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Bosnia and Herzegovina: Supplementary Letter of Intent, and Addendum to the Technical Memorandum of Understanding

Press Release:
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May 6, 2013

April 23, 2013

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SUPPLEMENTARY LETTER OF INTENT

Sarajevo and Banja Luka, Bosnia and Herzegovina

April 23, 2013

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Ms. Lagarde:

1. The Stand-By Arrangement (SBA) for Bosnia and Herzegovina (BiH) that was approved in September 2012 by the Executive Board of the International Monetary Fund (IMF) continues to provide us with a valuable framework for our economic policies. We remain committed to implementing the policies described in our Letter of Intent dated September 11, 2012, as well as to the policies described in our supplementary Letter of Intent of December 6, 2012. This supplementary Letter of Intent provides information on our efforts and achievements since the completion of the first review under the arrangement in December 2012, as well as on additional policy measures we plan to undertake during the remainder of 2013 to help ensure that the objectives of the SBA will be met.

2. The overall economic situation remains difficult. After two years of modest recovery, real GDP is estimated to have contracted in 2012 by close to 1 percent. With the outlook for Europe remaining subdued and limited room for domestic stimulus, modest growth is projected for 2013: we expect that growth in BiH will remain below 1 percent this year. Inflation, meanwhile, continues to be well contained at close to 2 percent, despite higher food and energy prices, with core inflation low at around ½ percent. Inflation is expected to remain low in 2013. Unemployment, however, is very high and continues to be a major concern.

Program Implementation

3. Our policies are well on track to meet program objectives. All quantitative performance criteria for end-December 2012 on the budget balances of the Institutions of BiH and the central governments of the Federation and the Republika Srpska were met with comfortable margins. As overall revenues were slightly less than forecasted, this outcome reflects our ongoing efforts to contain public spending. Similarly, we did not contract or guarantee any new non-concessional short-term external debt, nor did we accumulate any external payment arrears, neither through end-December 2012, nor in the first quarter of 2013. However, we face considerable difficulties in monitoring the observance of the performance criterion on the non-accumulation of domestic arrears, because of weaknesses and delays in reporting by lower levels of government. While we can report that the Institutions of BiH and the central governments of the Federation and the Republika Srpska did not see an increase in domestic arrears in the period through end-December 2012, data collection for the lower levels of government, extra-budgetary funds, and road and highway funds for end-2012 is yet to be finalized. This process involves in many cases the verification of the balance sheets and financial statements—a process that is complicated by a lack of a sufficient number of trained staff—and this process is not expected to be completed before end-May. Going forward, to avoid these delays, we request a modification of this performance criterion so that it applies only to the central governments of the Federation and the Republika Srpska and to the Institutions of BiH. As we remain committed to ensure the integrity of our public finances, we would also like to set indicative targets for the changes in the stock of “other accounts payable” for the general governments of the Federation and the Republika Srpska, for which information can be directly derived from our harmonized reporting template. In addition, we will seek further technical assistance from the IMF to assist us with improving reporting by lower levels of government.

4. Good progress has been made toward fiscal consolidation. Although final end-2012 data for the general government will only become available in the coming months, based on the information available to date we are confident that the overall deficit was below our target of 3 percent of GDP. Available information also suggests that the indicative target for the balance of the general government—which excludes foreign financed projects—is also likely to have been met. Fiscal consolidation will continue in 2013, with the 2013 budgets that were adopted in December being consistent with a further reduction in the overall deficit to 2 percent of GDP.

5. We have also made steady progress in advancing our structural reform agenda. We have continued to adhere to the Currency Board Arrangement (CBA) and refrained from introducing new privileged or special rights for retirement—both continuous structural benchmarks—and most of the structural benchmarks through end-December 2012 were observed, albeit in several cases with some delay and some are still awaiting parliamentary approval. These delays largely stemmed from the longer-than-expected time it took to obtain parliamentary approval where this was needed, in part reflecting a heavy legislative agenda and the need for adequate consultative processes. More specifically:

- The consolidated general government accounts for end-September 2012 have been published on the website of the Institutions of BiH and we expect to publish the accounts for end-December 2012 in May 2013;
- The eligibility audits of recipients of war benefits are continuing and the results of these audits through end-2012 have been published by both entities;
- Payments of accrued amounts to decommissioned army personnel whose entitlements were repealed at the State level in May 2012 have been made;
- To facilitate cooperation with foreign bank supervisors, the Banking Agency law was amended in the Federation to bring the treatment of confidential information in line with EU practices, and this process is expected to be completed in the Republika Srpska by end-June 2013;
- To strengthen the bank resolution framework, amendments to the banking laws of both entities to limit the duration of provisional administration to one year with a possible six month extension have been submitted to the respective parliaments. Parliamentary approval is expected by end-June 2013;
- The Law on Financing of the Institutions of BiH has been amended to secure that external debt service can continue regardless of the status of approval of the budget and to require the Institutions of BiH and its ministries to ensure that sufficient balances are accumulated and available in the relevant accounts held with the Central Bank of Bosnia and Herzegovina (CBBH) to service the foreign debt.

- The Ministry of Finance and Treasury of BiH, the Ministry of Finance of the Federation of BiH, the Ministry of Finance of the Republika Srpska, the Indirect Taxation Authority (ITA), and the CBBH signed a Memorandum of Understanding to regulate the disbursements from and servicing of all related obligations to the IMF. This memorandum specifies that all disbursements under the SBA will be exchanged into domestic currency by the CBBH and deposited in the subaccounts of the entities at the CBBH, and provides the CBBH with a standing authorization to execute debt obligations vis-à-vis the IMF as they fall due using the designated IMF payment account and the Indirect Tax Authority accounts designated for debt servicing.
- A new law on privileged pension has been adopted in the Federation (a prior action for this review). This law now provides a comprehensive system that is financially sustainable and socially fair. The new law ensures the separation of the contributory portion of pensions from the privileged portion: pension fund obligations cover only pension entitlements based on years of contributions and age, while the additional amounts stemming from military service will be paid from the central government budget. The new law also harmonized privileged pension levels across similar groups and, more importantly, substantially reduced the average level of privileged pensions, bringing it much closer to the average level of contributory pensions. Moreover, the new law introduced large penalties for early retirement. As these changes ensure that the costs to the budget would remain well within the maximum envelope of KM 197 million, the revisions allowed for an expansion of the number of beneficiaries to ensure fair treatment of older veterans and veterans with disabilities. The new law furthermore requires that existing recipients of privileged pensions who have not already been audited go through a process of re-certification to confirm their eligibility within a period of four months as of the date of effectiveness of the new law, and no applications for any privileged pensions will be accepted after December 1, 2013 (with the exception of those qualifying under Articles 4.1 and 4.3 of the new law). Moreover, no further new categories of privileged pensions will be introduced following the adoption of this law (a continuous structural benchmark). Going forward, the new law specifies that the increase in benefit levels will be less than the rate of consumer price inflation to achieve further convergence with the average level of contributory pensions, while the law also ensures the continued use of the rationing coefficient to guarantee that privileged pension

payments financed from the budget will not exceed the amount allocated in the central government budget in a particular year.

Further Reforms

6. A draft comprehensive pension reform strategy has been prepared in the Federation. This strategy is aimed at ensuring the financial sustainability of the pension system, including by raising the retirement age, increasing the number of contributors, and discouraging early retirement. The draft strategy is being discussed with stakeholders and is expected to be finalized and submitted to parliament—with the inclusion of an action plan—by end-May 2013.

7. A new budget system law has been adopted in the Republika Srpska, which introduced penalty clauses for undertaking commitments that exceed the level of budget allocations. A new law on budgets is also being prepared in the Federation with technical assistance from the IMF. A first draft has been discussed with IMF staff and we will update the draft in line with IMF staff recommendations, particularly to: (i) strengthen the intergovernmental consultation and coordination process; (ii) improve the medium-term budgeting process; (iii) ensure the inclusion of financial plans and outcomes of public companies and extra-budgetary funds as annexes to the annual budget documents; (iv) improve cash management procedures; and (v) strengthen internal and external audit provisions. As this will require more time, we expect the new law to be adopted by end-May 2013 (originally a structural benchmark for end-March). The Federation finance ministry will also expand its consolidation unit and seek additional assistance to train its staff and that of lower levels of government. The ministry will also seek further technical assistance from the IMF to strengthen its cash management.

8. We are moving ahead with strengthening our coordination in the area of tax administration. The Governing Board of the ITA approved new coefficients for the distribution of indirect tax revenues in March and will continue to do so quarterly, in line with the existing legal regulations and procedures. We will secure the functioning of the Final Consumption Unit under the Governing Board by staffing it with representatives of both entities by end-May 2013. The Governing Board will also approve a reorganization of the ITA by amending the Rulebook on Internal Organization and Systematization of the ITA with a view to targeting its resources—within its current budget envelope and existing number of employees—to the Large Taxpayer Unit and establish strategy and risk

analysis units, with the latter also focusing on the detection and coordination of activities for the prevention of VAT fraud. The four tax agencies (ITA, FTA, RSTA, and BDTA) expect to sign the Memorandum of Understanding on the exchange of taxpayer information as planned by end-May. The information sharing of taxpayer records will start in the following months and will be comprehensive, unfettered, and automated. In particular, the FTA, RSTA, and BDTA will have permanent access to each other's income tax and social contributions data, as well as the ITA's VAT, excise, and customs data. Conversely, ITA auditors will have permanent access to taxpayer data held by the FTA, RSTA, and BDTA for purposes of undertaking VAT and customs post clearance audits.

9. Increased efforts are underway to improve the financial soundness of the Health Fund in the Republika Srpska. The collection base has been broadened to capture farmers and temporary employment contracts, and the transfer from the budget has been increased. Further efforts will also be made to collect contribution arrears. To contain health care spending, we will adjust the network of health centers and their staffing in line with our Primary Health Care Strategy for 2013. In addition, we will: (i) reduce the wage bill of the Health Insurance Fund by approximately KM 2.5 million in 2013; (ii) reduce the level of sick leave compensation for sick leave longer than 30 days by 10 percent; (iii) reduce the list of covered medications and orthopedic aids; and (iv) reduce the coverage of medical treatment outside Republika Srpska.

10. In the financial sector, to further increase our crisis preparedness and contingency planning, the CBBH and the Banking Agencies signed the joint Memorandum of Understanding formalizing stress-testing procedures in March. The identification of financial institutions that are considered systemically important is also almost completed. The list of systemically important banks will serve as a platform to monitor developments in the financial sector more closely and discuss possible risks. Amendments to the law governing the Deposit Insurance Agency have been prepared in line with Fund recommendations and have been submitted to parliament. We will determine further steps to enhance our crisis preparedness, as well as steps to improve the resolution framework for non-performing loans following technical assistance from the IMF. To update and harmonize our legal and regulatory framework on banks with EU legislation, both entities, i.e., the entity finance ministries and banking agencies, and the Deposit Insurance Agency will coordinate work and take the necessary steps, with assistance of the IMF, to prepare new laws on credit institutions by mid-2014.

11. With high unemployment, and particularly youth unemployment, a major concern, we recognize there is need to make Bosnia and Herzegovina a more attractive place to invest and create more jobs. We are already preparing a one-stop process for business registration in Republika Srpska and a new law on companies in the Federation, to make it easier to start and operate a business. We have also started the consultative process with trade unions and employers' organizations to revisit labor legislation with a view to increase job creation. We expect to adopt new labor laws in the Federation and the Republika Srpska to this effect by end-2013. We have made progress in amending our rules and procedures covering food and animal safety to align these with EU requirements and expect to complete this process in the coming months, to avoid the disruption of exports of agricultural products to neighboring countries acceding to the EU.

Program Modalities

12. We believe that our economic program continues to be on course, despite a difficult environment, and that our policies set forth in our Letter of Intent of September 11, 2012, and supplemented by the policies described in the supplementary Letter of Intent of December 6, 2012 and this supplementary letter are adequate to achieve the objectives of our program. We stand ready, however, to take any additional measures that may be needed to achieve the objectives of our economic program. We will consult with the IMF on the adoption of additional policy measures and in advance of any revision to the policies contained in our economic program, in accordance with IMF policies on such consultation. We will continue to provide IMF staff with the necessary information for assessing progress in implementing our program and will maintain a close policy dialogue with IMF staff.

13. As the consideration of this second review was delayed slightly in order for the prior action to be implemented, we request the Executive Board to approve waivers of applicability of the end-March 2013 performance criteria on fiscal balances and domestic arrears, for which data are not yet available and for which there is no evidence that these were not observed. We also request the IMF's Executive Board to approve the modification of the performance criterion on the non-accumulation of domestic arrears for end-June 2013 and going forward so that it applies only to the central governments of the Federation and the Republika Srpska and to the Institutions of BiH, while establishing indicative targets for the general governments of the Federation and the Republika Srpska on changes to the stock of other accounts payable. We furthermore request the Executive

Board to complete the second review under the SBA and approve the third purchase under the arrangement in the amount of SDR 33.82 million.

14. We authorize the IMF to publish this Letter of Intent and its attachments, as well as the related staff report on the IMF's website following consideration of our request by the IMF's Executive Board.

/s/

Vjekoslav Bevanda
Chairman
of the Council of Ministers
Bosnia and Herzegovina

/s/

Nermin Nikšić
Prime Minister
Federation of Bosnia
and Herzegovina

/s/

Željka Cvijanović
Prime Minister
Republika Srpska

/s/

Nikola Špirić
Minister of Finance
and Treasury of
Bosnia and Herzegovina

/s/

Ante Krajina
Minister of Finance
Federation of Bosnia
and Herzegovina

/s/

Zoran Tegeltija
Minister of Finance
Republika Srpska

/s/

Kemal Kozarić
Governor
Central Bank of Bosnia and Herzegovina

Table 1. Bosnia and Herzegovina: Quantitative Performance Criteria and Indicative Target Under the 2012–14 Stand-By Arrangement, 2012–13

(Cumulative flow since the end of the previous year; in millions of KM)

	2012				2013					
	End-September		End-December		End-March		End-June	End-September	End-December	
	EBS/12/120	Act.	EBS/12/120	Act.	EBS/12/161	Act.	EBS/12/161			
Performance Criteria										
Floor on the net lending of 1/										
Institutions of BiH	10.7	47.6	-38.2	44.5	-15.0	...	-15.0	-20.0	-25.0	
Federation central government	180.4	146.8	44.0	74.8	0.0	...	60.0	120.0	179.0	
RS central government	57.8	88.4	-77.7	-33.0	10.0	...	10.0	30.0	120.0	
Ceiling on contracting and guaranteeing of new nonconcessional short-term external debt by										
Institutions of BiH	0	0	0	0	0	0	0	0	0	
Federation general government	0	0	0	0	0	0	0	0	0	
RS general government	0	0	0	0	0	0	0	0	0	
CBBH	0	0	0	0	0	0	0	0	0	
Ceiling on accumulation of domestic arrears by 2/										
Institutions of BiH	0	0	0	0	0	...	...	...	...
Federation general government	0	0	0	...	0	...	...	...	...
RS general government	0	0	0	...	0	...	...	...	...
Ceiling on accumulation of domestic arrears by 3/										
Institutions of BiH	...	...	...	0	0	...	0	0	0
Federation central government	...	...	...	0	...	...	0	0	0
RS central government	...	...	...	0	...	...	0	0	0
Ceiling on accumulation external payment arrears by 4/										
Institutions of BiH	0	0	0	0	0	0	0	0	0	
Federation general government	0	0	0	0	0	0	0	0	0	
RS general government	0	0	0	0	0	0	0	0	0	
CBBH	0	0	0	0	0	0	0	0	0	
Indicative targets										
Floor on the net lending of the general government of BiH 1/	413.0	48.4	-237.6	-192.6	-50.9	...	-24.6	-97.1	-17.1	
Ceiling on changes in the stock of "other accounts payable" 3/										
Federation general government	...	...	...	16.9	...	...	100.0	100.0	100.0
RS general government	...	...	...	81.2	...	...	160.0	160.0	160.0

1/ Excluding foreign financed projects as defined in TMU.

2/ The authorities requested modification of these performance criteria.

3/ Proposed performance criteria and indicative targets, starting end-June 2013.

4/ Continuous.

Table 2. Bosnia and Herzegovina: Structural Conditionality

Actions	Test date	Status
Prior Action for Board consideration of the second review		
1 Adopt a new law on privileged pensions in the Federation in line with IMF staff recommendations		Met
Structural benchmarks		
1 Continue to adhere to the Currency Board Arrangement as constituted under the law	Continuous	Met
2 Refrain from introducing new privileged or special rights for retirement	Continuous	Met
3 Publish on the web site of the Institutions of BiH quarterly consolidated general government accounts with a 6 week lag	Quarterly	Met in September; not met in December
4 Carry out eligibility audits for war benefit recipients; publish results (quarterly within 4 weeks after the end of each quarter) of audits (Entities)	Quarterly	Met with delay
5 Pay obligations accrued through May 2012 arising from early retirement provisions under the Law on Service in the Armed Forces of BiH	End-December 2012	Met
6 Amend the Law on Financing of the Institutions of BiH to allow for continued servicing of foreign debt in the absence of an adopted budget	End-December 2012	Met with delay
7 Amend the banking law in the Federation to limit provisional administration to one year with a possible six month extension	End-December 2012	Not met; reset to end-June 2013
8 Amend the banking law in the RS to limit provisional administration to one year with a possible six month extension	End-December 2012	Not met; reset to end-June 2013
9 Amend the legal frameworks related to the treatment of confidential information in the Federation and the RS to align them with EU requirements	End-December 2012	Not met; reset to end-June 2013
10 Sign a Memorandum of Understanding by the Ministry of Finance and Treasury of BiH, the Ministry of Finance of the Federation, the Ministry of Finance of the RS, and the CBBH, which will regulate the disbursements from and servicing of all related obligations to the IMF	End-December 2012	Met with delay
11 Adopt a new law on budget in the Federation that improves data reporting and enhancing control over lower level governments, extra-budgetary funds, and public companies	End-March 2013	Not met; reset to end-May 2013
12 Submit to the BiH Parliament a revised law governing the Deposit Insurance Agency along the lines specified in ¶28 of the LOI of September 11, 2012	End-March 2013	Met
13 Sign a joint Memorandum of Understanding by the four tax agencies (ITA, FTA, RSTA, and BDTA) on data exchange to further improve the exchange of information	End-May 2013	
14 Establish a one-stop shop process for business registration in RS	End-September 2013	
15 Amend legislation in the RS to eliminate the take-home pay protection for public sector employees	End-December 2013	

ADDENDUM TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING ON DEFINITIONS AND REPORTING UNDER THE 2012–14 STAND-BY ARRANGEMENT

The Technical Memorandum of Understanding (TMU) on Definitions and Reporting Under the 2012–14 Stand-By Arrangement dated September 11, 2012 and the Addendum to the TMU dated December 6, 2012 shall remain in effect except for the amendments below:

1. In Section E, references to “Federation and Republika Srpska General Governments” shall be replaced with “Federation and Republika Srpska Central Governments.”
2. A new Section F shall be introduced, reading:

“F. Ceiling on changes in the stock of “other accounts payable” by the Federation of Bosnia and Herzegovina and Republika Srpska General Governments (Indicative Target)

Definition

31. The indicative target established on the ceiling on changes in the stock of other accounts payable contemplates (i) a KM 100 million ceiling for the Federation of Bosnia and Herzegovina general government and (ii) a KM 160 million ceiling for the Republika Srpska general government, on the accumulation of other accounts payable compared to the balance as of December 31 of the previous year. The accumulation of other accounts payable (Ostale obaveze) is defined as the sum of change in float and change in arrears. These can arise from any expenditure item, including transfers to individuals, debt service, wages, pensions, energy payments, and goods and services.

Application of the indicative target

32. The respective ceilings on changes in the stock of other accounts payable apply to obligations of the Federation of Bosnia and Herzegovina and of the Republika Srpska general governments as defined above. This target will be measured quarterly on the basis of end-of-quarter data. Thus, if at the end of any given quarter any of the two governments exceed their corresponding ceiling on changes in the stock of other accounts payable compared to the balance of the same government’s other accounts payable as of December 31 of the previous year, the indicative target will be missed.

33. **Reporting requirements:** Data on “other accounts payable” (Ostale obaveze) for the general government will be contained in the data on quarterly general government

execution, including revenues, expenditure and financing, to be provided by the Ministries of Finance of the respective Entities no later than six weeks after the end of each quarter.”

3. Paragraphs 31, 32, 33, and 34 shall be renumbered 34, 35, 36, and 37 respectively.