credit developments and is prepared to adjust its policy if needed. The CBBH confirm that, in line with the staff's advice, the statutory 20 percent cap on RR has been removed (as of early October).

Financial stability and supervision

The authorities are committed to thoroughly analyze the FSAP recommendations and to address the identified shortcomings. In this context, the CBBH is developing its own capacities to better assess potential risks and weaknesses within the financial sector. The Fund's continued help in this regard is of great importance and the authorities hope to be able to rely on it in the future as well.
The authorities are well aware that the current organization of banking supervision is not adequate and it hinders further development. In this regard, a unified supervision system at the state level seems to be more effective in safeguarding financial stability and will be in line with the general approach of building a single economic space in BiH. However, since this issue is politically charged, further discussions on the supervision's coverage, institutional setup and location are expected to take place after the newly elected governments are formed.

The authorities agree that the leasing sector needs better supervision; however they do not share the staff's view that this should be done under the umbrella of banking supervision, particularly given that the leasing companies are not deposit taking institutions and do not affect the functioning of the banking sector in a material way. The authorities stress that, in view of the multiple assignments together with the limited resources, the banking supervision agencies should focus, at this point, on improving their risk assessments and bank oversight.

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Public Information Notice (PIN) No. 06/117
FOR IMMEDIATE RELEASE
October 19, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Bosnia and Herzegovina

On October 13, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Bosnia and Herzegovina.[3]

Background

Economic activity has remained robust and inflation low over the past several years. Growth has averaged 5 percent annually, and inflation—underpinned by the currency board—has remained low. Financial deepening has continued, the banking system is largely privatized, and international reserves are high and rising. Customs and indirect tax policy have been unified and a value-added tax (VAT) successfully introduced in January 2006. The general government balance has strengthened by 4 percentage points of GDP during 2001–05, while public debt at 32 percent of GDP at end–2005 is relatively low.

But these achievements continue to be hostage to fundamental political and economic imbalances: policy coordination hampered by weak institutions and lack of political will, lagging structural reforms, and a large current account deficit. While the recent intergovernmental agreement on a draft National Fiscal Council law represents a major step toward improved fiscal policy coordination, it has yet to be implemented.

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[3] 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.

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The fragmented fiscal system and the continuing dispute over the allocation of indirect tax revenue highlight the ineffectiveness of current coordination mechanisms and the resistance against centralizing key policy functions.

The approach of the October elections has led to fiscal policy slippages this year. Although the general government is likely to record a small surplus in 2006, this reflects temporary gains from the introduction of the VAT. If these lapse in 2007, the government deficit could—in the absence of corrective action—deteriorate by over 2 percentage points of GDP. Moreover, an uncertain but potentially large amount of outstanding claims against the government continues to be a major threat to fiscal sustainability over the medium term. Recent steps toward restructuring some of these claims are mitigating these concerns, but risks remain.

The current account deficit of the balance of payments, while likely much smaller than official estimates indicate, is large, reflecting insufficient private savings. Export growth has accelerated in 2004 and 2005, but the export base remains narrow and vulnerable to commodity price movements. Competitiveness indicators are mixed.

The rapid growth of credit to the private sector has drawn attention to the financial sector's vulnerabilities. The recent Financial Sector Assessment Program has found that, while the large presence of foreign banks may help enhance the system's resilience to shocks, they may underestimate credit risk and their reliance on low-cost foreign funding diminishes the incentive to mobilize long-term local deposits. The fragmentation of bank supervision among different agencies, the absence of consolidated supervision, and severe weaknesses in corporate governance are also sources of vulnerability for the financial sector.

Structural reforms lag behind those in neighboring countries and sustained private sector-led growth has yet to take root. At 50 percent of GDP, the government dominates the economy, while large segments of the corporate sector remain loss-making and unemployment is widespread. Notwithstanding a few large investments in metals and mining, foreign direct investment penetration, at less than $600 per capita, is one of the lowest in the region.

Executive Board Assessment

Executive Directors welcomed the strong economic growth and price stability achieved in recent years. They noted, however, that while postwar reconstruction and expansion of public consumption and investment had improved living standards, it had left the economy with inefficiencies in the structure of government, a large external imbalance, and high unemployment. While achievements in fiscal consolidation and in fostering price stability were recognized, Directors voiced concern over fragmented economic policy making and called for stronger policy ownership, improved coordination, and

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meaningful progress in structural reforms to strengthen the basis for sustained, private sector-led growth.

Directors noted that the fiscal situation remains fragile, given the intensifying spending pressures along with the transitory windfall from the VAT introduction, and the potentially large, unresolved domestic claims against the government. In this context, they cautioned that unrealistically generous terms for settling outstanding domestic claims would jeopardize long-term fiscal sustainability. Directors advised that a fiscal policy that aims at sustaining small surpluses over the medium term will help generate the increased domestic savings needed to address the external imbalance and keep public debt on a declining path. Reducing the duplication of government functions, prioritizing expenditures, and rationalizing social transfers and the wage bill will create room for additional priority spending, as well as for reducing the high burden of taxation.

Directors welcomed the agreement on a draft National Fiscal Council law, and urged that it be implemented without delay. They noted that, while the law is indispensable for better fiscal coordination, securing better fiscal policies and more efficient intergovernmental fiscal relations will also depend on strengthening the political cooperation. Over the medium term, it will be necessary to harmonize the provisions of the multitude of social safety nets and pension systems, as well as to rationalize revenue-sharing arrangements. These reforms will contribute to reducing the size of government and the tax burden.

Directors considered that the currency board has served Bosnia and Herzegovina well by providing an anchor for macroeconomic policies and contributing to business and investor confidence. They emphasized that, in addition to a prudent fiscal policy, structural reforms will be critical for maintaining the viability of the currency board, and expressed concern at their slow pace this year. Directors urged action on measures to make labor markets more flexible, amending labor laws to stop the accumulation of wage arrears, and accelerating corporate restructuring through bankruptcy and privatization. As the authorities intend to maintain the currency board until EU membership and adoption of the euro, the early launching of these reforms is imperative.

Directors noted that financial sector stability indicators are largely positive, and urged the authorities to address remaining vulnerabilities. The rapid credit growth of recent years highlights the need to improve credit risk management by banks. In this context, Directors urged the authorities to unify bank supervision as soon as possible. Directors welcomed the operation of the credit registry and the plans to extend it to cover households by end-2006.

Directors noted that, despite recent improvements in trade statistics, poor data quality hampers policy making and impedes effective surveillance. They urged the authorities to make data quality a priority and take all necessary steps, including by taking advantage

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of the donor technical support, to improve transparency, timeliness, and comprehensiveness of economic and financial data, particularly in the areas of the national accounts and balance of payments.

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