12.12 million	February 15, 1999	Completion of third review and observance of end-December performance criteria 2/
5. SDR 6.06 million	May 15, 1999	Observance of end-March performance criteria 2/

Source: Staff estimates.

1/ The proposed stand-by arrangement would be for SDR 60.6 million (50 percent of quota).
2/ Performance criteria have been defined only through end-September 1998. The performance criteria for end-December 1998 and end-March 1999 will be defined in the context of the first program review. The authorities would intend, based on performance under the stand-by arrangement and progress in defining structural policies, to request the cancellation of the stand-by arrangement and its replacement by arrangements under the ESAF.

Table 2. Bosnia and Herzegovina: Projected IMF Position During the Proposed Stand-by Arrangement, May 1998 - Apr. 1999 1/

	1998			1999 2/	
	End-Mar.	May-Jun.	Jul.-Dec.	Jan.-Mar.	Apr.-Jun.
			(In millions of SDRs)		
Purchases	0.0	24.2	18.2	12.1	6.1
Repurchases	0.0	0.0	0.0	3.8	3.8
Total Fund credit outstanding	30.3	54.5	72.7	81.0	83.3
			(In percent of quota) 3/		
Total Fund credit outstanding	25.0	45.0	60.0	66.9	68.7

Source: Staff estimates.

1/ Position under tranche policies.
2/ Assuming that the SBA is not replaced by arrangements under the ESAF in early 1999.
3/ Bosnia and Herzegovina's quota is SDR 121.2 million.

Table 3. Bosnia and Herzegovina: Monetary Survey, Dec.1994-Dec. 1998

(In millions of convertible marks; end of period) 1/

	1994 Dec.	1995 Dec.	1996 Dec.	1997 Mar.	1997 Jun.	1997 Sep.	1997 Dec.	1998 Dec. Proj.
Assets	364	395	775	765	837	970	969	1,658
Foreign assets (net)	-2,186	-2,034	-1,716	-1,868	-1,819	-1,743	-1,761	-1,345
Foreign assets	672	810	1,409	1,359	1,517	1,639	1,555	1,871
Foreign assets (MAs)	144	297	712	675	796	693	636	...
Foreign assets (DMBs)	528	513	697	684	721	946	919	...
Foreign liabilities	-2,858	-2,844	-3,125	-3,227	-3,336	-3,382	-3,316	-3,216
Foreign liabilities (MA)	-34	-98	-138	-149	-155	0	0	0
Foreign liabilities (DMBs)	-2,824	-2,746	-2,988	-3,078	-3,181	-3,382	-3,316	-3,216
Domestic assets (net)	2,550	2,429	2,491	2,633	2,656	2,713	2,729	3,003
Claims on central government (net) 2/	10	-95	-278	-261	-363	-427	-360	-395
Other claims	2,540	2,524	2,769	2,894	3,019	3,140	3,089	3,398
Claims on nonfinancial public enterprises	2,782	2,531	3,057	3,259	3,410	3,593	3,570	3,958
Other 3/	106	85	92	96	80	111	137	140
Other items (net) 4/	-348	-92	-380	-461	-471	-564	-618	-700
Liabilities								
Broad money	364	395	775	765	837	970	969	1,658
Money	13	56	354	329	355	321	254	...
Currency outside banks	2	28	96	88	89	89	113	...
Demand deposits	11	29	258	241	266	232	141	...
Demand deposits of nonfinancial public enterprises	8	26	184	158	177	193	101	...
Other 3/	3	3	74	83	89	39	40	...
Quasi-money	351	338	421	436	482	649	715	...
Time and saving deposits in BH dinars	1	4	7	15	18	11	9	...
Foreign currency deposits	350	334	414	421	464	638	706	...
Demand deposits	231	287	300	275	274	387	412	...
Nonfinancial public entreprises	154	222	255	230	238	250	262	...
Other 3/	77	65	45	45	36	137	150	...
Time and saving deposits	119	47	114	146	190	251	294	...
Nonfinancial public entreprises	82	34	73	89	120	138	154	...
Other 3/	37	13	41	57	70	113	140	...
Memorandum items:	(Changes in percent of beginning of year broad money stock)							
Foreign assets (net)	...	42	81	-20	-13	-4	-6	43
Foreign assets	...	38	152	-6	14	30	19	33
Foreign liabilities	...	4	-71	-13	-27	-33	-25	10
Domestic assets (net)	...	-33	16	18	21	29	31	28
Claims on central government (net) 2/	...	-29	-46	2	-11	-19	-11	-4
Other claims	...	-4	62	16	32	48	41	32
Broad money	...	8	96	-1	8	25	25	71
Money	...	12	75	-3	0	-4	-13	...
Quasi-money	...	-3	21	2	8	29	38	...

Source: Data provided by the Central Bank of Bosnia and Herzegovina (CBBH), the National Bank of Bosnia and Herzegovina (NBBH), the Federation Ministry of Finance and the National Bank of the Republika Srpska (NBRS); and staff estimates.

1/ At the official exchange rate for the KM and BH dinar, and market exchange rates for other countries.

2/ Includes net claims on Entity governments.

3/ Including noncentral government and private sector.

Table 4. Bosnia and Herzegovina: Consolidated Fiscal Position, 1996-1997

	1996	1997	1997				
	Consolidated	Consolidated Estimate	State	Federation Consolidated	Federation	Federation Cantons, Municipalities, and Social Funds	Republika Srpska 1/
			(In millions of convertible marka)				
Total Revenue	1,991	2,428	50	2,169	610	1,559	209
Tax revenue	1,381	1,615	0	1,418	565	853	197
Taxes on goods and services	767	976	0	875	279	596	100
Trade taxes	296	349	0	285	285	0	63
Taxes on income	296	284	0	256	0	256	28
Other taxes	22	7	0	1	0	1	6
Nontax revenue	609	813	50	751	45	706	12
Expenditures 2/	2,173	2,519	110	2,200	641	1,559	209
Wages	235	325	35	265	70	195	25
Goods and services	92	84	0	53	19	34	31
Military	188	394	0	321	254	67	73
Reconstruction	24	77	0	68	18	50	9
Transfers to invalids	198	206	0	192	175	16	15
Transfers to State budget	0	30	0	30	30	0	0
Other 3/	1,436	1,403	75	1,272	76	1,196	56
Financing	183	91	60	31	31	0	0
Domestic	41	0	0	0	0	0	0
External grants and concessional loans	142	91	60	31	31	0	0
			(In percent of GDP)				
Revenues	39.8	31.4	0.6	28.1	7.9	20.2	2.7
Expenditures	43.4	32.6	1.4	28.5	8.3	20.2	2.7

Source: Council of Ministers of Bosnia and Herzegovina; Entity Finance Ministries; and staff estimates.

1/ Excludes local government operations, but includes social funds.

2/ Cash basis.

3/ In the Federation, includes district, canton, and municipal expenditures, for which insufficient data are available to permit allocation among categories.

Table 5. Bosnia and Herzegovina: State Budget, 1997-1998

	1997 Budget	1997 Est.	1998 Budget
	(In millions of convertible marka)		
Expenditures	136	110	183
Administrative	40	35	57
Debt service	96	75	126
Revenues	136	50	173
Fees	20	20	20
Transfers from Entities	116	30	153
External Financing	0	60	10
	(In percent of GDP)		
Expenditures	1.8	1.4	1.7
Revenues	1.8	0.6	1.6

Source: Council of Ministers of Bosnia and Herzegovina; and staff estimates for 1997.

Table 6. Bosnia and Herzegovina: Federation Budget, 1996-1998

	1996	1997	1998
	(In millions of convertible marka)		
Revenues	318	610	822
Customs tariffs and excise taxes	312	565	766
Nontax revenue	6	45	56
Expenditure	394	641	917
Wages	62	70	88
Materials and services	13	19	33
Military	0 1/	254 1/	343 1/
Reconstruction	10	18	30
Transfers to invalids	95	176	257
Transfers to State budget	29	30	95
Other	185	74	71
Financing	76	31	95
Domestic	-15	0	15 2/
External grants and concessional loans	91	31	80
	(In percent of GDP)		
Revenues	6.4	7.9	7.7
Expenditures	7.9	8.3	8.5

Source: Federation Ministry of Finance.

1/ Under instructions from the Dayton peace conference, military expenditures were taken entirely off-budget when the two existing fiscal administrations in the Federation were combined for the first time in 1996. In 1995, reported military expenditures for these two administrations totalled DM 375 million, and it is estimated that additional military expenditures financed by local governments and foreign grants were at least as large as the on-budget figure. In 1996 these sources, plus the operations of unrecognized successor institutions of the wartime administrations, covered the entire cost of military expenditures, which is unknown. The budgeted figure for 1998 is only slightly higher than the estimated wage bill for the new, professional army of the Federation.
2/ Privatization revenues.

Table 7. Bosnia and Herzegovina: Republika Srpska Budget, 1996-1998

	1996	1997	1998
		(In millions convertible marka)	
Revenues	253	209-259 1/	365
Customs tariffs and other taxes on imported goods	95	63-73	92
Other sales and excise taxes	77	100	158
Income taxes	72	28-68	87
Other tax and nontax revenue	9	18	28
Expenditure	254	209 1/	468
Wages	39	25 *	107
Materials and services	36	31	38
Military	139	73 *	86
Reconstruction	5	9	14
Transfers to invalids	22	15	51
Social Fund	0	6	51
Transfers to State budget	0	0	60
Other	13	50	61
Financing	1	0 or -50	103
Domestic	-15	0 or -50	0
External grants and concessional loans	16	0	103
		(In percent of GDP)	
Revenues	5.1	3.4	3.4
Expenditures	5.1	3.4	4.4

Source: Republika Srpska Ministry of Finance and draft 1998 budget.

1/ The revenue estimates for 1997 are considered incomplete. The lower figure shown is based on the information reported to the new RS government by the payments bureau and officials of the former government, and corresponds mainly to revenues received on taxes levied in Yugoslav dinars. Taxes levied in foreign exchange were reported to have yielded much lower amounts than historical experience would have led the new government to expect. The higher revenue estimate includes a more normal figure for foreign exchange revenues, as a base for assessing likely developments in 1998 now that revenue administration is under better control. The expenditure figures marked with an (*) are considered those most likely to have been understated in 1997.

Table 8. Bosnia and Herzegovina: Selected Economic and Financial Indicators, 1994-1998 1/

	1994	1995	1996	1997 Est.	1998 Proj.
GDP (millions of U.S. dollars)	1,964	2,157	3,327	4,455	5,956
Industrial production (percent change) 2/					
Federation	...	341	122	30	...
Republika Srpska	...	-13	20	34	...
Employment, end-period 3/	143,962	220,396	338,656	340,361	...
Wages (DM/month) 4/					
Federation	...	43	168	266	...
Republika Srpska 5/	...	21	50	90	...
		(annual average percent change)			
Real GDP (annual average)	...	32	50	30	30
CPI 6/					
Federation (DM)	...	-4	-25	14	10
Republika Srpska (YUD)	...	118	66	3	...
Republika Srpska (DM-based index) 5/	...	13	45	-7	10
Money and credit 7/	...				
Broad money	...	9	96	35	...
Domestic credit	...	-13	14	17	...
		(in millions of DM)			
Consolidated government 8/					
Revenue (including grants)	557	1,043	1,996	2,418	...
Expenditure	896	1,051	2,173	2,518	...
Balance 9/	-339	-9	-177	-100	...
		(in millions of US dollars)			
External current account balance 10/ 11/	-492	-570	-1,306	-1,468	-2,005
Exports 11/	91	152	336	570	822
Imports 11/	894	1,082	1,882	2,199	3,007
Net invisibles 10/ 11/	311	360	240	161	180
Gross international reserves 12/					
In millions of U.S. dollars	92	213	459	684	859
In months of merchandise imports	1.2	2.4	2.9	3.7	3.4
External debt 13/					
(In millions of U.S. dollars)	...	3,784	4,506	5,059	5,837
(In percent of GDP)	...	175	135	114	98
Debt service (in percent of exports of goods and nonfactor services)	...	118	63	31	16
Memorandum items:					
Exchange rates (period average)					
BiH dinar per deutsche mark 14/	...	100	100	100	...
FR Yugoslav dinar per deutsche mark 15	1.2	2.4	3.5	3.9	6.0
Croatia kuna per deutsche mark	3.7	3.6	3.6	3.5	3.6

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

1/ Data refer to the entire country, unless otherwise indicated. Data for 1997 reflect staff projections.
2/ Data for industrial production in both Entities are affected by post-war instability in the sample base.
3/ Bosniac-majority area prior to November 1996, Federation thereafter.
4/ Data refer to average net wages paid in a particular period, not average earnings in that period; only firms paying wages in a particular month are included in the data.
5/ Measured in DM using the parallel market exchange rate for the FR Yugoslav dinar.
6/ Period average retail price index. Data for both Entities are affected by post-war adjustments to market pricing.
7/ Country-wide monetary aggregates.
8/ Excludes municipal government operations for Republika Srpska. Data for 1996 and subsequent years exclude military expenditures financed by external grants.
9/ No net domestic financing of the budget deficit, other than arrears, in 1996-98.
10/ Excluding official transfers.
11/ Data for 1992-93 are based on limited customs data for the Bosniac-majority area. Data for 1994-98 are rough estimates or projections for the whole territory of Bosnia and Herzegovina.
12/ Data for the whole country. Excluding earmarked funds and blocked accounts; including foreign exchange held by Payments Bureaus.
13/ Projected external debt and debt service for 1998 exclude debt relief.
14/ Official rate. Parallel rate not collected by the National Bank of BiH.
15/ YUD/DM exchange rate in the parallel market (which is also the interbank rate in the RS). The official rate exchange rate in the FR Yugoslavia was set at YUD 3.3=DM 1 from December 1995 to March 1998, and YUD 6.0=DM 1 since March 31, 1998.

Table 9. Bosnia and Herzegovina: Balance of Payments, 1994-2005
(In millions of US dollars)

	1994 Est.	1995 Est.	1996 Est.	1997 Proj.	1998 Proj.	1999 Proj.	2005 Proj.	2001-2005 Annual Average
Trade balance	-803	-930	-1,546	-1,628	-2,185	-1,858	-1,218	-1,082
Exports, f.o.b.	91	152	336	570	822	1,127	2,651	2,209
Imports, f.o.b.	-894	-1,082	-1,882	-2,199	-3,007	-2,985	-3,870	-3,291
Reconstruction	0	0	-796	-688	-1,224	-918	-148	-135
Humanitarian (in-kind)	-561	-459	-246	-360	-136	-56	0	-1
Other	-333	-623	-840	-1,151	-1,647	-2,011	-3,721	-3,155
Services, net	-88	-23	-74	39	8	161	954	729
Receipts	103	229	322	427	506	594	1,344	1,063
Expenditure	-191	-252	-396	-388	-498	-433	-390	-333
of which: transport for reconstruction	...	...	-111	-103	-184	-138	-22	-20
transport for humanitarian goods	-118	-97	-73	-76	-29	-12	0	0
other	-73	-155	-313	-209	-286	-284	-368	-313
Income, net	-165	-242	-222	-228	-118	-99	-156	-131
Interest due 1/	-165	-242	-222	-228	-118	-99	-156	-131
Unrequited transfers, net	879	1,002	1,094	772	480	345	37	153
Receipts	888	1,073	1,251	852	550	415	87	203
Official	315	377	558	422	190	100	32	44
UN agencies	300	297	501	372	140	50	0	2
Donations of goods & serv	265	262	436	306	105	38	0	2
Local procurement	35	35	65	66	35	13	0	0
Other	15	80	57	50	50	50	32	42
Private	573	696	693	430	360	315	55	159
Cash	158	401	301	300	300	285	55	159
Donations of goods & serv	415	295	392	130	60	30	0	0
Expenditure	-9	-71	-157	-80	-70	-70	-50	-50
Current account balance	-177	-193	-748	-1,046	-1,815	-1,451	-383	-330
Excl. official transfers	-492	-570	-1,306	-1,468	-2,005	-1,551	-415	-375
Capital transfers for reconstruction	0	0	796	689	1,224	918	0	0
Foreign investment	0	0	0	0	100	200	200	200
Multilateral and Paris Club creditors	-119	-144	628	162	334	271	97	110
Disbursements for reconstruction	...	...	865	212	376	282	180	164
Reconstruction	...	...	244	212	376	282	180	164
Other 2/	...	...	621	0	0	0	0	0
Amortization	-119	-144	-237	-50	-42	-11	-83	-54
Existing debt	-119	-144	-237	-50	-42	-11	-25	-23
New debt			0	0	0	0	-58	-31
Other creditors	-139	-127	-114	-107	-75	-74	-42	-45
Disbursements	0	0	0	0	0	0	0	0
Amortization	-139	-127	-114	-107	-75	-74	-42	-45
Existing debt	-139	-127	-114	-107	-75	-74	-42	-51
Capital account balance	-258	-271	1,310	743	1,583	1,314	255	266
Errors and omissions	-1	100	-90	223	0	0	0	0
Overall Balance	-436	-364	471	-80	-232	-136	-127	-65
Financing	436	364	-471	80	232	136	127	65
Gross reserves (increase, -)	6	-138	-367	-225	-175	-75	-50	-50
Central bank	15	-121	-246	-225	-175	-75	-50	-50
Commercial banks	-9	-17	-121	0	0	0	0	0
Net use of Fund resources	-4	7	-2	-1	0	-21	0	0
Purchases/loans	0	45	0	0	0	0	0	0
Repurchases/repayments	-4	-38	-2	-1	0	-21	0	0
Short-term liabilities (reduction, -)	7	19	23	0	0	0	0	0
Central bank	0	0	0	0	0	0	0	0
Commercial banks	7	19	23	0	0	0	0	0
Arrears (reduction, -)	427	476	-125	306	-1,497	-678	0	0
Multilateral creditors 3/	...	...	-475	8	-38	0	0	0
Paris Club creditors 4/	...	...	102	48	-760	0	0	0
London Club 5/	...	...	135	145	-741	0		0
Other creditors 6/	...	...	113	105	42	-678	0	0
Total financing gap 7/	...	...	...	...	1,903	910	177	115

Sources: Data provided by the Bosnian authorities; and Fund staff estimates.
1/ Includes late interest through end-1997.
2/ Includes IBRD loan of June 14, 1996 to consolidate arrears and remaining principal of US$621 million into a new loan with 30 years' maturity and 5 years' grace at nonconcessional interest rates.
3/ Clearance of IBRD arrears on June 14, 1996 and assumes clearance of arrears to other multilaterals in 1998.
4/ Assumes a Paris Club reschedulings by mid-1998.
5/ Reflects London Club debt consolidation agreed in December 1997.
6/ Assumes rollover of debt service to other creditors in 1998 pending conclusion of debt restructuring agreement to clear arrears in 1999.
7/ Before debt relief and balance of payments lending from IBRD, IDA, IMF, and other sources

Table 10. Balance Sheet of the Central Bank of Bosnia and Herzegovina 1/

(In millions of convertible marka)

	August 11, 1997	December 31, 1997	March 31, 1998
Foreign Exchange Assets	132.6	143.5	131.1
Foreign Assets	132.6	143.5	131.1
In DM	132.6	143.5	131.1
CBBH reserves	132.6	133.5	111.1
Deposit of NBBH	0.0	10.0	20.0
In other convertible currencies	0.0	0.0	0.0
Monetary Liabilities	132.6	160.1	137.4
BH dinar banknotes outside the monetary authority	100.9	114.6	102.3
Commercial banks' convertible marka deposits at CBBH	31.7	45.5	35.0

Source: Central Bank of Bosnia and Herzegovina.

1/ Excesses of monetary liabilities over foreign exchange assets at end-December 1997 and end-March 1998 reflect the extension of credit from the Central Bank to the National Bank of Bosnia and Herzegovina, through problems in the design and operation of the interbank settlements mechanism. As part of the program to be supported by the proposed stand-by arrangement, the authorities have undertaken to put in place arrangements to avoid a recurrence of this problem.

Table 11. Bosnia and Herzegovina: External Financing Requirements and Possible Sources of Financing, 1997-1999

(In millions of US dollars)

	1997	1998	1999
Merchandise trade balance	-1,628	-2,185	-1,858
Services balance	-189	-110	62
of which, interest due	-228	-118	-99
Private transfers, net	350	290	245
Current account balance, excluding official transfers	-1,467	-2,005	-1,551
Amortization of MLT loans	-157	-117	-86
Change in arrears (- is reduction)	306	-1,497	-678
of which: Multilateral	8	-38	0
London Club	145	-741	0
Paris Club	48	-760	0
Other	105	42	-678
Change in official reserves (- is increase)	-225	-175	-75
Errors and omissions	220	0	0
Gross external financing requirement	-1,323	-3,794	-2,390
Capital transfers for reconstruction	689	1,224	918
Other official transfers, net	422	190	100
Disbursements for reconstruction	203	376	282
Foreign direct investment	0	100	200
Financing gap after project and humanitarian flows	-9	-1,904	-890
London Club rescheduling	0	810	66
World Bank adjustment lending	9	80	34
Proposed IMF stand-by arrangement	0	49	33
Residual financing gap	0	-965	-757
Additional debt relief	0	839	678
Requirement for extraordinary balance of payments assistance	0	-126	-79

Source: Bosnia and Herzegovina authorities, and Fund staff estimates.

Table 12. Bosnia and Herzegovina: External Debt and Debt Service, 1997-2005 1/ 2/
(In millions of US dollars)

	Stock of debt		Projected debt service									
	Arrears at end-1997	1997 Est.	1998	1999	2000	2001	2002	2003	2004	2005	1998-2000 Annual Average	2001-2005 Annual Average
Total debt outstanding	2,396	4,425	...	...	...	...	...	...	...	...	...	...
Total debt service	...	...	235	205	200	196	233	248	255	281	213	243
Amortization			117	106	104	90	117	117	110	125	109	112
Existing Debt (disbursed by end-1997)	2,396	3,970	117	106	104	69	67	67	67	67	109	68
Multilateral	38	1,057	2	22	21	7	25	25	25	25	15	21
IMF	0	42	0	21	21	0	0	0	0	0	14	0
World Bank 3/		971	0	0	0	6	25	25	25	0	0	16
Other	38	45	2	2	1	1	0	0	0	0	1	0
Bilateral	872	1,396	41	10	9	9	0	0	0	0	20	2
Paris Club 4/	720	789	41	10	9	9	0	0	0	0	20	2
Other bilateral	152	608	0	0	0	0	0	0	0	0	0	0
London Club 4/	741	1,121	42	42	42	42	42	42	42	42	42	42
Other creditors 4/ 5/	490	594	31	31	31	11	0	0	0	0	31	2
Non-convertible currency debt 4/	255	257	2	1	0	0	0	0	0	0	1	0
New Debt (disbursed after end-1997)	...	...	0	0	0	21	50	50	43	58	0	44
Interest			118	99	96	106	117	131	145	156	104	131
Existing Debt (disbursed by end-1997)	..	...	106	77	68	60	53	48	43	38	83	48
Multilateral	...	...	43	43	42	41	39	38	36	34	43	38
IMF	...	...	3	3	2	1	1	1	1	1	3	1
World Bank 3/	...	...	40	40	40	40	38	36	35	33	40	36
Other	...	...	0	0	0	0	0	0	0	0	0	0
Bilateral	...	...	9	1	1	1	0	0	0	0	3	0
Paris Club 4/	..	...	9	1	1	1	0	0	0	0	3	0
Other bilateral	...	...	0	0	0	0	0	0	0	0	0	0
London Club 4/	...	...	30	27	20	17	14	10	7	3	26	10
Other creditors 4/ 5/	...	...	22	6	5	2	0	0	0	0	11	0
Non-convertible currency debt 4/	...	..	1	0	0	0	0	0	0	0	0	0
New Debt (disbursed after end-1997)	...	...	12	22	29	46	64	83	102	118	21	83

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

1/ Excludes an estimated US$54 of payments arrears at end-1997 for gas supplied from the Russian Federation, which is in dispute. Also excludes about US$ 200 million of claims on BiH banks for guarantees provided for construction work not completed, which is in dispute. Includes non-allocated debt of the former SFRY allocated on he basis o f the Fund key of 13.2 percent of the non-allocated debt of the former SFRY; the authories have not yet agreed to the allocation. Includes public and publicly guaranteed debt only.
2/ The authorities reported that BiH had claims amounting to about 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, BiH has a potential claim on the former SFRY's foreign exchange reserves.
3/ Incorporates clearance of IBRD arrears on June 14, 1996, and the prepayment of unmatured loans as part of the refinancing loan.
4/ Includes late interest through end-1997 for Paris Club creditors and for London Club, and through end-1998 for other creditors and non-convertible debt creditors.
5/ Mainly commercial creditors (i.e., suppliers and trade creditors).
6/ Includes proposed stand-by arrangement.

Table 13. Bosnia and Herzegovina: Macroeconomic Scenario, 1995-2005

	1995	1996	1997 Est.	1998	1999	2000	2005	2001-05 Average
				Projections				
GDP, millions of US$	2,157	3,328	4,456	5,966	7,485	8,634	13,765	11,785
Real GDP growth, in percent	32	50	30	30	22	12	5	7
	(In percent of nominal GDP)							
Current account balance, excl. official transfers	-26	-39	-33	-34	-21	-8	-2	-3
Foreign savings 1/	15	33	28	32	19	7	1	2
Gross national savings	2	1	6	9	17	22	25	25
Government 2/	0	-4	-5	-3	-1	0	2	9
Non-government	3	4	11	12	18	22	23	16
Domestic investment 3/	18	33	34	40	36	29	25	27
Government	7	26	18	23	16	8	8	8
Non-government	10	7	16	17	21	21	17	19

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

1/ Equals current account balance less offical transfers less net factor income.
2/ General government revenue excluding foreign grants (both for reconstruction and budgetary support) less current general government expenditure (including interest obligations on foreign debt).
3/ Gross capital formation.

Bosnia and Herzegovina: Fund Relations
(As of March 31, 1998)

I. **Membership Status**: Joined 12/14/45;[1] Article XIV

II. **General Resources Account**	SDR Million	Percent of Quota
Quota	121.20	100.0
Fund holdings of currency	151.50	125.0

III. **SDR Department**:	SDR Million	Percent Allocation
Net cumulative allocation	20.48	100.0
Holdings	0.00	0.0

IV. **Outstanding Purchases and Loans**:	SDR Million	Percent of Quota
Emergency Assistance	30.30	25.0

V. **Financial Arrangements**: None

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

	Overdue	Forthcoming				
	03/31/98	1998	1999	2000	2001	2002
Principal	--	--	15.2	15.2	--	--
Charges/Interest	--	1.7	2.1	1.4	0.9	0.9
Total	--	1.7	17.3	16.6	0.9	0.9

[1] Bosnia and Herzegovina succeeded to a portion of the membership of the former Socialist Federal Republic of Yugoslavia on December 20, 1995.

VII. Exchange Arrangement

The currency of Bosnia and Herzegovina is the Convertible Marka (KM), introduced on August 11, 1997. The Convertible Marka is pegged to the deutsche mark (DM) at KM 1 = DM 1 under a currency board arrangement. Pending the issuance of KM notes, the Convertible Marka is used only as unit of account and a means of non-cash payments. The Croatian kuna is also used in the Croat-majority area, and the Yugoslav dinar is used in the Republika Srpska. The DM, which circulates widely in all areas of the country, is the currency used for operations and transactions with the Fund for Bosnia and Herzegovina, until permanent arrangements can be made regarding Bosnia and Herzegovina's currency in the Fund.

The Central Bank of Bosnia and Herzegovina does not maintain restrictions on payments for current international transactions on capital account transactions, with the exception of restrictions on transactions related to internationally-mandated economic sanctions. Corresponding regulations, however, have not yet been issued in the Entities.

VIII. Last Article IV Consultation

The first Article IV consultation with Bosnia and Herzegovina was concluded on August 26, 1996. At that time, Directors welcomed the early signs of economic recovery in response to the cessation of hostilities and the implementation of stabilization policies by each of the three separate public administrations. They urged the authorities to take action quickly after the September 1996 elections to establish cooperation among those administrations and put in place a country-wide economic adjustment program that could be supported by a Fund financial arrangement.

IX. Resident Representative

Mr. Alessandro Zanello has been the Fund's resident representative in Bosnia and Herzegovina since June 25, 1996.

X. Technical Assistance, 1995-January 1998

Department	Timing	Purpose
FAD	December 1995	Diagnostic
	February 1996	Income tax policy
	February 1996	Customs and tax administrations

	April-May 1996	Tax administration
	November 1996	Diagnostic mission to Republika Srpska
LEG	May 1996	Tax administration law
LEG/TRE/SEC	December 1995	Assistance with succession to membership
MAE	December 1995	Institution-building and banking legislation
	October 1996	Payments Bureau
	February 1997	Payments, accounting, and information systems
	June 1997	Central Bank establishment and payments system
	July 1997	Central Bank accounts and administration
	March 1998	Further Development of the Central Bank and Payment System and Introduction of Currency Notes
	April 1998	(Continuation)
MAE/EU1	June 1996	Discussion of new Central Bank
MAE/LEG	January/February 1996	Assistance from headquarters drafting legislation for new Central Bank and bank agency
	November 1996	Refinement of new Central Bank and bank agency legislation
STA	November 1995	Diagnostic participation in premembership mission

April 1996	Money and banking statistics
June 1996	Money and banking statistics
November 1996	Money and banking statistics
August 1997	Money and banking statistics
January 1998	Multisector statistics

Relations with the World Bank Group

1. Bosnia and Herzegovina became a member of the World Bank Group on April 1, 1996, after having agreed to assume its share of the loans made by the Bank to, or with the guarantee of, the Socialist Federal Republic of Yugoslavia (SFRY);[1] and having agreed with the Bank on a plan to eliminate arrears on these loans.[2]

2. In parallel with efforts towards membership and resolution of arrears, the Bank initiated, in collaboration with the government of Bosnia and Herzegovina, the IMF and international donors, preparatory efforts for a program of post-war reconstruction and economic recovery. The external financing requirement of this program was estimated at US$5.1 billion effort over 3-4 years. At three pledging conferences in December 1995, April 1996, and July 1997 —co-chaired by the European Commission and the World Bank— some 60 donor countries, multilateral institutions and other donor agencies pledged US$3.0 billion of assistance on highly concessional terms to support Bosnia and Herzegovina in the implementation of the Priority Reconstruction Program. About US$1.8 billion disbursed since the end of 1995.

3. As of February 1998, the Bank has committed US$434.6 million in support of twenty emergency operations and disbursed US$330 million or about 76.1% of its commitments. The emergency projects have supported rehabilitation and reconstruction in a wide range of sectors, including agriculture, industry, energy, water supply, transport, education and health, and have directly supported employment creation through demobilization support, micro-credit and public works. One operation, the Transition Assistance Credit, provided direct fiscal and balance of payment support for a package of institutional reforms in the Federation.

4. The Bank's strategy aims to help Bosnia and Herzegovina move from reconstruction to sustainable growth. Its overall program will have the following objectives: (I) *strengthening the institutions of macroeconomic management,* in particular, in the area of public finance; (ii) *making the transition to a market economy,* with focus on enterprise privatization and banking sector reforms; and (iii) *deepening the sustainability of reconstruction,* with particular attention to cost recovery and appropriate sector policies.

5. The Bank and the IMF have worked in very close partnership since the beginning of the reconstruction effort; regular exchange of information, joint missions and joint chairmanship of the macroeconomic sector task force in Sarajevo have benefited both institutions.

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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 related to balance of payments support where single republics could not be identified as a beneficiary.

[2] The plan involved consolidation of outstanding balances plus arrears into a package of new IBRD loans (the consolidation loan package). The consolidation loan package became effective in June 1996, paving the way for regular IDA lending.

APPENDIX II

STATUS OF BANK GROUP OPERATIONS IN BOSNIA-HERZEGOVINA

A. STATEMENT OF BANK LOANS[1]
(As of February 28, 1998)

Loan No.	Fiscal Year	Borrower	Project	US$ Million (Less Cancellations) Loan	Undisbursed
Undisbursed Loans/Credits/Grants					
IBRD[2]					
4038-BOS	1996	Bosnia and Herzegovina	Consolidation Loan A	28.6	0.0
4039-BOS	1996	Bosnia and Herzegovina	Consolidation Loan B	284.9	0.0
4040-BOS	1996	Bosnia and Herzegovina	Consolidation Loan C	307.1	0.0
			Total	620.6	0.0
			Of Which: Repaid	24.9	
			Total Now Held by the Bank:	595.7	
TFBH[3] (Under Disbursement)					
TF-024030	1996	Bosnia and Herzegovina	Emergency Recovery Credit	45.0	1.2
TF-024031	1996	Bosnia and Herzegovina	Emergency Farm Reconstruction	20.0	0.0
TF-024032	1996	Bosnia and Herzegovina	Emergency Water Supply	20.0	0.5
TF-024033	1996	Bosnia and Herzegovina	Emergency Transport	35.0	5.8
TF-024034	1996	Bosnia and Herzegovina	Emergency District Heating[4]	20.0	1.4
TF-024035	1996	Bosnia and Herzegovina	Emergency War Victims Rehabilitation	5.0	0.0
TF-024040	1996	Bosnia and Herzegovina	Emergency Education Reconstruction	5.0	0.0
			Total	150.0	8.9
IDA					
2897-BOS	1996	Bosnia and Herzegovina	Emergency Education Reconstruction	5.0	0.6
2896-BOS	1996	Bosnia and Herzegovina	Emergency War Victims Rehabilitation	5.0	5.0
2902-BOS	1996	Bosnia and Herzegovina	Emergency Housing Repair	15.0	1.3
2903-BOS	1997	Bosnia and Herzegovina	Emergency Power Reconstruction	35.6	3.3
2904-BOS	1997	Bosnia and Herzegovina	Emergency Public Works and Employment	10.0	1.7
2905-BOS	1997	Bosnia and Herzegovina	Emergency Landmines Clearance	7.5	0.9
2906-BOS	1997	Bosnia and Herzegovina	Emergency Demobilization and Reintegration	7.5	3.7
2914-BOS	1997	Bosnia and Herzegovina	Transition Assistance Credit	90.0	0.0
N001-BOS	1997	Bosnia and Herzegovina	Emergency Industry Re-Start Guarantee	10.0	0.5
N002-BOS	1997	Bosnia and Herzegovina	Emergency Microenterprise/Local Initiatives	7.0	2.6
N003-BOS	1997	Bosnia and Herzegovina	Essential Hospital Services	15.0	11.4
N0320-BOS	1997	Bosnia and Herzegovina	Transport Reconstruction II	39.0	30.0
N0350-BOS	1997	Bosnia and Herzegovina	Education Reconstruction II	11.0	9.5
3028-BOS	1997	Bosnia and Herzegovina	Reconstruction Assistance Project	11.0	15.7
3029-BOS	1997	Bosnia and Herzegovina	Emergency Natural Gas	10.0	10.0
			Total	284.6	96.2

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

[2] Consolidation Loans A, B, and C were approved on June 13, 1996 and became effective on June 14, 1996.

[3] Trust Fund for Bosnia and Herzegovina.

[4] Disbursements to date are from the Project Start-Up Advance (of which US$2 million is disbursed for Gas).

APPENDIX II

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

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

Bosnia and Herzegovina: Statistical Issues

Soon after independence, the statistical system inherited from the former SFR Yugoslavia broke up into three separate agencies, each under the control of a different regional administration. Throughout the 1992-95 war, statistical offices continued operating, albeit in a limited manner, in Sarajevo, Mostar, and Banja Luka, covering the Bosniac-, Croat-, and Serb-majority areas, respectively. Similarly, the compilation of monetary statistics was handled separately by three monetary authorities. A slow process of institutional reintegration was initiated in the wake of the 1994 Washington agreement, which ended the hostilities between the Bosniac- and Croat-majority areas and established the Federation. The Dayton peace treaty of December 1995 implicitly gave responsibility for statistical functions to the two Entities (the Federation and the Republika Srpska (RS)). However, this resulted in a lack of country-wide economic statistics in most areas, as the Federation Statistical Office and the Institute of Statistics of the RS each collect and compile macroeconomic statistics relating only to the Entity in which they are located. Following proposals made by representatives of the international community, a memorandum of understanding proposing the establishment of a streamlined central institution, which will be responsible for compiling country-wide statistics based on data produced by the two statistical institutes, was approved by the Council of Ministers on February 26, 1998.

Progress toward restoring adequate statistical capabilities has been slowed both by resource constraints and lack of inter-Entity cooperation. There has nevertheless been noteworthy progress in a few areas, especially in the compilation of monetary data. The statistical authorities are cooperating with the international community under an action plan prepared by the Statistics Department of the IMF.

As described in the staff report, a number of domestic and foreign currencies are used in domestic transactions. As a result, even abstracting from organizational issues, monetary and balance of payments statistics are subject to unusually wide margins of error.

a. Real Sector

The January 1998 STA multitopic mission has prepared a comprehensive assessment of real sector data. Since the last Article IV discussions, efforts have been made in both Entities to prepare national accounts estimates based on international standards recommended under the 1993 SNA. The staff has the impression, however, that SNA concepts are not fully applied in compiling standard national income aggregates and that recently-created private activities are under-recorded. Both Entity statistical offices continue to compile price and production indices using the end of previous year as a base instead of fixed-period bases, a practice common to most transition economies. In addition, in both Entities the composition of retail price indices is changing as items excluded during the war are incorporated into the index, including some nontradeables (e.g. rent, utilities) that were formerly provided free of charge. Information on wages and employment is restricted to socially-owned enterprises.

b. Balance of payments

No comprehensive balance of payments statistics are compiled currently by the authorities either at the Entity or the State level, and information needed for country-wide balance of payment statements estimates is assembled only at the time of EU1 missions. Trade data are available with significant delays and with gaps in coverage. Information on flows of services and private unrequited transfers remains scanty. In the meantime, monthly surveys of foreign exchange cash flows in the banking system, available for both Entities, have provided an important input for compiling country-wide balance of payments. Additional information on official unrequited transfers is obtained on an ad hoc basis from donors or relevant Entity agencies. Estimates of external debt and arrears are assembled by Fund staff from information maintained by the Central Bank and foreign creditors. The establishment of a new, country-wide Central Bank and forthcoming Fund technical assistance are expected to provide a fresh impetus toward developing balance of payments compilation capabilities within the Central Bank.

c. Government finance

The quality and timeliness of Federation government data has improved significantly during 1997, reflecting continued assistance from U.S. Treasury experts. For lower levels of governments in the Federation (i.e., cantons and municipalities), excessive reporting lags still prevail. Moreover, no comprehensive information on the operations of social security funds is available. Coverage and reliability of government data in the Republika Srpska still exhibit major shortcomings, as a result of governance problems, more limited technical assistance received, and the exodus of skilled staff from the Ministry of Finance as a result of the recent political crisis. In both Entities, governments have been unable to establish a comprehensive inventory of domestic debt and payments arrears. Finally, no government finance statistics are compiled for nationwide general government in Bosnia and Herzegovina.

d. Monetary accounts

Considerable efforts have been devoted by the Fund, during most EU1 missions in 1995-98 and five STA missions in 1996-98, in establishing an integrated system of country-wide monetary statistics meeting Fund standards. Further technical assistance in this area is required, with a particular focus on facilitating the transfer of collection and processing responsibilities from the former monetary authorities to the newly-created Research and Development Department of the Central Bank of Bosnia and Herzegovina in Pale. Future improvements in the quality of monetary statistics will be largely contingent upon the implementation of a new chart of accounts for banks reflecting modern accounting practices.

Bosnia and Herzegovina: Core Statistical Indicators

(As of March 31, 1998)

	Exchange Rates 1/	International Reserves	Central Bank Balance Sheet	Reserve Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports 2/	Current Account Balance 3/	Central Government Balance	GDP
Date of Latest Observation	Mar. 31	Mar. 31	Mar. 31	Dec. 31	Dec.31	Dec.	Feb.	Dec.	...	Dec.	1996
Date Received	Apr. 2	Apr. 10	Apr. 10	Apr. 10	Apr. 10	Apr. 2	Mar. 15	Apr 10	...	Feb. 15	...
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	...	Monthly	Biannual
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Biannual	Monthly	Monthly	...	Monthly	Biannual
Source of Update	CBBH 4/	CBBH 4/	CBBH 4/	CBBH 4/	CBBH4/	CBBH 4/	Entity Statistics Institutes	Federation Statistics Institute	...	Federation and RS Finance Ministries	Entity Statistics Institutes
Mode of Reporting	Report to Missions	Report to Missions	Report to Missions	Report to Missions	Report to Missions	Report to Missions	Publication	Publication	...	Report to Missions	Report to Missions
Confidentiality	Public	Confid-ential	Confid-ential	Confid-ential	Confid-ential	Public	Public	Public	Confid-ential	Confid-ential	Public
Frequency of Publication	Daily	NA	NA	NA	NA	NA	Monthly	Monthly	NA	NA	Biannual

1/ The convertible marka (KM) has been fixed vis-à-vis the DM at KM1 = DM1 .
2/ For the Federation only.
3/ Figures on the current account balance are rough staff estimates based on piecemeal data.
4/ CBBH is the Central Bank of Bosnia and Herzegovina.

Bosnia and Herzegovina: Proposed Stand-By Arrangement

Attached hereto is a letter dated April 21, 1998, from the Co-Chairmen and the Vice Chairman of the Council of Ministers of Bosnia and Herzegovina, the Governor of the Central Bank of Bosnia and Herzegovina, the Prime Minister and the Deputy Prime Minister and Minister of Finance of the Federation of Bosnia and Herzegovina, the Prime Minister and the Minister of Finance of the Republica Srpska, Bosnia and Herzegovina, with an attached Memorandum of Economic and Financial Policies ("Memorandum"), requesting a stand-by arrangement and setting forth:

(a) the objectives, policies, and measures that the authorities of Bosnia and Herzegovina intend to pursue for the period of this stand-by arrangement; and

(b) understandings of Bosnia and Herzegovina with the Fund regarding reviews that will be made of progress in realizing the objectives of the program and of the policies and measures that the authorities of Bosnia and Herzegovina will pursue during the period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period of 12 months from [May -----] 1998, Bosnia and Herzegovina will have the right to make purchases from the Fund in an amount equivalent to SDR [60.6] million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 24.24 million until August [15], 1998, the equivalent of SDR 36.36 million until November [15], 1998, the equivalent of SDR 42.42 million until February [15], 1999, and the equivalent of SDR 54.54 until May [15], 1999.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Bosnia and Herzegovina's currency subject to repurchase beyond 25 percent of quota.

3. Bosnia and Herzegovina will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Bosnia and Herzegovina's currency subject to repurchase beyond 25 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that:

(i) the ceiling on gross credit from the banking system to the General Government or any of the sub-ceilings on gross credit from the banking system to the State Government or to either Entity Government, as specified in Annex I to the attached Memorandum, or

(ii) the limit on the free international reserves of the Central Bank of Bosnia and Herzegovina, as specified in Annex II to the attached Memorandum, or

(iii) the limit on the contracting and guaranteeing of new external debt with an original maturity of more than one year, as specified in Annex III to the attached Memorandum, or

(iv) the limit on the contracting and guaranteeing of new external debt with an original maturity of more than one year and up to and including five years, as specified in Annex III to the attached Memorandum, or

(v) the limit on the contracting and guaranteeing of new external debt with an original maturity of less and up to one year, as specified in Annex III to the attached Memorandum, or

(vi) the floor for the reduction in external payments arrears, as specified in Annex IV to the attached Memorandum, is not observed; or

(b) if, at any time during the period of that arrangement, the Central Bank of Bosnia and Herzegovina has failed to maintain full foreign exchange cover for its domestic liabilities, as specified in paragraph 40 of the attached Memorandum; or

(c) if, at any time during the period of that arrangement, Bosnia and Herzegovina fails to fulfill its intentions regarding the non-accumulation of new external payments arrears, as specified in paragraph 40 of and in Annex IV to the attached Memorandum; or

(d) after December 31, 1998, if Bosnia and Herzegovina has failed to introduce a new uniform chart of accounts for commercial banks, as specified in paragraph 43 of the attached Memorandum; or

(e) after August [14], 1998, and November [14], 1998, respectively, until the reviews contemplated in paragraph 3 of the attached letter and in paragraph 41 of the attached Memorandum are completed; or

(f) if, at any time during the period of the stand-by arrangement, Bosnia and Herzegovina

(i) imposes or intensifies restrictions on the making of payments and transfers for current international transactions; or

(ii) introduces or modifies multiple currency practices; or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Bosnia and Herzegovina is prevented from purchasing under this stand-by arrangement because of this paragraph 3, purchases will be resumed only after consultation has taken place between the Fund and Bosnia and Herzegovina and understandings have been reached regarding the circumstances in which such purchases can be resumed.

4. Bosnia and Herzegovina will not make purchases under this stand-by arrangement during any period in which Bosnia and Herzegovina has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation (a) in respect of a noncomplying purchase pursuant to Decision No. 7842-(84/165) on the Guidelines on Corrective Action, or (b) in respect of a purchase in support of debt and debt service reduction operations pursuant to Decision No. 9331-(89/167), as amended, or (c) pursuant to subparagraph 16(a) or 33(a) of Decision No. 8955-(88/126), as amended, on the Compensatory and Contingency Financing Facility, or (d) pursuant to section 2, paragraph (f) of the Guidelines for Fund Support for Currency Stabilization Funds.

5. Bosnia and Herzegovina's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive

Director or the Managing Director, formally to suppress or to limit the eligibility of Bosnia and Herzegovina. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Bosnia and Herzegovina and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, unless, at the request of Bosnia and Herzegovina the Fund agrees to provide SDRs at the time of the purchase.

7. Bosnia and Herzegovina shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

8. (a) Bosnia and Herzegovina shall repurchase the amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Bosnia and Herzegovina's balance of payments and reserve position improves.

(b) Any reductions in Bosnia and Herzegovina's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

9. During the period of the stand-by arrangement Bosnia and Herzegovina shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Bosnia and Herzegovina or of representatives of Bosnia and Herzegovina to the Fund. Bosnia and Herzegovina shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Bosnia and Herzegovina in achieving the objectives and policies set forth in the attached letter and annexed Memorandum.

10. In accordance with paragraph 3 of the attached letter and paragraph 39 of the attached Memorandum, Bosnia and Herzegovina will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the government or whenever the Managing Director requests consultation because any of the criteria in paragraph 3 above have not been observed or because the Managing Director considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Bosnia and Herzegovina has outstanding purchases in the upper credit tranches, the government will consult with the Fund from time to time, at the initiative of the government or at the request of the Managing Director, concerning Bosnia and Herzegovina's balance of payments policies.