INTERNATIONAL MONETARY FUND

BOSNIA AND HERZEGOVINA

2004 Article IV Consultation

Mission Concluding Statement

December 17, 2003

I. BACKGROUND

1. **Bosnia and Herzegovina has made major progress since 1995.** Real GDP has trebled, merchandise exports have increased ninefold, and international reserves have risen to provide four months of import cover. Backed by the currency board, inflation has stabilized at industrial country levels, and the overall fiscal balance has improved from a deficit of 9 percent of GDP in 1999 to a small surplus in 2003. The banking system has been almost completely privatized and about 50 percent of output now originates from the private sector. And perhaps the greatest symbol of progress is that many external refugees have returned, internally displaced people have returned to their former residences in numbers, and people again feel free to move throughout the country, even as the international security presence is scaled back (Table 1).

2. **Moreover, four major reform initiatives are about to commence**: a new framework for indirect taxation; a reorganization of domestic claims on government; defense reforms; and a raft of measures under the 6-month Action plan and PRSP. And with the new board for the CBBH installed smoothly in August, the institution at the heart of Bosnia and Herzegovina's macroeconomic framework, the currency board, has been secured. All this has been reflected in the good progress under the Stand-By Arrangement through mid-2003, and it marks concrete progress towards your aspiration to secure eventual EU accession.

II. MEDIUM-TERM MACROECONOMIC REFORM AGENDA

3. **But the recovery of activity is essentially no more than a peace dividend which, however welcome, leaves a legacy of major macroeconomic imbalances.** We estimate your external current account deficit at 18 percent of GDP, unemployment likely exceeds 20 percent with much higher rates among young people, and loss-making and wage arrears remain widespread in the corporate sector, particularly amongst large state owned and voucher-privatized companies. These imbalances are symptomatic of fundamental structural weaknesses. Key amongst these is that enterprise managers face distorted incentive structures: simply put, the bulk of managers in state owned and voucher privatized firms appear not to seek profits for their shareholders. This underlies and is symptomatic of a culture of non-payment—of wages, of debts to suppliers, of taxes, and of an appropriate return on capital. Unless these weaknesses are corrected, they will frustrate your hopes for growth and jobs.

4. **These challenges will be compounded by ongoing adverse shocks.** Foreign aid will continue to decline significantly over the medium term as the reconstruction era ends, and remittances from abroad could decline as refugees return. The reduction in external inflows will reduce the financing for imports and force a significant decline in the current account deficit. And the return of refugees will increase the supply of labor, aggravating unemployment problems, at least in the short run.

5. **In this context, the core challenge is to sustain growth while securing external adjustment**. Both goals will be realized through structural reforms. These will raise new investment, productivity and output as well as increasing domestic savings. The scale of the task is daunting: allowing for the gross inadequacies of the macroeconomic data, we estimate that an increase in domestic savings of 8-14 percentage points of GDP is needed over 5 years to accommodate rising corporate fixed investment and to curtail the current account balance (Table 2).

6. **With the fiscal position already in balance, the bulk of the increase in domestic savings should come from the corporate sector in the form of increased profits**. For this reason, accelerated privatization of large scale enterprises and improved corporate governance in voucher-privatized firms constitute the bedrock of the reform agenda, focused on transferring ownership to competent profit-seeking managers as soon as possible. In this context, the hiatus in privatization over the past two years is highly regrettable, not least because during the delay your corporate assets have continued to erode. Without strengthened political commitment to privatization, the dividends from other elements of the reform agenda—a strategy for corporate debt reduction, a targeted and affordable social safety net, strong bankruptcy proceedings, removal of portfolio limits on Privatization Investment Funds (PIFs), the bulldozer and other initiatives to improve the business environment, and reforms in government—will be much diminished.

7. **Increasing corporate profits will also require discipline in nominal wage settlements**. The collective agreements lock in rigid wage structures and sustain accrued wages at levels which many companies can ill afford, causing losses and wage arrears as well as impeding privatization. Reform of collective agreement structures is thus key. We would recommend that serious consideration be given to abolition of the entire coefficient structure in favor of free determination of wages. And we urge a disciplined response to demands for public sector wage increases in both Entities. Moreover, in the Federation the method for defining the minimum price of labor as a percentage of the average wage has compounded upward pressure on wages and on corporate losses. This arrangement should be abolished. An appropriate minimum wage structure in either Entity would provide a low minimum, would not be indexed to anything, and would make exceptions for labor market entrants.

8. **These corporate reforms will strengthen the banking system by improving overall economic performance—and they will, in turn, be strengthened by the banking system.** They will pave the way for deeper penetration of bank credit into companies, especially as the envisaged strengthening of collateral, pledge registry, and bankruptcy procedures take root. In the meantime, we welcome the development of deposit insurance and the recent strengthening of regulations on forex exposure, liquidity, and core capital. And we can see merit in initiatives to bring bank regulation under the

umbrella of the central bank, while cautioning that regulation should not suffer during the transition. But we remain concerned that the recent boom of credit to households may engender rising non-performing-loan difficulties in future, and that the immunity of regulators from prosecution, even when conducting their authorized tasks, remains so insecure. We urge early action to address both issues.

9. **With reform efforts focused on the corporate sector, we suggest that three principles should guide fiscal policy over the medium term.**

- First, any weakening of the underlying consolidated government budget balance should be avoided as this would set back your efforts to raise domestic savings.

  In this context, spending pressures must be contained. Thus budget wage adjustments would be made only as part of a comprehensive rationalization of the wage, benefit, and civil service structures, as is now envisaged by the RS authorities for mid-2004. And efforts to ensure an adequate safety net for enterprise workers lacking a complete record of social contributions need to be addressed within the constraint on total budget spending. The World Bank can assist both exercises.

  On the revenue side the relationship between the sales tax administration and the new Indirect Tax Administration (ITA) ahead of the introduction of the VAT needs to be clarified soon to ensure that revenue is sustained during the transition to the VAT. CAFAO and the IMF can provide advice on this.

- Second, fiscal sustainability must be maintained, thereby encouraging new private investment.

  In the context of ongoing prudent budget policy, your recently agreed plans on domestic claims are the cornerstone of fiscal sustainability. They represent, perhaps, your single most important macroeconomic initiative since the establishment of the currency board. Their announcement completes a key prior action for the fourth review of the Stand-By Arrangement. We applaud your willingness to resolve this daunting challenge. The IMF and U.S. Treasury advisors can help you address implementation challenges.

- Third, government is too big and this impedes economic activity.

  Large government forces private initiative into the grey economy by driving up tax rates. Tax rates should be reduced, and we regret that opportunities to do so with the 2004 budget have been overwhelmed by decisions to spend. In our view, your tax cutting efforts would best focus initially on labor taxes, thus directly improving profits while providing scope for increasing net wages and increasing the progressivity of labor taxation. In addition, the plethora of nuisance taxes needs to be pared back, and careful preparations are needed to lower external tariffs and surcharges

in a phased manner to encourage industrial restructuring and to anticipate eventual EU accession. The IMF can assist these initiatives.

Given the premium on maintenance of the fiscal balance while increasing outlays on operations and maintenance and public investment, this agenda for tax cuts requires efficiencies on current expenditure, particularly the wage bill and spending on war veterans and the military. We urge further initiatives to address these issues, and suggest that you call on World Bank expertise here.

10. **These corporate restructuring, financial sector, and fiscal reform initiatives will form essential support for the currency board, which remains the appropriate monetary and exchange rate framework for Bosnia and Herzegovina.** In this context there may be scope for the establishment of a lender of last resort (LOLR) function at the central bank, but it should be limited and remain fully within the currency board arrangement. The envisaged "umbrella" arrangement for bank supervision would also ensure full coordination of the LOLR with the supervisors. Further technical advice on these matters is available from the Monetary and Financial Affairs Department of the IMF.

11. **This demanding reform agenda will require a strengthening of your policymaking structures if it is not to falter, especially in the context of a prospective diminution in the role of the Office of the High Representative (OHR).** In particular:

- You lack an institution to establish a target for the annual consolidated fiscal balance and to apportion that target into its Entity and State components. You also lack a mechanism to ensure realization of the consolidated balance target through the year. These institutional gaps are essentially now filled, by default, by the IMF, a practice which should be terminated: this is not our mandate; these institutions form an essential counterpart to the currency board; you need them whether or not you are engaged with the IMF; and they are a core element of the effective exercise of your fiscal sovereignty. We suggest that you develop the ITA Governing Board into a Fiscal Council to undertake these tasks as well as to provide an informal venue for coordination across the whole gamut of fiscal and broader economic issues.

- With these institutional gaps filled, the premium on improving the capacity for research and analysis at the central bank and other state institutions will rise sharply. This capacity will guide your decision-making at the ITA board and elsewhere.

- But this research capacity will remain stymied, unless efforts are accelerated to strengthen your macroeconomic statistics. Sound estimates of nominal and real GDP by activity as well as by expenditure are needed urgently, alongside coherent data on employment and unemployment, inflation, the balance of payments, accrued and paid wages, and industrial production. In this regard, further delays to the appointment of a capable new director for the state Agency for Statistics will

be costly. And we see considerable merit in unification of the statistics agencies, as mandated by the law.

- And we urge you to determine a formula to determine the annual administrative transfer to the State so as to minimize the protracted ad hoc negotiations over this critical matter each year.

The IMF is available to advise on all four of these issues.

III. PRIORITIES FOR 2004

12. **The urgency of these challenges is underscored by recent economic trends.** In 2003, economic growth has slowed again to around 3½ percent as the 2002 credit-boom eased, compounded by drought. And while paid wages continue to rise, paid employment continues its downward track. On the plus side, however, the budget outturn appears strong, albeit with scattered signs of new expenditure arrears appearing. And, at last, there are tentative signs that the current account deficit may have peaked, now heading down modestly to some 18 percent of GDP (Table 1).

13. **The recovery from drought and a strengthening of the international economy in 2004 will provide buoyancy to activity, which we predict to grow by 5 percent in real terms.** But the necessary further deceleration in credit growth and initiation of corporate restructuring will be downside factors.

14. **In this context, your 2004 budgets need to continue to support efforts to rein in the current account deficit**. Adjusting for one-off items such as severance pay and cash payments related to the settlement of domestic claims, the consolidated fiscal balance should remain strong relative to GDP in 2004 .

15. **In realizing these targets, there is need to settle the size of Entity transfers to the State, as well as the expenditure functions which will shift there during 2004.** And functions shifted to the state should be transferred with their personnel and funding so as to minimize the adjustment costs. Agreement on this, alongside appropriate budgets, will form key elements for the fourth review of the Stand-By Arrangement.

16. **On the monetary side, policy would best continue to aim to reinforce the nascent deceleration in credit growth**. In this light we welcome the extension of the base for reserve requirements in 2003 and the recent decision by the CBBH to lower the rate of remuneration of excess reserves from January 1, 2004, a step which will strengthen central bank profitability and stem speculative capital inflows. We welcome the CBBH's intention to keep this rate, as well as the rate of reserve requirements under close review and its readiness to act again in light of developments. That said, we also hope that the CBBH will maintain its now well established tradition of avoiding unduly frequent changes to its instrument settings.

17. The banking regulatory reforms commenced in 2003 are proceeding well. In collaboration with the banking agencies, banks should implement their plans to adjust their foreign exchange exposure and liquidity ratios to the ceilings by July 2004. We

support the intention to review once again the liquidity regulations themselves, and suggest that their definition be shifted from the original to the residual maturity basis and that the key period of focus be shortened from 90 to 30 days. In addition the rules for asset classification and loss provisioning should be aligned with international standards. With most banks expected to be brought under the deposit insurance agency by end-2004, those that remain ineligible after that deadline should have their licenses withdrawn in accordance with the law.

18. 2004 will be a decisive year. If all goes well, it will be marked down as the year during which you shifted from preparation of major reform proposals to their implementation. In particular:

- You should render the ITA operational with all haste, merging the customs administrations, establishing a VAT implementation plan soon along the lines proposed in Annex I, and initiating the role of the ITA as a Fiscal Council. We recommend that you target a VAT introduction date no later than July 1, 2005 because, with application, this is feasible and because VAT is key to realizing your fiscal objectives and combating the culture of non-payment of taxes. As part of preparations for the ITA and the single revenue account, agreement is needed soon on a formula and detailed mechanism for allocating customs and, later, other indirect tax revenue between the Entities and Brcko District. We welcome your intention to use a formula based on the principle of final consumption for this purpose.

- Your plan to resolve domestic claims on government will require careful implementation. You rightly envisage careful verification of individual claims prior to settlement and prompt passage of the law prohibiting further court proceedings in respect of war damage claims. This process, and continued use of frozen foreign currency and privatization certificates, will likely result in some reductions in the claims, but more claims may also emerge, notably as data from the cantons are finalized. The final determination of bond structures in June 2004 will need to adjust for both developments, ensuring that the executed plan adheres to the envisaged 10 percent of GDP ceiling. In addition, we welcome your intention to phase the cash settlement element of your plans over a number of years and suggest that you do so even if privatization proceeds could finance earlier settlement in order to avoid an excessive impact on aggregate demand of such payments. When you come to resolve issues of restitution, any added burdens on government would best be kept to an absolute minimum so as to maintain government solvency.

- We welcome your intention to move quickly to implement your defense reforms: to demobilize over 8,000 defense staff in early 2004, to reduce numbers of conscripts and reservists, and to establish a unified defense command structure under a State-level Ministry of Defense. We urge that the severance payment per beneficiary be well below that granted in the 2002 demobilization exercise so as to avoid establishment through repetition of a precedent which cannot be afforded.

- Establishment of commercial courts and intensive training for judges and bankruptcy administrators is proceeding with USAID assistance. In anticipation of this we urge early passage by the Federation of the amendments to the bankruptcy law to lower the seniority of labor claims.

- Alongside, we recommend early reforms to the rules governing PIFs. Remaining limits on the share of an individual company that PIFs may own should be abolished, as should the limits on the portion of a PIF which an individual may own. These changes will allow PIFs to retain control of individual companies, and allow individual shareholders to take full control of PIFs, strengthening the corporate governance of both. In the meantime, rules now governing the remuneration of PIF management companies need urgent review as they are operating to the detriment of household investors in PIFs.

- An early review of the wage setting apparatus is also called for. The minimum price of labor and the coefficient structures appear to be impeding efficient operation of the labor market, inside the budget sector and outside of it. At the least, indexation of the minimum price of labor should be terminated and provision made for labor market entrants. These steps should, however, precede a more ambitious reform. And severance rules—notably those requiring settlement of all wage arrears prior to dismissal—impede labor mobility and efforts to curb overstaffing. This severance requirement should be withdrawn and mandatory provision for settlement of wage arrears should be left to standard bankruptcy procedures.

- You should begin to collect and monitor your own monthly data on developments in the consolidated fiscal accounts for Bosnia and Herzegovina, and avoid all further delays in efforts to strengthen your other macroeconomic statistics.

- Fiscal management, treasury operations and budget preparations continue to improve. The Federation needs to strengthen coordination between the central government and the cantons, and to review revenue allocation arrangements between the central government, cantons, and municipalities, particularly in the context of welcome and ongoing reductions in external tariffs. Both Entities should maintain their strict borrowing restrictions for local governments and extrabudgetary funds, while seeking to strengthen controls over spending by those funds which is financed from earmarked revenue.

- Given improved monthly budgeting procedures, there may be scope to relax the embargo on new borrowing by entity central governments from domestic commercial banks so as to smooth intra-year cash flows.

19. **And a key final objective for 2004 will be to convert the strategy outlined in Section II on privatization and corporate governance into specific policy measures.** You may draw on the assistance of the World Bank, the EU, and the IMF in realizing this very considerable task. In addition, you should conduct a comprehensive review of SOEs to ensure that all the key large firms are prioritized for privatization along with those already on the “strategic” list, and efforts to sell them should be sharply accelerated. This

requires settlement of legal and administrative problems that have delayed privatization so far.

IV. CONCLUDING REMARKS

20. **While substantial progress has been achieved in recent years, major tasks lie ahead.** In our discussions with you, we have been surprised that you have been slow to point out your very considerable successes. But equally, we are concerned that there may be insufficient recognition of the full extent of the coming challenges. Those challenges can be surmounted, but only if they are tackled head on and if the pattern of "offense and retaliation" between the Entities and within the coalitions which has so impeded the effective operation of government in the past is ended. Do that, and the IMF will provide strong further support for your efforts; and Bosnia and Herzegovina will thrive.

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The mission would like to thank the authorities for the warmth of the welcome afforded us during our visit.

Table 1. Bosnia and Herzegovina: Selected Economic Indicators, 2000-2004 1/

	2000	2001	2002	2003	2004
		Est.	Est.	Proj.	Proj.
Nominal GDP (KM million)	10.054	10.959	11.627	12.173	12.911
Gross investment (percent of GDP)	20,6	18,9	20,4	19,9	20,3
			(Percent change)		
Real GDP	5,5	4,4	5,5	3,5	5,1
Index of industrial production (period average) 2/	9,3	-2,0	11,5	3,8	…
Gross wages (period average) 2/	12,9	6,8	6,9	9,4	…
CPI (period average) 2/	5,0	3,2	0,3	0,1	0,9
Money and credit					
Broad money (end-of-period) 3/	14,0	89,2	7,0	7,7	…
Net domestic assets (percent contribution to broad money growth)	3,4	3,2	15,6	10,6	…
Of which: credit to the public sector	1,1	-7,0	-1,7	-1,2	

	(Percent of GDP)				
General government budget					
Revenue	53,7	49,7	49,1	47,7	47,1
Of which: grants	9,5	7,2	5,1	3,4	3,3
Expenditure (on a commitment basis) 4/	60,7	53,1	51,4	47,3	46,7
Of which: investment expenditure	10,9	9,2	6,3	4,5	5,0
Overall balance 4/ 5/	-7,0	-3,3	-2,2	0,4	0,4
External public debt	59,9	47,5	40,5	36,1	35,1
Stock of frozen foreign currency deposits 6/	27,9	25,5	24,1	23,0	21,7
	(Millions of U.S. dollars)				
Balance of payments					
Exports of goods and services	1.288	1.297	1.468	1.883	2.067
Imports of goods and services	2.741	2.900	3.317	4.058	4.240
Official current grants	36	28	19	17	29
Of which: budget support	36	28	19	17	29
Current account balance 7/ 8/	-621	-811	-1.036	-1.237	-1.193
(percent of GDP) 8/	-12,9	-15,9	-18,5	-17,7	-15,6
Gross official reserves	497	1.221	1.279	1.531	
(in months of imports)	2,2	5,1	4,6	4,5	
Net international reserves (percent of private sector deposits)	47,5	87,2	70,3	52,7	
External debt service	94	81	125	162	149
(percent of exports of goods and services)	7,3	6,3	8,5	8,6	7,2

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

1/ Data refer to the entire country.
2/ Based on weighted averages for the Federation and Republika Srpska.
3/ Broad money includes currency, demand deposits, time and savings deposits, bonds and money market instruments,restricted deposits, counterpart funds, and government lending funds.
4/ For consistency, third review data have been revised to reflect adjusted data on foreign investment projects.
5/ 2004 data includes one-time payments for military severance.
6/ Excludes any liabilities arising from war damage claims.
7/ 2002 and 2003 data have been adjusted to reflect new data on private transfers.
8/ For consistency, third review data have been revised to correct a classification error in the trade data.

Table 2. Bosnia and Herzegovina: Macroeconomic Framework, 2002-2008

	2002 Est.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.
Total foreign assistance (In percent of GDP) 1/	8,0	5,0	5,8	3,9	3,1	2,4	1,8
Real GDP growth (percent)	5,5	3,5	5,1	5,7	5,9	6,2	6,4
Inflation (percent)	0,3	0,1	0,9	1,8	2,0	2,2	2,2
Current account balance (including official transfers)	-18,5	-17,7	-15,6	-14,8	-13,1	-10,9	-8,9
Gross Investment	20,4	19,9	20,3	20,9	21,4	21,9	22,1
Domestic savings	-12,5	-11,1	-8,1	-5,8	-3,1	-0,2	2,6
General government balance	-2,2	0,4	0,4	0,4	0,5	0,5	0,5

Sources: Data provided by the Bosnia and Herzegovina authorities; and IMF staff estimates and projections.

1/ Includes disbursements of foreign loans, and grants.