October 2008
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Bosnia and Herzegovina: 2008 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Bosnia and Herzegovina

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with Bosnia and Herzegovina, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 24, 2008**,** with the officials of Bosnia and Herzegovina on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 28, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its September 17, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Bosnia and Herzegovina.

The document listed below has been or will be separately released.

Selected Issues

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INTERNATIONAL MONETARY FUND

BOSNIA AND HERZEGOVINA

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Consultation
with Bosnia & Herzegovina

Approved by Poul M. Thomsen and Martin Fetherston

August 28, 2008

Executive Summary

Background: The economy has been exhibiting robust growth, but imbalances have emerged: the current account deficit has widened and underlying inflation has picked up. Procyclical fiscal policy has added to these imbalances. Moreover, large public sector wage increases threaten to spill over to private sector settlements, thus exacerbating inflation pressures and weighing on competitiveness. Credit growth has started to slow down and tightened financial conditions have resulted in a fall in bank profitability. Looking ahead, the signing of the Stabilization and Association Agreement (SAA) with the EU and progress in fiscal coordination could provide impetus for much-needed structural reforms.

Staff views: The main challenge is to tighten fiscal and public sector wage policies. Moreover, fiscal policies should be more coordinated and anchored within a medium-term framework, and aim at reducing the size of the government and raising its efficiency. It is also important to further strengthen banking supervision and contain risks to financial stability. These policies should provide a solid basis for the stability of the currency board arrangement.

Authorities' views: The authorities broadly agreed with the staff's diagnosis and recommendations. On account of the SAA signing, they felt optimistic about their country's prospects and reform momentum, and hoped that recent progress in fiscal coordination would keep public finances on a strong footing.

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I. Overview

1. **The economy has been exhibiting robust growth, but macroeconomic imbalances have emerged.** Benefiting from the currency board and the effects of past reforms in key sectors and the financial system, Bosnia & Herzegovina (BiH) has seen strong growth and low inflation in recent years. However, with capital inflows driving a domestic-demand boom, economic tensions have built up. The current account deficit has widened, and, while inflation accelerated mainly on account of global food and energy price shocks, underlying inflation pressures have also intensified. Procyclical fiscal policy has added to these imbalances. Unsettled global financial markets and a worsening economic environment in Europe pose risks to BiH's stability and growth prospects.

2. **Progress vis-à-vis the EU is encouraging, but the complex political system complicates policymaking**. The SAA opens the road to EU accession and could help accelerate reforms. Also, the approval of the Fiscal Council law and agreement on a permanent indirect tax revenue allocation formula should help improve fiscal coordination. The Dayton Peace Agreement created two largely-autonomous entities, Republika Srpska (RS) and the Croat-Bosniak Federation of BiH (Federation) divided into ten largely-ethnic cantons, all held together by a central government (State) with a limited mandate. This structure causes duplication of many domestic policy functions and weakens incentives for cooperation. Moreover, policies are diverging between the two Entities, with the RS making steady progress on reforms and the Federation finding it difficult to mobilize action on needed reforms. Preparing BiH for eventual EU accession will require constitutional reform: a modest first attempt failed in 2006, and the conflicting views on the future makeup of the country suggest still little common ground.

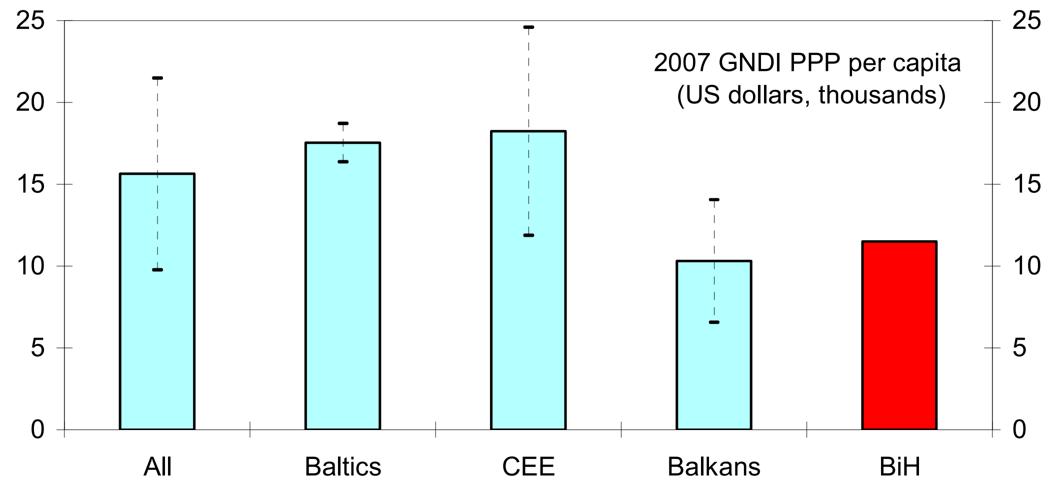
II. Background

3. **Despite robust economic performance in recent years, convergence to EU income levels has been slow.** Considering its late start to transition and the devastating effects of the 1992–95 war, BiH's current level of per capita income—which is above the Balkan average—is remarkable (Figure 1). Although real GDP increased by a cumulative 30 percent since 2002, BiH's growth dynamics put it somewhat below the convergence path traced by other countries at a similar point in transition.[1]

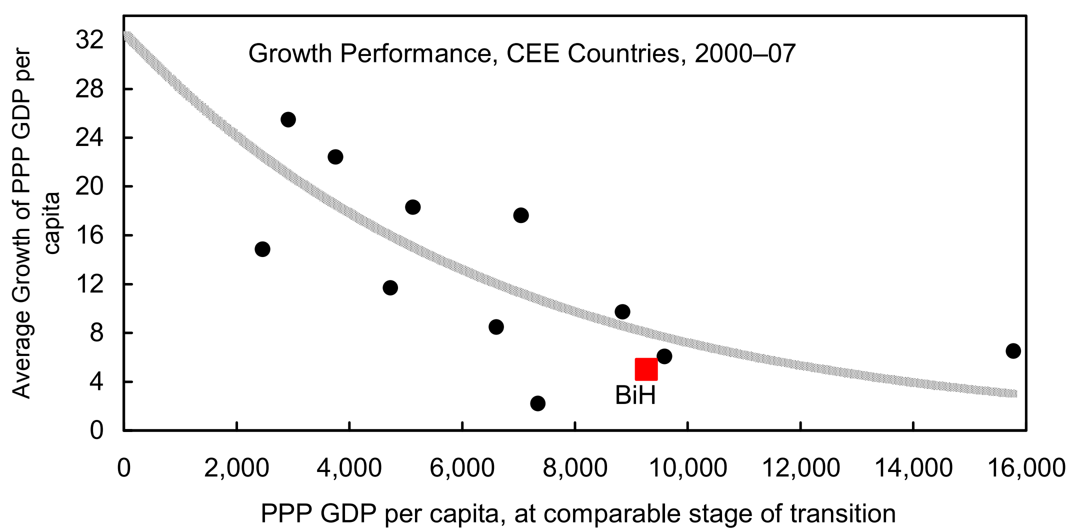
[1] See Chapter I "BiH: Catching Up or Falling Behind Other Transition Economies?" of the IMF Country Report for the Selected Issues for the 2008 Article IV consultation, released along with this document.

Figure 1. Bosnia and Herzegovina: Income and Growth

BiH compares favorably with its Balkan peers in terms of per capita income...

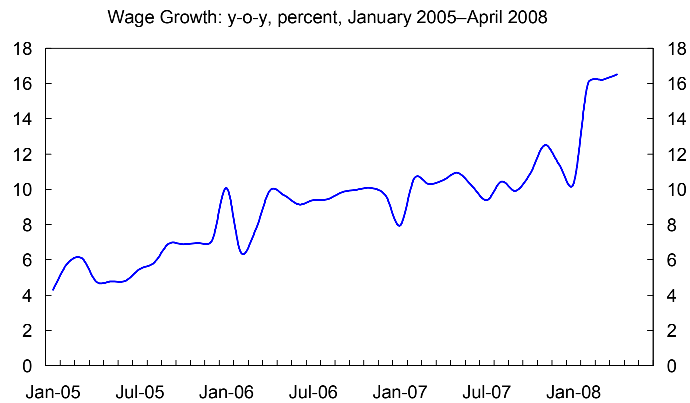


.... but growth remains short of performance by other countries
at similar stages of transition.



Sources: World Economic Outlook; BiH authorities; and IMF staff calculations.

4. **The economy is experiencing an absorption boom, but capacity constraints are emerging.** Solid output growth continued in 2007 supported by strong productivity gains, especially in the tradable sector. However, domestic demand—with broadly equivalent contributions from consumption and investment—took over as an engine of growth (Figure 2). It has been supported by robust real credit growth (22 percent), healthy wage increases (10 percent), and a sizeable fiscal impulse (1.2 percent of GDP). In 2008, leading indicators remain solid (Figure 3), but there are signs of capacity constraints. With most of unemployment structural, selected sectors (services and construction) are experiencing labor shortages—accentuated by workers seeking employment in neighboring countries. Moreover, wage and price pressures have been on the rise, with excess demand spilling over into a larger trade deficit. Although it is difficult to gauge the size of the output gap in a transition economy like BiH, staff estimates suggest that it has been narrowing (Figure 2)[2].



Bosnia & Herzegovina: Key Macroeconomic Indicators, 2003–07
(In percent of GDP, unless otherwise indicated)

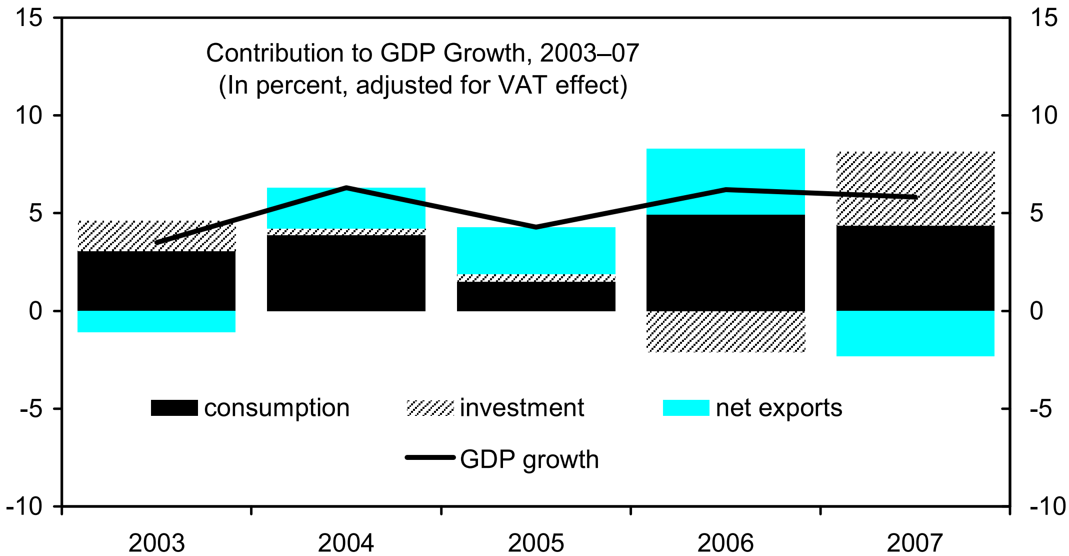
	2003	2004	2005	2006	2007 Est.
Real GDP growth (percent)	3.5	6.3	4.3	6.2	5.8
CPI (change in percent; average)	0.5	0.3	3.6	6.1	1.5
Current account balance	-19.4	-16.3	-18.0	-8.4	-13.0
General government balance	-1.7	-0.5	0.8	2.2	-0.1
Reserve cover (months of imports)	3.2	3.7	4.0	5.1	5.4
Gross external debt	49.1	47.5	52.6	48.0	48.5
Public debt	28.4	25.5	25.6	22.0	30.5

Sources: BiH authorities; and Fund staff estimates.

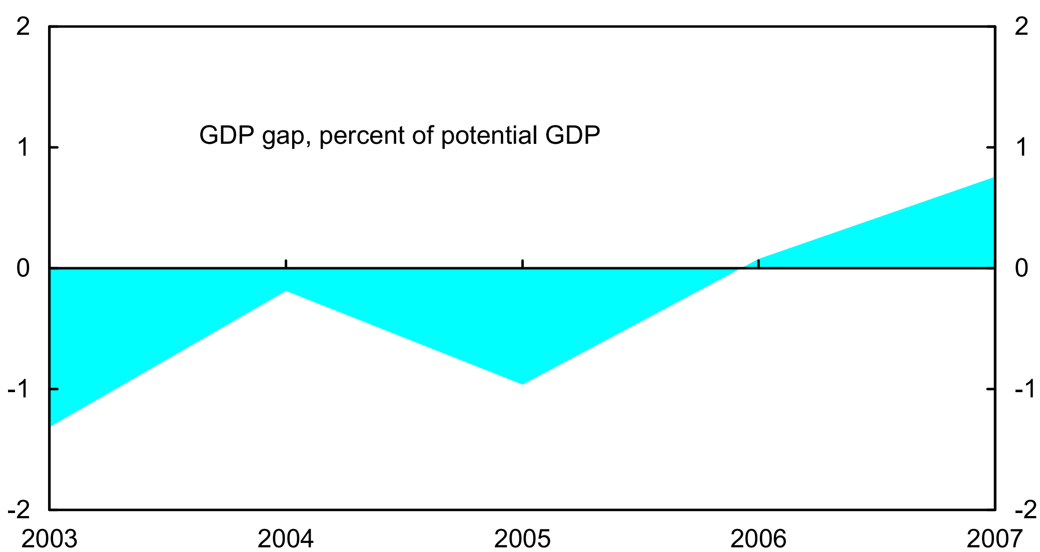
[2] See Chapter II "BiH: Accelerating Inflation—Reason for Concern?" of the IMF Country Report for the Selected Issues for the 2008 Article IV consultation, released along with this document.

Figure 2. Bosnia and Herzegovina: Growth Performance

Solid growth continued in 2007, but tilted toward domestic demand...

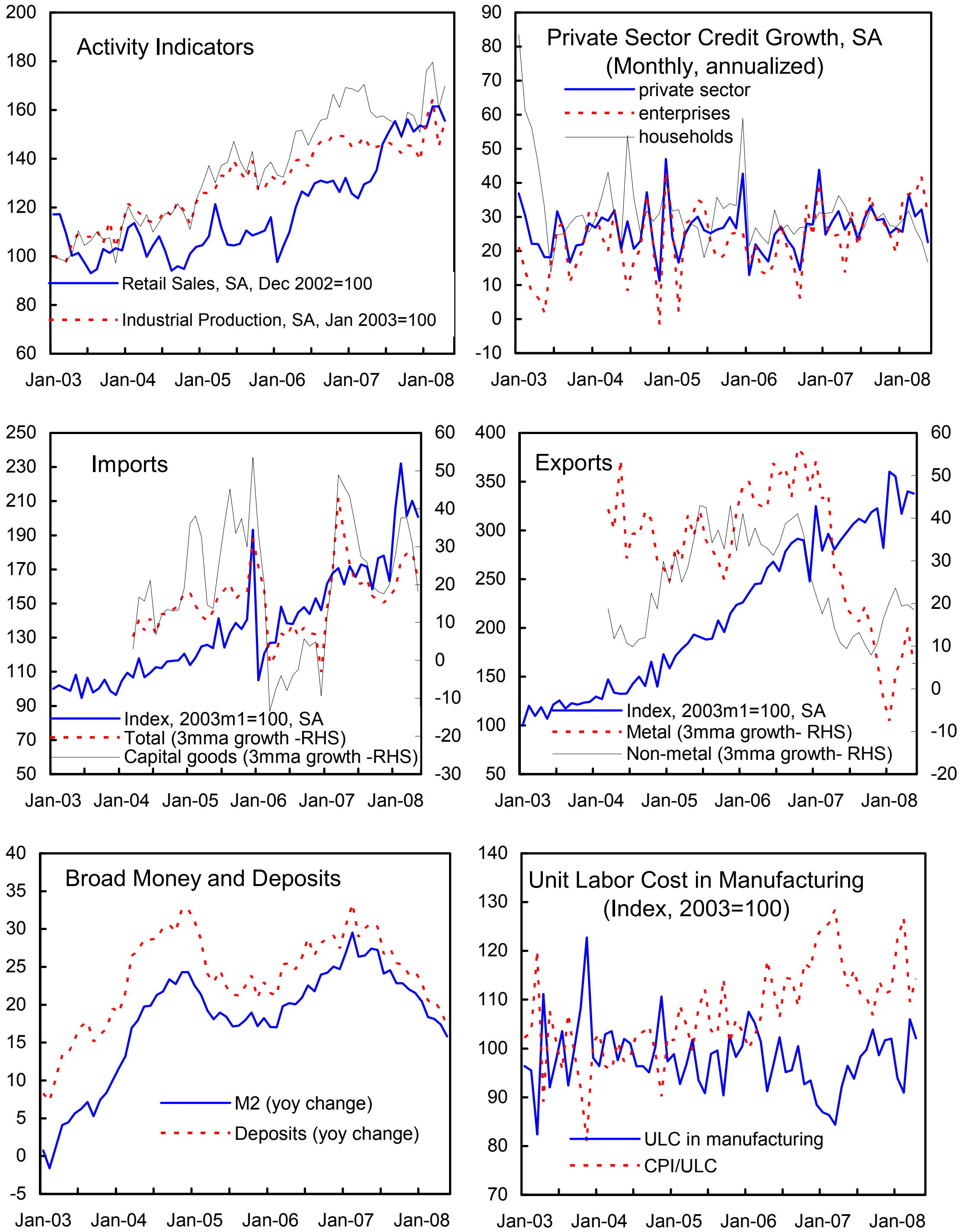


...and the negative output gap was eliminated.



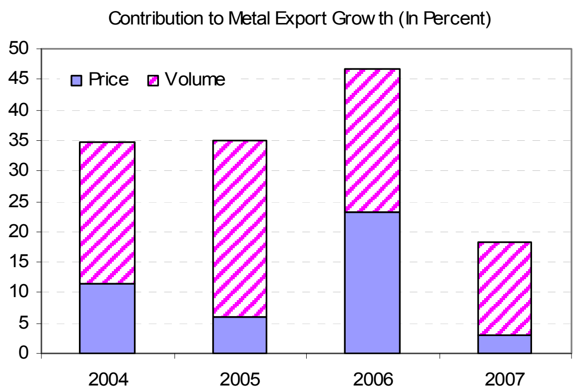
Sources: BiH authorities; and IMF staff calculations.

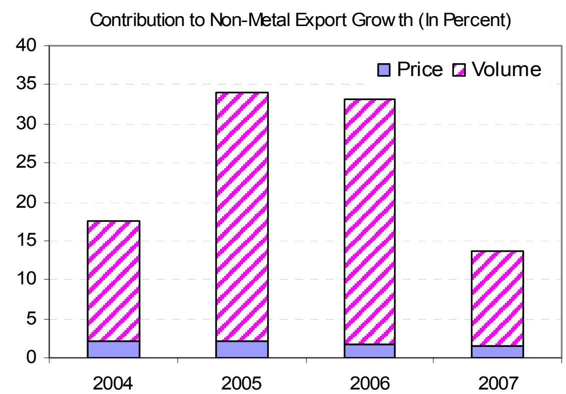
Figure 3. Bosnia and Herzegovina: Indicators of Economic Activity, 2003–08



Sources: BiH authorities; and IMF staff estimates.

5. **The current account deficit is widening, but official reserves rose in 2007 as the balance of payments benefited from large long-term inflows.** The absorption boom was mirrored by a widening external deficit, which reached 13 percent of GDP in 2007—an underlying deterioration of 1.5 percentage points of GDP.[3] Export growth moderated to 15 percent (driven by strong volume growth), after a torrid pace in the preceding years, and imports resumed their faster growth following a temporary, VAT-related slowdown in 2006. The current account deficit was fully covered by FDI, largely reflecting privatizations in the RS, which together with bank borrowing and other unidentified inflows pushed gross official reserves to €3.4 billion (5.4 months of imports) at end-2007. Data for early-2008 point to a further widening of the external deficit, with still-robust export growth overshadowed by strong import growth, and higher food and energy prices contributing more than half of the increase in the import-to-GDP ratio.





6. **The real effective exchange rate has been stable and external competitiveness appears adequate.** Staff calculations using various methodologies imply that the equilibrium current account deficit ranges between 7½–13½ percent of GDP, although a number of factors (e.g., underestimation of current inflows) merit consideration in making an assessment (Box 1). With the caveat of large uncertainties surrounding the estimates, the current account deficit has been moving toward unsustainable levels. At the same time, the real effective exchange rate has been stable, and, although some margin of overvaluation can not be ruled out, at present levels, does not raise significant external stability concerns. Indicators of price and cost competitiveness vis-à-vis neighboring countries remain benign, export growth has been strong, and export market share has steadily increased, amid robust productivity gains in the tradable sector (Figure 4). Finally, financing of the current account deficits remains tilted toward more stable sources—FDI and long-term bank-mediated inflows—and the external position does not indicate serious vulnerability risks (Figure 5).

[3] See Chapter III "Assessing BiH's External Stability and Competitiveness" of the IMF Country Report for the Selected Issues for the 2008 Article IV consultation, released along with this document.

Box 1. External Competitiveness

Staff analysis suggests that, while the external deficit currently exceeds sustainable levels, there is no strong evidence of a significantly overvalued real exchange rate (RER) at present that could result in future external instability. However, large uncertainties surround this assessment.

Equilibrium current account deficit (CAD) estimates are between 7½ –13½ percent of GDP.

- The CGER macroeconomic balance approach suggests an equilibrium CAD—taking into account about 2 percent of GDP capital transfers—of 9 percent of GDP. However, this may underestimate it in a setting of EU convergence and rapid financial integration. Accounting for these effects (IMF WP/07/64), the equilibrium CAD is 13½ percent, thus implying no gap from the underlying deficit.
- The external sustainability approach suggests that the CAD level required to stabilize net foreign liabilities (NFL) is 7½ percent, implying a 6 percent gap.
- The CGER equilibrium RER approach suggests a RER undervaluation of 17 percent. This result is driven mainly by a favorable productivity differential against trading partners.

	CGER Macrobalance approach	ALM (2007) Macrobalance approach 1/	External Sustainability Approach	CGER Equilibrium RER
Equilibrium CA balance (i)	-6.9	-11.5	-5.6	n.a.
Mitigating factor: Capital transfers (ii)	-1.8	-1.8	-1.8	n.a.
Adjusted equilibrium CA balance (iii) = (i)+(ii)	-8.7	-13.3	-7.4	n.a.
Underlying CA balance (iv)	-13.5	-13.5	-13.5	n.a.
CA gap (iii)-(iv)	4.8	0.2	6.1	n.a.
Implied over(+)/under(-) valuation	23.1	1.0	29.3	-17.2

Source: Staff estimates.
1/ Based on Abiad, Leigh and Mody (2007).

- The consistently-large and positive errors and omissions (2 percent of GDP)—which may reflect underestimation of current inflows (Country Report 06/368)—also merit consideration in interpreting the above CAD gaps.

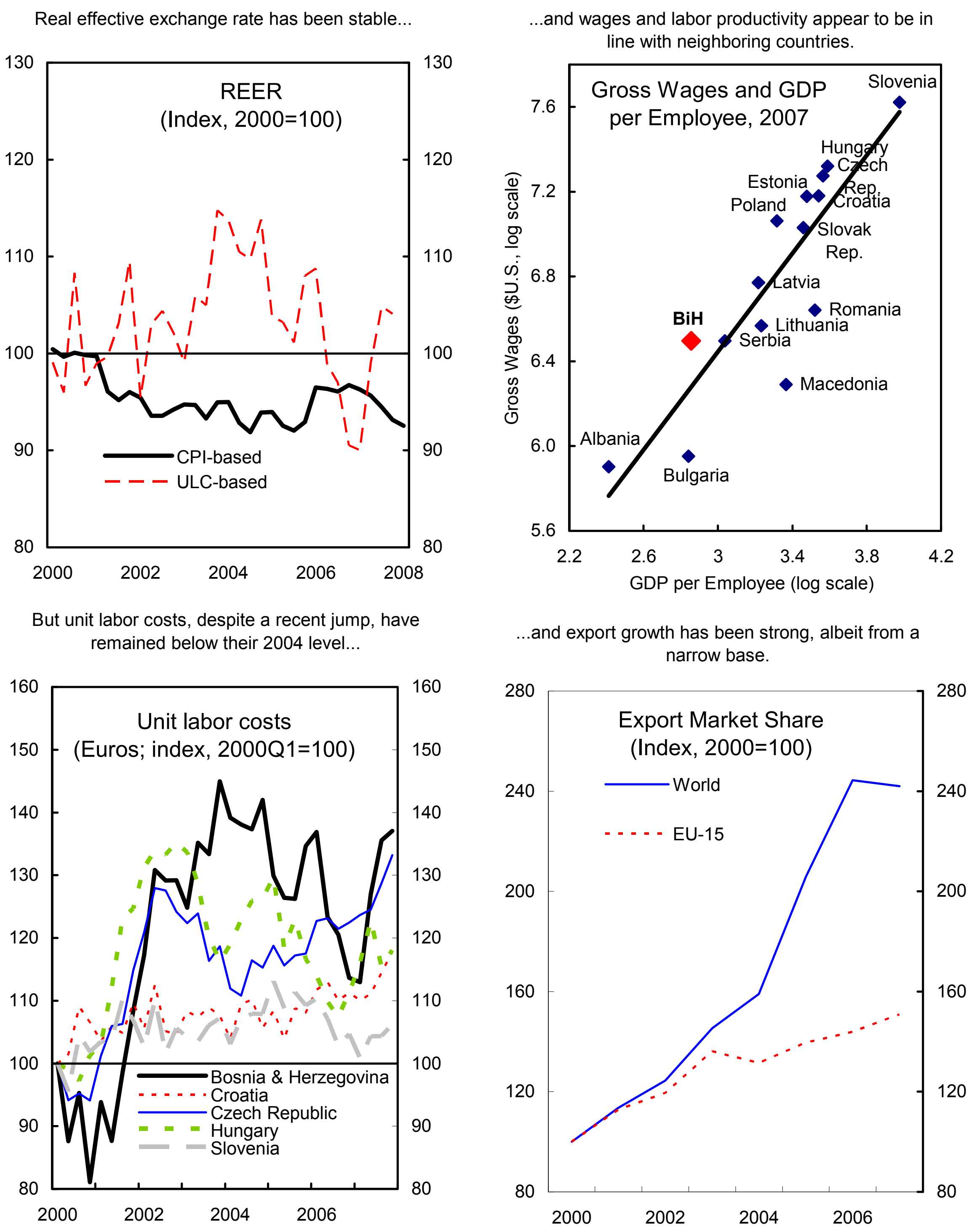
Export and productivity trends suggest that competitiveness is adequate.

- Export growth has been robust and export market share steadily increased. Constant-market-share analysis suggests that BiH's export growth over 2003–06 can be mainly explained by the competitiveness effect. Recent data point to continued robust export growth in 2007–08 (15 percent), with import growth mainly driven by imports of machinery and base metals (29 and 43 percent, respectively).
- Relative to nontradables, average labor productivity growth of BiH tradables over 2004–06 was much higher than that of the main trading partners.

Average productivity growth	2004-2006		
	Tradables	Nontradables	Tradables/ Nontradables
Bosnia & Herzegovina	13.4	3.4	9.6
Main Trading partners			
Euro Area	3.4	0.4	2.9
Croatia 1/	5.2	1.8	3.4
Slovenia	7.1	2.7	4.3

Sources: BiH Statistics Agency, Eurostat, and staff estimation.
1/ Croatia's data is only available for 2003-04.

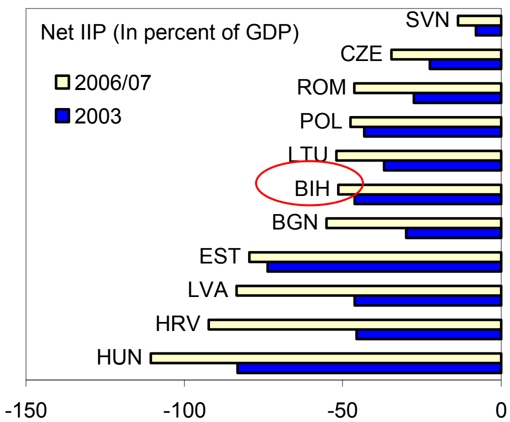
Figure 4. Bosnia and Herzegovina: Competitiveness Indicators, 2000–08



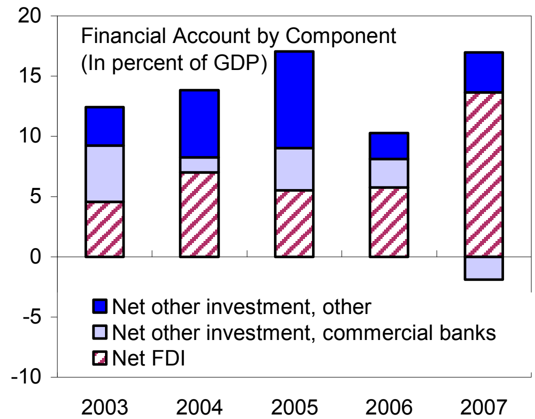
Sources: BiH authorities; Direction of Trade Statistics.; and IMF staff estimates.

Figure 5. Bosnia and Herzegovina: External Position

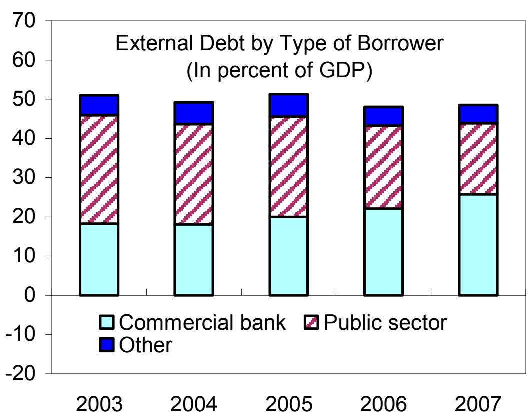
Bosnia & Herzegovina's net IIP is not high by regional standards.



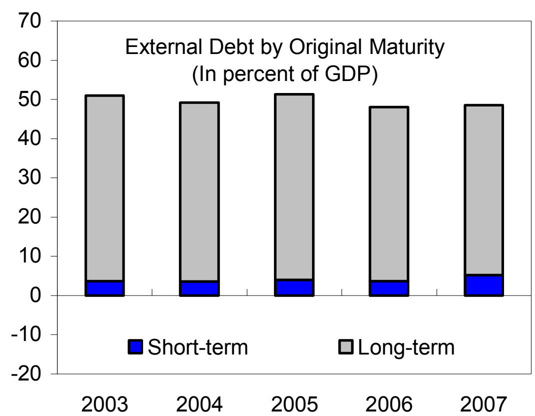
FDI has been the largest source contributing to the change in the IIP.



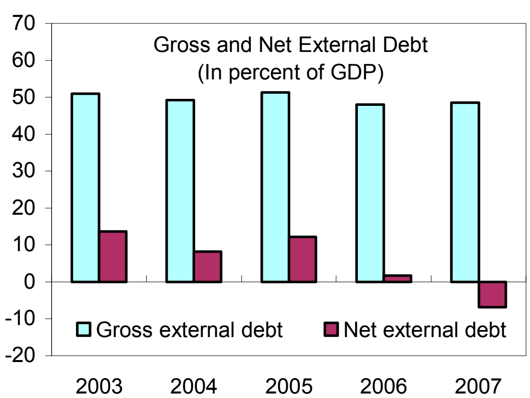
External debt has been stable...



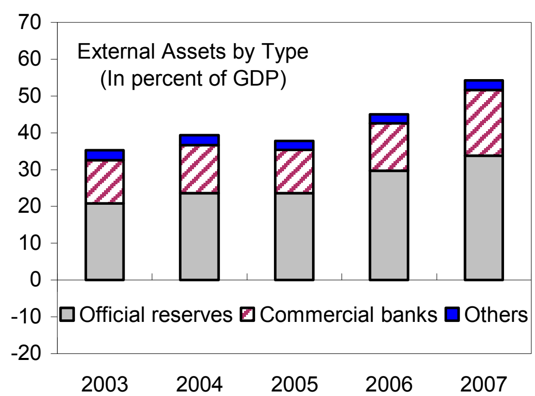
...with little on the short-term side.



Net external debt has declined as external assets have increased.



The sizable increase in external assets in 2007 was due to RS Telekom privatization.



Sources: CBBH, IMF, BIS and Fund staff estimates.

7. **Accelerating inflation raises concerns.** Headline inflation increased to 8.2 percent y-o-y in May, reflecting mainly food and energy price shocks (Figure 6). However, underlying inflation has also picked up, and producer price inflation has remained high (6.7 percent) suggesting that price setters, faced with higher input costs, are trying to maintain their markups. The authorities have resisted calls for reducing the VAT on food and, with the deregulated petroleum market, the pass-through of international to domestic prices has been instantaneous. To alleviate somewhat the impact of inflation on the poor, RS authorities increased targeted transfers, while both entities raised agricultural subsidies. The recent rise in inflation has been partially contained by the spillover of demand pressures into higher imports, and BiH's inflation performance compares favorably with that of its peers (Figure 6).

8. **Fiscal policy has become procyclical.** The general government registered a deficit of 0.1 percent of GDP in 2007, compared with a 2.2 percent surplus in 2006, adding further stimulus to an already-strong domestic demand. Driven mainly by sharp increases in transfers to households, capital spending, and wages, government expenditure approached 50 percent of GDP. Strong revenue performance has continued this year, but mounting transfers to households in the Federation (associated with unfunded legislative changes at end-2006) have led to liquidity problems that threaten its fiscal position.

General Government Operations, 2005–07
(In percent of GDP)

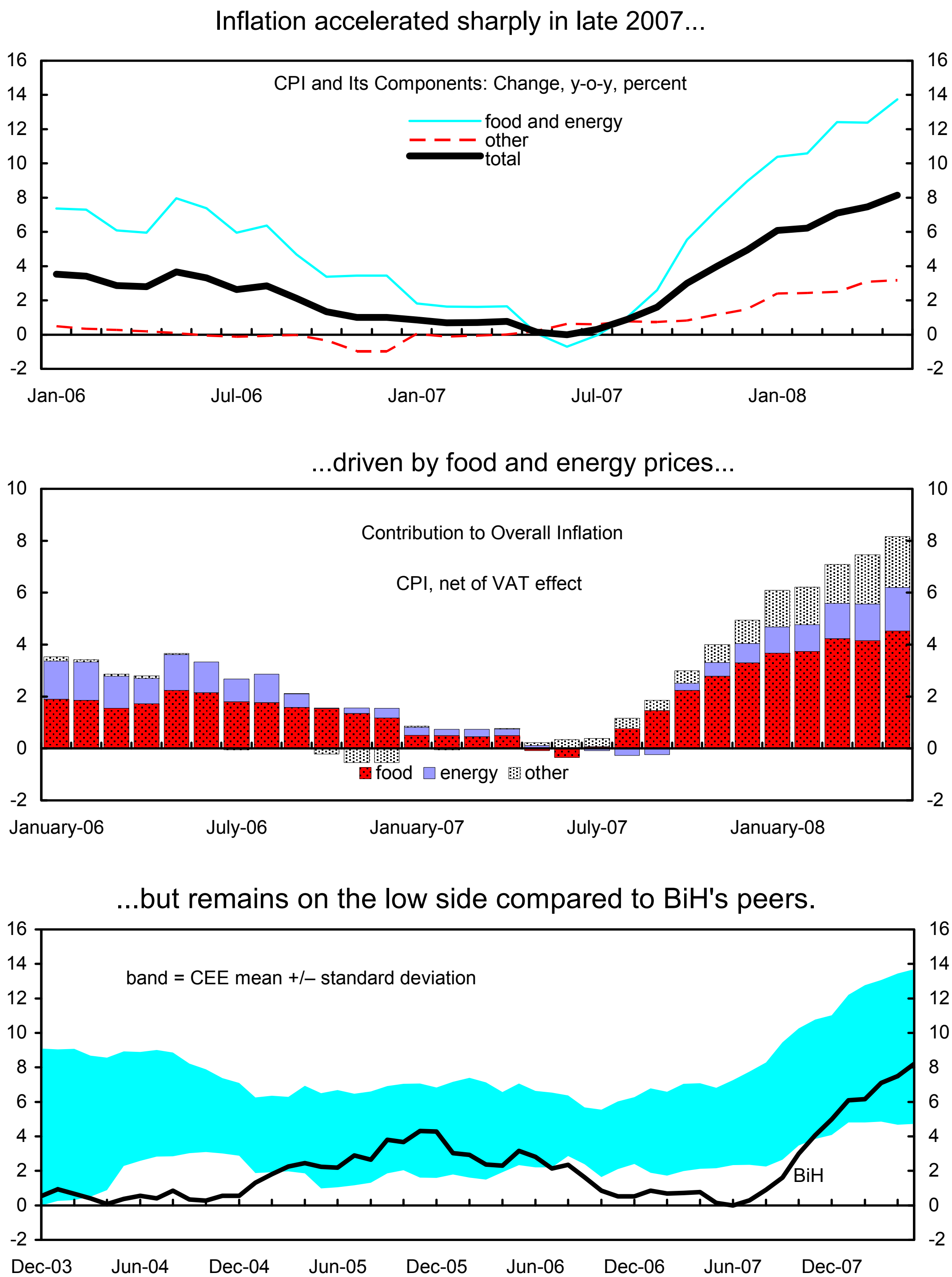
	2005	2006	2007
Revenue and grants	45.5	47.5	48.7
Expenditure	44.7	45.3	48.7
Of which: current primary	37.2	38.4	41.2
Balance	0.8	2.2	-0.1
Underlying balance 1/	1.1	1.0	-0.2
Fiscal impulse	0.1	0.1	1.2

1/ Adjusted for cycle and transitory factors.

9. **Although public debt is currently low, there are uncertainties about the size of the government's contingent liabilities.** At end-2007, gross public debt stood at 31 percent of GDP and general government deposits amounted to 15 percent of GDP. This favorable picture is clouded by: (i) the constitutional controversy over the issuance of bonds to cover frozen foreign-currency deposit (FFCD) obligations, which risks reopening court challenges to the size of the compensation;[4] (ii) uncertainty regarding the ultimate size of restitution claims and settlement terms; and (iii) the unknown size of government contingent liabilities to cover debts of loss-making state-owned enterprises.

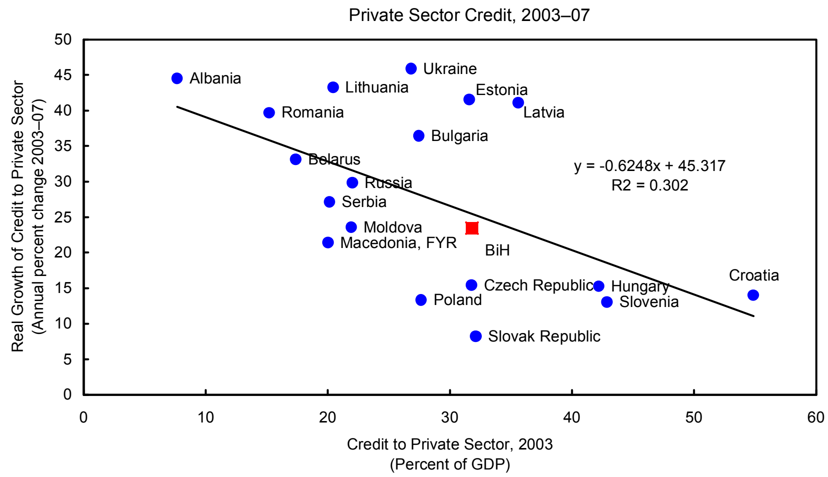
[4] Following the bond issuance by the RS, the CBBH withdrew its services as fiscal agent for issuance of FFCD bonds by the State on behalf of the Federation.

Figure 6. Bosnia and Herzegovina: Inflation, January 2006–May 2008



Sources: BiH authorities; Eurostat; and IMF staff calculations.

10. **Financial deepening accelerated in 2007, but remains in line with regional trends.** Benefiting from a low interest rate environment (Figure 7), robust credit growth brought the credit-to-GDP ratio to 56 percent in 2007. Concerns about the speed of credit expansion prompted the Central Bank of Bosnia and Herzegovina (CBBH) to increase reserve requirements at end-2007—from 15 to 18 percent. Long-term borrowing by the largely foreign-owned banking sector is the key factor underpinning rapid credit growth, because tight maturity-matching requirements limit banks' reliance on local deposits (Figure 8). Banks' open positions are limited but the large volume of FX-linked lending raises the possibility of currency mismatches in household and corporate sectors.[5] Despite several measures taken in 2007 (Table 11), banking supervision remains hampered by fragmentation into two Entity-based agencies and limited cooperation with foreign banking supervisors.



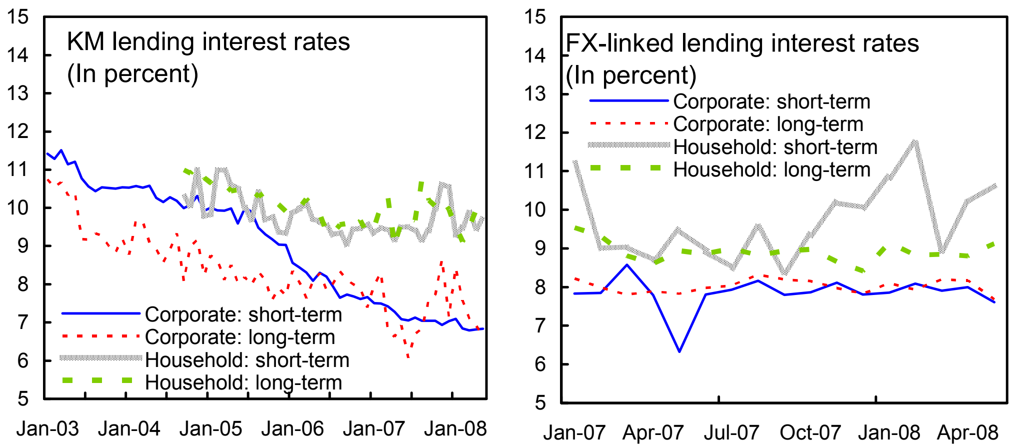
11. **Financial conditions have tightened somewhat in 2008.** Lending interest rates have so far remained flat, but commercial banks mentioned early indications that global financial tensions are affecting foreign funding. While bank soundness indicators are favorable, bank profitability declined in Q1 of 2008 (Table 10). With a widening external deficit and a slowdown in capital inflows, M2 growth slowed to 16 percent (y-o-y in May), against 22 percent at end-2007. Real private sector credit growth moderated to 20 percent (y-o-y in May) from 22 percent at end-2007, led by a deceleration of household credit growth.

12. **A breakthrough has been made on fiscal structural reforms.** The long-awaited approval of the Fiscal Council law and agreement on a permanent indirect revenue-allocation formula should improve fiscal coordination. Moreover, income tax reforms in the RS and the Federation represent a welcome step toward greater harmonization. Also, public wage reforms in the State and the RS have sought to simplify the wage structure and consolidate some allowances with wages. However, little progress has been made on the reform of public administration and the social benefit system.

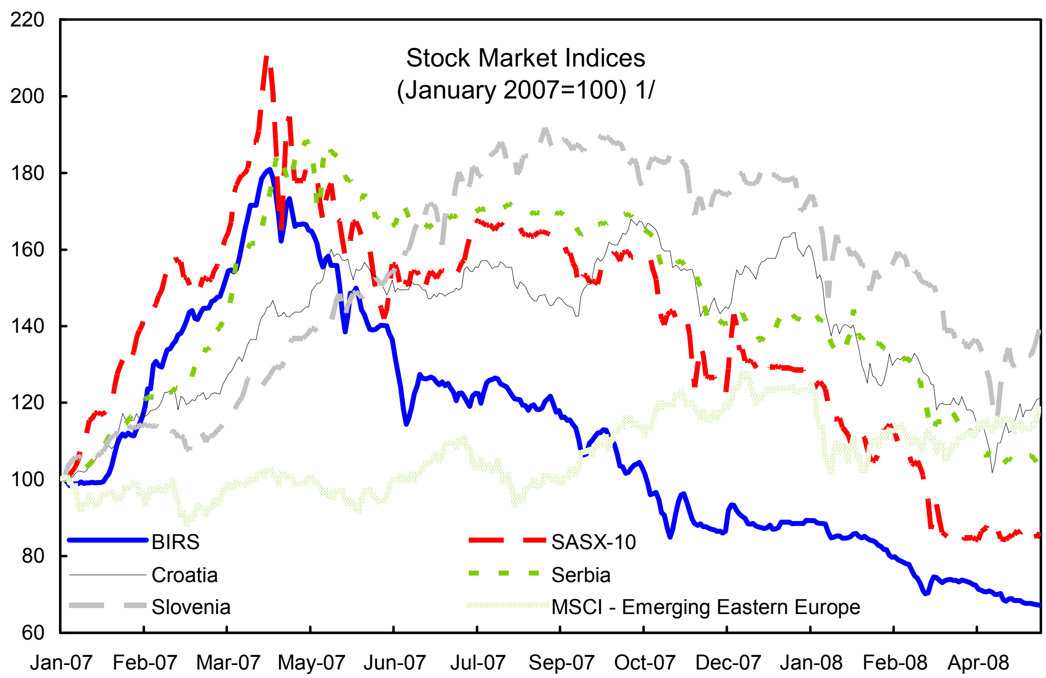
[5] Bank lending and deposit data suggest that the household sector FX position is broadly balanced. The corporate sector's position is less clear because of limited data availability.

Figure 7. Bosnia and Herzegovina: Financial Market Indicators, 2003–08

Lending interest rates have fallen over the years, and remained relatively flat in 2008.



Similar to the neighboring countries, Bosnian stock indices have fallen since their peaks in 2007.

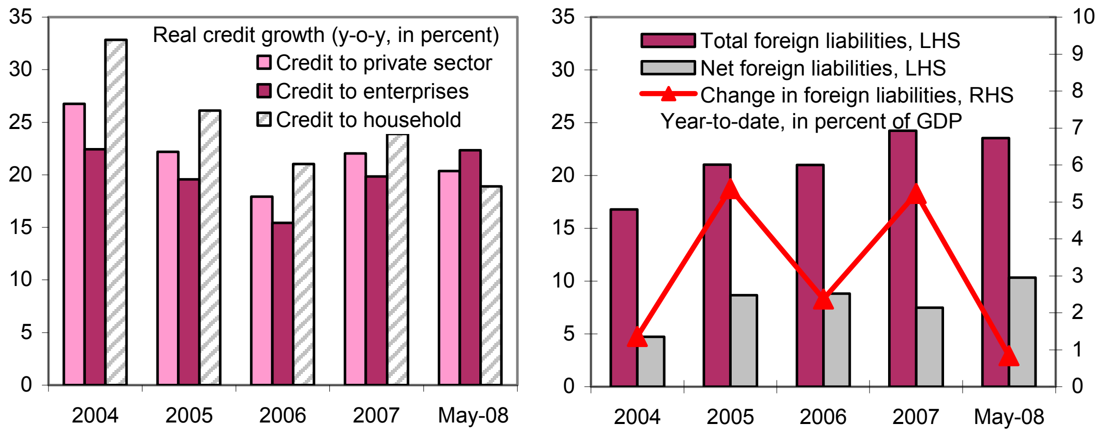


1/ SASX-10 is the stock market index of the Sarajevo Stock Exchange and BIRS is the stock market index of the Banja Luka Stock Exchange.

Sources: BiH authorities; European Central Bank; and IMF staff calculations.

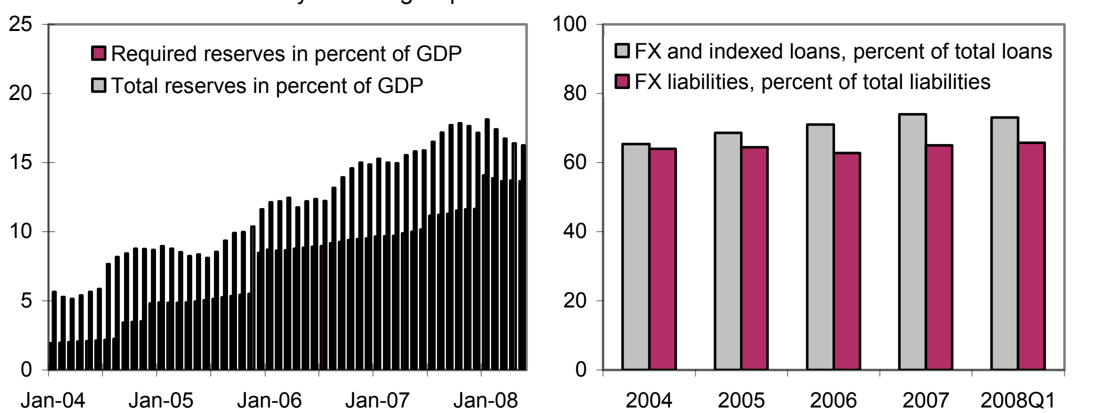
Figure 8. Bosnia and Herzegovina: Financial Sector Developments, 2004–08

Credit growth and bank-related capital inflows picked up in 2007 but have started to slow down.



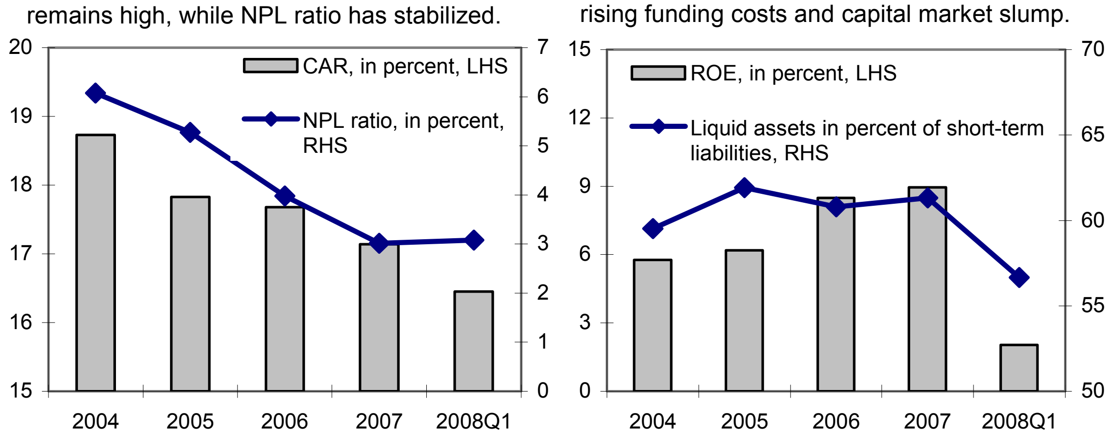
In 2008, excess reserves started to decline following the increase in reserve requirement and the relaxation of the maturity matching requirement.

The ratio of foreign currency and indexed loans is high and has risen over time.



Capital adequacy ratio has been falling but remains high, while NPL ratio has stabilized.

Profitability fell in the first quarter of 2008 following rising funding costs and capital market slump.



Source: CBBH; and IMF staff calculations.

13. **Progress on structural reforms is uneven.** BiH trails its best-performing peers on most structural indicators (Figures 9 and 10); in some areas—starting a business, registration, contract enforcement—by large margins. Privatization has advanced rapidly in the RS, but has yet to take off in the Federation. Moreover, in other important aspects—e.g., economic regulation and social programs—creating a single economic space remains elusive (Country Report 07/351).

Source: World Bank Doing Business indicators (2008).
1/ The ranks were transformed into an index, with 10 as the best and 0 the lowest value.

III. Policy Discussions

14. **The Article IV discussions took place amid renewed optimism about BiH's prospects, notwithstanding a complicated policy environment.** The SAA could renew the reform momentum, but the complex political structure may weaken the focus on reform. RS has emerged as a faster reformer owing to greater political cohesion and societal consensus, but the Federation finds it difficult to mobilize action on reforms. The discussions took place against a backdrop of concerns about inflation and the challenge of managing fiscal pressures in the face of rising public expectations, and focused on: (i) policies best suited to reduce vulnerabilities and promote sustainable strong growth; and (ii) the main risks to financial stability and ways to mitigate them. Table 12 summarizes the authorities' responses to past Fund recommendations.

A. Outlook

15. **In the short run, economic growth is set to remain strong**. For 2008, the fiscal stimulus of 1.8 percentage points of GDP and a loose public-sector wage policy suggest that domestic demand pressures are unlikely to diminish. The strong momentum is projected to keep GDP growth at 5½ percent in 2008, but emerging capacity constraints and a slightly lower fiscal stimulus will drive a slowdown in growth to 5 percent in 2009. Headline inflation is to average 7½ percent in 2008, with underlying inflation at around 3 percent. Buoyant domestic demand along with a projected terms-of-trade deterioration will push the current account deficit to 16 percent of GDP, with FDI covering about one-third.

Figure 9. Bosnia and Herzegovina: Progress in Structural Reforms, 2003–07

Bosnia & Herzegovina still lags behind neighboring countries...

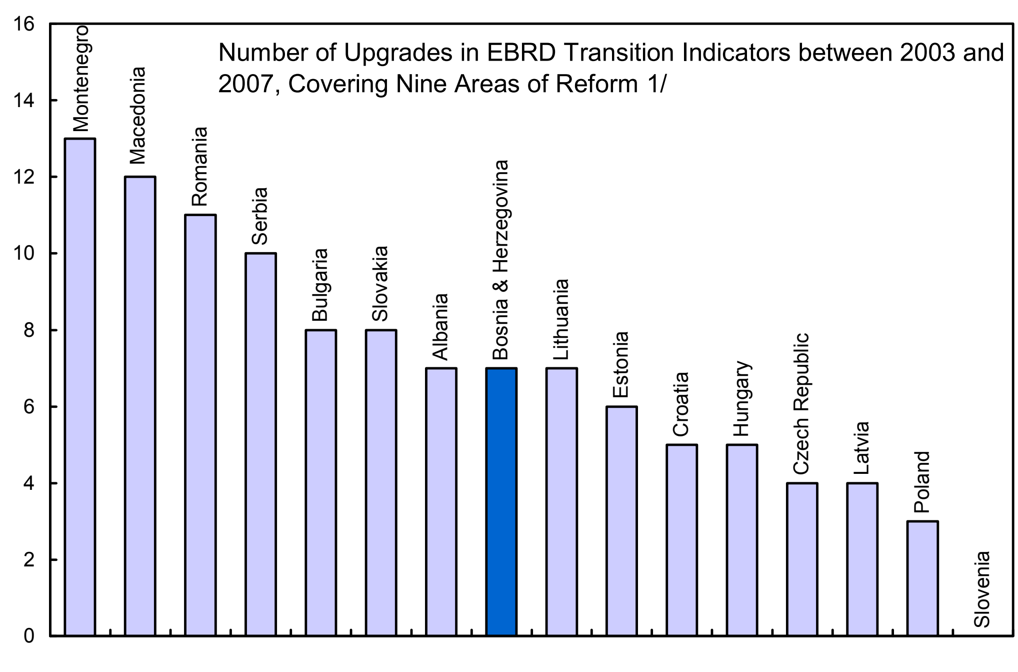
Bosnia & Herzegovina and Selected Countries: EBRD Transition Indicator Scores, 2007

		Enterprises			Markets and Trade			Financial Institutions		Infrastructure
	Private sector share of GDP EBRD midyear estimate (%)	Large-scale privatization	Small-scale privatization	Governance & enterprise restructuring	Price liberalization	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalization	Securities markets & nonbank financial institutions	Infrastructure reform
BiH	55	3.0	3.0	2.0	4.0	3.7	2.0	2.7	1.7	2.3
CE/Baltic 1/	76	3.8	4.3	3.4	4.3	4.3	3.2	3.8	3.4	3.2
SE Europe 2/	67	3.3	3.9	2.6	4.2	4.2	2.4	3.2	2.4	2.7

Sources: *EBRD Transition Report*, 2006; and IMF staff calculations of (unweighted) regional averages.

1/ Eight new EU member states: Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia.
2/ Southeastern Europe (excluding Bosnia and Herzegovina): Albania, Bulgaria, Croatia, FYR Macedonia, Montenegro, Romania, and Serbia.

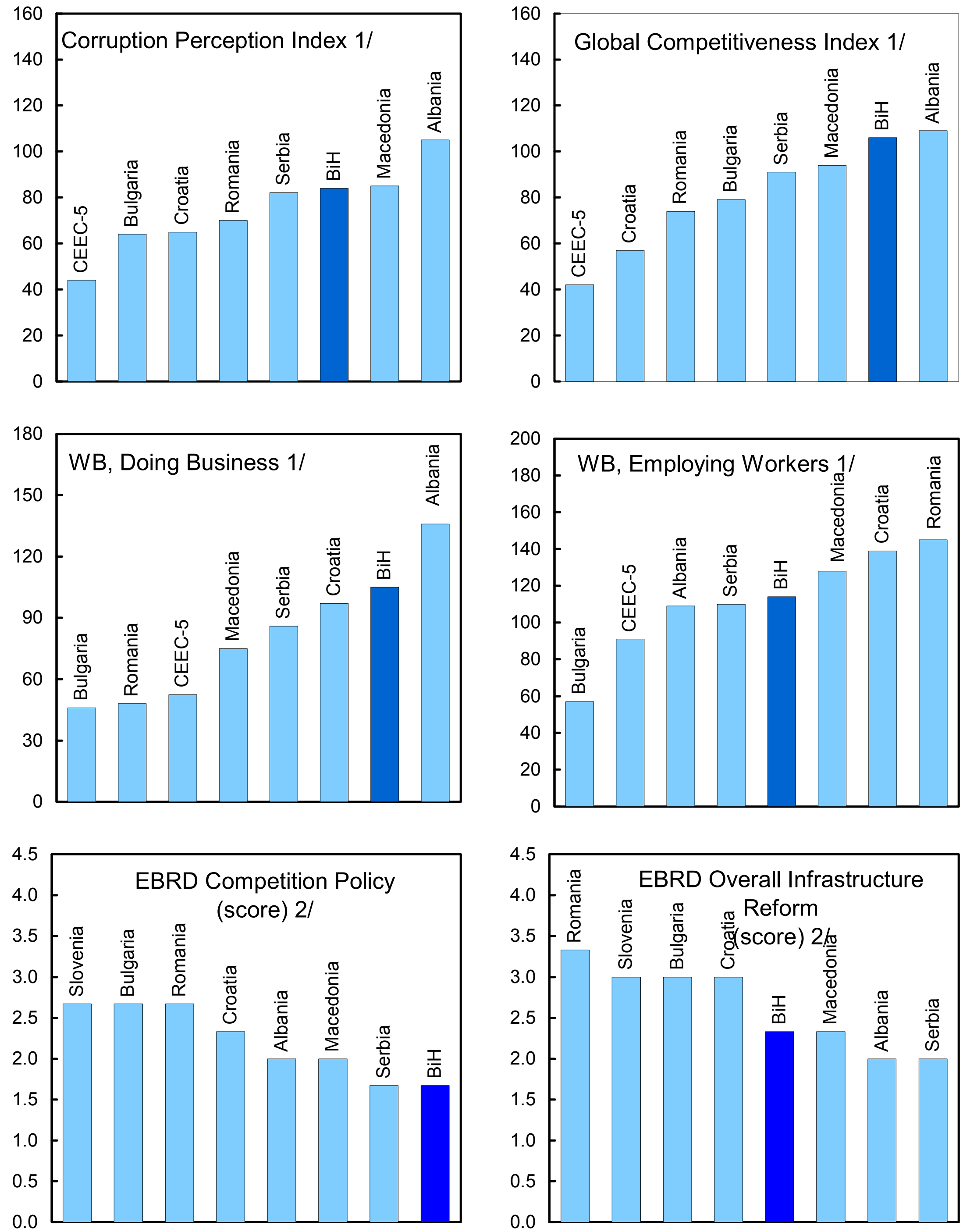
... and the pace of structural reform has been slow.



Sources: *EBRD Transition Reports*, 2003 and 2007; and IMF staff estimates of unweighted regional and category averages. Indicators range from 1 (no reform) to 4+ (standards of an industrialized market economy).

1/ The nine areas are large-scale privatization; small-scale privatization; governance & enterprise restructuring; price liberalization; trade & foreign exchange system; competition policy; banking reform & interest rate liberalization; securities markets & nonbank financial institutions; and infrastructure reform.

Figure 10. Bosnia and Herzegovina: Institutional Quality and Reform, 2007
(Rank, unless otherwise specified)



Sources: EBRD; Transparency International; World Bank, Doing Business Database; World Economic Forum.

1/ Lower ranking means better environment. The corruption perception index relates to perceptions of the degree of corruption as seen by business people and country analysts, it covers 180 countries. The global competitiveness index covers 125 countries. The World Bank indices cover 178 countries.

2/ The EBRD maximum score is 4.33, with maximum being best.

CEEC-5 = Czech Republic, Slovakia, Poland, Hungary, Slovenia.

Bosnia & Herzegovina: Key Macroeconomic Indicators, 2007–09
(In percent of GDP, unless otherwise indicated)

	2007	2008	2009
	Est.	Baseline Proj. 1/	
Real GDP growth (percent)	5.8	5.5	5.0
CPI (change in percent; average)	1.5	7.4	4.0
Current account balance	-13.0	-16.0	-14.0
General government balance	-0.1	-1.9	-2.5
Reserve cover (months of imports)	5.4	4.3	5.3
Gross external debt	48.5	40.5	39.0
Public debt	30.5	34.3	37.5

Sources: BiH authorities; and Fund staff projections.

1/ On the basis of current policies.

16. **While there are upside risks to the baseline, the balance of risks is tilted somewhat to the downside.** Although for now there are no signs of slowing economic activity, higher bank funding costs could soon lead to a scaling back of lending. More pronounced spillovers from the deteriorating external environment could undermine growth and external stability. With higher price and wage inflation, external competitiveness would deteriorate, and the risk of a disruptive adjustment rise. On the upside, sustained high metal prices, lower oil prices, higher grants or stronger FDI could lift economic performance.

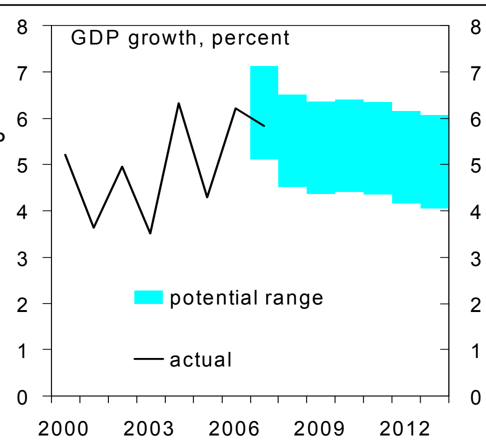
17. **Under current policies, unattended vulnerabilities will hamper BiH's medium-term growth prospects.** Growth-accounting analysis suggests that—with investment and total factor productivity growing at historical averages, and a pickup in labor force growth—

Growth Accounting Assumptions

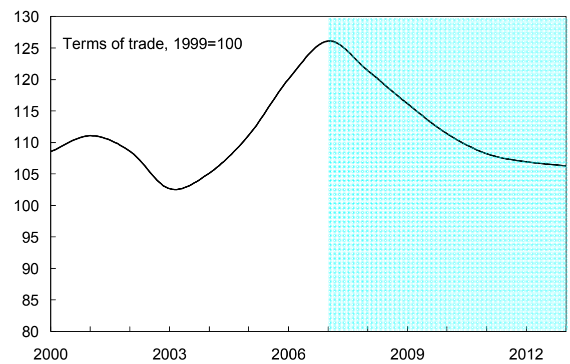
Investment rate: 25–28 percent of GDP
(2000–07 average: 26 percent)

Labor force growth: 0.7 percent
(2000–07 average: –0.2 percent)

TFP growth: 2–4 percent
(2000–07 average: 3.3 percent)



output growth would moderate over the medium term. In the baseline scenario, slow progress on structural reforms would limit productivity gains and export growth prospects. With broadly unchanged fiscal policy, the large public sector would narrow the space for private sector investment and growth. Domestic demand growth would slow down somewhat as private sector credit growth would decelerate. With the projected terms-of-trade deterioration[6], the current account deficit would remain at about 15 percent of GDP in 2010-11, before leveling off at around 13–14 percent by 2013—at the high-end of the sustainable range (Figure 11). While public debt would hover at 40 percent of GDP, any further fiscal deterioration would put it on an unsustainable path.



18. **The authorities took a more sanguine view regarding BiH's medium-term prospects.** Their framework is predicated on strong output growth (5–6 percent per year) and low inflation (2 percent). They shared the baseline external outlook, but emphasized upside risks stemming from FDI and continued strong inflows from banks and other sources. Staff acknowledged that with the right policy mix—fiscal policy crowding in the private sector by targeting a balance over the medium term and ambitious reforms supporting productivity gains—potential output would be boosted and the external deficit be reduced to sustainable levels (Table 9b and Figure 11).

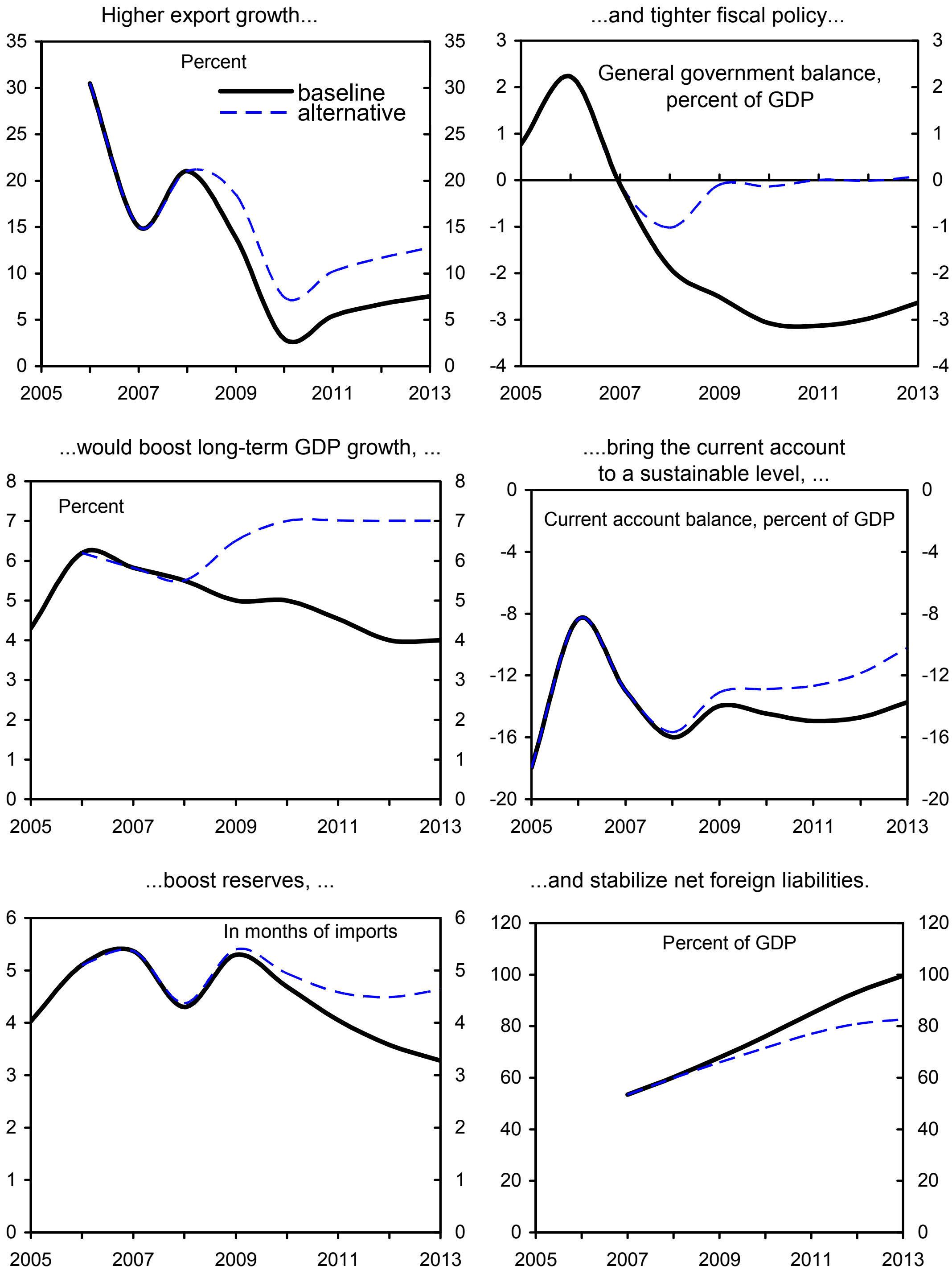
B. Public Finances

19. **Fiscal policy is key for ensuring macroeconomic stability.** The widening current account deficit, the associated external stability risks, and unabated inflationary pressures call for fiscal policy to avoid a recurrence of last year's procyclical easing. This, together with prudent public-sector wage policy, should help stabilize the economy. The authorities agreed that fiscal policy was the only macroeconomic-management tool to ensure the stability of the currency board and reiterated their commitment to such arrangement until euro adoption—their exit strategy.

20. **Staff thus argued that a general government balance was an appropriate medium-term target.** First, with the external stability assessment suggesting that the current account deficit has been hovering at unsustainable levels, a balanced-budget target would contribute to ***macroeconomic stability***, by helping narrow the S–I gap and gradually bringing the external deficit to sustainable levels. Second, it would ensure ***fiscal sustainability***—by contributing to a reduction in the debt-to-GDP ratio to below 30 percent ahead of the lapsing

[6] The projected drop in metal export prices accounts for 3½ percent of GDP current-account deterioration.

Figure 11. Bosnia and Herzegovina: Outlook under Alternative Scenarios, 2005–13



Sources: BiH authorities; and Fund staff simulations.

of concessionality of government debt[7] and minimizing risks from the uncertain burden of unsettled claims against the government.[8] Third, it would be a ***simple and transparent anchor*** for policymakers and the public—an important consideration in BiH. While broadly agreeing with these observations, no authority was in a position to articulate clear medium-term fiscal policy objectives for BiH as a whole.

21. **The mission cautioned against fiscal stimulus in 2008.** The adopted budgets envisage an overall deficit of 3 percent of GDP, implying a significant fiscal relaxation. This would exacerbate already-strong domestic demand pressures and contribute to a widening current account deficit. Mounting commitments for transfers to households in the Federation, rapidly-increasing public-sector wages, and customs revenue loss are already putting pressure on public finances. On account of strong revenue performance and the historical pattern of underexecution in investment projects, staff projects a slightly lower deficit outturn (2 percent of GDP)—still a significant and ill-timed expansion. The mission stressed that macroeconomic imbalances called for strong efforts to avoid fiscal stimulus. While acknowledging that this might not be feasible at this stage, it urged the authorities to reduce the fiscal impulse in 2008 relative to the budget and target a balance in 2009 (see below). In this vein, a deficit of up to 1 percent of GDP in 2008 would provide a realistic and credible target toward medium-term balance. This would require: (i) the RS saving as much as possible of its revenue overperformance; (ii) in the absence of legislative changes, the Federation cutting other spending to accommodate war-related benefits; and (iii) the lower levels of government rationalizing spending.

General Government: Overall Balance, 2007–08
(In percent of GDP)

		2008		
	2007 Est.	Budgets	Proj.	Staff-recommend. scenario
General Government	-0.1	-3.0	-1.9	-1.0
Of which:				
RS	0.3	-0.5	-0.2	0.0
Federation	0.3	-1.3	-0.8	-0.2
of which: cantons	0.2	-0.7	-0.5	-0.2
State	0.4	-0.4	-0.2	0.0
Indirect tax authority	-0.5	...	...	...
Foreign loan-financed projects	-0.5	-0.7	-0.7	-0.7

Source: Staff estimates and projections.

22. **The authorities considered a fiscal tightening unduly restrictive.** They viewed BiH's low debt, and abundant privatization proceeds (in the RS) and foreign financing as providing fiscal space to boost much-needed infrastructure and support growth. They also argued that a small deficit would pose little risk to fiscal sustainability. Federation officials also found it difficult to tighten fiscal policy in 2008, due to limited prospects of resisting

[7] A large part of external public debt has been contracted on concessional terms. With the newly-contracted debt on commercial terms, the effective average degree of concessionality is declining.

[8] The baseline includes an allowance for a likely upper bound of contingent liabilities that would ultimately be taken over by the state (15 percent of GDP).

social-transfer pressures in the runup to the October local elections. In this context, they voiced their frustration about the parliamentary practice of approving legislation that creates unfunded spending commitments.

23. **The 2009 budget would provide an opportunity for a new fiscal policy approach.** It should support macroeconomic stability by targeting a balance and incorporate reforms to improve the quality of spending.[9] The authorities were confident that the Fiscal Council and the permanent indirect tax revenue allocation formula open the road for a more coordinated and predictable fiscal policy. It is thus important to make the Council operational as soon as possible by involving it in the design of the 2009 budget and medium-term fiscal targets. Improving fiscal reporting, including by harmonizing accounting standards and budget calendars for all governments, will be critical for the Council's effectiveness. There is also a need to overhaul budgetary procedures in the Federation to ensure new legislation is funded, strengthen cash-management practices to avoid future liquidity problems, and reform the system of transfers to households.

24. **Privatization proceeds should be used to support BiH's growth objectives without compromising macroeconomic stability.** The RS authorities are committed to use most of the funds for infrastructure and pension reform. In the Federation, plans have been drawn up to use most of the proceeds for investment, but due to unfunded social-transfer commitments, there is a risk that a large part could be used for recurrent spending. The mission expressed concerns about the effectiveness of subsidized lending through development banks, and encouraged the authorities to engage in a systematic evaluation of alternative uses of privatization proceeds (including a reduction in contingent liabilities related to public-enterprise debts, or financing of the transitional pension-reform cost). Finally, while private sector involvement in infrastructure is welcome, a strong institutional framework for public-private partnerships is necessary.

25. **A strict public-sector wage policy is critical for containing demand pressures.** The public wage reforms in the State and the RS are welcome, but recent large public-sector wage increases draw attention to BiH's large government payroll and the relatively high level of public wages compared with the rest of the economy (Figure 12). Also, the step adjustment in RS public-sector wages was particularly steep, although the RS government is committed to improve efficiency and freeze wages for the next three years. The State wage indexation mechanism (and similar mechanisms in the Federation and lower levels of government) could lead to substantial further increases in the wage bill; but the State authorities committed to avoiding destabilizing wage increases by invoking a special clause in the state wage law. As for the risk that public-sector wage competition could spill over to private-sector settlements, the authorities were confident that market discipline would ensure that private-sector settlements continue to be competitive.

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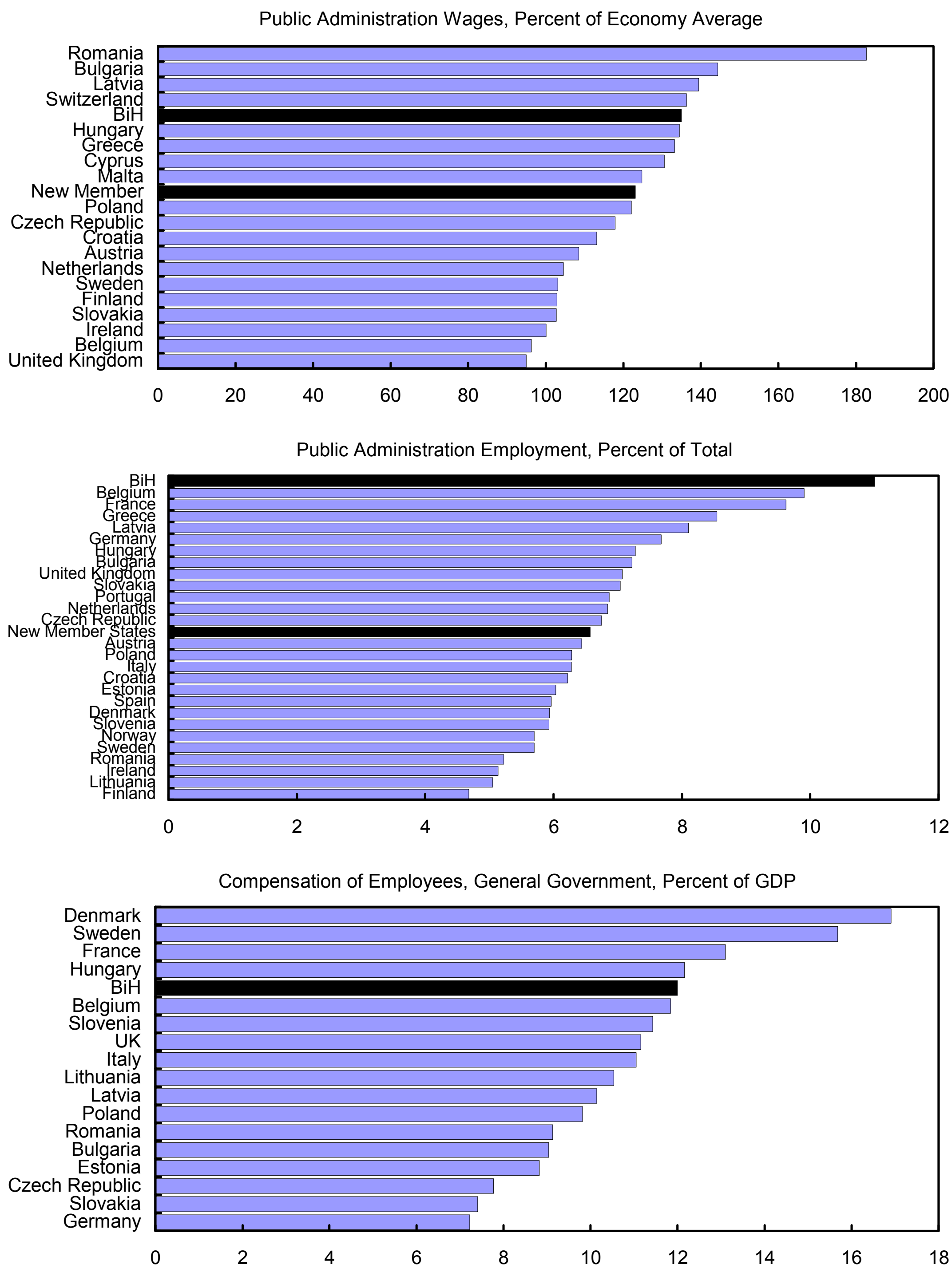
[9] The proposals in the World Bank's 2006 Public Expenditure Review remain pertinent.

Figure 12. Public Administration Wages and Employment, 2006 1/



1/ 2007 for Bosnia and Herzegovina.
Sources: Eurostat; and IMF staff calculations.

Net Wage, Monthly

	2006	2007	Latest	
Percent change, y-o-y				
Federation				
Average	8.2	9.8	13.0	April
Public administration	11.6	10.7	17.2	April
Education	12.2	11.4	16.1	April
Health and social services	4.7	11.6	19.2	April
Republika Srpska				
Average	12.3	11.7	31.6	May
Public administration	8.9	14.9	15.5	May
Education	10.1	7.3	74.8	May
Health and social services	10.5	16.9	103.6	May
Percent of average wage				
Federation				
Average	100	100	100	
Public administration	132	133	137	
Education	102	103	108	
Health and social services	114	116	119	
Republika Srpska				
Average	100	100	100	
Public administration	148	152	136	
Education	88	84	109	
Health and social services	100	105	158	

Sources: BiH authorities; and Fund staff calculations.

C. Financial Sector Issues

26. **Financial sector surveillance needs to be intensified and preemptive measures be considered.** Higher inflation and input costs are beginning to put pressure on the budgets of households and enterprises, raising concerns about their debt-servicing ability. This calls for continued monitoring of balance-sheet risks at the corporate and household level, especially given possible currency mismatches. While competing for market share, some banks may have built up higher credit risk. Pressed by rising funding costs, large banks are likely to raise lending interest rates soon—for the first time since the beginning of the credit boom. Although stress tests based on end-2006 data suggest that the banking system can absorb losses from asset quality deterioration and is resilient to risks of slowing capital inflows, supervisors should not hesitate in encouraging banks to strengthen their capital positions—especially given banks' reliance on external borrowing. Staff welcomed the CBBH's plan to soon publish its 2007 financial stability report (FSR), featuring more recent stress tests.

27. **There was agreement that containing risks to financial stability would require better risk management.** Staff welcomed measures to mitigate risks, such as the regulation on disclosing effective interest rates to improve transparency, and the relaxation of maturity matching rules to ease pressures to borrow from abroad. Moreover, the two banking agencies have introduced new regulations on liquidity, market, and operational risk management, and have begun to take on supervision of leasing companies and micro-credit organizations. Further enhancing supervisory oversight of risk management will require strengthening the

capacity of supervisors and improving statistics. Thus, staff welcomed CBBH's efforts to utilize credit registry data in its FSR and construct real estate price indices.

28. **Progress on information sharing between the CBBH and banking agencies needs to be complemented by better coordination at the policy level.** Staff welcomed the newly-signed MOU on information exchange, which advances the financial stability work program at the technical level, and encouraged the CBBH and banking agencies to inform each other of monetary policy and major prudential decisions. Improved coordination should also be extended to plans to tighten asset classification and provisioning rules to take into account the credit cycle and the banking system's health. Finally, staff reiterated the long-standing recommendation to unify bank supervision, but the authorities argued that this step would need to await constitution reform.

29. **CBBH officials recognize the importance of strengthening crisis-preparedness arrangements.** They are reviewing existing procedures and intend to formulate a comprehensive crisis-management plan. Staff encouraged these efforts and highlighted the need to coordinate regulatory and prudential actions with foreign regulators.

D. Capacity Building

30. **Improving the quality of statistics and strengthening capacity are prerequisites for successful economic management.** Most importantly, the quality, coverage, and timeliness of fiscal data need improvement, to enhance the effectiveness of the Fiscal Council.[10] The recently-completed Data ROSC provides a roadmap. Moreover, expertise and capacity at various relevant institutions needs upgrading, while the CBBH's observer status in the Council offers it a crucial advisory role in the currency-board setting.

IV. Staff Appraisal

31. **Bosnia and Herzegovina's economy has been performing relatively well.** Real GDP growth averaged 5.2 percent during 2002−07, thus leading to a level of per capita income above the Balkan average, and inflation remained low until mid-2007. These achievements largely reflect the benefits of the currency board, and the effects of reforms in key sectors and the financial system.

32. **But policymakers now face several challenges.** The current account deficit currently exceeds sustainable levels, although there is no strong evidence of a significantly overvalued real exchange rate at present that could result in future external instability. However, going forward, more expansionary fiscal and public-sector wage policies could threaten competitiveness and increase risks to external stability. Inflation pressures are on the

[10] For example, due to different coverage, there is a discrepancy between the 2007 fiscal positions estimated by the staff and the authorities (Table 13).

rise, largely reflecting global shocks to food and energy prices, but underlying inflation pressures have also intensified. Unsettled global financial markets and a worsening economic environment in Europe pose risks to the country's stability and growth prospects. Finally, a number of long-standing distortions—e.g., the inefficient public sector and overregulated business environment—remain.

33. **In these circumstances, fiscal and incomes policies should be tightened.** Following last year's procyclical fiscal relaxation, fiscal policy intentions point to further expansion in 2008. This would exacerbate domestic demand pressures and keep the current account deficit at unsustainable levels. Amid signs of increasing macroeconomic instability, it would have been appropriate to respond to the private-sector absorption boom by avoiding fiscal stimulus in 2008. While this may not be feasible at this stage, the fiscal stance in 2008 should be significantly tightened compared to what is planned under the budget and a balanced budget targeted for 2009. To this end, limiting the general government deficit to up to 1 percent of GDP in 2008 would put it on a credible consolidation path toward balance over the medium term. Such a target would help stabilize the economy and ensure fiscal sustainability, without crowding out the private sector. Moreover, privatization proceeds should be used to support BiH's growth objectives without compromising macroeconomic stability; and a strong institutional framework for public-private partnerships should be put in place. Finally, it is important to maintain wage discipline in the public sector.

34. **Fiscal policy coordination and budgetary practices need to be strengthened.** The establishment of the Fiscal Council and the agreement on a permanent indirect tax revenue allocation formula are crucial steps toward a more coordinated fiscal policy. The Council should be made operational as soon as possible and play a role in the design of the 2009 budget, setting medium-term fiscal targets, and mandating harmonization in fiscal reporting. Moreover, fiscal expertise and capacity should be upgraded, and budgetary procedures overhauled in the Federation to ensure new legislation is funded.

35. **Maintaining financial stability requires further improving risk management and close policy coordination.** Bank supervisors have made major progress in containing risks to financial stability with the introduction of new regulations on liquidity, market and operational risk management, and the expanded coverage of their supervision to include leasing companies. Going forward, supervisors need to give priority to further improve the oversight of risk management, closely monitor credit risk, and encourage banks to increase capital buffers, if necessary. And close policy coordination—beyond information exchange—between the CBBH and bank supervisors will be needed. Unification of banking supervision remains necessary for financial stability and for establishing cooperation with key foreign supervisors.

36. **Poor data quality impedes effective surveillance.** Although important progress has been made to improve statistics, major problems remain with the timeliness and coverage of

fiscal data. The authorities should persevere with their efforts and follow up on the recommendations of the recently-completed Data ROSC.

37. **BiH has not accepted the obligations under Article VIII, Sections 2, 3, and 4,** but maintains restrictions on the transferability of balances and interest accrued on frozen foreign-currency deposits, subject to Fund jurisdiction under Article VIII. Staff does not recommend approval of these restrictions.

38. It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Bosnia and Herzegovina: Selected Economic Indicators, 2004–09

	2004	2005	2006	2007	2008	2009
				Est.	Projections	
Nominal GDP (millions of KM)	15,786	16,928	19,106	21,091	24,545	26,541
Gross national saving (in percent of GDP)	11.1	9.4	12.6	12.1	10.0	12.1
Gross investment (in percent of GDP)	27.5	27.4	20.9	25.1	26.0	26.1
	(Percent change)					
Real GDP	6.3	4.3	6.2	5.8	5.5	5.0
Index of industrial production (period average)	13.6	11.1	10.5	8.1	5.5	5.0
Gross wages (period average)	3.7	5.6	9.1	10.3	17.2	7.3
CPI (period average)	0.3	3.6	6.1	1.5	7.4	4.0
Money and credit (end of period)						
Broad money	24.3	18.2	24.7	21.6	15.2	...
Credit to economy	27.5	27.5	23.3	28.1	25.1	...
	(In percent of GDP)					
General government budget						
Revenue	44.2	45.5	47.5	48.7	47.9	47.3
Of which: grants	3.1	3.0	2.6	3.2	3.0	2.9
Expenditure (on a commitment basis)	44.7	44.7	45.3	48.7	49.7	49.8
Of which: investment expenditure	7.0	6.9	6.1	6.9	7.7	7.6
Primary balance	0.1	1.4	2.9	0.6	-1.2	-1.5
Overall balance	-0.5	0.8	2.2	-0.1	-1.9	-2.5
External public debt	25.5	25.6	21.2	18.1	14.6	13.9
NPV of external public debt	19.5	19.6	16.2	13.8	11.2	10.6
Total public debt 1/	25.5	25.6	22.0	30.5	34.3	37.5
	(In millions of euros, unless noted otherwise)					
Balance of payments						
Exports of goods and services	2,373	2,832	3,589	4,062	4,934	5,549
Imports of goods and services	5,704	6,393	6,493	7,656	9,273	9,923
Unrequited transfers, net	1,604	1,628	1,762	1,853	1,982	2,158
Current account balance	-1,318	-1,555	-816	-1,401	-2,007	-1,896
(In percent of GDP)	-16.3	-18.0	-8.4	-13.0	-16.0	-14.0
Foreign direct investment	566	477	562	1,471	680	2,000
(In percent of GDP)	7.0	5.5	5.8	13.6	5.4	14.7
Gross official reserves	1,768	2,145	2,761	3,425	3,325	4,382
(In months of imports)	3.7	4.0	5.1	5.4	4.3	5.3
Net international reserves	1,673	2,083	2,730	3,404	3,269	...
External debt service	419	267	412	321	450	467
(In percent of exports of goods and services)	17.6	9.4	11.5	7.9	9.1	8.4

Sources: BiH authorities; and IMF staff estimates and projections.

1/ Increase in 2007 reflects the estimated recognition of domestic claims, and in 2008–09 the projected recognition of domestic claims.

Table 2. Bosnia and Herzegovina: Balance of Payments, 2004–13
(In millions of euros, unless otherwise indicated)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Est.			Projections			
Merchandise trade	-3,678	-3,962	-3,406	-4,142	-5,039	-5,141	-5,626	-6,024	-6,353	-6,650
Exports, f.o.b.	1,677	2,060	2,687	3,092	3,742	4,260	4,386	4,623	4,933	5,305
Imports, f.o.b.	-5,354	-6,022	-6,093	-7,234	-8,781	-9,401	-10,012	-10,647	-11,286	-11,955
Reconstruction	-266	-250	-200	-164	-194	-252	-327	-368	-398	-409
Other	-5,089	-5,772	-5,893	-7,069	-8,586	-9,148	-9,685	-10,278	-10,889	-11,546
Services, net	347	401	501	548	700	767	834	899	974	1,055
Exports	696	772	901	970	1,192	1,290	1,386	1,481	1,585	1,700
Imports	-349	-371	-400	-422	-492	-523	-553	-582	-612	-644
Income, net	408	378	326	340	350	320	355	305	280	261
Credit	544	549	582	650	750	743	806	776	776	790
Debit	-136	-172	-256	-310	-400	-423	-451	-470	-495	-529
Of which : interest	-78	-84	-97	-127	-209	-223	-242	-251	-268	-291
Current transfers, net	1,604	1,628	1,762	1,853	1,982	2,158	2,333	2,518	2,701	2,955
Receipts	1,773	1,788	1,942	2,048	2,188	2,374	2,561	2,757	2,954	3,221
Public	261	251	237	186	186	234	272	304	323	370
Private	1,512	1,538	1,705	1,862	2,002	2,140	2,289	2,453	2,631	2,851
Payments	-169	-160	-179	-195	-206	-216	-228	-240	-253	-266
Current account balance	-1,318	-1,555	-816	-1,401	-2,007	-1,896	-2,104	-2,302	-2,397	-2,379
Capital and Financial Accounts	1,358	1,709	1,237	1,839	1,687	2,713	1,599	1,704	1,876	1,969
Capital account	242	234	234	215	223	237	252	273	294	307
Capital transfers	242	234	234	215	223	237	252	273	294	307
Official transfers	122	126	118	101	101	106	112	122	133	146
Private transfers	256	108	115	114	122	131	140	150	161	161
Financial account	1,116	1,475	1,003	1,625	1,464	2,476	1,348	1,432	1,582	1,662
Direct investment	566	477	562	1,471	680	2,000	800	840	930	990
Outward	-1	-1	-2	-7	0	0	0	0	0	0
Inward	567	478	564	1,478	680	2,000	780	840	930	990
Portfolio investment	-2	-2	0	1	0	0	0	0	0	0
Other investment	552	999	440	153	784	476	548	592	652	672
Assets (increase, –)	248	288	78	-572	481	154	169	130	134	130
Commercial banks	-178	-100	-118	-616	361	72	69	39	38	37
Other	426	387	196	44	120	82	101	91	96	94
Liabilities	305	712	363	725	303	322	378	462	518	541
Trade credits	95	200	176	203	262	272	291	312	328	348
Commercial banks	280	402	350	411	131	137	144	182	225	240
Amortization	-293	-142	-269	-175	-203	-244	-282	-287	-309	-320
Drawing of loans	222	251	107	285	113	156	226	256	274	273
Project	144	124	82	64	94	146	216	246	264	263
Program	32	10	10	10	19	10	10	10	10	10
Reserve assets (increase, –)	-351	-381	-627	-637	100	-1,056	255	338	241	111
Monetary gold	0	0	0	0	0	0	0	0	0	0
Special drawing rights	2	0	0	0	0	0	0	0	0	0
Reserve position in the IMF	0	0	0	0	0	0	0	0	0	0
Foreign exchange	-348	-378	-616	-623	100	-1,057	254	338	241	110
Other claims	-5	-4	-12	-15	0	0	0	0	0	1
Net Errors and Omissions 1/	311	228	207	199	220	240	250	260	280	300
Memorandum items:										
Current account balance (percent of GDP)	-16.3	-18.0	-8.4	-13.0	-16.0	-14.0	-14.5	-14.9	-14.7	-13.7
Trade balance (percent of GDP)	-45.6	-45.8	-34.9	-38.4	-40.2	-37.9	-38.7	-39.1	-39.0	-38.4
Import of goods (change, percent)	7.6	12.5	1.2	18.7	21.4	7.1	6.5	6.3	6.0	5.9
Export of goods (change, percent)	28.7	22.8	30.5	15.0	21.0	13.8	3.0	5.4	6.7	7.5
Transfers (percent of GDP)	19.9	18.8	18.0	17.2	15.8	15.9	16.1	16.3	16.6	17.0
Net foreign direct investment (percent of GDP)	7.0	5.5	5.8	13.6	5.4	14.7	5.5	5.5	5.7	5.7
External debt/GDP (percent)	47.5	52.6	48.0	48.5	40.5	39.0	38.3	38.4	38.8	38.9
Private	22.0	27.0	26.8	30.4	25.9	25.1	24.7	24.7	25.0	25.2
Public	25.5	25.6	21.2	18.1	14.6	13.9	13.7	13.7	13.8	13.7
External public debt service/exports of G&S (percent)	17.6	9.4	11.5	7.9	9.1	8.4	9.1	8.8	8.9	8.7
Gross official reserves	1,768	2,145	2,761	3,425	3,325	4,382	4,128	3,790	3,549	3,440
(Months of imports of goods and services)	3.7	4.0	5.1	5.4	4.3	5.3	4.7	4.1	3.6	3.3
Nominal GDP	8,071	8,655	9,769	10,783	12,549	13,570	14,538	15,412	16,305	17,337

Sources: BiH authorities; and IMF staff estimates and projections.

1/ Errors and omissions are explicitly projected to capture unrecorded capital inflows.

Table 3. Bosnia and Herzegovina: Selected Vulnerability Indicators, 2004–08

	2004	2005	2006	2007 Est.	2008 Proj.	Latest Actual	Latest Observation
External sector							
Exports of goods (change, percent, in euros)	28.7	22.8	30.5	15.0	21.0	16.4	Jan–May 08
Imports of goods (change, percent, in euros)	7.6	12.5	1.2	18.7	21.4	25.4	Jan–May 08
Terms of trade (change, percent)	2.4	5.7	8.0	5.0	-3.4	5.0	2007
Current account balance (percent of GDP)	-16.3	-18.0	-8.4	-13.0	-16.0	-13.0	2007
Capital and financial account (percent of GDP)	16.8	19.7	12.7	17.1	13.4	17.1	2007
Net FDI inflows (percent of GDP)	7.0	5.5	5.8	13.6	5.4	13.6	2007
Gross international reserves (end of period, millions of euros)	1,768	2,145	2,761	3,425	3,325	3,313	May-08
In months of imports of goods and services	3.7	4.0	5.1	5.4	4.3	5.4	2007
In percent of short-term debt at remaining maturity	473.0	476.4	840.4	481.8	659.7	481.1	2007
In percent of reserve money	106.7	105.7	106.9	107.5	107.5	108.1	May-08
Total gross external debt (percent of GDP)	47.5	52.6	48.0	48.5	40.5	48.5	2007
Of which short-term external debt (remaining maturity, percent of GDP)	5.4	7.1	4.8	7.3	5.4	7.3	2007
Of which extermal public debt (percent of GDP)	25.5	25.6	21.2	18.1	14.6	18.1	2007
REER (annual average percentage change; depreciation =-)	-1.6	0.8	2.3	-1.8	5.1	-1.8	2007
Exchange rate (per U.S. dollar, period average)	1.6	1.6	1.6	1.4	1.3	1.2	Apr-08
Financial and financial market indicators							
Broad money (change, percent)	24.3	18.2	24.7	21.6	15.2	15.8	May-08
Credit to private sector (change, percent)	27.5	27.5	23.3	28.1	25.4	28.5	Jun-08
Credit to private sector (percent of GDP)	37.3	44.3	48.4	56.1	61.8	56.1	2007
Interest rates							
Average interest rates on KM loans to enterprises 1/	9.6	8.9	8.0	7.5	...	6.7	May-08
Average interest rates on KM loans to households 2/	10.9	10.4	9.7	9.3	...	9.8	May-08
Average interest rates on foreign currency-linked loans to enterprises 1/	...	...	...	7.9	...	7.6	May-08
Average interest rates on foreign currency-linked loans to households 2/	...	...	...	8.9	...	9.1	May-08
Stock market indices, end of period							
Banja Luka Stock Exchange 3/	1,150	1,367	2,885	2,564	...	1,631	Jul-08
Sarajevo Stock Exchange 4/	...	1,612	2,856	3,685	...	2,049	Jul-08
Foreign currency debt rating 5/	B3	B3	B2	B2	...	B2	Jul-08
Outlook	Positive	Positive	Stable	Stable	...	Stable	Jul-08

Sources: BiH authorities; and IMF staff estimates and projections.

1/ Simple average between short-term and long-term rates.
2/ Long-term rates.
3/ Banja Luka Stock Exchange's BIRS index.
4/ Sarajevo Stock Exchange's SASX-10 index.
5/ Moody's foreign currency sovereign rating.

Table 4. Bosnia and Herzegovina: General Government, 2004–13
(In percent of GDP)

	2004	2005	2006	2007	2008		2009	2010	2011	2012	2013
				Est. 1/	Budget	Proj.	Projections				
Revenue	44.2	45.5	47.5	48.7	46.8	47.9	47.3	47.0	46.6	45.7	45.4
Tax	34.2	35.7	38.4	38.5	37.2	38.1	37.6	37.4	37.0	36.6	36.6
VAT / Sales tax	10.2	10.8	14.2	13.9	13.8	13.9	13.8	13.9	13.8	13.9	13.8
Excises	5.2	5.8	5.4	5.2	4.8	4.9	5.1	5.2	5.3	5.4	5.5
Trade taxes	3.5	3.7	2.9	3.1	2.7	2.7	2.1	1.6	1.1	0.6	0.6
Direct taxes	2.6	2.7	2.9	2.7	2.8	3.0	3.0	3.0	3.0	3.0	3.0
Social Security contributions	12.7	12.7	13.1	13.6	13.0	13.7	13.7	13.8	13.8	13.8	13.8
Non-tax	6.9	6.9	6.5	6.9	6.5	6.7	6.8	6.6	6.6	6.6	6.6
Grants	3.1	3.0	2.6	3.2	3.1	3.0	2.9	3.0	3.0	2.6	2.2
For budget support	0.2	0.3	0.1	0.6	0.4	0.3	0.1	0.1	0.1	0.1	0.1
For investment	2.9	2.7	2.5	2.6	2.7	2.7	2.8	2.9	3.0	2.5	2.1
Consolidated expenditure on a commitment basis	44.7	44.7	45.3	48.7	49.8	49.7	49.8	50.1	49.7	48.7	48.0
Wage bill	12.0	11.4	11.1	11.8	11.9	12.4	12.3	12.4	12.3	12.3	12.2
Goods and services	10.1	9.7	10.0	9.8	9.7	10.0	9.9	9.9	9.9	9.9	9.9
Subsidies and transfers to non-public agents	12.8	13.2	13.7	16.3	15.9	16.8	16.9	16.8	16.7	16.6	16.6
Social benefits	7.4	7.8	8.2	9.3	9.1	9.5	9.4	9.4	9.4	9.4	9.4
Other transfers to households	4.1	4.1	4.0	5.3	5.0	5.6	5.7	5.7	5.6	5.6	5.5
Subsidies to industry and agriculture	1.3	1.3	1.5	1.7	1.8	1.8	1.7	1.7	1.7	1.7	1.7
Interest payments	0.6	0.6	0.7	0.6	0.6	0.7	1.0	1.1	1.1	1.2	1.3
Other current spending	2.2	3.0	3.6	3.4	2.8	2.1	2.2	2.2	2.1	2.1	2.0
Investment expenditure	7.0	6.9	6.1	6.9	8.9	7.7	7.6	7.8	7.5	6.6	6.0
Foreign financed investment projects	4.7	4.1	3.2	3.2	3.4	3.4	3.9	4.4	4.5	4.1	3.6
Other investment expenditure	2.3	2.8	3.0	3.7	5.4	4.3	3.7	3.4	3.0	2.5	2.4
Balance	-0.5	0.8	2.2	-0.1	-3.0	-1.9	-2.5	-3.1	-3.1	-3.0	-2.6
Financing	0.5	-0.8	-2.2	0.1	3.0	1.9	2.5	3.1	3.1	3.0	2.6
Domestic financing	-0.8	-1.4	-2.1	0.2	2.7	1.6	2.0	2.2	2.1	2.0	1.7
GSM proceeds	0.0	0.4	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Privatization proceeds	0.0	0.3	0.1	8.0	0.1	0.0	9.0	0.0	0.0	0.0	0.0
Repayment of other arrears and float	-0.4	-0.5	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other domestic financing	-0.5	-1.6	-2.3	-7.9	2.5	1.5	-7.1	2.0	2.0	1.9	1.6
Foreign financing	1.3	0.7	-0.1	-0.2	0.3	0.2	0.5	0.9	1.0	1.0	0.9
For budget support	0.4	0.1	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
For investment	1.8	1.4	0.7	0.5	0.7	0.7	1.1	1.5	1.6	1.6	1.5
Amortization	-0.9	-0.8	-0.9	-0.7	-0.5	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Memorandum items:											
Net lending of the RS Development Bank 2/	0.0	0.0	0.0	0.0	1.2	0.6	0.9	0.6	0.3	0.0	0.0
Primary balance	0.1	1.4	2.9	0.6	-2.4	-1.2	-1.5	-2.0	-2.0	-1.8	-1.4

Sources: Ministries of Finance; and IMF staff estimates.

1/ Estimate of 2007 is based on Federation cantonal and municipality data as submitted by the Ministry of finance, and the receipts of VAT revenue as reported by the ITA..

2/ Not included in the calculation of the overall fiscal balance.

Table 5. Bosnia and Herzegovina: Elements of General Government, 2004–13

(In percent of GDP)

	2004	2005	2006	2007	2008		2009	2010	2011	2012	2013
				Est.	Budget	Proj.	Projections				
Federation budget											
Revenue and grants	6.6	6.5	5.9	6.2	6.1	5.9	5.6	5.3	5.2	5.1	5.1
Expenditure	6.2	5.4	4.5	6.2	6.4	6.2	6.5	6.6	6.7	6.8	6.9
Of which: transfers to other levels of government	0.5	-0.1	0.0	0.3	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Balance	0.4	1.1	1.4	0.0	-0.3	-0.2	-0.9	-1.3	-1.6	-1.8	-1.9
Federation Road Fund											
Revenue and grants	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Of which: transfers from the Federation budget	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	0.5	0.8	0.7	0.6	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Balance	0.0	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Cantonal and municipal budgets											
Revenue and grants	10.6	10.5	11.1	11.6	11.3	11.0	11.0	10.9	10.7	10.5	10.5
Of which: transfers from the Federation budget	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	10.8	11.0	10.9	11.4	12.0	11.5	11.1	10.8	10.6	10.4	10.2
Balance	-0.1	-0.5	0.2	0.2	-0.7	-0.5	-0.1	0.0	0.1	0.1	0.3
Federation extra-budgetary Funds											
Revenue and grants	9.5	9.5	9.7	10.7	10.0	10.5	10.4	10.4	10.4	10.4	10.4
Of which: transfers from the Federation budget	0.2	0.2	0.0	0.7	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Expenditure	9.1	9.3	9.4	10.6	10.2	10.5	10.4	10.4	10.4	10.4	10.4
Balance	0.4	0.2	0.3	0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
RS budget and municipalities											
Revenue and grants	8.2	8.5	8.8	9.0	8.2	8.9	8.8	8.7	8.6	8.4	8.4
Expenditure	8.3	7.8	8.6	8.8	8.6	9.1	9.0	8.9	8.5	8.0	7.8
Of which: transfers to other levels of government	1.0	0.9	1.3	1.1	0.8	1.1	1.0	1.1	1.1	1.1	1.0
Balance	-0.1	0.6	0.2	0.2	-0.4	-0.2	-0.2	-0.2	0.1	0.4	0.6
RS Road Fund											
Revenue and grants	0.4	0.4	0.4	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Of which: transfers from the RS budget	0.0	0.0	0.0	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Expenditure	0.4	0.6	0.5	0.3	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Balance	0.0	-0.2	-0.1	0.1	-0.1	-0.1	-0.1	-0.1	0.0	0.0	0.0
RS extra-budgetary funds											
Revenue and grants	4.2	4.4	5.0	4.8	4.7	5.3	5.2	5.3	5.3	5.3	5.3
Of which: transfers from the RS budget	0.7	0.9	1.3	1.0	0.8	1.1	1.0	1.1	1.1	1.1	1.0
Expenditure	4.1	4.2	4.9	4.8	4.7	5.3	5.3	5.3	5.3	5.3	5.3
Balance	0.1	0.2	0.0	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0
State											
Revenue and grants	1.5	2.2	3.5	3.7	3.4	3.4	3.8	4.0	4.0	4.1	4.0
Of which: transfers from other levels of government	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditure	1.5	2.0	3.4	3.3	3.8	3.6	3.8	4.0	4.0	4.1	4.0
Balance	0.0	0.2	0.1	0.4	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0
ITA											
Balance	...	0.3	0.6	-0.6	...	...	...	...	...	...	...
Brcko District											
Revenue and grants	1.3	1.0	1.0	1.0	0.8	0.9	0.9	0.9	0.8	0.8	0.8
Expenditure	1.1	1.1	1.0	0.9	0.9	0.9	0.8	0.8	0.8	0.8	0.8
Of which: transfers to other levels of government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance	0.3	0.0	0.1	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Foreign-financed investment projects											
Grants	2.9	2.7	2.5	2.6	2.7	2.7	2.8	2.9	3.0	2.5	2.1
Expenditure	4.7	4.1	3.2	3.2	3.4	3.4	3.9	4.4	4.5	4.1	3.6
Balance	-1.8	-1.4	-0.7	-0.5	-0.7	-0.7	-1.1	-1.5	-1.6	-1.6	-1.5

Sources: Ministries of Finance; and IMF staff estimates.

Table 6. Bosnia and Herzegovina: Monetary Survey, 2003–08 1/
(In millions of KM, unless noted otherwise)

	2003	2004	2005	2006	2007 Est.	2008 Proj.
Net foreign assets	1,932	2,739	2,755	3,745	5,145	3,862
Foreign assets	4,370	5,391	6,314	7,757	10,260	9,233
Foreign liabilities	2,438	2,652	3,559	4,012	5,115	5,371
Domestic credit	4,630	5,465	6,977	8,411	9,801	13,237
Claims on central government (net)	-468	-443	-553	-894	-2,148	-1,725
Claims on noncentral government	22	25	32	60	111	150
Claims on private sector	5,076	5,883	7,498	9,245	11,838	14,813
Non-financial enterprises and cooperatives	3,017	3,146	3,924	4,735	5,955	7,504
Households	1,966	2,629	3,457	4,373	5,685	7,106
Other	92	108	117	136	197	202
Broad money	5,496	6,832	8,077	10,074	12,247	14,106
Narrow money	3,113	3,535	4,108	5,071	6,160	6,915
Currency outside banks	1,601	1,671	1,729	1,978	2,185	2,404
Demand deposits of noncentral government	220	343	410	571	744	444
Demand deposits of the private sector	1,293	1,521	1,970	2,522	3,231	4,067
Quasi-money	2,383	3,296	3,969	5,002	6,087	7,191
Time and savings deposits in domestic currency	462	703	818	1,099	1,338	1,580
Foreign currency deposits	1,921	2,593	3,150	3,903	4,749	5,611
Other items (net)	-1,066	-1,372	-1,655	-2,082	-2,700	-2,993
Memorandum items:						
Broad money growth (year-on-year) 2/	10.0	24.3	18.2	24.7	21.6	15.2
NDA growth (year-on-year)	22.3	18.0	27.7	20.6	16.5	35.1
NFA growth (year-on-year)	-9.9	41.8	0.6	35.9	37.4	-24.9
Domestic credit contribution to broad money growth (year-on-year)	16.9	15.2	22.1	17.8	19.8	43.8
NFA contribution to broad money growth (year-on-year)	-4.2	14.7	0.2	12.2	13.9	-10.5
Broad money (in percent of GDP)	37.9	43.3	47.7	52.7	58.1	57.5
Domestic credit (in percent of GDP)	31.9	34.6	41.2	44.0	46.5	53.9
Private sector credit (in percent of GDP)	35.0	37.3	44.3	48.4	56.1	60.3
Credit to household sector (in percent of GDP)	13.6	16.7	20.4	22.9	27.0	29.0
Nominal GDP	14,505	15,786	16,928	19,106	21,091	24,545
Velocity of Broad Money	2.6	2.3	2.1	1.9	1.7	1.7
Broad money multiplier	2.1	2.1	2.0	2.0	2.0	2.0

Sources: CBBH; and IMF staff estimates.

1/ Data for March 2005 onward are based on the upgraded classification of general government, so there is a structural break in March 2005.
2/ The jump in broad money growth in 2004 reflects banks' efforts to mobilize foreign currency deposits, following a tightening of end-month forex exposure limits. Further regulatory changes in late 2004 dampened these efforts.

Table 7. Bosnia and Herzegovina: Monetary Authorities' Balance Sheet 2003–08
(In millions of KM, unless noted otherwise)

	2003	2004	2005	2006	2007 Est.	2008 Proj.
Reserve money	2,608	3,239	3,970	5,052	6,229	6,030
Currency outside monetary authorities	1,722	1,817	1,907	2,154	2,440	2,684
Currency outside banks	1,601	1,671	1,729	1,978	2,185	2,404
Commercial bank cash in vaults	121	147	178	176	254	280
Commercial bank deposits with CBBH	884	1,420	2,060	2,887	3,777	3,334
Other demand deposits with CBBH	2	2	3	10	12	12
Net foreign assets	2,807	3,484	4,223	5,427	6,599	6,406
Domestic credit (net)	-18	-45	-36	-124	-73	-73
Claims on general government (net)	-19	-45	-38	-126	-75	-75
Claims on the private sector	0	0	2	2	2	2
Other items (net)	-181	-201	-217	-252	-298	-304
12-month growth rates (percent)						
Reserve money	12	24	23	27	23	-3
Net foreign assets	13	24	21	29	22	-3
Net claims on general government	17	-11	27	234	-41	0
Memorandum items:						
NFA in percent of currency outside the banks	175	209	244	274	302	267
NFA in percent of broad money	51	51	52	54	54	45

Sources: CBBH; and IMF staff estimates.

Table 8. Bosnia and Herzegovina: Survey of Domestic Money Banks, 2003–08 1/
(In millions of KM, unless noted otherwise)

	2003	2004	2005	2006	2007 Est.	2008 Proj.
Net Foreign Assets	-875	-745	-1,467	-1,683	-1,580	-2,543
Assets	1,562	1,906	2,090	2,329	3,534	2,827
Liabilities	2,437	2,651	3,558	4,011	5,114	5,370
Net Domestic Assets	4,768	5,904	7,812	9,768	11,629	13,997
Net claims on central government	-449	-398	-515	-768	-2,073	-1,651
Of which: credits	24	21	19	8	16	16
Of which: deposits	473	419	533	760	2,057	1,634
Claims on non-central government	22	25	32	60	111	150
Claims on private sector	5,076	5,882	7,496	9,243	11,836	14,810
Of which: households	1,966	2,628	3,456	4,373	5,685	7,106
Of which: non-financial enterprises and cooperatives	3,017	3,146	3,924	4,735	5,955	7,504
Of which: other	92	108	117	134	195	199
Reserves	884	1,420	2,060	2,887	3,777	3,334
Of which: required reserves	271	758	1,435	1,818	2,274	2,524
Of which: excess reserves	613	661	625	1,069	1,503	810
Cash in vaults, not included in reserves	121	147	178	176	254	280
Other Items (net)	-885	-1,170	-1,439	-1,831	-2,276	-2,925
Deposits (excl. central government)	3,893	5,159	6,345	8,085	10,049	11,454
Deposits in foreign currency	1,921	2,593	3,150	3,903	4,572	4,253
Deposits in domestic currency	1,972	2,566	3,195	4,182	5,477	7,202
Memorandum items:						
Nominal GDP	14,505	15,786	16,928	19,106	21,091	24,545
Adjusted credit to the private sector 2/	4,613	5,882	7,496	9,243	11,836	14,810
12-month growth (percent)	24.8	27.5	27.5	23.3	28.0	25.1
Adjusted credit to enterprises	2,554	3,146	3,924	4,735	5,955	7,504
12-month growth (percent)	17.2	23.2	24.7	20.7	25.8	26.0
Credit to households (12-month growth, percent)	36.6	33.6	31.5	26.5	30.0	25.0
Year-to-date growth of deposits (percent)	19.5	32.5	23.0	27.4	24.3	14.0
Year-to-date increase in credit to private sector	918	806	1,615	1,747	2,593	2,974
Adjusted credit to the private sector (percent of GDP) 2/	31.8	37.3	44.3	48.4	56.1	60.3
Base for reserves	5,413	7,584	9,902	12,096	15,163	16,824
Excess reserves/deposits (in percent)	15.8	12.8	9.8	13.2	15.0	7.1
Velocity of deposits	3.7	3.1	2.7	2.4	2.1	2.1

Sources: CBBH; and IMF staff estimates.

1/ Data for March 2005 onward are based on an upgraded classification of general government, so there is a structural break in March 2005.
2/ 2003 data are adjusted to correct for the structural break due to the RS government takeover of KM 463 million of old bank claims on RS enterprises in June 2004.

Table 9. Bosnia and Herzegovina: Baseline Medium-Term Outlook, 2004–13 1/

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Est.	Projections					
Real sector										
Real GDP growth (percent)	6.3	4.3	6.2	5.8	5.5	5.0	5.0	4.5	4.0	4.0
CPI, period average percent change	0.3	3.6	6.1	1.5	7.4	4.0	2.8	2.5	2.5	2.5
	(In percent of GDP, unless otherwise indicated)									
Savings and investment										
Consumption	113.8	113.7	108.8	108.3	108.6	106.2	106.3	106.8	107.4	107.3
Public	21.5	20.4	19.8	19.9	19.5	19.5	19.5	19.5	19.4	19.3
Private	92.3	93.3	89.0	88.4	89.0	86.7	86.8	87.3	88.1	88.1
Investment	27.5	27.4	20.9	25.1	26.0	26.1	26.6	26.5	25.5	25.0
Public	7.0	6.9	6.1	6.9	7.7	7.6	7.8	7.5	6.6	6.0
Private	20.5	20.5	14.8	18.2	18.3	18.5	18.8	18.9	18.9	18.9
National savings	11.1	9.4	12.6	12.1	10.0	12.1	12.2	11.5	10.8	11.2
Public	6.6	7.6	8.2	5.3	4.3	3.9	3.6	3.4	3.0	3.3
Private	4.5	1.8	4.4	6.8	5.7	8.2	8.6	8.2	7.8	7.9
Foreign savings	16.3	18.0	8.4	13.0	16.0	14.0	14.5	14.9	14.7	13.7
General government										
Total revenue and grants	44.2	45.5	47.5	48.7	47.9	47.3	47.0	46.6	45.7	45.4
o/w Grants	3.1	3.0	2.6	3.2	3.0	2.9	3.0	3.0	2.6	2.2
Total expenditure	44.7	44.7	45.3	48.7	49.7	49.8	50.1	49.7	48.7	48.0
Current	37.7	37.8	39.1	41.9	42.0	42.2	42.3	42.2	42.1	42.0
Capital	7.0	6.9	6.1	6.9	7.7	7.6	7.8	7.5	6.6	6.0
Overall balance	-0.5	0.8	2.2	-0.1	-1.9	-2.5	-3.1	-3.1	-3.0	-2.6
Overall balance excl. grants	-3.6	-2.2	-0.4	-3.3	-4.9	-5.4	-6.1	-6.1	-5.6	-4.8
Public debt (percent of GDP) 2/	25.5	25.6	22.0	30.5	34.3	37.5	37.0	37.2	37.7	38.0
Balance of payments										
Current account balance (percent of GDP)	-16.3	-18.0	-8.4	-13.0	-16.0	-14.0	-14.5	-14.9	-14.7	-13.7
Export growth rate (percent)	28.7	22.8	30.5	15.0	21.0	13.8	3.0	5.4	6.7	7.5
Import growth rate (percent)	7.6	12.5	1.2	18.7	21.4	7.1	6.5	6.3	6.0	5.9
Gross reserves (months of imports of GNFS)	3.7	4.0	5.1	5.4	4.3	5.3	4.7	4.1	3.6	3.3
	(In percent of exports of goods and services)									
Total external debt service	17.6	9.4	11.5	7.9	9.1	8.4	9.1	8.8	8.9	8.7
Memorandum item: GDP, millions of KM	15,786	16,928	19,106	21,091	24,545	26,541	28,435	30,143	31,889	33,909

Sources: BiH authorities; and IMF staff estimates and projections.

1/ On the basis of current policies.

2/ Increase in 2007 reflects the estimated recognition of domestic claims, and in 2008–09 the projected recognition of domestic claims.

Table 9b. Bosnia and Herzegovina: Alternative Medium-Term Outlook, 2004–13 1/

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
				Est.	Projections					
Real sector										
Real GDP growth (percent)	6.3	4.3	6.2	5.8	5.5	6.5	7.0	7.0	7.0	7.0
CPI, period average percent change	0.3	3.6	6.1	1.5	7.4	4.0	2.8	2.5	2.5	2.5
	(In percent of GDP, unless otherwise indicated)									
Savings and investment										
Consumption	113.8	113.7	108.8	108.3	108.8	104.3	101.6	100.4	100.0	98.6
Public	21.5	20.4	19.8	19.9	19.1	18.8	18.6	18.2	18.0	17.9
Private	92.3	93.3	89.0	88.4	89.7	85.6	83.0	82.2	82.0	80.7
Investment	27.5	27.4	20.9	25.1	25.5	26.8	29.2	29.6	28.7	28.4
Public	7.0	6.9	6.1	6.9	7.6	7.8	8.3	8.7	8.3	8.0
Private	20.5	20.5	14.8	18.2	18.3	18.9	20.9	20.9	20.4	20.4
National savings	11.1	9.4	12.6	12.1	9.8	13.7	16.3	16.9	16.9	18.1
Public	6.6	7.6	8.2	5.3	4.7	6.3	6.9	7.3	7.5	7.7
Private	4.5	1.8	4.4	6.8	5.4	7.4	9.4	9.6	9.4	10.4
Foreign savings	16.3	18.0	8.4	13.0	15.7	13.1	12.9	12.7	11.9	10.2
General government										
Total revenue and grants	44.2	45.5	47.5	48.7	48.1	47.5	46.7	46.3	45.3	44.6
o/w Grants	3.1	3.0	2.6	3.2	3.3	3.2	3.1	3.2	2.7	2.2
Total expenditure	44.7	44.7	45.3	48.7	49.1	47.6	46.9	46.3	45.3	44.5
Current	37.7	37.8	39.1	41.9	41.5	39.8	38.6	37.6	37.0	36.5
Capital	7.0	6.9	6.1	6.9	7.6	7.8	8.3	8.7	8.3	8.0
Overall balance	-0.5	0.8	2.2	-0.1	-1.0	-0.1	-0.1	0.0	0.0	0.1
Overall balance excl. grants	-3.6	-2.2	-0.4	-3.3	-4.3	-3.3	-3.2	-3.2	-2.7	-2.1
Public debt (percent of GDP) 2/	25.5	25.6	22.0	30.5	34.3	36.4	33.1	30.5	28.1	25.9
Balance of payments										
Current account balance (percent of GDP)	-16.3	-18.0	-8.4	-13.0	-15.7	-13.1	-12.9	-12.7	-11.9	-10.2
Export growth rate (percent)	28.7	22.8	30.5	15.0	21.0	18.5	7.4	10.2	11.7	12.8
Import growth rate (percent)	7.6	12.5	1.2	18.7	20.8	8.7	8.1	8.2	8.3	8.2
Gross reserves (months of imports of GNFS)	3.7	4.0	5.1	5.4	4.4	5.4	4.9	4.6	4.5	4.6
	(In percent of exports of goods and services)									
Total external debt service	17.6	9.4	11.5	7.9	9.1	8.1	8.4	7.9	7.6	7.2
Memorandum item: GDP, millions of KM	15,786	16,928	19,106	21,091	24,545	26,920	29,390	31,895	34,717	37,980

Sources: BiH authorities; and IMF staff estimates and projections.

1/ On the basis of staff-recommended policies.

2/ Increase in 2007 reflects the estimated recognition of domestic claims, and in 2008–09 the projected recognition of domestic claims.

Table 10. Bosnia & Herzegovina: Financial Soundness Indicators, 2002–08

	2002	2003	2004	2005	2006	2007	2008Q1
Capital							
Tier 1 capital to risk-weighted assets (RWA)	18.2	15.9	14.9	13.7	13.6	12.6	13.1
Net capital to RWA	20.5	20.3	18.7	17.8	17.7	17.1	16.5
Quality of assets							
Nonperforming assets (NPAs) to total assets	6.9	5.2	3.8	3.3	2.5	1.8	2.0
NPAs net of provisions to tier 1	27.5	25.2	19.5	20.4	15.2	12.9	12.7
Nonperforming loans to total loans	11.0	8.4	6.1	5.3	4.0	3.0	3.1
Provision to NPAs	42.5	42.9	44.6	40.1	39.6	37.2	37.7
Profitability							
Return on assets	-0.3	0.4	0.7	0.7	0.9	0.9	0.2
Return on equity	-2.0	3.4	5.8	6.2	8.5	8.9	2.0
Net interest income to gross income	39.6	45.2	49.7	54.1	54.3	59.9	61.0
Noninterest expenses to gross income	101.9	95.2	91.3	90.1	86.4	84.9	95.0
Liquidity							
Liquid assets to total assets	33.8	35.1	35.7	36.1	35.9	37.7	34.9
Liquid assets to short- term financial liabilities	51.5	58.7	59.5	61.9	60.8	61.3	56.7
Short- term financial liabilities to total financial liabilities	77.6	69.0	68.7	66.1	67.1	69.0	69.3
Foreign exchange risk							
Foreign currency and indexed loans to total loans	...	64.9	65.4	68.7	71.0	74.0	73.0
Foreign currency liabilities to total financial liabilities	...	61.5	64.0	64.4	62.8	65.0	65.7
Net open position	...	42.2	11.6	8.3	8.9	4.9	1.4

Source: CBBH.

Table 11. Bosnia & Herzegovina: Implementation of FSAP and Staff Recommendations

Key FSAP and Staff Recommendations	Progress
Financial sector surveillance • Develop a financial sector surveillance unit within the CBBH that reports and disseminate financial stability report (FSR) • Improve the quality of data on credit by extending the CBBH credit registry to cover all borrowers (corporate and households)	**Financial sector surveillance** • Done. Financial Stability Unit established in 2006. The FSR for 2006 was published for internal use. The FSR for 2007 will be published and publicly disseminated in 2008. • Done. From the beginning of 2007, the CBBH credit registry covers all borrowers and guarantors
Bank Supervision and Regulation • Upgrade supervision of bank provisioning and loan evaluation • Foster a shift from foreign to local financing by relaxing tight limits on maturity mismatches and introduce a regulatory capital charge for market and other risks • Raise the fines for non-compliance with prudential regulations • Strengthen the independence, powers and capacity of banking supervisors. • Strengthen consolidated supervision and cooperation with the home country supervisors of the major foreign-owned banks in BiH.	**Bank Supervision and Regulation** • Not done. Still in the process of developing new provisioning regulations. • Done. A comprehensive guideline for liquidity management was introduced at end-2007. Regulations to phase in capital charges for market risks were also introduced. • Not done. Raising fines will need parliamentary approval. • Ongoing. • Partially done. The Bosnian supervisors have not been able to sign an MOU with the Austrian supervisor.
Organization of Supervision • Unify two banking agencies at the State level	**Bank Supervision and Regulation** • Not done. Unifying the agencies implies a transfer of competencies from the Entities to a State-level agency which cannot be decided separately from the broader constitutional debate.
Deposit Insurance • Develop specific contingent arrangements for the Deposit Insurance Agency in case of possible shortfalls in its fund.	**Deposit Insurance** • Ongoing. A contingent arrangement is being developed together with the EBRD.
Non-Bank Supervision • Approve leasing legislation • Strengthen insurance supervision • Approve micro finance legislation and strengthen oversights of microcredit institutions	**Non-Bank Supervision** • Ongoing. Both banking agencies are now mandated by law to supervise leasing companies. Law on leasing was adopted in the RS, and is expected to be adopted in the Federation by end-2008. • Ongoing. Regulations on better data provision were recently introduced in both entities. • Done. Microcredit institutions are now regulated by the Banking Agencies.
Strengthening Corporate Governance • Strengthen disclosure of beneficial owners, quality of financial reporting, accountability of corporate bodies and effectiveness of regulatory agencies.	**Strengthening Corporate Governance** • Partially done. In the RS, a new company law was approved and financial reporting strengthened and disseminated.

Table 12. Bosnia & Herzegovina: Response to Past Fund Policy Recommendations

The authorities have broadly agreed with Fund recommendations and notable progress has been made recently on fiscal coordination. However, goals are not always translated into coherent policy plans, there is no medium-term fiscal framework, and the reform momentum is slow.	
Fiscal policy	The easing in 2007 and the projected further easing in 2008 are inappropriate. The size of government is excessive, there has been no progress in rationalizing spending, and untargeted (and unfunded) social transfers are on the rise in the Federation. On the positive side, income tax reforms have been successfully completed in the Entities.
Fiscal coordination	Notable progress has been achieved in 2008: the Fiscal Council law was adopted, and a permanent (indirect tax) revenue allocation mechanism agreed.
Financial sector	The authorities responded positively to the 2006 FSAP recommendations. The recently-established financial sector surveillance unit within the Central Bank of BiH (CBBH) started producing a financial stability report; and closer coordination between the entity bank supervisors and the CBBH advanced with the signing of a memorandum of understanding (MOU) on information exchange. However, unification of bank supervision remains elusive and is contingent on progress with constitutional reform.

Table 13. Bosnia and Herzegovina: General Government Reconciliation, 2007

Revenue reconciliation:	Millions of KM	Percent of GDP
Revenue, CBBH	9,832	46.6
Adjustments:	430	2.0
Change in ITA float	-140	-0.7
GSM license proceeds	-35	-0.2
Grants	683	3.2
Budget	125	0.6
Project	559	2.6
Other	-78	-0.4
Revenue, IMF	10,262	48.7

Expenditure reconciliation	Millions of KM	Percent of GDP
Expenditure, CBBH	9,554	45.3
Adjustments:	721	3.4
Foreign loan-financed investment	111	0.5
Foreign grant-financed investment	559	2.6
Other	51	0.2
Expenditure, IMF	10,275	48.7
Overall balance, CBBH	278	1.3
Overall balance, IMF	-13	-0.1

Sources: CBBH; and IMF staff estimates and calculations.

BOSNIA & HERZEGOVINA: DEBT SUSTAINABILITY ANALYSIS

The debt sustainability analysis is based on the staff baseline scenario (unchanged policies). It assumes moderate growth and inflation over the medium term; and fiscal deficits in the order of 2–3 percent of GDP.

After an initial jump in 2007, reflecting the settlement of domestic claims, and subsequent increases in 2008–09 to 38 percent of GDP, the public debt-to-GDP ratio stabilizes at that level over the medium term. The issuance of bonds to cover domestic claims in 2007–09 is estimated to total about 25 percentage points of GDP (see Box 1). Assuming no policy changes, the debt would stay broadly at that level. The dynamics of the debt outlook are fairly robust to interest rate shocks, but a growth slowdown or a fiscal deterioration could put the debt on an unsustainable path. Also, contingent risks remain, related to debt from unrestructured public enterprises and court claims for Frozen Foreign Currency Deposits. With the balanced budget policy (as recommended by staff), the debt to GDP ratio would decline more rapidly, to around 22 percent of GDP by 2013, significantly bolstering the country's debt sustainability.

Box 1. Key Assumptions for the Public Debt Sustainability Analysis

- Moderate growth and inflation, and unchanged policies in line with the staff's baseline projections. General government registers deficits around 2–3 percent of GDP (Table 9).
- Lower access to concessional external borrowing (average grant element of 35 percent), dropping to ¾ percent of GDP during 2008–13 compared to around 1.5 percent in 2005.
- Domestic borrowing on commercial terms (6-month Euribor plus 200 basis points) to cover residual financing needs.
- Increase in debt by 11.5 percent of GDP in 2007 due to the recognition of frozen foreign currency deposits and war claims, with an average grant element of 53 percent.
- Increase in the face value of debt to about 10 percent of GDP in 2008 and 5 percent in 2009, due to the recognition of additional domestic claims (restitution, losses of public enterprises, etc. on similar terms as the FFCD). This also covers the assumption of public enterprise debt of the mining sector expected in 2009, totaling 1½ percent of GDP.
- Privatization proceeds of 9 percent of GDP in the Federation in 2009.

Bosnia & Herzegovina's external debt-to-GDP ratio slightly improves over the medium term, even in the absence of policy change. This reflects the assumption that economic growth will remain above the real effective interest rate on external debt, as the latter reflects a large share of concessional debt—notably to the World Bank, and also the smaller role of debt-creating flows in financing the current account deficits (Box 2). Although current account deficits remain sizable, the projection assumes that FDI and reserves rundown are the major sources of financing as commercial banks' external borrowing is projected to moderate with a slow-down in credit growth and public sector's external borrowing is projected to remain relatively flat. Gross external financing needs as a percentage of GDP increase in 2008 due to the terms-of-trade shock, but decline over the projection period. Bound tests show limited risks, with debt-to-GDP ratios at the end of 2013 lower than 50 percent in all scenarios. A change in the borrowing structure (from public to private or from concessional to nonconcessional) could also weaken the dynamics of Bosnia and Herzegovina's external debt, although this risk appears manageable.

Box 2. Key Assumptions for the External Debt Sustainability Analysis

- Moderate growth and inflation, and unchanged policies in line with the staff's baseline projections (Table 9).
- Decelerating growth rate of exports and imports (in value).
- Limited access to concessional external borrowing, with new borrowing at market rates. World Bank disbursements declining sharply during the projection period.
- A decline in commercial banks' borrowing as banks mobilize more domestic funds.
- Stable remittances inflows, and declining income inflows due to the reduction of international organizations staff.
- Capital transfers and errors and omissions are included in the non-debt creating flows.

Table 1. Bosnia and Herzegovina: Public Sector Debt Sustainability Framework, 2003–2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	28.1	25.5	25.6	22.0	30.5	**34.3**	**37.5**	**37.0**	**37.2**	**37.7**	**38.0**	**-1.1**
o/w foreign-currency denominated	28.1	25.5	25.6	21.2	18.1	14.6	13.9	13.7	13.7	13.8	13.7	
Change in public sector debt	-3.7	-2.6	0.1	-3.7	8.5	3.9	3.2	-0.5	0.2	0.5	0.2	
Identified debt-creating flows (4+7+12)	-5.2	-4.0	0.4	-5.5	-0.2	7.6	-4.1	0.6	1.0	0.9	0.4	
Primary deficit	1.0	-0.1	-1.4	-2.9	-0.6	1.2	1.5	2.0	2.0	1.8	1.4	
Revenue and grants	46.9	44.2	45.5	47.5	48.7	47.9	47.3	47.0	46.6	45.7	45.4	
Primary (noninterest) expenditure	47.9	44.1	44.2	44.6	48.1	49.0	48.9	49.0	48.6	47.5	46.7	
Automatic debt dynamics 2/	-6.2	-3.9	2.1	-2.4	-3.1	-3.6	-1.6	-1.4	-1.0	-0.8	-1.0	
Contribution from interest rate/growth differential 3/	-0.8	-1.7	-1.1	-2.2	-1.4	-3.6	-1.6	-1.4	-1.0	-0.8	-1.0	
Of which contribution from real interest rate	0.2	-0.1	-0.1	-0.8	-0.3	-2.2	0.0	0.3	0.6	0.6	0.4	
Of which contribution from real GDP growth	-1.1	-1.6	-1.0	-1.4	-1.2	-1.4	-1.6	-1.8	-1.6	-1.4	-1.4	
Contribution from exchange rate depreciation 4/	-5.3	-2.2	3.2	-0.2	-1.7	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	-0.3	-0.1	3.5	10.0	-4.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	-0.3	-0.1	-8.0	0.0	-9.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	11.5	10.0	5.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	1.5	1.4	-0.3	1.8	8.7	-3.7	7.3	-1.1	-0.8	-0.4	-0.1	
Public sector debt-to-revenue ratio 1/	60.0	57.8	56.3	46.3	62.6	71.7	79.3	78.7	79.8	82.5	83.7	
Gross financing need 6/	2.9	1.5	0.1	-2.2	0.3	3.2	3.4	4.2	4.2	4.0	3.6	
in billions of U.S. dollars	0.2	0.1	0.0	-0.3	0.0	0.6	0.7	1.0	1.0	1.0	1.0	
Scenario with key variables at their historical averages 7/						**34.3**	**36.3**	**33.9**	**31.8**	**30.4**	**29.3**	**-2.0**
Scenario with constant primary balance in 2008-2013						**34.3**	**37.2**	**35.9**	**35.3**	**35.4**	**35.5**	**-1.0**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.5	6.3	4.3	6.2	5.8	5.5	5.0	5.0	4.5	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	2.4	2.3	2.5	3.1	3.2	2.6	3.0	3.0	3.2	3.4	3.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.8	-0.1	-0.4	-3.2	-1.1	-7.7	0.0	1.0	1.8	1.7	1.3	
Nominal appreciation (increase in US dollar value of local currency, in percent)	20.7	9.1	-11.6	0.8	9.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	1.6	2.4	2.8	6.3	4.3	10.3	3.0	2.0	1.4	1.7	2.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.4	-2.2	4.5	7.2	14.2	7.6	4.6	5.4	3.6	1.6	2.3	
Primary deficit	1.0	-0.1	-1.4	-2.9	-0.6	1.2	1.5	2.0	2.0	1.8	1.4	

1/ General government.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

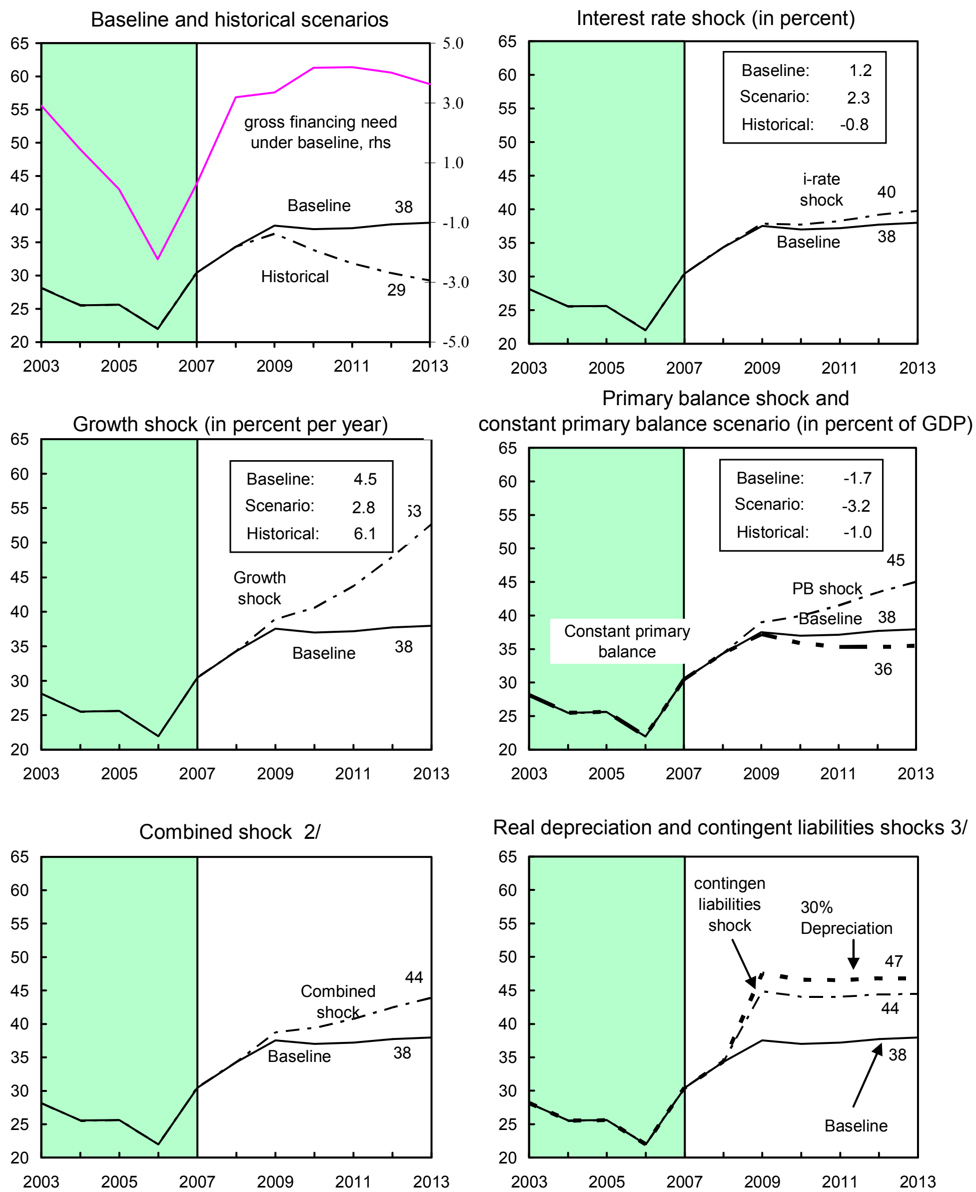
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Bosnia and Herzegovina: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 2. Bosnia & Herzegovina: External Debt Sustainability Framework, 2003-2013
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	49.1	47.5	52.6	48.0	48.5	**40.5**	**39.0**	**38.3**	**38.4**	**38.8**	**38.9**	**-8.6**
Change in external debt	-4.7	-1.6	5.1	-4.6	0.5	-8.0	-1.5	-0.7	0.1	0.4	0.1	
Identified external debt-creating flows (4+8+9)	-5.4	-5.6	3.8	-8.3	-12.7	6.5	-5.0	4.9	4.7	4.9	4.5	
Current account deficit, excluding interest payments	18.3	15.4	17.0	7.4	11.8	14.3	12.3	12.8	13.3	13.1	12.0	
Deficit in balance of goods and services	45.5	41.3	41.1	29.7	33.3	34.6	32.2	33.0	33.3	33.0	32.3	
Exports	26.1	29.4	32.7	36.7	37.7	39.3	40.9	39.7	39.6	40.0	40.4	
Imports	71.6	70.7	73.9	66.5	71.0	73.9	73.1	72.7	72.9	73.0	72.7	
Net non-debt creating capital inflows (negative)	-13.7	-13.9	-10.9	-10.3	-17.5	-7.4	-17.1	-7.8	-8.6	-8.4	-7.8	
Automatic debt dynamics 1/	-10.0	-7.1	-2.3	-5.4	-7.0	-0.4	-0.2	-0.1	0.0	0.2	0.2	
Contribution from nominal interest rate	1.1	1.0	1.0	1.0	1.2	1.7	1.6	1.7	1.6	1.6	1.7	
Contribution from real GDP growth	-1.5	-2.6	-1.9	-2.9	-2.3	-2.0	-1.9	-1.8	-1.6	-1.4	-1.5	
Contribution from price and exchange rate changes 2/	-9.6	-5.5	-1.4	-3.5	-5.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	0.7	4.0	1.3	3.7	13.2	-14.5	3.5	-5.5	-4.6	-4.5	-4.4	
External debt-to-exports ratio (in percent)	187.8	161.5	160.8	130.7	128.8	103.1	95.4	96.6	97.0	97.1	96.3	
Gross external financing need (in billions of US dollars) 4/	2.1	2.3	2.5	1.8	2.6	4.0	4.0	4.4	4.3	4.6	4.6	
in percent of GDP	24.8	23.0	23.0	14.6	17.6	20.6	18.8	19.6	17.9	17.7	16.7	
Scenario with key variables at their historical averages 5/						**39.0**	**40.7**	**33.0**	**26.6**	**21.0**	**16.2**	**-13.3**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	3.5	6.3	4.3	6.2	5.8	5.5	5.0	5.0	4.5	4.0	4.0	
GDP deflator in US dollars (change in percent)	21.7	12.5	3.0	7.1	13.9	24.1	3.9	2.4	1.9	2.2	2.8	
Nominal external interest rate (in percent)	2.7	2.4	2.2	2.1	3.0	4.5	4.4	4.6	4.5	4.5	4.6	
Growth of exports (US dollar terms, in percent)	35.0	34.5	19.6	27.7	23.6	36.7	13.5	4.4	6.2	7.3	8.0	
Growth of imports (US dollar terms, in percent)	26.9	18.0	12.3	2.4	28.7	36.3	8.0	6.9	6.8	6.5	6.5	
Current account balance, excluding interest payments	-18.3	-15.4	-17.0	-7.4	-11.8	-14.3	-12.3	-12.8	-13.3	-13.1	-12.0	
Net non-debt creating capital inflows	13.7	13.9	10.9	10.3	17.5	7.4	17.1	7.8	8.6	8.4	7.8	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

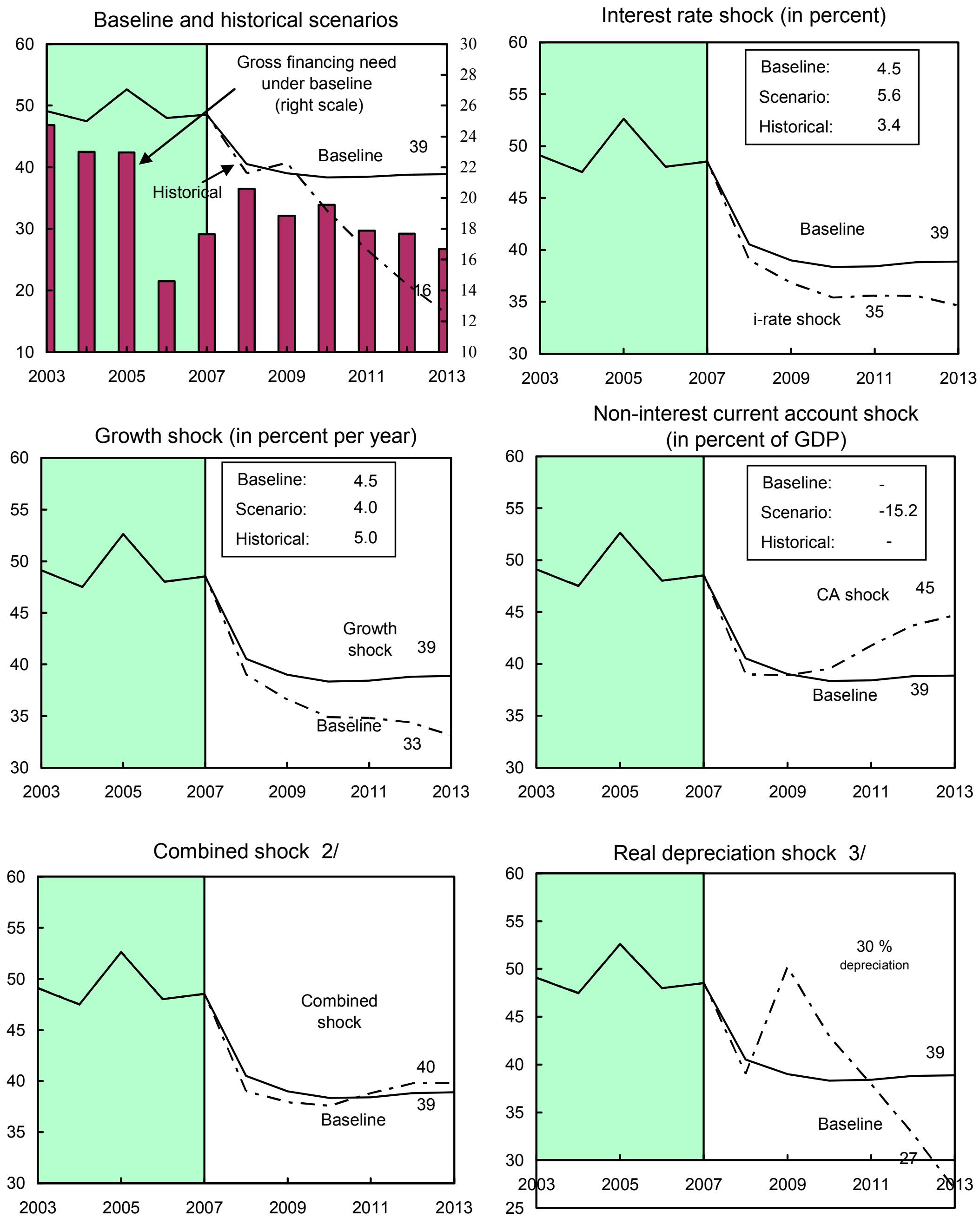
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 2. Bosnia & Herzegovina: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2009.

APPENDIX I—BOSNIA & HERZEGOVINA: FUND RELATIONS
(As of June 30, 2008)

Mission: Sarajevo, Banja Luka, June 11–24, 2008.

Staff team: Messrs. Christou (head), Cuc and Ms. Chivakul (all EUR), Ms. Eble (FAD), and assisted by Mr. Slack, Resident Representative, and Mmes. Jankulov and Milić at the Resident Representative Office.

Country interlocutors: The mission met with Mr. Spirić, Chairman of the State Council of Ministers; Mr. Vrankić, State Finance Minister; Mr. Branković, Prime Minister and Mr. Bevanda, Finance Minister of the Federation; Mr. Dodik, Prime Minister, and Mr. Džombić, Finance Minister of the RS; Mr. Kozarić, Governor of the CBBH; and Mr. Lajčák, High Representative; and other representatives of the international community, political parties, employers and labor unions, and the media. Mr. Tomic (OED) participated in some of the meetings.

Data: Data provision is inadequate for surveillance purposes, especially for national accounts and general government statistics.

I. Membership Status: Member since 12/14/1992; Article XIV

II. General Resources Account:	SDR Million	%Quota
Quota	169.10	100.00
Fund Holdings of Currency	169.10	100.00

III. SDR Department:	SDR Million	%Allocation
Net cumulative allocation	20.48	100.00
Holdings	0.46	2.26

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-by	8/02/2002	2/29/2004	67.60	67.60
Stand-by	5/29/1998	5/29/2001	94.42	94.42

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

	Forthcoming				
	2008	2009	2010	2011	2012
Principal					
Charges/Interest	0.30	0.60	0.60	0.60	0.60
Total	0.30	0.60	0.60	0.60	0.60

VII. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, Central Bank of Bosnia and Herzegovina (CBBH) was subject to an assessment in the context of a potential successor for the 2002 arrangement. The assessment was completed on January 24, 2005 and recommendations were made to address weaknesses identified in the Bank's safeguards. Based on the information received from the authorities all the recommendations have been implemented.

VIII. **Exchange Rate Arrangements**

The currency of Bosnia and Herzegovina is the convertible marka (KM), introduced on August 11, 1997. On September 5, 2002, the State parliament approved an amendment to the CBBH law that changes the peg of the KM from the DM to the Euro under a currency board arrangement. The KM is pegged to the euro at KM 1 = 0.5113 euro.

Bosnia and Herzegovina maintains restrictions on payments and transfers for current international transactions resulting from measures taken with respect to frozen foreign currency deposits as identified in IMF Country Report No. 02/52.

IX. **FSAP**

Two FSAP missions took place in December 2005 and March 2006, and an *Aide Mémoire* was presented to the authorities. The FSAP assessed risks to financial stability and weaknesses in banking supervision using a Basel Core Principles assessment. It also considers financial sector development needs in the areas of insurance, access to finance, the insolvency regime and corporate governance, drawing on a detailed assessment of the OECD Principles of Good Corporate Governance. The FSSA was presented to the Board along with the 2006 Article IV consultation IMF Country Report No. 06/371.

X. **Last Article IV Consultation**

Bosnia and Herzegovina is on the twelve month cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002. The last Article IV consultation was concluded on July 16, 2007.

XI. **Resident Representative**

IMF no longer has a resident representative in Bosnia and Herzegovina. Mr. Slack was the resident representative until end-July 2008. The office in Sarajevo remains open and is staffed by a local economist and support staff.

XII. **Technical Assistance 2000–08**

Department	**Timing**	**Purpose**
FAD	August 2000	Treasury systems
	September–October 2000	Value-added tax
	July 2001	Treasury Systems
	April 2002	Value-added Tax
	April 2002	Treasury systems
	February 2003	Treasury systems
	May 2003	Public expenditure management
	June 2004	VAT policy and implementation
	March 2005	Poverty and social impact analysis (VAT)
	March 2005-2006	Macro-Fiscal advisor
MCM	September 2000	Advisor on payments system.
	March–April 2001	Payments system, currency management, accounting and research
	January–February 2002	Payment system
	October–November 2002	Strengthening Banking Supervision
	August–September 2003	Banking supervision
	September 2003	International reserve management
	April 2004	AML/CFT Supervision
	January 2005	Advisor to CBBH Governor
	January 2005	Banking supervision
	April 2005	Credit Risk and Rapid Credit Growth
	September 2005	Financial soundness indicators
	November–December 2005	FSAP (primary mission)
	March 2006	FSAP (second mission)
	November 2006	Financial sector surveillance, banking supervision and reserve management
STA	October 2000	Money and banking statistics
	December 2001	Money and banking statistics
	April–May 2004	Money and banking statistics
	May 2004	Government finance statistics
	March 2005	Workers’ remittances
	November 2005–07	Real sector statistics advisor
	March 2007	Data ROSC
	January 2008	Balance of Payments and International Investment Position

APPENDIX II—BOSNIA & HERZEGOVINA: WORLD BANK RELATIONS

A. New Country Partnership Strategy for Bosnia and Herzegovina (FY08-FY11)

1. On December 13, 2007, the World Bank Board of Executive Directors endorsed a new **Country Partnership Strategy (CPS)** for Bosnia and Herzegovina. The new CPS outlines a lending program of about US$ 200 million in support of the country's priorities, including integration with the European Union. The CPS will support Government's priorities outlined in the Platform for Action adopted on October 16, 2007. The Paper, which was signed by the State and Entity level Prime Ministers, and the Mayor of Brcko District, commits the authorities to: (i) improve fiscal coordination and stability; (ii) create a better business environment; and (iii) promote other reforms ensuring sustainable development.

2. The FY08-FY11 CPS is structured along two mutually reinforcing pillars.

- **Pillar I** – improve the environment for private sector led growth and convergence to Europe (expand business activity and increase economic opportunities; improvements in key infrastructure and links to Europe; regional approach to public goods, including environment and clean energy)
- **Pillar II** – improve the quality of Government spending and the delivery of public services for the vulnerable (improve delivery of municipal services and strengthen mucnipal finance; improve quality of social services delivery; reduce urban-rural disparities in income; increase targeting of social benefits; reduce excess burden of Government in economy and strengthen fiscal coordination)

3. Through this program the World Bank will support investments in infrastructure, municipal development, transport and energy sectors, business environment, public sector reform, and social sectors reform. With a mix of financial and non-financial services, the World Bank will support the Government to achieve their development goals of improving infrastructure and the investment climate, increasing the efficiency of public spending, and strengthening service delivery - in particular those directed to the most vulnerable segments of the population.

B. World Bank Projects

4. While no longer receiving the levels of financing following the 1995 Dayton Accord, Bosnia and Herzegovina still enjoys exceptional access to concessional IDA financing despite income per capita well-above the IDA threshold. However, this CPS period will mark a transition from borrowing under IDA conditions to more commercial, but still relatively cheap borrowing under IBRD conditions (note: IBRD recently significantly reduced its pricing and improved loan terms and conditions). The current portfolio includes 15 active projects (14 IDA investment loans, and one GEF grant) with a total commitment of US$275 million, of which about 64% remain to be disbursed.

5. Improving the business environment with support from the **Business Environment Adjustment Credit (BAC)** was critical in strengthening growth and employment and encouraging investment. Although delayed, supporting legislation has now been passed in both entities. Consequently, intended outcomes in business registration and inspection reforms have been achieved and conditions for disbursement of the final US$ 30 million tranche were met in December 2007. BAC closed on 15 December, 2007.

6. **Recent approved projects**. **The Road Infrastructure and Safety Project**, approved in December 2007 is a US$ 25 million operation aimed at accelerating the recovery of the main road network and improving institutional capacity in relation to road safety. The project will finance rehabilitation of about 240 kilometers of regional roads in both entities. The project will also help develop a strategy for improving road safety in the country. US$ 25 million of IDA credit by the World Bank is a part of a broader road rehabilitation program financed by the two entity governments, the European Investment Bank, and the European Bank for Reconstruction and Development. Two new projects **(Agriculture and Rural Development**; and **Avian Influenza Preparedness Project**) and two supplemental financing for two existing projects (**Urban Infrastructure and Service Delivery;** and **Forest Development and Conservation Project**) amounting in total to about US$35 million, were recently declared effective.

7. **Project pipeline**. Two GEF grants, **Neretva and Trebisnjica River Basin Management Project**, and **Protected Forest and Mountain Areas**, were negotiated in March-April 2008 and will be presented to GEF Board for approval. The total amount of grant financing under these two operations will be US$ 9.4 million. Follow up **Solid Waste Management Project** is scheduled for negotiations in June 2008 and will provide US$ 35 million (blend of IDA and IBRD resources) for further investments in this sector.

8. Key pieces of analytic and advisory services that will be provided in 2008 include: **Investment Climate Assessment**, and **Proxy Means Targeting Study**. **Country Economic Memorandum**, focuses on trade: it attempts to assess the binding constraints to growth of BiH export and import-competing industries, in particular in wood processing and automotive industries, as well as agriculture.

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APPENDIX III—BOSNIA & HERZEGOVINA: STATISTICAL ISSUES

1. Data provided to the Fund have serious shortcomings that significantly hamper surveillance, most notably in the area of balance of payments statistics and the source data for government finance statistics. Real sector statistics have recently been upgraded, with 2006 data for GDP by expenditure at current and constant prices, GDP by industry at constant prices, and a countrywide consumer price index (CPI) based on internationally recommended practices. However, there is a lack of short-term economic indicators and the source data for national accounts need improvement.

2. The Dayton peace treaty, which ended the civil war, implicitly gave responsibility for statistical functions to the two resulting Entities (The Federation of Bosnia and Herzegovina and Republika Srpska (RS)). In August 1998, the State created its own statistical institute, the Bosnia & Herzegovina Agency for Statistics (BHAS) with a view to compiling country-wide statistics in accordance with internationally accepted methodologies, consolidating data produced by the Entities' Statistical Institutes, and acting as the primary coordinating agency for contacts with international agencies. Significant technical assistance has been provided in recent years, mainly by the European Union. An IFS country page has been in existence since July 2001. A Fund resident statistical advisor was assigned to the Central Bank of Bosnia & Herzegovina (CBBH) during May 1999–June 2004 to provide technical assistance in the development of all areas of macroeconomic statistics. A STA resident real sector statistical advisor was appointed in the period November 2005–November 2007. A mission to prepare the ROSC Data Module took place in March 2007 and the report was published in February 2008.

A. Real Sector Statistics

3. Efforts have been made in both Entities to improve real sector statistics, but results have been mixed. The Federation and RS both have published nominal GDP estimates using the production approach based on international standards recommended by the *1993 SNA*, since 1998 and 1999, respectively. GDP estimates by production at constant prices have been developed with the technical assistance of the IMF and these estimates have been released for the entities and for the country with 2004 as the reference year. Also, expenditure-based GDP data at current and constant prices have been developed. These data, which are now being regularly compiled by the BHAS, have been made available for the period 2004-2006. Other improvements include coverage adjustments made to GDP with the inclusion of an estimate for nonobserved economic activities and imputation of rental services of owner-occupied dwellings. Discrepancies between the production and expenditure measures of GDP are relatively high and more work will be needed to reconcile these estimates.

4. Both statistical offices compile retail price indices using outdated methodologies, and consistent time series are not available. A consumer price index (CPI) based on internationally recommended practices has been implemented with the technical and financial support of the Italian government. This CPI was released in 2007, and monthly and consistent series are available countrywide and for the entities, with the series starting in

January 2005. The CPI weights are derived from the household budget survey conducted in 2004. Industrial production indices are prepared in each Entity, but there is no index at the country level and consistent time series are not available. Both entity institutes compile data on employment, unemployment, and wage rates based on questionable methodologies. However, the recent Labor Force Survey conducted in April 2007 follows international methodological standards. Data on employment, unemployment, population and labor force for the country and the entities are available for 2006 and 2007. The data for 2006 and 2007 are also available in a dissagregate form for different socio-demographic groups.

B. External Sector Statistics

5. Trade data are published by the BHAS and balance of payments statistics by the CBBH. The quality of the balance of payments data is generally poor, particularly the coverage of foreign grants, workers' remittances, income received by residents working for international organizations in the country, spending by their nonresident staff, trade credit by suppliers, informal trade, and changes in foreign currency cash holdings.

6. Merchandise trade is recorded using the Automated System for Customs Data processing system. The customs administration for the whole country has been reorganized, and a trade classification system introduced. BHAS now produces export and import data from customs records, but needs to produce the data on a general trade basis and not on a special trade basis.

C. Government Finance Statistics

7. The CBBH compiles government finance statistics (GFS) in accordance with the definitions and concepts of the *Government Finance Statistics Manual 2001*. The 2007 data ROSC mission found that the institutional coverage of the GFS is broadly consistent with international guidelines, but not all stocks and flows are measured due to insufficient source data. In addition, the GFS does not include transactions related to projects directly financed by international donors. Because accrual accounting has not yet been fully introduced in all government institutions, transactions are recorded on a mixed accrual/cash basis. Data on the level of outstanding domestic debt are being developed. The periodicity and timeliness of data on government operations and quarterly consolidated central government operations meet or exceed GDDS recommendations. External government debt is published quarterly. GFS data are broadly consistent with the balance of payments, but not with the national accounts or monetary and banking statistics.

8. Since 2005, the CBBH has reported GFS to STA for publication in the *Government Finance Statistics Yearbook,* covering central government operations starting with data for 2003. Higher frequency fiscal data have been reported for publication in the IFS: the CBBH has submitted quarterly GFS data up to 2007Q3. However, there has been no new submission for data after that date. The authorities are aware of this delay in data reporting;

and the IMF resident statistical advisor is following up on this issue. The CBBH has been receiving ongoing technical assistance on GFS compilation from the resident statistical advisor.

D. Monetary and Financial Statistics

9. The CBBH reports monetary accounts to the Fund on a countrywide and Entity basis. In early 2003, it began reporting weighted average interest rates for bank deposits and loans. The IFS includes interest rate data since January 2002. From 1996 to 2004, several Fund missions assisted in establishing an integrated system for compiling countrywide monetary statistics compatible with Fund standards. The April/May 2004 mission reviewed institutional changes and accounting developments and assisted in revising and updating the compilation procedures. The mission recommended improvements in the treatment of "passive accounts" on banks' balance sheets, banks' claims arising from "credit card debts," "euro-linked" loans in national currency, and government accounts. The CBBH has been working towards reporting monetary data to the Fund using the Standardized Report Forms developed by STA that embody the methodology of the *Monetary and Financial Statistics Manual*.

Appendix IIII: Table of Common Indicators Required for Surveillance

(As of May 22, 2008)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	5/15/08	5/15/08	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/2008	06/2008	M	M	M		
Reserve/Base Money	05/2008	06/2008	M	M	M	O, O, LO, O	O, O, O, O, O
Broad Money	05/2008	06/2008	M	M	M		
Central Bank Balance Sheet	05/2008	06/2008	M	M	M		
Consolidated Balance Sheet of the Banking System	05/2008	06/2008	M	M	M		
Interest Rates[2]	05/2008	06/2008	M	M	M		
Retail Price Index	05/2008	06/2008	M	M	M	LNO, NO, LNO, LO	LNO, LO, LNO, LO, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2007	07/2008	A	A	A	O, LNO, LO, LO	LNO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	12/2007	03/2008	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2007	03/2008	A	A	A		
External Current Account Balance	Q1 2008	07/2008	Q	Q	Q	O, O, LO, LO	LNO, O, LO, O, LO
Exports and Imports of Goods and Services	Q1 2008	07/2008	Q	Q	Q		
GDP/GNP	2007	04/2008	A	A	A	O, LNO, LO, LO	LNO, LNO, LO, LO, LO
Gross External Debt	2007	03/2008	A	A	A		
International Investment Position	N/A	N/A					

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions. [2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds. [3] Foreign, domestic bank, and domestic nonbank financing. [4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. [5] Including currency and maturity composition. [6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA). [7] Reflects the assessment provided in the data ROSC or the Substantive Update (published on February 2008and based on the findings of the mission that took place during March 13–28, 2007) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA). [8] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

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IMF Executive Board Concludes 2008 Article IV Consultation with Bosnia and Herzegovina

On September 17, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bosnia and Herzegovina.[1]

Background

Bosnia and Herzegovina's economy has been exhibiting robust growth, but macroeconomic imbalances have emerged. In 2007, the economy grew by 5.8 percent, with domestic demand becoming an engine of growth, supported by robust credit growth, healthy wage increases, and a sizeable fiscal impulse. The domestic demand boom was mirrored by a widening external current account deficit, which reached 13 percent of GDP. Export growth moderated to 15 percent, and imports resumed their faster growth following a temporary, VAT-related slowdown in 2006. Data for early-2008 point to a further widening of the current account deficit, mainly driven by higher food and energy prices. Headline inflation increased to 8.2 percent in May 2008, reflecting largely food and energy price shocks although underlying inflation has also picked up.

Fiscal policy has become procyclical and added further stimulus to domestic demand. The general government registered a deficit of 0.1 percent of GDP in 2007, compared with a 2.2 percent surplus in 2006. Driven mainly by sharp increases in transfers to households, capital spending, and wages, total government expenditure approached 50 percent of GDP in 2007. Strong revenue performance has continued in 2008, but mounting spending pressures in the Federation of Bosnia and Herzegovina (Federation) have led to liquidity problems and threaten its fiscal position.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Financial deepening accelerated in 2007, but remains in line with regional trends. Benefiting from a low interest rate environment, private sector credit growth in 2007 contributed 7.7 percentage points to the credit-to-GDP ratio, bringing it to 56 percent. Concerns about the speed of credit expansion prompted the Central Bank of Bosnia and Herzegovina (CBBH) to increase reserve requirements at end-2007—from 15 to 18 percent. There are early indications that global financial tensions have started to affect foreign funding. While bank soundness indicators remain favorable, bank profitability declined in the first quarter of 2008.

A breakthrough has recently been made on fiscal structural reforms with the approval of the Fiscal Council law and an agreement on a permanent indirect tax revenue allocation formula. However, progress on other structural reforms has been uneven and Bosnia and Herzegovina trails its best-performing peers on most structural indicators. Moreover, policies are diverging between the two Entities, with the Republika Srpska (RS) making steady progress on reforms and the Federation finding it difficult to mobilize action on needed reforms. The signing of the Stabilization and Association Agreement with the European Union (EU) on June 16, 2008, opens Bosnia and Herzegovina's road to EU accession and could help accelerate reforms.

Executive Board Assessment

Executive Directors welcomed Bosnia and Herzegovina's solid growth performance, which largely reflects the effects of reforms in key sectors, the benefits of the currency board, and a favorable external environment. Directors congratulated the authorities on the recent signing of the Stabilization and Association Agreement with the EU, and hoped that it would become a catalyst for accelerated progress in structural reforms.

At the same time, Directors expressed concern about the emerging macroeconomic imbalances and the unfinished structural reform agenda. They noted that the current account deficit has been moving toward unsustainable levels, underlying inflationary pressures have intensified, and the recent fiscal policy loosening is exacerbating demand pressures. While noting the staff's assessment that the level of the real effective exchange rate does not raise significant external stability concerns at this stage, Directors emphasized that the key challenge for the authorities will be to strengthen policies and enhance structural reforms to reduce vulnerabilities, promote sustainable strong growth, and reduce unemployment. This will require improved policy coordination, and a tighter fiscal and incomes policy stance to counteract private sector-driven macroeconomic imbalances and support the currency board, which has served the economy well.

Directors welcomed the authorities' intention to tighten the fiscal stance in 2008, and encouraged the authorities to aim for a balanced budget target in 2009. They underscored the importance of maintaining wage discipline in the public sector, reducing large, untargeted social spending, and improving the efficiency of the public sector. Containing unfunded social transfers in the Federation will require their fundamental overhaul. Directors also encouraged the authorities to use privatization proceeds to support the country's growth objectives without compromising macroeconomic stability.

Directors emphasized the need for improved fiscal policy coordination. They welcomed the recent establishment of the Fiscal Council and agreement on a permanent indirect tax revenue-allocation formula. The Fiscal Council should be made operational as soon as possible and should be assigned a coordinating role in the design of the 2009 general government budget and in the setting of medium-term fiscal targets. A more medium-term-oriented fiscal policy would not only help maintain sound public finances but would also increase the efficiency of public spending. Moreover, budgetary procedures in the Federation need to be overhauled to ensure that new legislation is funded.

Directors welcomed the authorities' efforts to contain risks to financial stability, and encouraged the authorities to further improve the oversight of risk management, closely monitor credit risk, and urge banks to increase capital buffers, if necessary. Directors welcomed the signing of the memorandum of understanding on cooperation among the central bank and the two banking supervisors, and encouraged the authorities to intensify the policy coordination between these institutions and to continue to work toward unifying bank supervision.

Directors welcomed recent progress in improving statistics, and encouraged the authorities to persevere with their efforts to improve data quality, including by following up on the recommendations of the recently-completed Data Report on the Observance of Standards and Codes (ROSC).

Bosnia and Herzegovina: Selected Economic Indicators, 2004–08

	2004	2005	2006	2007 Est.	2008 Proj.
			(Percent change)		
Real GDP	6.3	4.3	6.2	5.8	5.5
CPI (period average) 1/	0.3	3.6	6.1	1.5	7.4
Money and credit (end of period)					
Broad money	24.3	18.2	24.7	21.6	15.2
Credit to economy	27.5	27.5	23.3	28.1	25.1
			(In percent of GDP)		
General government budget					
Revenue	44.2	45.5	47.5	48.7	47.9
Expenditure (on a commitment basis)	44.7	44.7	45.3	48.7	49.7
Overall balance	-0.5	0.8	2.2	-0.1	-1.9
External public debt	25.5	25.6	21.2	18.1	14.6
NPV of external public debt	19.5	19.6	16.2	13.8	11.2
Total public debt	25.5	25.6	22.0	30.5	34.3
			(In millions of euros)		
Balance of payments					
Exports of goods and services	2,373	2,832	3,589	4,062	4,934
Imports of goods and services	5,704	6,393	6,493	7,656	9,273
Current account balance	-1,318	-1,555	-816	-1,401	-2,007
(In percent of GDP)	-16.3	-18.0	-8.4	-13.0	-16.0
Gross official reserves	1,768	2,145	2,761	3,425	3,325
(In months of imports)	3.7	4.0	5.1	5.4	4.3
External debt service	419	267	412	321	450
(In percent of exports of goods and services)	17.6	9.4	11.5	7.9	9.1
Exchange rate regime			Currency board since August 1997		
Exchange rate, July 16, 2007			1KM = Euro 0.5113		
Real effective exchange rate (2000=100, increase=appreciation)	91.6	92.3	90.8	89.1	... 2/

Sources: Bosnian authorities; and IMF staff estimates and projections.

1/ Based on weighted averages for the Federation and Republika Srpska. In 2006, affected by the VAT introduction.

2/ Adjusted for VAT effects.

Statement by Age Bakker, Executive Director for Bosnia and Herzegovina and Miroslav Tomic, Advisor to Executive Director
September 17, 2008

Introduction

The authorities of Bosnia and Herzegovina (BiH) would like to thank the staff for the constructive and analytical discussions during their visit in June 2008, as well as for the cooperation through the Resident Representative's office and technical assistance projects. The authorities broadly agree with staff's analysis and share their views regarding the economic challenges ahead. The authorities consent to publication of the report.

The economy of BiH booked impressive results in the last several years: the average annual growth rate was almost 6 per cent, and the general price level, except in 2006 when VAT was introduced, was stable with average inflation in 2007 under the euro zone rate. From 2004 to 2008 the global export share more than doubled and external debt service more than halved, to 8% in terms of goods and services exports. The total public debt stands at the comfortable level of 30.5 percent of GDP. The fact that primary surpluses were registered in the last 5 years is a very strong indicator of prudent policy making. As a result of secured macro stability, the level of income achieved is above the Balkan region average. These impressive results can be contributed to the currency board regime which provided a nominal anchor, institutional reforms, particularly in the financial, tax system and business regulation sectors, and a beneficial external environment. The previous Fund involvement and recommendations, although sometimes hotly debated, contributed to this positive picture. However, despite achieved macro stability, the major economic problem, a 29% unemployment rate[1], remains unsolved. The high level of - mainly structural –unemployment creates economic waste, complicates prudent policy making and leaves less discretion in expenditure policy.

Macroeconomic development and outlook

The external environment deteriorated rapidly at the end of 2007. Although the global financial crisis did not have any substantial negative impact on the BiH economy so far, it did decrease the growth prospects of major trading partners. At the same time, global food and oil prices increased sharply, resulting in the CPI measured inflation pickup at the end of 2007. The same trend has continued in 2008, although BiH's inflation still compares favorably to that of peer countries. The authorities allowed an instantaneous pass through of global food and oil prices and managed to resist strong pressure by the public that requested changes in the indirect taxation system as a short-term attempt to contain inflation

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[1] This is the data from Labor Force Survey based on ILO's methodology for 2007. Unemployment rates vary across the regions and entities: in the Federation BiH unemployment rate is 31.1%, in Republika Srpska 25.2%.

(introduction of the (second) lower VAT rate, introduction of the zero rate for food, abolishment of the excise on oil, etc.).

As leading indicators of economic activity suggest, real growth in 2008 is likely to continue in the healthy range between 5-6%. While there has been a positive trend in the labor market in the first half of 2008, when the officially registered employment increased by 14% year-on-year, the extremely low labor participation rate of 43.1% cannot be ignored. The overall macroeconomic outlook for the BiH economy remains positive: while the external environment has deteriorated compared to previous years, the institutional set-up for policy making in BIH has substantially improved. On the political front, BiH signed a Stabilization and Association Agreement (SAA) with the European Union (EU) and, in terms of economic policy making, the Law on Fiscal Council (FC), that will provide for better intergovernmental coordination, and was a major concern of several recent Article IV consultations, has been adopted.

Fiscal Policy

The authorities share the staff's assessment that fiscal policy is the main tool to safeguard macroeconomic stability, and are confident that fiscal policy will continue to contribute to both stability and overall economic development. Besides progress in the fiscal architecture through the adoption of the FC Law which will enable effective medium-term fiscal framework planning, a permanent solution to the indirect tax revenue allocation between the entities was enacted in June 2008. The implemented reforms started delivering: the reform in direct taxes, adopted at the entity level under the USAID project, not only introduced modern and transparent tax systems but started producing tangible results. The Republika Srpska (RS) corporate income tax revenues increased by 30% during the first half of 2008 and similar results are expected in the Federation of Bosnia and Herzegovina (FBiH) when the adopted legislation is implemented in 2009. The direct tax rates (CIT 10% and PIT10%, with few exemptions) stand reasonably attractive in regional comparison. In addition, both entities are contemplating changes in the legislation that regulates social contributions, with a view to making formal employment more attractive. By establishing a Reserve Pension Fund, Republika Srpska embarked on a process of pension reform.

While moderate fiscal relaxation is expected in 2008, the authorities are confident that the consolidated fiscal position will be below 1% of GDP deficit, a target recommended by the staff. Despite the fall in custom revenues due to the application of the Trade Agreement with the EU as of July 2008, the Indirect Taxation Authority (ITA) will collect 5% more indirect tax revenues in 2008 than planned. However, besides the overall optimism associated with future EU accession, the Finance Ministers are aware of the revenue loss due to the free trade agreement and have continued to look for improvements in the tax system. The Republika Srpska will introduce a modern property tax, aimed at broadening the base and taxing property at market value rather than per physical unit as is currently the case. It is expected that this law will be enforced as of January 1, 2010. In addition, and in line with European best practice, changes in lottery and gambling regulations are envisaged. Similar preparatory activities are ongoing in FBiH.

Historical evidence reveals prudence in fiscal policy and the future position seems even more promising: after the FBiH adopted the Law on Debt and Guarantees in 2007, now all levels of government are bound by the law in terms of debt creation and borrowing. By the enacted rule, debt service cannot exceed 18% of the revenues collected in the previous year. This setup, along with the relatively comfortable current debt level, provides a strong framework for securing fiscal sustainability. That said, the authorities remain aware of opportunities to decrease public spending and of options to further strengthen the public expenditure management system, and to link public expenditures to outcomes. Under the project supported by the DFID, program-based budgeting has been initiated.
The authorities believe that staff's policy advice with respect to a balanced overall position over the medium term seems reasonable and accepts its recommendations as it gives enough flexibility.

External balance and competitiveness
Although a limited widening of the current account balance is expected in 2008, a substantial part of this deterioration is due to higher food and oil prices. Given that the governments of both entities have increased subsidies for agriculture, as well as the fact that price increases make this production more profitable, it is expected that pressure on food imports will diminish in the near future. In addition, the only oil refinery in BIH was privatized and is currently under reconstruction. It is expected that production will begin by the end of October 2008, which could further contribute to a lower import value since instead of the final product, BiH will import crude oil. However, the widening of the current account deficit is also a consequence of increased investment spending as the increased share in imports of machinery shows, and could be read as a positive sign since it will contribute to future export growth and a more balanced external position. Given the stable financing sources (in 2007 FDI were 14% of the GDP), the authorities are confident that the current account deficit widening is only a temporary phenomenon, as staff's analysis confirms, since the current account deficit is projected to decrease, even in the baseline scenario.

BiH's export share has more than doubled in the last couple of years and that export growth rate has stabilized at a solid 15%. The fact that this was mainly due to productivity growth, particularly in tradeables vis-a-vis main trading partners, supports optimism with respect to future current account developments. Despite the recent growth in average wages, unit labor costs are lower than they were in 2004**.** Finally, export performance and productivity growth support the staff's assessment that the exchange rate is in line with economic fundamentals. That said, the authorities are aware of the recent modest appreciation of the real effective exchange rate during the first quarter of 2008 and will continue careful monitoring of the competitiveness indicators.

Financial stability and monetary policy

Although financial deepening accelerated in 2007, the banking system, mostly in hands of foreign banks, still remains the dominant sector in the financial system. Confronted with rapid credit growth in 2007, provided through long-term funding from abroad, the Central Bank raised reserve requirements from 15 to 18 percent at the beginning of 2008. The measure resulted in credit growth deceleration in 2008, and for the first time credit to enterprises became bigger than credit to consumers. Global financial turbulence did not cause capital outflows as BiH does not rely on volatile sources. Bank soundness indicators remain satisfactory: capital adequacy remains high and the ratio of non-performing to total loans decreased substantially compared to previous years. Bank profitability in the first quarter was influenced by the recorded huge loss of only one bank while other banks had good results. Most of the 2006 FSAP recommendations have been implemented (such as introduction of comprehensive guidelines for liquidity management and broadening supervision of leasing companies by a banking agency), or are currently in the process of implementation (strengthening insurance supervision, strengthening corporate governance, etc.). Cognizant of the need to improve coordination and cooperation in banking supervision across the entities in the presence of constitutional limits for unification of the entity banking supervision agencies, the Central Bank and entity agencies signed a Memorandum of Establishing Firm Coordination in Banking Supervision in June 2008. The Memorandum, apart from regular data exchange, also mandates cooperation in implementing the Core Basel Principles and Directives of the European Union for Effective Surveillance. Currently, a strategy for implementation of the Basel II Principles is being prepared. While banking sector resilience against external shocks is adequate, the BiH authorities are devoted to improving monitoring and cross border supervisory cooperation. During 2008, multilateral agreement on banking supervision in South Eastern Europe was signed with Albania, Bulgaria, Cyprus, Greece, Montenegro, Macedonia, Romania and Serbia.

Sovereign debt servicing is executed in a timely manner and the authorities remain absolutely determined to keep as its first priority all debt servicing toward foreign creditors in the future. While BiH could not join Article VIII due to an issue of frozen foreign currency deposits, BiH is committed to maintaining a liberalized regime for capital and current transfers. Finally, there is full political support for the currency board and absolute consensus on the exit strategy, namely adoption of the euro in the context of accession to the European Union.

Privatization, Structural reforms, Infrastructure

The authorities are aware that privatization is still business unfinished, particularly in the FBiH. In the Republika Srpska, privatization proceeds are planned to be used in a transparent and accountable manner for the increase in productivity, infrastructure and removal of bottlenecks. Given the big regional differences in development, part of the funds will be used for revitalization of these areas, while other parts will be used to smoothen the reform of the pension system. Infrastructure projects are long awaited and could contribute to capacity increase and stimulate a higher labor activity rate. Implementation of the projects so far confirms, however, that the authorities remain cautious about the potential implications on the aggregate demand and the possible effect on prices.

According to the Federation BiH's Strategy for the Energy Sector, BiH currently uses only 38% of its hydro energetic potential and is in a good position to become a leading regional player in electric energy production. Several greenfield investments in the energy sector are being negotiated, ranging from wind, hydro and thermal energy production facilities. British ETF, a private company, is about to begin construction of Thermo plant Stanari whose annual output could reach up to 25% of the current total electricity output, and substantially increase the export potential of the country. This project has huge regional importance and could speed up other investments.

Public Wages and Employment

The authorities share staff's recommendation that keeping the public wage bill under control is an essential component of fiscal prudence and important for preserving competitiveness. Having said that, the authorities believe that long-standing major regulatory progress was achieved in the public wage bill policy in 2008. Prior to the adoption of the law, wages for the employees in the Institution of BiH were regulated by a dozen different legal acts, leading frequently to inadequate relative ratios between similar positions and a low compression ratio. Besides the relative salary structure, if an annual increase for experience allowance is neglected (0.5% per annum), wages for employees in the Institutions of BiH have not been increased for several years in nominal terms. The Council of Ministers (CoM) of BiH first adopted the wage bill policy for 2008-2010, by which the growth of wage expenditures was limited to up to 50% of the real economy growth rate. After that, the Law on Wages was adopted which gives the option to the CoM to keep the wage envelope under control if the fiscal position so requires. These instruments are expected to result in a decrease of the total wage bill in GDP as well as of overall public expenditure and to provide more space for capital investment. Adoption of the Law, however, is understood by the authorities as the beginning of the process of public administration reform and not its end.

The increase of wages in Republika Srpska (RS) (Staff report, page 27) needs careful assessment as it reflects the overall effort to modernize the public wage bill system by introducing the so called gross principle (no tax exempt allowances), as well as the RS government's intention to improve the relative position of the education and health sectors, given their critical importance for economic development. After a one-time adjustment of the salaries in these sectors, the RS government is determined not to increase public salaries in the next period. Finally, the authorities are aware of the need to have better coordination of public wages to avoid both competition between different government levels and a negative spillover effect to the private sector, and will pay attention to this issue in the future functioning of the Fiscal Council. While higher public wages are not guaranteed to eradicate corruption, they are an important element in the authorities' overall attempt to fight corruption and to improve the business environment.

Statistics

The authorities remain cognizant of the need to improve official statistics and are particularly grateful for the ROSC report. Although data dissemination practices meet or exceed GDDS recommendations for macroeconomic statistics, the data quality could be improved in many areas. The recent compilation and monthly dissemination of the CPI, with the assistance of the Italian government, represents important progress. The authorities, however, remain determined to resolve the remaining issues in a timely manner, particularly given the importance of statistics for integration into the European Union.

Going Forward…..

Fully aware of the many challenges ahead, particularly exacerbated by the global economic deterioration, the authorities remain confident that the recent signing of the SAA agreement represents a major incentive to speed up necessary reforms. The authorities look forward to continued cooperation with international institutions, without whose assistance many successfully implemented reforms would not have been possible, and reiterate their intention to maintain close cooperation with the Fund in the years to come.