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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/130

10:00 a.m., December 22, 2000

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Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	**Alternate Executive Directors**
	A.S. Alosaimi
	D. Ondo Mañe
T.A. Bernes	P. Charleton
	I.M. Woolford, Temporary
	B. Siegenthaler, Temporary
B. Esdar	
	C.A.E. Sdralevich, Temporary
D.I. Djojosobroto	
	V. Bhaskar, Temporary
	J. Prader
	J. Sigurgeirsson, Temporary
K. Lissakers	M. Lundsager
	G. Bauche
A. Mirakhor	
	A. Lushin
	E. Kornitch, Temporary
	J.R. Suárez, Temporary
	S.P. Collins
	A. Maciá, Temporary
	J. Milton, Temporary
A.S. Shaalan	T. Koranchelian, Temporary
	Jin Qi
J. de Beaufort Wijnholds	
	S. Hinata, Temporary
	R. Maino, Temporary

A. Mountford, Acting Secretary
S. Djumena, Assistant

Also Present
IBRD: N.S. Gray, Europe and Central Asia Regional Office; Z. Hurtic, Office of Executive Director. European I Department: M.C. Deppler, Director; S.M. Schadler, Deputy Director; J.J. Fernandez-Ansola, G.B. Oestreicher, F.J. Rozwadowski, K. Udovicki, E.J. Zervoudakis. External Relations Department: C.N. Lotze. Fiscal Affairs Department: J.E. Ligthart. Legal Department: I. Mouysset. Policy Development and Review Department: G.R. Kincaid, B. Mukhopadhyay. Secretary's Department: L. Hubloue. Advisor to Executive Directors: N. Guetat. Assistants to Executive Directors: J.G. Borpujari, H. Hagan, F. Haupt, G. Nadali-Ataabadi, J. Nelmes, P.A. Nijsse, L. Redifer, Wei X.

1. EXECUTIVE DIRECTOR

The Executive Directors welcomed Ms. Lundsager, the new Alternate Executive Director for the United States.

2. BOSNIA AND HERZEGOVINA—STAND-BY ARRANGEMENT—REVIEW, EXTENSION, AND REPHASING OF ARRANGEMENT

The Executive Directors considered a staff paper on the fourth and fifth reviews under the Stand-By Arrangement for Bosnia and Herzegovina and requests for extension and rephasing of the arrangement (EBS/00/262, 12/8/00; and Cor. 1, 12/21/00).

Mr. Wijnholds made the following statement:

I. Introduction

The Bosnian authorities are grateful for the tireless efforts of staff, for their advice in economic policy-making and their role as a macroeconomic sparring partner. It has been a slow process at times—in unique circumstances to be sure—but results of economic reform are becoming increasingly visible. They want to particularly thank Mr. Fernandez-Ansola as outgoing mission chief and welcome Mr. Rozwadowski as his successor.

I am also pleased to inform the Board that the authorities have indicated their intention to publish the complete set of program documents.

II. Macroeconomic Stability

Monetary Policy

The currency board remains an anchor of economic stability. The downward trend in inflation and strict adherence to the currency board rules are bolstering the acceptability of the convertible marka (KM). The KM, introduced in 1997, now amounts to 59 percent of the broad money supply. The use of the deutsche mark, Croatian kuna (mainly in the Croat area of the Federation) and Yugoslav dinar (mainly in the Republika Srpska) is commensurately in decline. The share of foreign currency deposits in broad money has declined from 79 percent at end-1998 to 41 percent in September 2000. Legislation eliminating other currencies than the KM from the payments system has also been instrumental in promoting use of the KM.

Fiscal Policy

The fiscal situation in both entities, and by extension the State level to which they make transfers, is very tight. Although there were substantial overruns in pensions and wage commitments at the beginning of 2000, these were in large part reversed. Wages in the Federation were rolled back by 9 percent, and in the Republika Srpska a 33 percent wage increase was reduced to 13 percent. Both entities announced a public sector employment freeze. Similarly, earlier-announced pension increases in the Republika Srpska were also largely reversed. The resolve of the authorities to bring the fiscal program back on track is particularly noteworthy in light of the political sensitivity of the measures (there are frequent demonstrations by pensioners in particular) and given that this was an election year.

As staff notes, fiscal sustainability will require a rationalization of the tax system and major changes in the structure of expenditure. The authorities wholeheartedly agree. Significant headway has been made on the revenue side in this regard.

The authorities have undertaken a comprehensive reform of tariffs and excises and these have now been fully unified across the two entities. Long and complicated negotiations on the allocation rules for inter-entity excise revenue have recently been concluded. The unification of excises and the harmonization of tariffs have reduced the scope for tax evasion, have enhanced transparency, and have increased good governance. These measures are further enhanced by the Customs Policy Law set to be adopted this week. This law broadens the base, limits the number of duty-free zones, and restricts the location of duty-free shops to the exit side of international airports (thereby eliminating loopholes).

Sales tax reform has cut the number of rates from four to two in the Federation, limited the number of exemptions, and closely harmonized the sales tax between the entities.

A significant effort is under way to combat smuggling activities and fraud, which is of vital importance given the large shares of excises and trade tariff revenues in entity budgets. A structural problem until now had been that Bosnia had 430 different border crossings, most of which were ill-patrolled, not patrolled at all, or subject to control by local/regional authorities (which opened up the possibility of differential treatment across ethnic groups). Estimates of cigarette smuggling, in particular, are substantial. The Bosnian authorities, with the support of the donor community, are confident that the newly created State Border Police, set up at the State level, will solve many of these problems. In addition to strengthened control at the border, a revenue task force has been set up to conduct regular spot checks and raids at the retail level (i.e., retail outlets), and this is having a beneficial demonstration effect.

As the staff report notes, important remaining tax reform for 2001 lies in the area of personal income taxes, corporate income taxes, and social security contributions. The authorities have also announced their interest in moving towards a value-added tax (VAT) by July 2003. This has been highly successful in Macedonia and Croatia, two other former Yugoslav republics. The Fiscal Affairs Department is providing technical assistance in this area.

As for the expenditure side, the authorities have moved ahead forcefully on the difficult subject of military outlays. The substantial army in both entities is a legacy from the war, which in light of the extremely high unemployment rate (over 30 percent) is difficult to trim down rapidly. Although it was originally envisaged that the authorities would address the size of the military as part of a PRGF program, they have decided not to postpone this any longer. Military expenditure in both entities has been cut this year by 5 percent and military employment reduced by 15 percent.

A final important measure in the fiscal area relates to the budget process. Alongside the approval of the budget, each entity's Parliament passes a 'budget execution law,' which stipulates that budgets must be in balance on a cash basis. This prevents a carry-over of arrears from one year to the next and has generally forced a compression of expenditure towards year-end.

III. Structural Issues

The most notable progress in the structural area is in the reform of the payments system and the banking sector. As things stand now the new payments and clearing system is on track to start on January 5. A full dress rehearsal will take place on January 3 to test the capacity of the system and to test for last-minute bugs. Governor Nicholl informed me that the testing of the system has gone extremely well so far and that they are even a few weeks ahead of schedule. The banks too are enthusiastic, with 37 banks having participated in the testing so far. Although a few may fall by the way-side during the testing period, there will be more than enough banks ready to take over the domestic payments operations come January 5.

Closure of the payments bureaus will mean lower costs for banking transactions (the payments bureaus charged very high fees) and an end to the monopoly on many payment transactions (enterprises under the old system were obliged to conduct many types of transactions through the payments bureaus rather than through a commercial bank).

Coupled with the impending introduction of deposit insurance (in the Federation), increases in minimum capital requirements, the start of banks operating in both entities (one has been approved and a second has applied), and the arrival of several good foreign banks, the banking system is set to change dramatically for the better over the next two years. Banking supervision has also been forcefully established, with 18 banking licenses having been revoked in 2000 alone (leaving just 38 banks in the Federation).

Bosnia continues to rank number 1 on the Fund's trade restrictiveness index, making it one of the most open economies in the region.

Mr. Mirakhor made the following statement:

Despite a difficult political environment, the authorities of Bosnia and Herzegovina have skillfully managed to carry the reform program forward. Progress toward achieving macroeconomic stability has continued. Real GDP is projected to revive in 2000 in a low-inflation environment. External current account balance and international reserves position have improved and acceptance of convertible marka has continued to grow. In response to difficulties that had emerged in public finance, the authorities took a bold and impressive set of measures, as presented in Box 1 of the staff report, to correct expenditure policy as well as to improve tax collection. Moreover, significant progress was made on the structural front during the year including: overhauling the payments system, strengthening banking supervision, implementing important measures in the area of the labor market, and accelerating privatization. In view of the strong commitment the authorities have shown in stabilizing the economy and carrying out reforms, we have no hesitation in supporting the completion of the fourth and the fifth review under the Stand-By Arrangement (SBA) and the extension and rephasing of the arrangement. We agree with the thrust of the staff appraisal and the view that establishing a solid basis for fiscal sustainability and fostering market development should be the program's main objectives.

In the fiscal area, significant measures have already been taken toward budget consolidation and fiscal sustainability. An important step in this direction was the revision of the 2000 budget by entities aimed at maintaining macroeconomic stability while providing support for the return of refugees. The authorities are to be commended for taking immediate action to correct expenditure-policy slippages, including a temporary freeze on public sector employment, the rollback of public sector wage increases, as well as the commitment to protecting pension resources and bringing pension entitlements in line with available resources. The authorities' progress in breaking with an old budgetary practice of assuming commitments beyond available resources is welcome. Nevertheless, to achieve medium-term fiscal viability, strict implementation of the budget for 2001, as agreed with staff, is crucial. We welcome the shift from recurrent and nonproductive expenditures to capital expenditure in the composition of overall spending, as well as the authorities' commitment to maintain the wage bill at a manageable level. On the revenue side, we welcome the measures to improve excise tax collection, to better coordinate between customs and tax administrations, and to harmonize the excises between the two entities. In view of these and other revenue measures taken by the authorities, we agree with staff that revenue projections under the 2001 budget are conservative.

On monetary policy, we fully support the objective of maintaining the credibility of the Currency Board Arrangement. This arrangement has helped boost confidence in domestic currency, as evidenced by further decline in the share of foreign currency deposits in broad money. In order to provide further support for the Currency Board Arrangement, strengthening and enforcing the injunction against government borrowing from the banking system is crucial. As a further step in enhancing the monetary system, we are pleased to note that the authorities will seek to increase the free international reserves of the Central Bank in order to expand its coverage of the domestic liabilities.

On the structural front, we welcome the progress made in privatizing small enterprises and removing obstacles to privatization of large enterprises by adopting international tender regulations. The acceleration of privatization and labor market reforms aimed at providing a conducive environment to private sector activity has been among the crucial steps that need to come to completion, buttressed with the reform of the social protection system. We are pleased to note that the authorities are presently drafting a social protection strategy with support from the World Bank. The improvement of the legal and judicial system is essential for further market development. Also, staff have rightly pointed out the crucial need for proper sequencing of structural reforms. In this respect, we echo their concerns that adequate alternative treasury and tax administration services should be established before the elimination of payments bureaus. We welcome the adoption of the new payments and clearing system and its successful testing as indicated in Mr. Wijnholds's helpful statement.

In view of the enormity of the reform agenda and limited implementation capacity, Bosnia and Herzegovina needs financial and technical assistance from the international community to complete the task of reconstruction and reform of the economy. The staff projections indicate potentially large financing gaps for the second half of 2001 and for 2002, which have to be filled by external assistance. The donor community should be encouraged to extend its generous support to Bosnia and Herzegovina in the next donor conference to take place in early 2001.

Mr. Alosaimi made the following statement:

I commend the authorities of Bosnia and Herzegovina on their continued perseverance with program implementation in the face of the difficult circumstances that Mr. Wijnholds' statement rightly refers to as unique. The pursuit of Currency Board discipline with fiscal tightening and renewed structural reforms also answers to the policy priorities that emerged during the Board discussion last March. The payoff to this effort is evident in the economy's continued strong growth, in conditions of low inflation and rising external reserves. Given this background, I fully support the proposed decision for completion of the pending reviews and extension and rephasing of the Stand-By Arrangement.

Going forward, I am encouraged by staff's indications of the authorities' increased ability to reach and implement policy agreements. Continuation of this trend is clearly crucial in view of the lingering concerns over the existing administrative arrangements. Indeed, given the situation's complexities, the progress so far only provides a starting point for adjustment and reforms that will need to be extended well beyond the period of the present Stand-By Arrangement. Here, I broadly agree with the priorities laid out in the staff appraisal and will only add a few brief remarks.

The program's continued priority for further fiscal reforms is crucial. The extensive prior actions noted in Box 1 on both spending and revenue sides, as well as on reform of budgetary practices, attest to the authorities' commitment in that regard. The challenge now is to keep up the momentum and proceed with timely implementation of the agreed agenda. Containment of wage increases within productivity gains and reform of taxes, including lower rates and a broader base, are particularly important. Here, I agree with the staff to provide an adequate social safety net for workers affected by the privatization of state-owned enterprises.

On monetary policy, I share the consensus that the Currency Board and Convertible Marka Arrangements have served the economy well and should be continued. Transition from development, dependent on reconstruction assistance to a more self-sustained process, clearly hinges on speedy completion of broad-based structural reforms. In particular, early establishment of a business-conducive environment is critical for market-led growth driven by domestic and external private capital. In that context, I am encouraged by the imminence of a new payments and clearing system to replace the more expensive and restrictive payments bureau currently in place. The authorities should also heed the staff's several suggestions for reform of the legal and financial systems and privatization of state enterprises.

Further, given the country's special internal circumstances, I agree that the staff should remain engaged to help sustain the reform momentum in close collaboration with partners, including particularly the World Bank. With these remarks, I wish the authorities success in meeting the difficult challenges ahead.

Mr. Prader made the following statement:

Mr. Chairman, all performance criteria having been met and all prior actions taken, we can agree with the proposal to complete the fourth and fifth reviews of the SBA and agree to extend and rephase the arrangement. I would like to make the following points.

The staff's claim that "Bosnia and Herzegovina has continued to make progress toward achieving macroeconomic stability" may be something of an overstatement given the reality of very large increases in wages and pension entitlements in addition to spending by the ministries. It is commendable that the authorities have taken action—though apparently only under pressure from the Office of the High Representative, the World Bank, and the IMF—to correct these shocking mistakes "in large part" (Mr. Wijnholds's preliminary statement). But this sequence of events continues a rather sad history of little or no progress in coming to grips with the problems of a fragile country and economy whose sustainability is far from certain.

The nature of these mistakes, public spending commitments made to meet pre-election demands from various groups which far exceed available resources—and the country's other problems such as a high-tax economy—make it clear that Bosnia and Herzegovina must move away from a system where everything is expected from the government and foreign aid. The country must create a business-friendly environment, the lack of which till now has repelled foreign investors. At present, private business is very much at the mercy of the discretionary powers of local politicians and the bureaucracy. The private sector must be strengthened by measures that will improve the economy's competitiveness through appropriate tax and wage policies and the completion of privatization. Unfortunately, privatization has slowed, according to media reports, due both to homegrown problems and to unproductive international advice. But privatization remains the key to building a sustainable, investment-friendly economy. Privatization of the banking sector will be a very important step, but the program for privatizing it has not been completed on schedule. We acknowledge that steps have been taken towards reforming the banking sector, but the bulk of the reform work still lies ahead.

So far the economy, still bogged down in the structures and attitudes of central planning, is subsisting on foreign aid flows and other forms of artificial life support. It is extremely urgent to make the change to a self-sustaining economy based on a strong private sector because continued flows of foreign assistance can never be guaranteed. Changes in Bosnia/Herzegovina's support could come sooner than expected, whether due to donor fatigue and frustration with the lack of willingness to reform or for reasons lying beyond the authorities' control. It is certain that the present level of external support will not be sustained for very long. Prudence suggests getting ready now, rather than later, to make do with less aid. I hope the authorities will exploit this brief period of ample foreign assistance to create the legal and economic institutions of a free-market economy, establish good governance, and make the necessary changes in their economic policies.

Unfortunately, as pointed out by our former colleague, Mr. Grilli, an aid-based economy's functioning and efficiency are distorted in many ways, including inflation of public sector wages that creates disincentives for work and business in the private sector and pushing up the exchange rate past the level needed for the economy to be competitive. One might also add that the intravenous feeding of an economy with aid flows creates illusions among policy-makers and reduces their will to resist uneconomic demands.

Under these conditions, Bosnia/Herzegovina's chances of making a successful transition to a market economy do not seem very strong. We nonetheless must acknowledge and appreciate the continuing efforts—or should we say the uphill struggle—of the local authorities and the various international agencies, including the Fund, who are trying to convert Bosnia/Herzegovina into a self-sustaining country and economy under extremely difficult circumstances.

In light of these problems, we must give very high marks to the authorities, who according to Mr. Wijnholds have "moved ahead forcefully on the difficult subject of military outlays." Given recent positive changes in the FRY, this would seem a propitious moment to seek an even more rapid reduction of military expenditures. Despite the role that military spending plays in maintaining social peace during the present period of high unemployment, this opportunity for further change should not be missed.

Finally, it is most heartening to learn from the staff report that the successful completion of the prior actions shows that strong ethnic divisions can sometimes be put aside for the sake of economic necessities and the common good.

Mr. Esdar made the following statement:

The sizable overruns in the fiscal program this year are highly regrettable. Mr. Prader mentioned the aid dependence of Bosnia and Herzegovina and the consequences the resulting change in attitude has for the incentive structure in the economy, which is one of the issues which has to be addressed and is of concern. At the same time, it must be acknowledged that policy implementation has been seriously impeded by the fallout of the Kosovo crisis and the inter-ethnic rivalries. There has nevertheless been progress in certain policy areas. The firm implementation of the Currency Board regime and the growing acceptance of the convertible marka are important cornerstones of macroeconomic stabilization and should facilitate plans to modernize the payments system. On the structural front, we welcome the advances in financial sector reform and supervision, while acknowledging that the authorities are at the beginning of the process. At this juncture it is of critical importance that the authorities implement a strong package of measures to correct the slippages in the fiscal area.

As regards the Fund-supported program, we are again confronted with a high-risk program. This stems, among other reasons, from the prevailing political instability in the region. However, recent fiscal corrections have been undertaken in a difficult political climate in the run-up to the general elections. This should be taken as a promising sign that the ethnic and political division will be overcome in the spirit of economic and social reconstruction. It is against this background and in light of the comprehensive list of prior actions undertaken by the authorities that we can support today's decision.

Having said this, the challenge faced by the country to reach durable growth and a sustainable external position can hardly be overstated. Since they are addressed in well-balanced terms in the staff document, I shall only focus on two points relating to private sector activity and fiscal reform.

First, the expected decline in foreign assistance needs to be replaced by increased foreign direct investment and private sector initiative in order to finance the rebuilding of the economy. There is a need to accelerate the privatization of medium-sized and large state-owned enterprises. According to the EBRD, the privatization process has been affected by irregularities and the lack of transparency. It is, thus, crucial that the newly introduced international tendering procedures will be strictly adhered to in order to gain the confidence of foreign investors. Furthermore, as staff points out, a strengthened legal and judicial system is vital for improving the investment climate. In addition, the recent legislative moves to enhance the flexibility of the labor markets are encouraging and should be implemented expeditiously.

Second, wide-ranging fiscal reforms are critical, both to achieve fiscal sustainability and to reduce high unemployment and enhance international competitiveness. The recent measures to improve expenditure control, enhance revenue collection, and correct pension imbalances need to be sustained. We also welcome the reforms announced in Mr. Wijnholds's statement to rationalize the tariff and sales tax system to combat smuggling and to reduce military spending. In addition, we encourage the authorities to follow through with their plans for the 2001 reform to the system of income taxes and social contributions.

Mr. Sdralevich made the following statement:

At the outset, le me express our gratitude to staff for the excellent work done in very difficult circumstances. We particularly appreciate their effort to engage in wider discussions within the country, at both the political and community levels. Given Bosnia/Herzegovina's (B/H's) complex social and political structure, this approach is most appropriate and should help build the needed support for what remains a daunting adjustment and reform effort.

Despite significant delays, the Fund program with B/H is moving forward. The country has remained current on its external obligations, including those with the Fund. While the reconstruction process will demand further significant efforts and resources during the coming years, the markets' increasing confidence in B/H's future prospects begins to be a tangible phenomenon.

Against this background, and also in light of the prior actions implemented by the authorities (see Box 1), we support completion of the fourth and fifth reviews and can go along with the requested extension and rephasing of the arrangement. The release of Fund resources should in turn activate disbursements by the World Bank and some bilateral donors, which are also crucial to fill up B/H's financing gap.

Mr. Chairman, let me underline that our support comes with some reservations. We particularly regret the slippages in the fiscal area and commend the authorities for the implementation of corrective measures.

Anyway, we hope that B/H will continue on this positive course, but it is clear that the challenges ahead can be confronted only if the different ethnic groups maintain political cohesiveness and if the reform and macrostabilization agenda is addressed with ownership and determination.

Since we broadly share the staff's analysis and recommendations, I will only make a few comments.

In the long run, only fiscal discipline can help Bosnia-Herzegovina become less dependent on aid. Financial policies should continue to aim for a stringent implementation of the Currency Board rules and fiscal prudence. The difficult task here is pursuing fiscal consolidation and at the same time reforming the tax system, a process that has already been initiated. The measures aimed at lowering the tax burden and at making the tax system more efficient ought to be designed and implemented in such a way not to jeopardize medium-term fiscal sustainability.

We agree with staff that there has been progress in the reform process. Probably the most important result is on the front of the closure of the payments bureaus. They have represented one of the factors hindering the development of the banking sector in B/H, so this step is fully appropriate. Yet, the staff is right in expressing a note of caution, as it would be unfortunate if the treasury functions were not fully preserved under the new system.

In the banking sector, the authorities are to be commended for pursuing a tough strategy without hesitating when an insolvent bank must be liquidated or closed. This attitude is particularly reassuring given the centrality of having a robust banking system in the context of the Currency Board Arrangement. We have called attention in the past on the key role of the banking sector, and we continue to place much importance on it, so we join Mr. Prader in urging for progress in this field, especially in privatizing public banks.

The labor market reform is another example of success. The changes to the labor legislation mark a radical change and should contribute to increase the flexibility of the labor market, a feature that can prove particularly valuable in the context of the bank and enterprise restructuring.

In the structural field there is still much to do. With regard to privatization, the past delays should now be reversed by the authorities. We welcome the priority attached by the authorities to a number of important state-owned entities to be divested.

The social security system must be urgently reformed, especially with a view to provide an adequate safety net to the most vulnerable groups in an environment that is undergoing radical changes.

I would like to conclude by welcoming the authorities' decision to publish this report.

Ms. Koranchelian made the following statement:

Despite the difficult, but improving political environment and the insufficient institutional capacity, the performance of the Bosnian economy under the Stand-By Arrangement has been favorable. Most macroeconomic indicators have evolved satisfactorily, inflation has been maintained at low levels, growth was favorable, and official reserves have increased on account of the acceptance of the convertible marka. However, serious difficulties remain in public finances, and the outstanding agenda of structural reforms is large. To preserve the Currency Board Arrangements, the authorities need to take corrective actions in their fiscal policy. Furthermore, the reform agenda needs to be accelerated in order to maintain policy credibility.

With regard to the fiscal policy, the current stance is not sustainable. During 2000 the approved budget was not implemented. Expenditures exceeded available resources due to the substantial wage increases, larger pension entitlements, and higher spending in a number of ministries. Furthermore, the high tax rates encouraged tax evasion, aggravating the situation. We urge the authorities to take corrective measures directed at reestablishing macro stability. In this regard, government wage increases should be frozen, and expenditure management strengthened while a comprehensive reform of the tax system is undertaken by broadening the tax base, enforcing tax administration, and lowering labor tax rates to address the unemployment problem. As noted in the staff report, the authorities are aware of the fiscal problem and are committed to pursuing a course of action that will correct excesses of the current year. However, there are risks that the measures on which the authorities are relying, particularly on the expenditure side, may not be fully implemented. In this event, there would be a need to identify contingency measures, and we wonder whether such measures were discussed with the authorities.

The second challenge facing the Bosnian authorities is to press ahead with structural reforms in order to establish the necessary conditions for the development of the private sector. In particular, priority should be given to speeding up enterprise privatization. In this regard, we welcome the decision of the authorities to adopt international tender regulations and believe that this measure could increase the participation of international investors. In this connection, it is important to provide a suitable social safety net for redundant workers of the enterprises to be privatized. This should, of course, be implemented together with the labor market reform where the authorities have prepared adequate legal framework to promote labor market flexibility.

The establishment of a sound and modern financial sector should also be a priority. In this regard, we commend the authorities for their achievements in strengthening bank regulation and supervision. In particular, we note the passage of amendments to the banking laws aiming at increasing the minimum capital requirements for banks. We also urge the authorities to complete the closure of all insolvent banks and intervene in problematic banks in both entities. Furthermore, the authorities' intention to eliminate payment bureaus and transfer their clearing functions to commercial banks is commendable. The development of the RTGS and BCS systems are also positive steps toward establishing an efficient interbank system of payment. However, priority should be given to finding solutions for Treasury and tax administration services to avoid loss of budgetary control and monitoring capacity.

In view of Bosnia and Herzegovina's effort toward achieving macroeconomic stability, we support the proposed decisions and wish the authorities success in their actions.

Mr. Collins made the following statement:

We have serious concerns about the progress in Bosnia, echoing those we have heard, for example, from Mr. Prader and Mr. Esdar, among others. Not enough progress has been made in the year since Dayton to take ownership of the reform process and push ahead with transition. This will have to change as international financial support to Bosnia declines in the coming years. We are concerned about the situation in the public finances. The Bosnian authorities must accept that it will not be possible to continue the practice of increasing expenditure beyond revenue. In this regard, they must exercise restraint in wage increases. As staff contend, this not only threatens macro stability, but it also undermines the policy credibility of the government. Additionally, it undermines the belief in the Bosnian desire to commit to reform. Bosnia must now remain committed to the corrective measures which have been implemented to achieve and maintain policy credibility.

In addition, they must move quickly to reform the tax system. Both in broadening the tax base and ensuring that taxes can be collected. Bosnia must also work harder to implement the structural reform agenda. There is still a long way to go. Delays are hampering both private investment and FDI in Bosnia. The country will not be able to attract FDI unless considerable changes are made, particularly, to the legal and financial systems, especially as the amount of international support for Bosnia declines.

However, speed is not always paramount, and Bosnia must make sure that systems are put in place to ensure that the phasing out of the payments bureaus does not adversely affect budgetary control. Sequencing is important, which is well recognized in the staff report. The entities in Bosnia must work closely together to ensure policy coherence.

There is a serious risk that a delay in the provision of Fund support could result in serious damage to the economy and could be costly to reverse. For this reason, but with the reservations I have already enumerated, we are prepared to support the completion of the fourth and fifth reviews and the associated decisions.

Mr. Siegenthaler made the following statement:

Five years after Dayton, the political and economic situation in Bosnia remains extremely difficult. Immense efforts have been made in order to maintain a frail political stability in a multiethnic state. We sincerely commend these efforts and hope that the recent signs of increasing cooperation will spread in a manner that is conducive to an acceleration of economic activity. This will be all the more important because on the economic side, the financial gaps in the budget and the external accounts continue to be clearly unsustainable. For the time being, international donors are providing sufficient funds to fill these gaps. Yet we believe, like other speakers, that this support cannot and will not be kept up indefinitely. To face the anticipated deadline in the substantial foreign assistance, public and private savings will have to increase significantly.

Assessing the economic situation in Bosnia is a challenging task: first, accounting for two entities and consolidating their activities is tricky. Hopefully, strengthened cooperation and transparency will continuously improve this situation. Second, there is a substantial time lag created by the slow policy implementation under the SBA—much of what is reported seems to pertain to the first half of 2000.

I have the following remarks on policy implementation:

As regards macroeconomic policy, the monetary area continues to be a bright spot. Adherence to the Currency Board rules has helped to achieve low inflation and increasing acceptance of the convertible marka. The Currency Board remains the anchor of economic stability in Bosnia, and it is therefore important to support the Currency Board by prudent fiscal policies in order to avoid an unsustainable real exchange-rate appreciation. The corrective measures to roll back unaffordable expenditure commitments and implement the approved budgets for 2000 were indispensable in this respect. Concerning the budgets for 2001, we welcome the reduction in the high levels of military spending and the agreement to limit the rise in the wage bill. Apart from limiting expansion in civil service employment, however, the authorities have to resist any further pressure for wage increases in excess of productivity gains, in order not to jeopardize competitiveness.

As to the structural area, we are happy to note that all conditionality has been met to date. We also welcome the progress in reforming the payments system and in strengthening bank regulation and supervision. However, enterprise and bank privatization must be accelerated, as many other colleagues have already indicated. We would also like to emphasize the staff's concern regarding the legal and judicial system. Aside from the necessity to further improve inter-entity cooperation and governance, the quality of the legal and judicial environment is of utmost importance for achieving sustainable economic success. To stimulate much-needed foreign and domestic investment, the authorities' efforts to implement a comprehensive anticorruption strategy have to be strengthened and legal and institutional reforms accelerated.

We support the proposed decision and wish the authorities all the best.

Mr. Bauche made the following statement:

The last time we discussed Bosnia, this chair regretted that due to implementation slippages, the program was running under annual reviews instead of the agreed quarterly schedule. This time, the review is taking place "only" after nine months. It is difficult, though, to consider that a success.

Some progress has been recorded which indeed was difficult to obtain, given the political situation. We welcome the reinforcement of high-level administrative capacities in Bosnia.

Temptations for fiscal slippages have been resisted only because of threats to utilize blind expenditure control mechanisms, which is not a very good sign of genuine fiscal commitment. We welcome the avoidance of arrears, but a more spontaneous, rigorous budget management would be even more welcome. Still on fiscal issues, since tax rates are relatively high, combating tax evasion in both entities would deserve strong attention. Transparency will be a key element to foster confidence and improve cooperation among all levels of government.

As far as monetary policy is concerned, the Currency Board is serving the country well, and we welcome the increased use of the convertible marka. While the devaluation of the YUD has eliminated the use of that currency, the use of the Kuna in the western part of the Federation at the time of the last review remained relatively high.

On the structural side, we welcome the progress that has been recorded and support the determined but cautious approach proposed by staff, particularly as regards the closure of the payment bureaus. There is a mention of voucher privatization in the Federation. Since in other transition countries this method of privatization has shown some serious weaknesses, could staff elaborate on the reason why this scheme has been chosen? Turning to trade, we support further trade liberalization, particularly as this could help foster regional integration.

Finally, the external financing needs remain huge, and therefore continued discipline is required. The high level of international financial support deserves a stronger resolve from the authorities to implement the reforms.

Here I would like to make a few brief remarks:

I can understand the discomfort of some Directors on the speed of the reconstruction and of the adjustment process, especially when considering repeated fiscal slippages and the continued strong reliance on international support.

However, one must not forget that the situation of Bosnia is indeed unique, as stated by Mr. Wijnholds. Having witnessed the situation in Bosnia right after the Dayton agreements in 1995 when no single building in Sarajevo, Mostar had been spared by bullets and rockets, not to mention what happened in the villages in almost every part of the Federation, I consider it very positive that, despite deep ethnic divisions, progress has been achieved in the reinforcement of high-level administrative capacities and in the implementation of all structural conditionality. Therefore, I think that the authorities deserve the benefit of the doubt, and in that spirit, I support the proposed decisions, adding nevertheless that by doing so, and given that it takes two to tango, we urge the authorities to demonstrate from now on a real commitment to their program with the Fund.

Mr. Maino made the following statement:

As many other speakers before me, let me first congratulate the Bosnian authorities for the ability to maintain macroeconomic stability in an environment complicated by the Kosovo crisis. I will make four comments for emphasis.

First, we concur with Mr. Wijnholds's statement and Mr. Siegenthaler's views on the benefits arising from the Currency Board as an anchor for economic stability in Bosnia. We encourage the authorities to persevere in their monetization efforts so as to solidify the coverage of domestic currency.

Second, we remain concerned about the lack of proper credit expansion in the banking sector. Although monopoly and payments bureaus were removed in 1999, the sector is underdeveloped considerably. Bosnia should expedite the process to provide legal and institutional reforms in the banking area, aiming at lowering the risks associated with bank lending. The weak and underdeveloped banking system is an impediment for success in any stabilization effort.

Therefore, technical assistance from international financial institutions in this regard is critical. Also, we would welcome comments from the staff on the possibility of licensing commercial banks to perform payments transactions. We welcome the progress made on overhauling of the payments systems and strengthening bank supervision.

Third, we encourage the government to keep working under the umbrella provided by the World Bank's trade and transportation program in southeast Europe to favor sustained recovery of exports. It is vital to work toward coordinating and harmonizing customs and tax administration in the area, and most of all with the European Union. We call for revision of the tax system and review of the rates and tax rates basis, with the aim of helping the establishment of a competitive domestic industry.

Fourth, we concur with Mr. Mirakhor that Bosnia and Herzegovina has already taken significant measures toward budget consolidation and fiscal sustainability. We welcome the prudent expenditure controls and revenue collection measures advanced by the authorities. We would like to ask the staff about the high levels of tax evasion. Is that a consequence of high tax rates or a result of a lack of appropriate enforcement? We also would like to ask the staff whether a switch over to a private capitalization approach for the pension system is envisaged.

Finally, I agree with Mr. Prader's concerns on privatization. The challenges ahead are particularly significant in structural areas. Reforms in this realm would allow for the resumption of sustainable growth and would help reinforce the necessary conditions to foster private sector development.

Privatization could reduce the fiscal burden on the entities, but most of all it can add the much-needed productivity gains for the overall economy. Limited progress has been achieved so far in transferring public enterprises into private hands. The timing for a fruitful privatization effort is of utmost importance. A suitable regulatory framework is needed as a precondition for successful open voucher auctions. We wish the authorities success in their future endeavors.

Ms. Kornitch made the following statement:

At the outset I would like to thank the staff for the well-focused report prepared for this discussion. Also, I would like to thank Mr. Wijnholds for his helpful preliminary statement.

I am encouraged by the progress achieved by the Bosnian authorities on the way towards economic stabilization and recovery from the external shocks. Despite a number of external shocks and internal problems, the authorities have demonstrated their commitment to prudent macroeconomic policy implementation. The economy is continuing to grow at a sustainable rate, inflation remains under control, and external position is strengthening. Currency Board Arrangement continues to work successfully as an anchor of financial stability, and the confidence in the convertible marka (KM) has increased. However, major challenges remain before the Bosnian authorities, specifically in the fiscal area and in the field of structural reforms, and the program provides an appropriate framework for addressing existing imbalances.

As I am in broad agreement with the staff appraisal, I would like to highlight only a few policy areas.

Fiscal Policy

Serious problems emerged on the fiscal front at the beginning of 2000 due to wage increases not envisaged by the approved budget, larger transfers to the pension fund, higher external debt repayments, and higher spending on refugees and displaced persons. In addition, revenue performance in the Federation has suffered from increasing tax evasion. The authorities are to be commended for taking corrective measures to bring fiscal position to a more sustainable footing. These measures include those directed to strengthening expenditure control, enhancing revenue collection, and correcting pension imbalances. I urge the authorities to continue their efforts in these areas.

I am also pleased to know that the authorities have made some progress in improving fiscal transparency.

Monetary Policy

With respect to the monetary policy, I go along with the view that Currency Board Arrangement has served the economy well and should be maintained. To preserve stability of the Currency Board Arrangement, the authorities should continue to enforce the injunction against borrowing from the banking system by any level of government.

Structural Reforms

Much remains to be done in the area of structural reforms. The priorities are rightly specified in the program, and the authorities should remain committed to the envisaged structural reform agenda. The main objectives in this field are establishing market mechanisms and improving the environment for private sector activity. I welcome the progress achieved so far in small enterprise privatization and in preparing large enterprises for privatization. I believe that the privatization process should be accelerated and implemented on a transparent basis to avoid any shortcomings.

The progress in implementing reform of the payments system and undertaking measures to strengthen bank supervision are also very much welcome.

With these remarks I support the proposed decision and wish the authorities every success.

Ms. Lundsager made the following statement:

Donors, creditors, and international institutions remain committed to working closely together to restore the productive base, promoting rapid economic growth, and fostering macroeconomic stability in Bosnia. Intensive coordination has brought about numerous positive changes, and we join others in recognizing that the capacity for effective economic policy implementation has improved, with the result that growth has improved. But, as noted by Mr. Prader and others, this paradigm must change if a viable private-sector-based economy is to emerge.

Among the positive developments, the Currency Board has generated monetary stability, enhancing domestic confidence as demand for domestic currency increased. We also noted the progress made earlier in the year on the structural front, particularly in overhauling the domestic payments system and starting to improve bank supervision. We also welcome the announced reduction in military spending in each entity.

Yet while improved in some areas, policy implementation continues to seesaw, as excessive wage increases and transfers to the pension fund were later rolled back due to lack of financing. As financing dried up, payments were not made. This policy drama can only undermine the credibility of the authorities and further postpone the restoration of economic stability and, importantly, full ownership on the part of the public of the economic program. In this vein, we noted that tax evasion is increasing, not decreasing, in the Federation and remains a serious problem in the RS as well, although Mr. Wijnholds pointed to the tariff and tax reforms as vehicles for reducing the incentives for tax evasion.

Competitiveness is highlighted as a concern in the staff report, and we would be interested in staff comments regarding figure 2. Although the Real Effective Exchange Rate (REER) for the RS has remained unchanged this year, it remains quite appreciated compared to the base year, to the Federation, and to other countries. Also, the current account projections made in the medium-term outlook are not particularly encouraging in this regard. The implications we draw are that more rapid restructuring, privatization, and deregulation are needed to promote a stronger impetus to the productive sectors, including exports. This will also have the benefit of creating employment. Finally, these changes could perhaps bring about a change in investor sentiment over time and attract more foreign investment beyond that expected from the upcoming privatizations.

Current account viability will not emerge, however, if policy slippages continue. This year, backsliding and other problems in fiscal policy, labor market reform, and enterprise and bank privatization significantly delayed Board consideration of these reviews and thus have delayed moving on to the next stage of the reform agenda. The labor reform proposals are now nearing completion, and we would welcome a staff assessment as to whether these will generate the sought-after flexibility or if additional labor reforms will need to be prepared. Obviously, the complement of a sound social safety net is needed to complete the package as well, and we wonder if the timetable presented is timely enough to provide the needed underpinning to privatization and labor market reform. The slow pace of privatizing or liquidating state owned-banks is also a concern, but we note the link to the World Bank credit and hope that spurs further speedy action.

Regarding trade reform, we are not particularly satisfied with the imposition of the export tax on lumber but noted that it is an intermediate step, replacing an export ban. We urge this intermediate step to be of short duration and took note of Mr. Wijnholds' comments on the overall openness of this economy.

Finally, on the budgetary/financing matters, we noted in paragraph 39 that Fund financing is being utilized for budgetary support, along with donor contributions. We had generally thought of Fund financing as providing support to official reserves, not funding Central Bank support of fiscal deficits. Let me add here that we welcome the authorities' intent to continue to place half of each drawing in their SDR account at the IMF. Therefore I am a bit confused as to the use of Fund financial support and would appreciate clarification. Does the Fund financing, with its simultaneous creation of a Central Bank liability create the scope for budgetary financing?

Also, the budgets for 2001, while they agreed with the staff, have yet to be approved by the Parliaments, with the recent elections meaning that the new government has not yet been formed or the Parliaments convened. Therefore, we are concerned that we do not have in place a concrete budgetary policy for the fiscal year beginning in just 10 days. We know that there are strict limits placed on the government's ability to spend, but with significant policy slippages occurring this past year, we are not confident that we will see steady policy implementation without full domestic approval of the budget. We would have much preferred to have this Board review in the new year, giving the new authorities time to garner approval from the new Parliaments for the policy stance they plan to pursue.

For these reasons we have strong reservations about going forward with disbursements at this time and wish to be recorded as abstaining on this program review.

Mr. Macia made the following statement:

The authorities have been successful in sustaining a tight macroeconomic stance, continuing the recovery from war devastation, and possibly reaching a 10 percent GDP growth for end-2000. Drought has affected production, but industrial output has maintained its pace while traditional industries still operate at medium levels from the prewar period. Inflation has had a mixed behavior, as the Republika Srpska, being the most affected in its agricultural sector, reflects a higher inflation than the Federation. The budget confronted lower revenues combined with salary increases, additional transfers to the pension fund, and larger allocations for refugees and displaced persons. Strict cash management has been imposed, and restraints in spending and a budget revision were implemented as part of the fiscal correction efforts.

Private sector credit remains limited, with little provision for financial intermediation services. Given the thrust in economic growth, there is an increasing demand for the convertible marka since the second half of 1999, and domestic currency holdings have increased as a result of the strengthening of official reserves that have increased to about two and a half months of import cover at end-2000. Inflows of concessional foreign assistance remain large, and competitiveness remains crucial to recovery, a condition that has been assisted by the depreciation of the real effective exchange rate (REER) of both currencies.

The entities have made progress on structural issues, namely, the financial sector has moved forward to implement the payments clearing system; bank regulation and supervision have been strengthened; and the authorities have pursued the revision of bank licenses. In privatization, tenders in banks and enterprises including the airlines should open private sector investment opportunities and must be moved ahead expeditiously. Gains in tax administration include improved collection efforts, controls on tax evasion, and border smuggling.

In addition, prospective reforms on trade and sales tax, a broadening of the tax base, and rationalization of tax rates are challenges to tackle promptly. Reforms to the legal framework in the labor market and future controls on wages based on productivity measures and revision of the labor tax should promote private sector growth and employment opportunities.

The financing requirements and reconstruction will continue to depend heavily on donors, external assistance, and inflows of private capital. The donors' conference early 2001 is deemed crucial to assure the financing gaps expected in 2001–02. The authorities are committed to imposing sustained growth efforts with strong macroeconomic policies and structural reforms, providing for a larger private-sector driven economy, and improving overall competitiveness in the productive sectors.

Under the above analysis, we concur with the staff's recommendation to conclude with the pending reviews, the extension of the Stand-By Arrangement, and the rephasing of the remaining disbursements.

Mr. Hinata made the following statement:

Bosnia and Herzegovina's economy has performed well under the Stand-By Arrangement. Real GDP growth has been high and inflation low, and there has been an increase in international reserves. All the performance criteria at end-June were achieved. However, I am disappointed that the fiscal balance deteriorated because of an increase in wages beyond the budgeted level and an unexpected increase in pension benefits due to political pressure. There was also a delay in structural reform, including in the financial sector and in the privatization of public enterprises. I think this shows that the authorities still face a number of political, implemental, and social risks, and they should therefore redouble their efforts to establish fiscal sustainability and to create a foundation for a sound banking system and other structural reforms.

This chair broadly agrees with the thrust of the staff appraisal but would like to make a few comments on fiscal policy and structural reform, which we think are most important.

On fiscal policy, it is important to strengthen fiscal discipline and pursue fiscal consolidation, in light of the adoption of the Currency Board Arrangement and the need to largely cover the fiscal deficit through donor support. In particular, the fact that both entities spent more than the 2000 budget calls for strengthening expenditure control and compressing recurrent and nonproduct expenditures. In this context, I commend the authorities for having improved their monitoring of expenditures and for their commitment to reducing military expenditures and using the money saved for high priority investment and reconstruction. I hope the authorities will implement these measures decisively.

On the structural reform front, Bosnia and Herzegovina currently depends to a large degree on donor support, which is declining. That said, as staff pointed out, facilitating exports is important not only for improving the balance of payments position but also for achieving sustainable economic growth. In this regard, I urge the authorities to further promote the country's international competitiveness as well as improve the business environment through privatization and labor market, financial sector, and judicial reform.

With these remarks, I support the proposed decision and wish the authorities well in their future endeavors.

Mr. Wei made the following statement:

First of all I would like to thank staff for the detailed report and Mr. Wijnholds for providing us with the latest economic developments and policy measures.

As Mr. Wijnholds indicates in his preliminary statement, "the results of economic reform are becoming increasingly visible." We are glad to see the encouraging developments of the reforms, such as adherence to Currency Board rules, rapid real GDP growth, low inflation, greater acceptance of the convertible marka, progress in establishing the payment system, and banking sector reform. Especially, I would like to commend the authorities for their resolve in taking corrective measures to reign in excessive expenditure. As fiscal discipline is crucial to maintaining macroeconomic stability and achieving policy credibility in the country, we welcome the authorities' forthcoming measures on structural reform and on the fiscal front to maintain fiscal sustainability, and we support the thrust of the staff appraisal.

The big challenge facing the country seems to be unemployment—as mentioned by Mr. Wijnholds, the unemployment rate is as high as 30 percent;

the country is relocating returning refugees; and state enterprise privatization is expected to generate laid-off workers. I would like staff to elaborate on the authorities' plans to solve this problem and the likely effectiveness of these plans.

I share Mr. Mirakhor's opinion that the reform agenda is enormous, as the authorities are constrained financially, and financial and technical assistance from the international community is much needed. I support the authorities' request for the conclusion of the fourth and fifth review and an extension and rephasing of the Stand-By Arrangement. I would also like to wish the authorities success in fulfilling their commitments.

The staff representative from the European I Department made the following statement:

While it is true that the uncertainty in the budget is particularly high on the revenue side, staff have adopted a two-pronged approach in this program to handle that issue. First, the revenue estimates that we have agreed with the authorities are on the conservative side, which creates a buffer. Second, as is the normal practice in Bosnia, we intend to reopen the budget at midyear with the authorities in the context of either a Board review, or possibly a new program. For last year that means carrying out a rebalancing of the budget, taking into account six months of further information on tax receipts and external financing.

On the licensing of commercial banks, all is in place for the clearing functions of the payments bureaus to be taken over by the commercial banks, and the intention of the Central Bank is to have the new clearing mechanism in place on January 5, 2001. On January 3, 2001, the authorities intend to carry out a dress rehearsal for the new clearing system. A number of commercial banks have been licensed, and as an interim measure, those banks that do not have licenses will be able to piggyback on banks that are licensed. Therefore, in the assessment of the Central Bank, a critical mass of banks is in place.

On whether tax evasion was due to high rates or to poor enforcement, the answer is both. Tax rates are high, particularly for indirect taxes, and there is a high imposition on labor income; enforcement problems also exist.

In the area of pensions, at this stage plans are not afoot to switch to a funded pension system. The pension reform has focused on ensuring that pension entitlements are kept in line with available resources. The next important step will be to strengthen collection by broadening the base and lowering the rates.

> Competitiveness is an issue in general. It is an issue in the Republika Srpska, in particular, and it is an issue that staff need to keep an eye on. However, the message that is given by the figure in the staff report is skewed by the fact that the base for those graphs is 1994, which is possibly not the right year, given that the war was still going on. In subsequent reports, we will change the base.
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> As regards concerns about the assurances that we have about the budget for 2001, staff also has concerns about that. We decided that given that it was important to move ahead with the program and with the review, we needed to find a way to address that concern. Therefore, we approached the leaders of the major opposition parties in both entities and obtained written assurances that they would, as members of a new government, implement the policies in the letter of intent, which they had been provided in advance. They would also work to ensure that the draft budgets prepared by the outgoing government would pass through Parliament.
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> On the question of the use of Fund resources for budgetary support, this is also the case in a number of other countries, particularly countries with Currency Boards and fixed exchange rate regimes. In Bosnia the fiscal agent is not the Central Bank but the government, i.e., the Ministry of Foreign Trade and Economic Relations of the State. It is that ministry that effects the purchase of Fund resources and leaves half of those in the SDR account. The remaining half is divided between the two entity governments.
>
> The labor reforms address the most severe problems in the labor market. This is a significant reform, and I expect that it will have a major impact quickly. The labor reforms create a more streamlined and flexible labor market with respect to the hiring and firing of employees. The reforms are also supported by a framework that defines unemployment benefits which are consistent with the resources available by the State.

The staff representative from the Policy Development and Review Department explained that the Fund's fiscal agent was the government in the Bosnian case, because the Central Bank had not been established at the time of membership. Fund support for the budget, and for international reserves, which were held in the SDR account at the Fund, had been a feature of the program with Bosnia since it was approved by the Board two and-a-half years ago and was therefore not a new development.

The staff representative from the World Bank made the following statement:

> In terms of privatization, the way the program was set out was to start with small-scale privatization and later move into the medium scale. It is true that this has developed more slowly than expected, but there has been a recent increase in the number of privatizations regarding small-scale privatization in the Federation. In total 133 enterprises have been privatized, with the target

under the Bank's adjustment credit being 150. In the Republika Srpska, 49 enterprises have been privatized, which was above the target. In the Federation, more small-scale enterprises than specified in the target have also been liquidated.

On the larger scale enterprises, the concern has been to ensure that the tender procedures are carried out in a transparent manner. Also, problems with ensuring that strategic investors exist that can take over these enterprises have been resolved. Additionally, we expect improvements in medium-scale enterprise privatizations in the near future.

Bank privatization has been a problem, particularly in the Federation. After difficult negotiations with the government, particularly concerning the largest bank group in the Federation, an agreed strategy was reached on October 19, 2000, which provides for liquidation for insolvent members of the banking group.

The labor market reforms and new legislation significantly increase the flexibility in the labor market and have helped the authorities' strategy to improve private sector development and to create greenfield new investment opportunities. The labor market reforms were part of a two-stage strategy on social sector reforms, with the second stage being further reforms to social protection and safety nets. Under the first stage, the Bank had reached agreement with the government on social protection strategies, but this needs to be fleshed out in terms of specifying necessary regulatory and legal reforms in order to implement the social protection strategies. This is envisaged in the follow-up credit under the Bank's country assistance strategy, SOSAC II. It is part of an ongoing program of social sector reform. The Bank is open to working with the authorities and looking at whether any further budget assistance in the Bank's adjustment credits could help in the privatization process, specifically the problem of layoffs during privatization.

On the FRY and the possibilities of increased trade, the trade facilitation loan and the harmonization of customs is scheduled for discussion at the Bank Board in February 2001. That is part of an initial six-country initiative, of which Bosnia is the final one. All Board conditions have been met, and I expect that once a program with the FRY is implemented, trade facilitation will be one of the key elements in the program.

Mr. Prader noted that lending funds directly to the Russian Ministry of Finance had been controversial and embarrassing for the Fund. He asked why the Fund had not learned from that experience, also with regard to cases like Bosnia.

The Acting Chairman said that that was an issue for future discussion. Russia and Bosnia had not been the only cases where the question of the use of Fund money had arisen.

Another example was Turkey, where the possibility of helping to deal with the costs of banking sector problems had been considered. In general, that was a complicated issue.

Mr. Collins said that it was a technicality whether the fiscal agent was the Central Bank or the central government. A program could always be constructed to enable the Central Bank to advance money to the government to finance the budget deficit, if that was the way in which the external financing gap was manifested in the economy.

The Acting Chairman suggested holding that discussion on another occasion and added that a program could not easily be constructed when strong laws prevented the Central Bank from financing the government in either the primary or the secondary market.

Mr. Wijnholds made the following concluding remarks:

> I would like to thank Directors for their comments, Mr. Mirakhor for his statement, and others Directors for their oral statements which are helpful and will be transmitted to the authorities. It is a platitude to say that the case of Bosnia and Herzegovina is difficult, but the situation is improving, and some encouraging signs exist. The challenge now is to keep up the momentum, and Fund and Bank involvement are crucial for that process.
>
> I agree that a falloff in external aid may occur in the coming period, and as other cases emerge, a loss of interest in Bosnia may take place. Therefore, it is important that the reform process is maintained and even speeded up in order to ensure that the country is able to implement more on its own. While that process is still ongoing, it needs to be reinforced.
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> It was recognized in general by Directors that the Currency Board is functioning well. That is a success, and the authorities are now moving on with the reform of the payments system. Weaknesses in the fiscal area still exist, and Directors' warnings in this area will be passed on to the authorities. We look forward to continuing to work closely with the Bosnian authorities and the staff. We hope to come back to the Board next year with further progress, so that Bosnia can move on to a PRGF.

The Acting Chairman made the following summing up:

> Executive Directors noted that fiscal restraint and strict adherence to the rules of the Currency Board have resulted in considerable progress toward macroeconomic stability and country-wide acceptance of the convertible marka. They emphasized the importance of continuing the stabilization effort into 2001, including through the maintenance of the present policy of not borrowing domestically to finance the budget.
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> Directors expressed serious concern over the fiscal slippages in early 2000, notably the unsustainably high increases in wages and pensions as

well as other expenditure overruns. They commended the authorities on the partial reversal of these wage and pension increases but stressed that such stop-go actions were disruptive. They recommended that the authorities avoid sudden unwarranted policy shifts in the future and promote stabilization and the maintenance of a viable external position by limiting wage increases to levels justified by productivity growth.

Directors considered the overall fiscal stance in the 2001 budgets to be appropriate. They noted, however, that the share of expenditure allocated to capital formation remains very small and cautioned that it will have to rise over the medium term to compensate for expected declines in foreign-financed reconstruction projects. The forthcoming reform of the social welfare system and the expected decrease in military expenditure in both entities in 2001 were seen as important first steps to shift expenditures toward productive investments. One Director expressed concern that the Board discussion was taking place before the budgets for 2001 had been passed by the relevant legislatures.

Directors commended the authorities for their commitment to increase transparency and control over the budget through the establishment of State-, entity-, and canton-level treasuries and to bring all military expenditure on-budget by 2002. Noting that the high tax rates in Bosnia and Herzegovina encourage tax evasion and inhibit business investment, Directors urged the authorities to follow through with reforms to broaden the tax base, improve collection, and rationalize and reduce tax rates. They supported the authorities' efforts to combat smuggling and fraud.

With regard to financial sector reforms, Directors noted that financial intermediation in Bosnia and Herzegovina remains severely hindered by an inadequate legal environment that makes loan collection and the taking of collateral difficult, and they urged the authorities to work toward resolving this situation.

Directors stressed the importance of a successful launch in early 2001 of the new payments and clearing mechanism and were encouraged by the positive test results so far.

Directors noted that despite the significant success achieved with small-enterprise privatization, the largest and most important commercial enterprises remain under State control. They welcomed the progress achieved to date in preparing a transparent framework for large-scale privatization, including the adoption in both entities of international tendering rules and the involvement of major donors in the process, and they encouraged the authorities to privatize the large state-owned enterprises. Directors also commended the authorities for the significant advances made so far with respect to labor market reform. They hoped that the recent passage of key legislation in this area will contribute to creating an environment that is conducive to private sector development and to increased investor interest in the privatization process. Directors strongly welcomed the authorities' commitment to intensify their efforts to fight corruption at all levels of government, noting that good governance is key to preserving internal and external confidence in their reform program.

Directors welcomed the authorities' intention to publish the staff report and the Letter of Intent.

The Executive Board took the following decision:

1. Bosnia and Herzegovina has consulted with the Fund in accordance with paragraph 3(f) of the Stand-By Arrangement for Bosnia and Herzegovina (EBS/98/78, Sup.1, 6/2/98) as amended, and paragraph 3 of the letter 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 Republika Srpska, Bosnia and Herzegovina, dated April 21, 1998.

2. The letter from the 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 Republika Srpska, Bosnia and Herzegovina dated December 4, 2000 and its Annexes shall be attached to the Stand-By Arrangement, and the letter dated April 21, 1998, as supplemented, shall be read as supplemented and modified by the letter dated December 4, 2000, together with its Annexes.

3. Accordingly, the Stand-By Arrangement for Bosnia and Herzegovina shall be modified in the following manner:

(a) Paragraph 1 shall be modified to read as follows:

"For the period of 36 months from May 29, 1998, Bosnia and Herzegovina will have the right to make purchases from the Fund in an amount equivalent to SDR 94.42 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund."

(b) Paragraph 2(a) shall be modified to read as follows:

"Purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 24.24 million until June 28, 1999, the equivalent of SDR 53. 27 million until February 15, 2000, the equivalent of SDR 64.27 million until May 15, 2000, the equivalent of SDR 72.35 million until August 15, 2000, the equivalent of SDR 80.43 million until February 15, 2001, and the equivalent of SDR 88.51 million until May 15, 2001."

(c) The performance criteria set out in paragraphs 3(a)(i) through 3(a)(vi) of the Stand-By Arrangement for end-December 2000 and end-March 2001 shall be as specified in Annexes II, III, IV, and V to the letter dated December 4, 2000.

(d) Paragraph 3(e) shall be modified to read as follows:

"After August 14, 1998, September 14, 1999, December 14, 1999, May 14, 2000, August 14, 2000, February 14, 2001, and May 14, 2001, until the reviews respectively contemplated in paragraph 3 of the letter dated April 21, 1998, and paragraph 41 of its attached memorandum, in paragraph 19 of the letter of February 23, 2000, and its Annex I, in Annex I of the letter of December 4, 2000, are completed; or"

4. The Fund decides that the fourth and fifth reviews contemplated in paragraph 3(e) of the Stand-By Arrangement for Bosnia and Herzegovina are completed, and that Bosnia and Herzegovina may continue to make purchases in accordance with the provisions of the Arrangement, on the condition that the information provided by Bosnia and Herzegovina on the implementation of the measures specified in Table 1 attached to the letter dated December 4, 2000, is accurate. (EBS/00/262, 12/8/00)

Decision No. 12386-(00/130), adopted
December 22, 2000

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/129 (12/21/00) and EBM/00/130 (12/22/00).

3. PRGF TRUST—AMENDMENT

The International Monetary Fund (the "Fund"), in its capacity as Trustee of the Poverty Reduction and Growth Facility (PRGF) Trust, approves the amendments to the borrowing agreements between the Fund and the lenders to the Loan Account of the PRGF Trust, and their related annexes, as enumerated below, and authorizes the Managing Director to take such action as is necessary to conclude and implement the amendments:

1. The references to the interest rates on domestic instruments in:

paragraph 4(a)(i) of the borrowing agreement with the National Bank of Belgium effective July 2, 1999;

paragraph 4(a)(i) of the borrowing agreements with the Government of Canada effective May 9, 1995 and April 6, 2000;

paragraph 4(a)(i) of the borrowing agreement with the Government of China effective July 5, 1994;

paragraph 3(a)(i) of the borrowing agreement with the National Bank of Denmark effective May 3, 2000;

paragraph 4(a)(i) of the borrowing agreement with the Central Bank of Egypt effective June 13, 1994;

paragraph 5(b)(i) of the borrowing agreement with the Agence Française de Développement effective on April 5, 1988, and paragraph 5(a)(i) of the borrowing agreements with the Agence Française de Développement effective January 3, 1995 and December 17, 1999;

paragraph 4(a)(i) of the borrowing agreements with the Bank of Italy effective October 4, 1990, May 29, 1998, and March 1, 2000;

paragraph 6(b)(i) of the borrowing agreements with the Japan Bank for International Cooperation effective April 12, 1988, and October 5, 1994;

paragraph 4(a)(i) of the borrowing agreements with the Bank of Korea effective April 20, 1989, and June 20, 1994;

paragraph 4(a)(i) of the borrowing agreement with the Bank of the Netherlands effective September 29, 1999;

paragraph 4(a)(i) of the borrowing agreements with the Bank of Norway effective April 14, 1988, and June 16, 1994;

paragraph 4(a)(i) of the borrowing agreement with the OPEC Fund for International Development effective December 20, 1994;

paragraph 4(a)(i) of the borrowing agreements with the Bank of Spain effective June 20, 1988, and February 14, 2000; and

paragraph 4(a)(i) of the borrowing agreement with the Swiss National Bank effective June 22, 1995, shall be amended to read as follows:

the bond equivalent yield for six-month U.S. Treasury bills, the six-month euro interbank offered rate (Euribor), the bond equivalent yield on six-month Japanese treasury bills, the six-month interbank rate in the United Kingdom, and…"

2. In the borrowing agreements with the Agence Française de Développement, all references to the text "euros (as the currency of France and Germany)" shall be changed to read "euros."

3. In the borrowing agreements and exchange of letters with the Japan Bank for International Cooperation, all references to "the percentage weight of the euro component of the SDR" made in regard to the former deutsche mark and French franc components of the SDR valuation basket shall be understood to mean solely "the percentage weight of the euro component of the SDR."

4. In the borrowing agreement with the Kreditanstalt für Wiederaufbau effective March 31, 1989:

Paragraph 4(a)(i) shall be amended to read as follows:

"U.S. dollar – Libor, the euro – Euribor, Japanese yen – Libor, as well as pound sterling – Libor, as defined in the Annex to this agreement, and…"

5. In the borrowing agreements with the Kreditanstalt für Wiederaufbau, and related Annexes, effective May 17, 1995, and June 19, 2000:

(i) Paragraph 4(a)(i) shall be amended to read as follows:

"U.S. dollar-rate on six-month certificates of deposit, the euro – Euribor, Japanese yen – Libor, as well as pound sterling – Libor, as defined in the Annex to this agreement; and…"

(ii) Paragraph 1(b) of the Annex shall be amended to read as follows:

"(b) **Euro—Euribor**:

means the rate at which euro interbank term deposits are offered for a period of six months within the European Monetary Union zone by one prime bank to another at 11:00 a.m. Brussels time."

(iii) Paragraph 1 (c) of the Annex shall be deleted.

6. In the borrowing agreements with the Kreditanstalt für Wiederaufbau, all references to the text "the euro as the currency of Germany and France, respectively" shall be changed to read "euros." (EBS/00/275, 12/19/00)

Decision No. 12387-(00/130) PRGF, adopted
December 21, 2000

4. REPUBLIC OF MOLDOVA—POVERTY REDUCTION AND GROWTH FACILITY—THREE-YEAR ARRANGEMENT

Pursuant to paragraph 3 of the decision, dated December 15, 2000 (EBS/00/249, Correction 1), the Fund decides that the World Bank has concluded that the Interim PRSP submitted by the Republic of Moldova provides a sound basis for the development of a fully participatory PRSP and for Bank concessional financial assistance. Accordingly, the approval of the three-year PRGF arrangement for the Republic of Moldova as set forth in EBS/00/249, shall become effective on the date of this decision. (EBS/00/249, Sup. 2, 12/20/00)

Decision No. 12388-(00/130), adopted
December 21, 2000

5. SÃO TOMÉ AND PRÍNCIPE—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—DECISION POINT

Pursuant to Paragraph 2 of the decision adopted in principle on December 19, 2000, set forth in EBS/00/254 (Sup. 1, 12/20/00), the Fund decides that the World Bank has concluded that São Tomé and Príncipe has reached its Decision Point under the enhanced HIPC Initiative. Accordingly, Paragraph 1 of the decision adopted on December 19, 2000, as set forth in EBS/00/254 (Sup. 1, 12/20/00) shall become effective on the date of this decision. (EBS/00/254, Sup. 2, 12/20/00)

Decision No. 12389-(00/130), adopted
December 21, 2000

APPROVAL: June 14, 2001

SHAILENDRA J. ANJARIA
Secretary