

International Monetary Fund

[Bosnia and Herzegovina](#) and the IMF

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

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BOSNIA AND HERZEGOVINA: SUPPLEMENTARY LETTER OF INTENT

Sarajevo and Banja Luka, Bosnia and Herzegovina
October 13, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

Further to our letter of September 17, 2010, which reiterates our commitment to the economic program supported by the Stand-By Arrangement (SBA) with the Fund, we hereby request a waiver of applicability for the end-September 2010 performance criterion on net bank credit to the government, which has become controlling in view of the October 15, 2010 date for Board consideration of the second and third SBA reviews. While we do not have the full information to assess the performance under this criterion, we are confident that it was observed. The continuous quantitative performance criteria on external public debt service arrears, short-term non-concessional external public debt, and public guarantees and assumption of enterprise debt to domestic banks have been observed. The margin by which the performance criterion on domestic expenditure arrears was breached (in the first quarter of 2010)—for which we had requested a waiver of nonobservance in our September 17, 2010 letter—remains unchanged (Table 1).

/s/

Dragan Vrankić
Minister of Finance
and Treasury of
Bosnia and Herzegovina

/s/

Vjekoslav Bevanda
Minister of Finance
Federation of Bosnia
and Herzegovina

/s/

Aleksandar Džombić
Minister of Finance
Republika Srpska

Table 1. Bosnia and Herzegovina: Performance Criteria Under the 2009–12 Stand-By Arrangement, 2010
(In millions of KM)

	Cumulative flow since December 31, 2009									
	2010									
	March			June			September			December
	Program	Adj. Program ²	Actual	Program	Adj. Program ²	Actual	Program	Adj. Program ²	Actual	Program
Ceiling on accumulation of net credit of the banking system to: ¹										
General government	333	292	104	580	604	175	751	N/A	N/A	631
<i>of which:</i>										
State government	20	20	3	-11	-11	-71	112	N/A	N/A	121
RS government	251	237	127	429	480	243	499	N/A	N/A	521
Federation government	61	34	-23	164	137	19	159	N/A	N/A	-8
Ceiling on the increase in the total value of outstanding commitments by the State, Federation and RS governments under guarantees of private and public sector enterprises' debts to domestic banks plus the value of enterprise debts to domestic banks assumed by these governments ³	0		0	0		0	100		0	100
Ceiling on accumulation of new external debt service arrears by the State, Federation and RS governments and CBBH ³	0		0	0		0	0		0	0
Ceiling on contracting or guaranteeing of new nonconcessional short-term external debt by the State, Federation and RS governments and CBBH ³	0		0	0		0	0		0	0
Ceiling on the increase in the stock of domestic expenditure arrears by: ³										
State government	0		0	0		0	0		0	0
RS government	0		15	0		-1	0		-1	0
Federation government	0		-6	0		-17	0		-30	0

¹ Equal to the sum of the three listed sub-ceilings plus the net bank credit to the District of Brčko, which is not monitored individually due to its small size.

² The targets on banking system net claims the general government will be adjusted upward (downward) by the full amount of any shortfall (surplus) in programmed disbursements of budget support loans and grants; and will also be adjusted upward (downward) by the amount by which reported change in float is arithmetically smaller (greater) than its targets in the fiscal program. The upward adjustment is limited to 10 percent of the absolute value of the respective change-in-float target (see Technical Memorandum of Understanding on Definitions and Reporting Under the 2009–12 Economic Program).

³ Continuous.

BOSNIA AND HERZEGOVINA: LETTER OF INTENT

Sarajevo and Banja Luka, Bosnia and Herzegovina
September 17, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

1. Despite the challenging external environment, the strengthening of our policies and the substantial financial support provided by the IMF since the approval of the Stand-By Arrangement (SBA) in July 2009 have helped stabilize the economy of Bosnia and Herzegovina (BiH) and set the stage for sustainable growth over the medium term. Macro-financial vulnerabilities have been reduced, as public confidence in banks has returned following the 2008 mini-deposit run, the decline in the foreign exchange reserves of the Central Bank of Bosnia and Herzegovina (CBBH) has been contained, and foreign banks have maintained their overall exposure to our country.

2. Implementation of the IMF-supported program has been in line with our commitments (Tables 1 and 2):

- *Quantitative performance criteria.* All end-March targets and end-June 2010 quantitative criteria were observed, except the one on the accumulation of domestic arrears.
- *Structural benchmarks.* We have met the structural benchmark for the publication on the State government's website of quarterly consolidated general government data for end-March and end-June 2010. In the Federation, the implementation of end-March 2010 structural benchmarks fell behind schedule, but the authorities have now advanced the program's reform agenda. Specifically, parliament adopted public wage legislation in July, the government approved a pension reform strategy in June, and eligibility audits for war benefit recipients began in early-July. The reform of privileged pensions and the latest round of eligibility audits of civilian disability benefit recipients will now take place in 2011. In Republika Srpska (RS), all end-March 2010 benchmarks—related to eligibility audits, the reform of privileged pensions, and the pension reform—have been met; and the end-June 2010 benchmark related to publication of results from eligibility audits was met with a few days' delay.

3. Overall budget implementation by the Institutions of BiH (State), Federation, and the RS has been in line with the program. At the same time, in the Federation, there are worrying signs that the reforms of rights-based cash transfer programs are not delivering the expected savings. In the RS, the finances of the pension and health insurance systems continue to be under pressure. In response, Entity governments have identified additional revenue sources and measures to contain expenditures, elaborated in this Letter.

4. In view of this performance and our continued commitment to the program, we request completion of the second and third reviews under the Stand-By Arrangement. On the basis of the corrective measures being taken, we request a waiver of non-observance of the performance criterion on non-accumulation of domestic arrears. In the RS, the zero sub-ceiling on accumulation of domestic arrears was exceeded during the first quarter of 2010, mainly on account of liquidity difficulties in the Health Fund, but since then outstanding arrears have been eliminated. In 2011, we will address this issue in the context of the planned reform of the health insurance system. In the Federation, the collection of detailed information on arrears of lower levels of government has proved very difficult within the reporting deadline, owing to capacity constraints, the decentralized government structure, and the lack of enforcement powers on the part of the central government. Available final information shows a reduction in the existing stock of domestic arrears for the central government and the cantons during January–June 2010, and preliminary information indicates that the zero ceiling on arrears accumulation was not exceeded by municipalities and cantonal extrabudgetary funds. To deal with these difficulties, we have prepared a template which will be introduced for reporting of arrears of all levels and we will increase the staff in the Ministry of Finance unit responsible for the collection of fiscal information from lower levels of government, in order to be able to meet the reporting deadline in future program reviews.

5. The policies set forth in this Letter and our previous letters (of June 16, 2009 and March 5, 2010) are adequate to achieve the objectives of our economic program, and we stand ready to take additional measures as appropriate to ensure the attainment of these objectives. We will consult with the IMF before modifying measures contained in this letter or adopting new measures that would deviate from the goals of the program, and provide the IMF with the necessary information for program monitoring.

A. Macroeconomic Framework

6. Our macroeconomic framework has retained cautious assumptions. We continue to believe in a gradual return to positive growth, with real GDP gaining about 0.5 percent in 2010 and 3 percent in 2011, aided by the recovery in the euro area. Inflation is expected to pick up to 2½ percent this year. Weak domestic demand in 2010 will keep the current account deficit considerably below pre-crisis levels. We expect the external financing situation to remain favorable. Foreign parent banks are expected to broadly maintain their total exposure to BiH, taking into account residents' direct borrowing from parent banks.

Other private flows, along with financing from the IMF, the World Bank, and the EU, should be sufficient to meet all external financing needs in 2010.

B. Fiscal Policy

7. In support of our commitment to the currency board, continued fiscal consolidation and structural fiscal reforms will remain the cornerstones of our policymaking. When the crisis hit, our fiscal position was threatened. The disbursements under the Stand-By Arrangement and the SDR allocations allowed us to maintain continuity of public services and gave us time to elaborate ambitious fiscal reforms aimed at putting public finances on a sustainable path. Our adjustment efforts focus on controlling current expenditure, while protecting transfers to vulnerable population groups and spending on much-needed infrastructure. In particular, public sector wages, which have grown very rapidly over the past few years, are being kept in check, while the system of social transfers is being reformed to improve its efficiency through better targeting.

8. The program's overall consolidated fiscal deficit objective of 4½ percent of GDP for 2010 remains appropriate. Although performance during the first half of the year is in line with the program, continued efforts will be needed to stay within the program targets.

9. The State has exercised prudence since the beginning of the program. In 2009, we accomplished an overall reduction in expenditures of KM 100 million compared to budget, and recorded a KM 12 million surplus. We implemented restrictive measures this year, and are targeting a deficit of KM 173 million, which will be financed from surpluses from earlier years, succession receipts, and funds from the budgetary support loan by the EU.

10. The Federation resisted expenditure pressures. Benefiting from better-than-budgeted revenue, it recorded a consolidated deficit of KM 97 million compared with the program's objective of KM 293 million in the first half of the year. However, due to delays in the implementation of the reforms of benefits, without additional efforts, expenditure pressures will continue to threaten the sustainability of our finances. We are thus determined to deal with these pressures with strong and concrete measures, which have been incorporated in a rebalanced 2010 budget (adoption by Parliament is a prior action and was met on September 14). Specifically:

- *Wages.* The Federation parliament adopted the Law on Wages in July (end-March structural benchmark) aimed at harmonizing and making more transparent the remuneration policies across levels of government. This Law along with a hiring restraint in the remainder of the year will ensure that the Federation central government's wage bill will not exceed the 2010 budgetary allocation; in fact, we expect to generate at least KM 3 million savings.

- *War-related cash benefits.* After some delay, we have started eligibility audits of beneficiaries (continuous structural benchmark). During July–August 2010, we audited 2,185 beneficiaries and referred 469 cases for further verification of documentation in military records. We will immediately suspend payments in cases of confirmed lack of adequate documentation. Owing to the delay in initiating the audit process and its complexity, we expect that savings will begin to materialize only toward the end of this year, but under current procedures the generated savings will be insufficient to allow us to stay within the budgeted allocation for war disability benefits. We will improve the audit process by giving priority to certain groups of beneficiaries (e.g., those who became eligible by proving their status and membership in the armed forces through administrative procedures, beneficiaries who exercised their rights without providing payroll certificates from the armed forces, the most recent beneficiaries, and those entitled on the basis of mental illness). We will also amend the Rulebook on the establishment and work of audit teams to allow the possibility for establishing up to 20 audit teams (instead of the current 15). The government will issue a decision to incorporate the aforementioned changes in the audit process by September 10, 2010 (prior action) and the Federation Ministry of Veterans' Affairs will issue the amended Rulebooks by end-September 2010. In addition, in October 2010 the FBiH government will evaluate the budget implementation and, if necessary, will apply an appropriate rationing coefficient in the last quarter of 2010 for all budget users. Finally, we will publish on a government website detailed results from the eligibility audits performed through August and will continue to publish these results quarterly.
- *Medal holders' benefits.* We have introduced income tests for war medal holders effective May 1, 2010. Payments of benefits were suspended pending the outcome of eligibility audits and means-testing. We have removed from the beneficiary list 196 individuals who have failed to re-apply for benefits as of May 1, 2010, and following the income tests we will also remove from the beneficiary list by end-2010 the 20 percent of beneficiaries with the highest income. All these measures will result in savings of at least KM 1 million relative to the 2010 budget allocation.
- *Demobilized soldiers' benefits.* The repeal of the Law on Demobilized Soldiers effective May 1, 2010 has resulted in cessation of all cash transfers to demobilized soldiers. Realized savings of KM 4.1 million relative to the budget allocation on this expenditure item have been used to settle arrears on unemployment benefits of demobilized soldiers accumulated in 2009. In the future, the social needs of demobilized soldiers will be addressed through existing programs of the social safety net.
- *Privileged pensions.* We will overhaul the system of privileged pensions in the context of the implementation of the pension system reform in 2011. In the

meantime, no new privileged or special rights for retirement will be introduced (continuous structural benchmark). We will tighten eligibility criteria and expedite audits of beneficiaries, and publish results quarterly. No one will be eligible to retire and use privileged or special provisions for retirement without the completion of an audit. Benefits will cease immediately in cases of fraud. To control the overall fiscal cost and improve equity of the public pension system, we will aim at aligning the average level of privileged pensions to that of pensions earned through full contributions.

- *Regularization of outstanding obligations.* We will resolve problems arising from weaknesses in budgeting, fiscal reporting and cash management, which have given rise to ad hoc treatment of outstanding obligations to final beneficiaries and those arising between various levels of government. We have already established and will publish an inventory of all outstanding obligations by level of government as of end-June 2010 toward beneficiaries under main transfer programs. As a next step, we will regularize and clear all outstanding obligations by planning funds for these purposes in the budgets of the FBiH starting from 2011, including by submitting to parliament a draft law for settlement of outstanding obligations to non-war invalids with the view of full payment in the course of the next two years, and by exploring different options for settlement of the FBiH Central Government debt to the Pension Fund, debt to demobilized soldiers, and other beneficiaries under main transfer programs.
- *Cantons.* Reflecting large expected transfers from the Federation government and unrealistic revenue projections, some cantons have approved expansionary budgets, and increased current spending compared with 2009. We will urge cantons to rebalance their budgets in line with the objectives of the Law on Savings. To this end, the Federation government will issue a decision to condition the transfers for deficit financing of cantons on cantonal budget rebalances to reduce current expenditures (prior action—met on September 8).

11. The RS exercised prudence in the first half of the year, recording a consolidated general government deficit of KM 199 million compared with the program's objective of KM 303 million. The government is committed to making strong efforts to limit the 2010 consolidated general government deficit to KM 503 million in line with the program. With better-than-projected revenue performance, our efforts will concentrate on keeping expenditure in check.

12. Ahead of the implementation of our comprehensive pension reform strategy, the RS government has begun addressing the liquidity challenges of the Pension Fund in the current year through increased transfers and borrowing from commercial banks. Parametric reforms have been initiated and the third pillar has been introduced during the past several years. The transition to the second pillar has been ruled out as too costly and difficult in the near term.

Future envisaged steps include: further increase in the effective retirement age of men and women; transition to the system of points similar to the German model; and indexation in line with the Swiss model (50 percent to CPI and 50 percent to wage growth). To this end, the RS government will, by end-2010, adopt the draft Law on Pension and Disability Insurance and forward it for adoption to the RS National Assembly in accordance with the adopted Strategy of the Pension System Reform (structural benchmark). Eligibility audits of veterans' and social benefits will continue.

13. The RS Government will initiate a reform of the health insurance system in accordance with the Strategy of Primary Health Care and the Strategy of Secondary and Tertiary Health Care in the RS. The reform will entail cost rationalization, introduction of a new payments model to health care institutions, and upgrades in information technology.

14. We have taken steps to strengthen the revenue side. We have amended the Law on Income Tax to: (i) make the costs of hot meals prepared by the employer and those delivered to the employer by a company registered for catering services tax free in the maximum amount of KM 3.5 a day per employee, or the maximum amount of KM 77 monthly per employee; (ii) reduce the amount of tax-exempt personal income from KM 3,600 to KM 3,000 annually; (iii) tax capital gains from the sale of property that was used for personal use; and (iv) tax pensions paid out from voluntary pension insurance plans up to KM 1,200. In tax administration, efforts to improve collection of revenues will focus on amending legislation and regulation with the view to improve control and broaden the coverage of taxpayers.

15. By end-2010, we will pass a new rulebook on financial reporting for budget users of the republic, municipalities, cities and funds; and, by end-September 2010 we will publish a new rulebook on the chart of accounts for budget users of the republic, municipalities, cities and funds, with application starting on January 1, 2011.

16. All governments are committed to maintaining fiscal discipline over the medium term. We therefore intend to reduce the general government deficit to 3 percent of GDP in 2011. Fiscal efforts will continue to focus on the expenditure side, which will benefit from the impact of the reforms undertaken this year.

- The Fiscal Council (FC) will adopt the Global Framework of Fiscal Balance and Policies in BiH consistent with the SBA to ensure that the 2011 State budget expenditures will remain at the 2010 level. This Framework will provide the basis for the preparation of the budgets of the State and the Entities for 2011.
- To improve the transparency of government operations, the 2012 budgets of the State, Federation, and RS will include foreign-financed investment projects financed from external loan drawings and grants, excluding technical assistance, that pass through the Treasury, as well as complete accounting of financing operations.

- Medium-term fiscal planning in the Federation will have to address substantial needs for capital investments in infrastructure. The consolidation of the wage bill, transfers and other current expenditures will continue. Restructuring and privatization of state-owned enterprises will be one of the important sources of financing.
- In the RS, the main challenges ahead will be containing pressure on social benefits arising from unfavourable demographic trends, transitioning to lower financing available for capital projects, and building up savings to service foreign debt obligations. This will imply strict control over the wage bill and other current spending. The RS government will adopt a Development Strategy (by end-May 2011) aimed at correcting the unfavourable economic structure inherited from the past and underutilization of the economy's comparative advantages and natural resources. The objective of the Strategy is to ensure competitiveness of the economy, increased employment, increased standard of living and improved social security of citizens.

17. We recognize the important role of the Fiscal Council in coordinating fiscal policy across BiH. We will establish common methodology according to which the State and the Entities will undertake a comprehensive analysis of expenditures. The results of the analysis will be presented to the FC in the context of the preparation of the 2012–14 Global Framework. We will continue to strengthen the Council's operational framework, including by improving fiscal methodology and multi-annual planning for the Global Framework, drafting proposals for short-term and long-term macroeconomic projections, and implementing established goals and criteria when adopting and executing the budget.

18. The unfavorable economic situation may have an impact on the vulnerable groups of our population. Thus, the envisaged reforms by the Entities are critical to ensuring that financial public support for households is better targeted toward the most vulnerable groups of the society, and that financial integrity of public pension and unemployment insurance schemes does not become jeopardized.

C. Financial Sector Policies

19. The banking system withstood the immediate impact of the global financial crisis well. However, nonperforming loans increased to 5.8 percent at end 2009 and continued to rise in the first half of 2010 reaching 8.7 percent at end June; and profitability has declined over the same period. The two Banking Agencies (BAs) are closely monitoring banking sector developments and are taking steps to ensure that banks continue to have adequate capital. To this end, banks were encouraged to retain profits, and use them to strengthen their capital buffers. In addition, the Banking Agencies will ensure that banks have forward-looking capital plans that will show how any potential deterioration in capital levels will be addressed. The BAs and the banks will review and, if necessary, revise such plans periodically, to account for changing macroeconomic environment. The BAs have strengthened their cooperation with foreign home supervisors including through their

participation in colleges of supervisors, and they hope to soon finalize bilateral Memoranda of Understanding with Austria's and Italy's banking supervisors.

20. We will follow up with parent banks on their pledge to continue to support their subsidiaries in BiH by keeping them adequately capitalized and maintaining their exposure to our country. As per the Bank Coordination Initiative, the CBBH along with the BAs prepared stress tests based on end-2009 data and discussed the results on a bilateral basis with each participating bank. We plan to update the stress tests using end June 2010 data and review with banks the need for additional capital based on the updated results. We will continue to monitor the exposure of parent banks vis-à-vis BiH, both directly to their subsidiaries and to the economy in general based on data provided to us on a regular basis by the parent banks. On an aggregate level, the parent banks' overall exposure at end-March 2010 was 1½ percent lower compared with end-2008. Following the second round of bilateral discussions with banks regarding the adequacy of their capital base and developments in the parent banks' exposure, we plan to convene another meeting of the parent banks to review and renew their commitments to BiH.

21. We have strengthened our framework for crisis preparedness and management. To this end we have established a Standing Committee for Financial Stability (SCFS), which consists of members of the Fiscal Council, the CBBH, the two Banking Agencies, and the Deposit Insurance Agency. A Memorandum of Understanding that establishes the formal framework of cooperation among the various parties has already been signed. The first meeting of the SCFS was held in May 2010, and we plan to meet at least once every quarter to discuss and exchange information related to financial stability. Prior to the meeting the CBBH and the Banking Agencies will prepare brief reports on the conditions in the financial sector. The reports will provide the basis of our discussion which will focus on identifying risks to the system and the appropriate response. Moreover the CBBH plans to increase the resources available for its Financial Stability Unit to enhance its capacity to monitor and analyze financial sector developments, and the BAs will continue to upgrade their information systems so that banking sector data can be readily processed and analyzed.

D. Data Issues

22. We have continued to make important progress in improving the quality of statistics. This has allowed us to meet the structural benchmark on the publication of preliminary consolidated general government fiscal data for the first and second quarters of 2010. At the same time, we are mindful of the significant gaps in the quality of published data, due among other things to the fact that budget execution data do not include transactions related to foreign-financed projects, accrual accounting has not yet been fully introduced in all government institutions; and the long delays in reporting by lower levels of government, particularly in the Federation. To address these serious problems, we are working with the help of TA from the regional TA advisor to transition to GFS 2001 reporting standards and shorten reporting delays. To this end, the Fiscal Council will establish a working group that,

by December 31, 2010 will make recommendations, and propose guidelines and a timetable for application of international accounting standards for the public sector and other international standards of financial reporting, including a harmonized fiscal reporting template, at all levels of government in BiH (structural benchmark). We will make progress towards improving data collection and reconciliation of external grants and loan disbursements at the level of donors, state, and Entities. At this stage we will improve statistics of project-tied grants that are extended through central governments and take steps to measure foreign in-kind grants.

E. Program Issues

23. The program will continue to be monitored through quarterly reviews, prior actions, quantitative performance criteria, and structural benchmarks. Revised quantitative targets for 2010 are set out in Table 1; and prior actions and structural benchmarks are set out in Table 2. We request that the end-September, and end-December 2010 targets be established as performance criteria. The understandings between the authorities of BiH and IMF staff regarding the quantitative performance criteria discussed in this Letter are further specified in the attached Technical Memorandum of Understanding. In light of our stronger-than-programmed reserve position, we also request rephrasing of purchases envisaged for the second year of the arrangement to a smoother disbursement schedule (50 percent of quota at the completion of each quarterly program review). As a result, the amount of purchases that can be made upon successful completion of this review will be SDR 118.4 million (70 percent of quota). Of this amount, we plan to draw SDR 33.82 million to support the Entity budgets; and, given our strong reserve position, we will not draw the remaining amount at this stage and will consult with Fund staff should a need for further purchases arises.

24. IMF resources under the arrangement will be disbursed to the central bank, which acts as the fiscal agent for BiH, and credited to an account of the State. Resources earmarked for the budget will be allocated to the two Entity budgets on the customary 2/3:1/3 split.

/s/

Nikola Špirić
Chair
of the Council of Ministers
Bosnia and Herzegovina

/s/

Mustafa Mujezinović
Prime Minister
Federation of Bosnia
and Herzegovina

/s/

Milorad Dodik
Prime Minister
Republika Srpska

/s/

Dragan Vrankić
Minister of Finance
and Treasury of
Bosnia and Herzegovina

/s/

Vjekoslav Bevanda
Minister of Finance
Federation of Bosnia
and Herzegovina

/s/

Aleksandar Džombić
Minister of Finance
Republika Srpska

/s/

Kemal Kozarić
Governor
Central Bank of Bosnia and Herzegovina

Attachment

TECHNICAL MEMORANDUM OF UNDERSTANDING

BOSNIA AND HERZEGOVINA

**Technical Memorandum of Understanding on Definitions and Reporting Under the
2009–12 Economic Program**

September 17, 2010

This memorandum supplements the Letter of Intent dated September 17, 2010. The memorandum updates and replaces the technical memorandum of understanding included in the IMF Board document for the 1-st SBA Review (Country Report 10/101). It sets out the understanding between the government of Bosnia and Herzegovina and the IMF mission regarding the definitions of quantitative performance criteria and targets and structural benchmarks for the stand-by arrangement (Tables 1–2) as well as data reporting requirements for program monitoring (Table 4).

I. DEFINITIONS

In the following definitions, the end-quarter test dates apply to the last working day of each quarter for both banking and budgetary statistics.

**A. Ceiling on the Cumulative Change in Net Credit from the Banking System to the
General Government**

Definitions

- ***The general government*** is defined to include the governments of the State, the Republika Srpska Entity (RS), the Federation of Bosnia and Herzegovina Entity (Federation) and the District Brcko. The Federation government is defined to include the central government, the cantonal governments, the municipal governments, the extrabudgetary funds and the road fund. The RS government is defined to include the central government, the municipal governments, the extrabudgetary funds and the road fund. Extrabudgetary funds include, but are not limited to, the pension funds, health funds, unemployment funds, and children's fund in the two Entities. Any new budgetary and extra budgetary funds, created during the program period will also be included in the definition of the general government consistent with the definitions of the *IMF Manual on Government Finance Statistics 2001*. The BIH authorities will inform IMF staff of the creation of any such new funds.
- ***The banking system consists*** of the Central Bank of Bosnia and Herzegovina (CBBH) and the commercial banks in both Entities and the District of Brcko.

- ***Net credit of the banking system to the general government*** (net bank claims on general government) is defined as all banking system claims on general government (e.g., loans, securities, bills, and other claims in both convertible marka and foreign currencies) minus general government claims on the banking system (deposits, loans and other claims, including deposits in entities' escrow accounts) as defined in the Table 3 below.¹ For program purposes, those components of claims that are denominated in foreign currencies will be converted into convertible marka at current exchange rates.

Application of performance criteria

- The value of net bank claims on general government will be monitored from the accounts of the banking system, as compiled by the CBBH, and supplemented by information provided by the Ministries of Finance of each Entity and the State. Table 3 shows the banking system net claims on the general government as of end-December 2009.
- The ceilings on the cumulative change in net bank claims on general government will be defined, for each test date, as the cumulative change from the level existing on December 31 of the previous year.
- The ceilings on the cumulative change in net bank claims on general government will be defined in terms of three sub-ceilings that, together with the net bank claims on the District of Brčko,² sum to the ceiling for the general government. These sub-ceilings will be on the cumulative change in net bank claims on the government of the State, the governments of the Federation of Bosnia and Herzegovina and of the Republika Srpska. For the purposes of program monitoring, compliance with the ceiling on net bank claims on general government will require that each of these three sub-ceilings be observed independently.

¹ Excluded from the definition of the general government claims on the central bank will be government deposits at CBBH counterpart to any future SDR purchases under the Stand-By Arrangement used for increase of the foreign reserves of the central bank.

² The net bank credit to the District of Brčko is not monitored individually because of its small size.

Adjustors to performance criteria

- The targets on net bank claims on general government will be adjusted upward (downward)³ by the full amount of any shortfall (surplus) in programmed disbursements of budget support loans and grants. Program budget support disbursements are defined as external disbursements from official creditors (e.g., World Bank, IMF, and European Commission) used for financing of general government budget deficits.
- The targets on net bank claims on general government will be adjusted upward (downward)⁴ by the amount by which reported change in float is arithmetically smaller (greater) than its targets in the fiscal program. Float is defined as accrued but unpaid purchases of goods and services, wages and salaries, pensions, social benefits, and investments that are not in arrears (as defined in the text below). The upward adjustment is limited to 10 percent of the absolute value of the respective change-in-float target.

BiH: General Government Change in Float, 2009
(In millions of KM)

	2009 Dec
Change in float ((1)-(2)-(3))	180
State government	0
FBiH government	113
RS government	67
District Brcko	0
(1) Change in arrears and float	180
State government	0
FBiH government	113
RS government	67
District Brcko	0
(2) External debt service arrears	0
State government	0
FBiH government	0
RS government	0
District Brcko	0
(3) Domestic arrears	0
State government	0
FBiH government	0
RS government	0
District Brcko	0

Sources: Ministries of Finance; and IMF staff estimates.

B. Operation of the Central Bank of Bosnia and Herzegovina

Under the Central Banking Law and the program, the CBBH is required to ensure that the value of its domestic liabilities does not exceed the convertible marka counter-value of its net foreign exchange reserves. Furthermore, the CBBH will pay a dividend only if its initial capital and general reserves exceed 5 percent of its monetary liabilities.

Definitions

³ In the case of both positive and negative targets on net bank claims on general government, upward means resetting of the target to an arithmetically bigger number, whereas downward means resetting of the target to an arithmetically smaller number.

⁴ In the case of both positive and negative targets on net bank claims on general government, upward means resetting of the target to an arithmetically bigger number, whereas downward means resetting of the target to an arithmetically smaller number.

- ***Net foreign exchange reserves of CBBH*** are defined as the value of foreign assets less the value of foreign liabilities, including short-term liabilities denominated in convertible currencies or convertible marka.
- ***Foreign assets*** are defined to include: (i) any gold, other precious metal and stones held by or for the account of the Central Bank; (ii) any banknotes and coins in freely convertible foreign currency held by or for the account of the Central Bank; (iii) convertible foreign exchange notes; (iv) credit balances in convertible foreign exchange—including SDRs—on the books of foreign central banks or other financial institutions; (v) liquid debt securities issued by the government and the central bank of the country on whose currency the securities are denominated; and (vi) officially guaranteed forward and repurchase contracts of different types providing for future payments in convertible foreign exchange by nonresidents. Excluded are (i) assets in nonconvertible currencies; (ii) any assets that are pledged, collateralized, or otherwise encumbered; (iii) claims on residents; and (iv) foreign exchange claims arising from derivatives in foreign currencies vis-à-vis domestic currency.
- ***Foreign liabilities*** are defined to include: (i) foreign exchange and convertible marka balances on the books of the CBBH due to nonresidents, including foreign central banks and international financial institutions; (ii) credit balances due to foreign central banks, governments, international organizations, and foreign financial institutions; (iii) forward and repurchase contracts of different types providing for future payments in foreign exchange by the CBBH to nonresidents; and (iv) any other liabilities due to nonresidents.
- ***Monetary liabilities*** are defined as the sum of (a) currency in circulation, (b) credit balances of resident banks at the CBBH, and (c) credit balances of other residents at the CBBH.
- ***Capital and reserves*** are defined as (a) initial capital, (b) accumulated profits of the CBBH since the beginning of its operation on August 11, 1997, (c) shares, (d) other reserves.
- ***Free reserves of the CBBH*** are defined as foreign exchange reserves not utilized as backing for the currency. They therefore consist of the stock of CBBH net foreign exchange reserves less the stock of CBBH monetary liabilities.
- Foreign currency holdings will be converted into convertible marka at the exchange rates of April 30, 2009, as published in the IMF *International Financial Statistics*.

Valuation changes will therefore be monitored from the accounts of the CBBH, with information on net foreign assets provided monthly by the CBBH.⁵

C. Ceiling on External Payment Arrears

Definitions

- **External payment arrears** are defined as overdue debt service arising in respect of debt obligations incurred directly or guaranteed by the the State, Republika Srpska, and the Federation governments or CBBH, except on debt subject to rescheduling or restructuring.
- **Debt obligations** are defined as all current liabilities, which are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which require the State, Republika Srpska, and the Federation governments or CBBH to make one or more payments in the form of assets (including currency), at some future point(s) in time to discharge principal and/or interest liabilities incurred under the contract. In effect, all instruments that share the characteristics of debt as described above (including loans, suppliers' credits and leases) will be included in the definition and be subject to the ceiling.

Application of performance criterion

- The ceiling on the change in external payments arrears applies to the change in the stock of overdue payments on medium- and long-term debt contracted or guaranteed by the the State, Republika Srpska, and the Federation governments or by the CBBH. This criterion will apply continuously.
- The limit on the change in external payments arrears also applies to the change in the stock of overdue payments on short term debt in convertible currencies with an original maturity of up to and including one year.
- Accumulation of new external arrears is prohibited under the program.

⁵ At end-April 2009, one SDR unit was equal to 1.1283 euro, or to 1.4978 U.S. dollars.

D. Ceiling on Domestic Expenditure Arrears

Definition

The performance criterion established on the stock of domestic payments arrears contemplates a zero ceiling on the increase in the stock of arrears compared with the stock as of December 31 of the previous year. The stock of arrears is defined as the sum of payments obligations (accounts payable) past the due date stipulated by the contractual or legal payment period for each expenditure item and are nondisputed. They can arise on any expenditure item, including transfers to individuals, debt service, wages, pensions, energy payments and goods and services. Past-due payments obligations on inter-governmental transfers (i.e., transfers between Entity central governments and local governments, and extrabudgetary funds) are not included in the stock of arrears.

Application of performance criterion

The zero ceiling on the increase in the stock of arrears applies to the State, the Federation, and the Republika Srpska governments. This criterion applies continuously. Thus, if, in any given day any of the three governments exceeds the zero ceiling on the change in the stock of its arrears compared with the stock of the same government's arrears as of December 31 of the previous year, the performance criterion will be missed.

E. Contracting or Guaranteeing of New Nonconcessional Short-Term External Debt

Governments will consult with the IMF before contracting or guaranteeing any new external debt.

Definitions

- *The term "debt"* is defined to include all current liabilities to non-residents, which are created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which require the State, Republika Srpska, and the Federation governments or CBBH to make one or more payments in the form of assets (including currency), at some future point(s) in time to discharge principal and/or interest liabilities incurred under the contract (No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt, Decision No. 6230-(79/140), August 3, 1979, as amended by Decision Nos. 11096-(95/100), October 25, 1995, 12274-(00/85), August 24, 2000, and 14416-(09/91), August 31, 2009, effective December 1, 2009). In effect, all instruments that share the characteristics of debt as described above (including loans, suppliers' credits and leases) will be included in the definition.

- *New nonconcessional external debt* is defined as including all debt (as defined above) contracted or guaranteed by the State, Republika Srpska, and the Federation governments or the CBBH during the program period that is not on concessional terms.
- *Concessional loans* are defined as those with a grant element of at least 35 percent of the value of the loan, using currency-specific discount rates based on the commercial interest rates reported by the OECD (CIRRS). For short-term loans, the average CIRRS of the proceeding six-month period (plus a margin of 0.75 percent) will be used.
- *Short-term external debt* is defined as debt contracted or guaranteed with an original maturity of up to and including one year.

Application of performance criteria

The ceiling on contracting new short-term external nonconcessional debt applies to obligations of the State, Republika Srpska, and the Federation governments, and CBBH. This criterion will apply continuously.

F. Ceiling on the Increase in the Total Value of Outstanding Commitments by the State, Republika Srpska, and the Federation of Bosnia and Herzegovina under Guarantees of Private and Public Sector Enterprises' Debts to Domestic Banks plus the Value of Enterprise Debts to Domestic Banks Assumed by these Governments

The authorities will consult with the IMF before guaranteeing to domestic banks the repayment of loans by private and public enterprises and before assuming enterprise debt to domestic banks.

Definition

The increase in the total value of outstanding commitments of the State, Republika Srpska, and the Federation of Bosnia and Herzegovina under guarantees for the repayment by private and public sector enterprises of debts to domestic banks plus the value of enterprises debts to domestic banks assumed by these governments will be limited during the program period.

Application of performance criteria

This criterion will apply continuously. This ceiling on the increase in the total value of outstanding commitments under the above-referred guarantees by the State, Republika Srpska, and the Federation of Bosnia and Herzegovina plus the value of enterprise debts to domestic banks assumed by these governments will apply relative to the total value of such commitments and assumed debts existing as of December 31 of the previous year.

II. DATA REPORTING

The Bosnia and Herzegovina authorities will report the following data to the Fund within the time limits listed below. The authorities will also provide, no later than the first week of each month, a summary of key macroeconomic policy decisions taken during the previous month; a summary of regulatory changes in the area of banking and financial sector, report any revisions to monthly and annual fiscal reports as well as any amendments to the Entity and state budget and local government budgets within a week after their approval.

Any revisions to past data previously reported to the Fund will be reported to the Fund promptly, together with a detailed explanation. The data will be provided in an electronic form.

All magnitudes subject to performance criteria or indicative targets will be reported in millions of convertible marka where the corresponding target is in convertible marka, or in millions of euro where the target is in euro.

The Bosnia and Herzegovina authorities will supply the Fund with any additional information that the Fund requests in connection with monitoring performance under the program on a timely basis.

Table 1. Bosnia and Herzegovina: Performance Criteria Under the 2009–12 Stand-By Arrangement, 2010
(In millions of KM)

	Cumulative flow since December 31, 2009							
	2010							
	March			June			September	December
	Program	Adj. Program ²	Actual	Program	Adj. Program ²	Actual	Program	Program
Ceiling on accumulation of net credit of the banking system to: ^{1,2}								
General government	333	292	104	580	604	175	751	631
<i>of which:</i>								
State government	20	20	3	-11	-11	-71	112	121
RS government	251	237	127	429	480	243	499	521
Federation government	61	34	-23	164	137	19	159	-8
Ceiling on the increase in total value of guarantees by the State, Federation and RS governments of private and public sector enterprises' debts to domestic banks plus the value of enterprise debts to domestic banks assumed by these governments ³	0		0	0		0	100	100
Ceiling on accumulation of external debt service arrears by the State, Federation and RS governments and CBBH ³	0		0	0		0	0	0
Ceiling on contracting or guaranteeing of new short-term external nonconcessional debt by the State, Federation and RS governments and CBBH ³	0		0	0		0	0	0
Ceiling on accumulation of domestic expenditure arrears by: ³								
State government	0		0	0		0	0	0
RS government	0		15	0		-1	0	0
Federation government	0		-6 ⁴	0		-17 ⁴	0	0

¹ Equal to the sum of the three listed sub-ceilings plus the net bank credit to the District of Brčko, which is not monitored individually due to its small size.

² The targets on banking system net claims the general government will be adjusted upward (downward) by the full amount of any shortfall (surplus) in programmed disbursements of budget support loans and grants; and will also be adjusted upward (downward) by the amount by which reported change in float is arithmetically smaller (greater) than its targets in the fiscal program. The upward adjustment is limited to 10 percent of the absolute value of the respective change-in-float target (see Technical Memorandum of Understanding on Definitions and Reporting Under the 2009–12 Economic Program).

³ Continuous.

⁴ Based on preliminary information for lower levels of Federation government (cantons, municipalities, and cantonal extrabudgetary funds).

Table 2. Bosnia and Herzegovina: Structural Measures under the Stand-By Arrangement, 2010

Test date	Actions	Objective	Status	Type
Continuous				
Continuous	Continued adherence of the Currency Board Arrangement as constituted under the law	Anchor for macroeconomic policy; Contribute to economic and political stability.	Met	Structural Benchmark
Continuous	Publish on the State government's web site quarterly consolidated general government accounts with a 5 week lag	Enhance fiscal transparency and program ownership.	Met (for March and June)	Structural Benchmark
Continuous	Carry out eligibility audits for civil and war benefit recipients; publish results (quarterly within 4 weeks after the end of each quarter) of audits, including expected savings from disqualifications (Federation, RS)	Reduce recurrent spending through better targeting of transfer programs.	RS (Met for March, and June (with delay in publication)); Federation (not met)	Structural Benchmark
Continuous	No new privileged or special rights for retirement will be introduced prior to the pension system reform (Federation).	Contain the cost to central government of financing the pension system.		Structural Benchmark (New)
Second and Third Reviews				
end-March 2010	Adopt by Parliament wage legislation consistent with the 2010 fiscal policy objectives (Federation)	Harmonization of remuneration policies across levels of government with the view of containing the public wage bill.	Met with delay in July	Structural Benchmark
end-March 2010	Reform privileged pensions by entity governments (Federation, RS)	Steps toward containing the cost to central governments of financing the pension systems.	RS (Met); Federation (Not met)	Structural Benchmark
end-March 2010	Prepare a strategy for pension reform by entity governments (Federation, RS)		RS (Met); Federation (Met with delay in June)	Structural Benchmark
	Approval by Federation Parliament of a 2010 revised Federation central government budget consistent with the authorities' commitments in Paragraph 10 of this Lol (Federation).	Reflect measures to contain the wage bill and transfers, ensure full funding of central government obligations on current-year transfers	Met	Prior Action
	Adoption of a government decision on measures to improve the audit process consistent with the authorities' commitments in Paragraph 10 of this Lol (Federation).	Reduce recurrent spending through better targeting of transfer programs.		Prior Action
	Adoption of a government decision to condition the transfers to the cantons on cantonal budget rebalances to reduce current expenditures (Federation).	Reduce recurrent spending by cantons.	Met	Prior Action
Fourth Review				
end-December 2010	Adoption by government of the Law on Pension and Disability Insurance in accordance with the Strategy of the Pension System Reform (RS)	Step toward containing the cost to central government of financing the pension system.		Structural Benchmark
end-December 2010	Establish a working group under the Fiscal Council to propose by December 31, 2010 recommendations, guidelines and a timetable for application of international accounting standards for the public sector and other international standards of financial reporting, including a harmonized fiscal reporting template, at all levels of government in BiH.	Enhance medium-term budget planning, fiscal transparency, and program ownership.		Structural Benchmark

Table 3. Bosnia and Herzegovina: Net Claims of the Banking System on the General Government, as of December 31, 2009

(In millions of KM)

	Stock
Total net bank claims on the general government ((1) + (2))	-2,025
(1) Central bank claims on general government (net)	-398
Claims	0
State government	0
FBiH government ¹	0
RS government ²	0
District Brcko	0
Deposits	398
On-balance sheet deposits in KM ³	50
State government ⁴	48
FBiH government ¹	2
RS government ²	0
District Brcko	0
Off-balance sheet deposits in foreign currency	347
State government ⁵	347
FBiH government	0
District Brcko	0
(2) Commercial bank claims on general government (net)	-1,627
Claims	350
State government	1
FBiH government ¹	40
RS government ²	303
District Brcko	6
Deposits	1,977
State government	46
FBiH government ¹	963
RS government ^{2,6}	890
District Brcko	78

Source: CBBH.

¹ Includes FBiH central government, cantons, municipalities, road fund, and social funds.² Includes RS central government, municipalities, road fund, and social funds.³ Excludes on-balance sheet accounts at CBBH used for safekeeping on behalf of State and Entity governments of the proceeds from sale of general and special SDR allocations.⁴ The deposits of the State government, as reported by CBBH, are adjusted to exclude the deposits of the Indirect Tax Administration (KM 33.65 million at end-September, 2009).⁵ Excludes the off-balance sheet account at CBBH used as a pass-through account for external debt servicing on behalf of Entity governments; and the off-balance sheet account at CBBH used for safekeeping on behalf of State and Entity governments of succession funds from the distribution of rights, obligations, assets and liabilities of the former Socialist Federal Republic of Yugoslavia among successor states.⁶ The deposits of the RS government are adjusted to exclude the deposits of investment funds managed by the RS Development Bank. Whereas the latter is not included in the definition of general government, some banks report the deposits of these investment funds as part of net bank credit to government. At end-September 2009, the amount of excluded deposits stood at KM 33.78 million.

Table 4. Bosnia and Herzegovina: Data Reporting Requirements under the 2009 SBA

Data series	Data frequency	Periodicity of data reporting	Timeliness of data reporting
I. Daily data reporting	Daily	Weekly	Up to 14 working days after the end of each week, unless noted otherwise
1 Gross international reserves			
2 CBBH foreign exchange purchases and sales			
II. Monthly data reporting	Monthly	Monthly	Up to 4 weeks after the end of each month, unless noted otherwise
Financial sector			
1 The balance sheet of the CBBH.			
2 The commercial bank survey and monetary survey			
3 Weighted average interest rates by bank and by type of loans			
4 Banking sector credit to the general government (by level of government)			
5 Government deposits in the banking sector			
Government finances			
6 Revenues, expenditures and financing data for central governments (the State, and the Entity governments). Expenditures will include those financed from deposits in the escrow accounts.			
7 ITA revenues.			
9 Report on inflows into and outflows from escrow accounts (FBiH, RS).			
10 Transfers to the Entity Development Banks from the Entity central governments.			
Debt service			
8 New external loans contracted or guaranteed by governments.			
III. Quarterly data reporting	Quarterly	Quarterly	Up to five weeks after the end of each quarter, unless noted otherwise
Financial sector			
1 Banking supervision: financial soundness indicators			
2 Banking supervision: bank-by-bank commercial banks' summary balance sheets and income statements and prudential data on loan quality, liquidity, and exposures ¹			
14 Net exposure to BiH of foreign bank groups participating in the European Bank Coordination Initiative for BiH ²			
Government finances			
3 Revenues, expenditures and financing data for municipalities (in both entities), and cantons (in the Federation), and Brcko District			
4 Revenues, expenditures and financing data for the road funds in both entities			
5 Revenues, expenditures and financing data for the extrabudgetary funds (pension funds, health funds, unemployment funds and (in the RS) the children's fund)			
6 Revenues, expenditures and financing data for consolidated BiH, consolidated FBiH, and consolidated RS general governments			
16 End-period stock of outstanding arrears and float during the reference period by creditor and type of expenditure (wages, social benefits, pension, goods and services, etc.)			
7 Financial statements of the RS Investment and Development Bank			
17 Number of demobilized soldiers receiving unemployment benefits (by canton), and amounts paid			
Debt service			
8 External debt service projections for current year; total, by creditor, by level of government, and in original currency			
9 Newly issued government guarantees on external and domestic loans contracted by public and private entities			
10 Newly contracted government external loans and degree of concessionality (grant element); total, by creditor, by purpose (project/budget support), original currency, and maturity			
11 External debt service payments (interest, amortization) by level of government			
12 External loan and grants disbursements; by creditor, by level of government, by purpose (project/budget support) and original currency			
13 Stock of external debt for public sector, private nonbank sector, and banking sector			
15 Stock of domestic government debt outstanding (by level of government, type of obligation, and holder (bank and non-bank sectors)); projected domestic government debt interest and amortization payments (by level of government, type of obligation, and holder)			

¹ Up to six weeks after the end of each quarter² Upon request within eight weeks