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**Bosnia and Herzegovina: Letter of Intent**

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# Bosnia and Herzegovina: Supplementary Letter of Intent

Sarajevo and Banja Luka, Bosnia and Herzegovina

June 12, 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) approved in September 2012 by the Executive Board of the International Monetary Fund (IMF) continues to be a valuable anchor 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 Letters of Intent of December 6, 2012 and April 23, 2013. This supplementary Letter of Intent provides information on our efforts and achievements since the completion of the second review under the arrangement in May 2013, as well as on the additional policy measures we plan to undertake during the remainder of 2013 and early 2014 to help ensure that the objectives of the SBA will be met.

2. The economy has started to show some tentative signs of recovery: industrial production and exports rose in the first quarter of this year. Despite the difficult external economic environment and the still considerable downside risks, we continue to expect that our economy will grow modestly in 2013, at a rate about  $\frac{1}{2}$  percent. Inflation continues to be well contained at below 2 percent, with core inflation low at around  $\frac{1}{2}$  percent, and is expected to remain low.

## **Program Implementation**

3. Our policies remain well on track to meet program objectives. We can confirm that we made good progress toward fiscal consolidation in 2012. With end-year revenue and expenditure data having become available for all levels of government, the overall deficit for the consolidated general government is estimated at 2.6 percent of GDP for 2012, below our target of 3 percent of GDP. We missed the end-2012 indicative target on net lending excluding externally-financed operations, however, as domestic capital spending proceeded at a faster pace than projected, mainly in extra-budgetary funds in the Federation and RS, while a larger share was financed by a drawdown of deposits. While the outlook for 2013 remains challenging, we expect that we will

achieve the further reduction in the overall deficit to 2 percent of GDP this year as targeted. However, this will require us to improve tax collection and reach an understanding on investment plans and the distribution of dividends of our electricity distribution company TRANSCO, while we will adhere to the spending ceilings in the approved budgets.

4. In addition, all quantitative performance criteria for end-March 2013 on the budget balances of the Institutions of BiH and the central governments of the Federation and the Republika Srpska (RS) were met. Revenues were somewhat less than forecasted, largely reflecting an unexpected increase in VAT refunds (see below). Strong spending controls, however, allowed us to meet the fiscal targets. We also did not contract or guarantee any new non-concessional short-term external debt, nor did we accumulate any external payment arrears through end-March 2013. As during the second review, we can report that the Institutions of BiH and the central governments of the Federation and the RS did not see an increase in domestic arrears in the period through end-March 2013, but data collection for the lower levels of government, extra-budgetary funds, and road and highway funds for end-December 2012 as well as for end-March 2013 is yet to be finalized. We are taking further measures to address this issue (see below).

5. We have made further progress in advancing our structural reform agenda in the last few months:

- The new law on privileged pension that was adopted by the Federation parliament in April was put into effect. Sufficient administrative resources have been allocated to ensure that the requalification of existing beneficiaries and screening of new entrants be completed within the prescribed deadlines.
- The four tax agencies (ITA, FTA, RSTA, and BDTA) signed a Memorandum of Understanding on the exchange of taxpayer information, facilitating the sharing of taxpayer records (a structural benchmark for end-May 2013). In particular, this Memorandum sets out the necessary legal and technical steps that need to be taken to allow the FTA, RSTA, BDTA, and ITA to have permanent, unfettered, and automated access to each other's taxpayer data, effective January 1, 2014.
- The new law on budgets being developed in the Federation with technical assistance from the IMF will be submitted to parliament by end-June and is expected to be approved by end-September 2013 (a new deadline for the end-May 2013 structural benchmark). Improvements included in this new law are, among others: (i) a strengthening of the intergovernmental consultation and coordination process; (ii) the inclusion of a fiscal rule—requiring balanced current budgets and enhancing the Federation finance minister's control over all borrowing—and an improvement of the medium-term budgeting process; (iii) enhanced spending controls; (iv) the inclusion of financial plans and outcomes of public companies and extra-budgetary funds as annex to

the annual budget framework document; and (v) improved cash management procedures.

- The pension reform strategy for the Federation has been prepared and is expected to be submitted to parliament together with an action plan by end-July 2013. The 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.
- In the financial sector, we have already taken significant steps to further enhance our crisis preparedness and contingency planning. The CBBH and the Banking Agencies completed the identification of systemically important banks with a view to closely monitoring financial sector developments and better assessing potential risks.
- Amendments to the RS Banking Agency law have been submitted to parliament, to bring the treatment of confidential information in line with EU practices. Parliamentary approval is expected before end-June (a structural benchmark for end-June 2013). This process had already been completed in the Federation and with the imminent completion also in the RS, this will help us to press forward with enhancing our cooperation with foreign bank supervisors, including by signing of Memoranda of Understanding with them.
- 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 also been submitted to the respective parliaments. Parliamentary approval is expected by end-June 2013 (structural benchmarks for end-June 2013).
- The amendments to the law on the Deposit Insurance Agency (the submission of which had been an end-March 2013 structural benchmark) have been approved by the BiH parliament, enhancing the coverage and effectiveness of our deposit insurance system.

### **Further Reforms**

6. While gross indirect revenue has held up relatively well given modest economic growth, monitoring tax collection is at the top of our agenda as growing VAT refunds and weak collection of excises on tobacco products even after the recent rate increase begin to weigh on fiscal performance. The recently approved Rulebook on the Organization of Work Posts of the ITA will enable the ITA to function more efficiently. We will continue to monitor revenue collection and mandate the ITA to have its staff more focus on large taxpayers and to improve its work on the detection and prevention of VAT fraud. We will also review and clarify our VAT refund practices and harmonize excise rates on fine cut tobacco products with those on cigarettes, while continuing their convergence towards EU levels. We will continue to adjust the indirect tax revenue allocation coefficients on a quarterly basis, and will reach understandings on

the settlement of any outstanding obligations. In addition, in the Federation we have started a modernization program of the FTA, with the assistance of the IMF. As a first step, we will prepare a revised Rulebook on Tax Administration by end-September 2013 that provides the director of the FTA with sufficient authority for the organizational design and human resource management.

7. A new corporate income tax law is under preparation in the Federation and is expected to be submitted to parliament by end-December 2013. This law, which provides broad conformity between tax and accounting principles, aims to broaden the tax base, while reducing deductions and tax expenditures.

8. We have also been working to strengthen the public procurement framework in BiH. A new procurement law has been drafted with the assistance of the OECD and the EU. This law, that will bring our procurement processes in line with EU legislation, will be submitted to the BiH parliament by end-September 2013 and we expect it to be approved by end-December 2013.

9. To improve fiscal reporting and especially the monitoring of spending arrears, in the Institutions of BiH and both entities we will establish procedures for budget users to enter commitment due dates into the Treasury system, starting July 1, 2013. The Institutions and both entities will establish a common definition of arrears by end-October 2013, with any amount that is not paid within 90 days after the due date considered to be in arrears. In addition, in the RS the treasury system will be expanded to cover the health sector by end-March 2014, while in the Federation, the treasury system will be expanded to cover extra-budgetary funds by the same date. In the Federation efforts will also continue to integrate municipalities into the treasury system. We will also conduct a review of the Federation's treasury system by end-2013 to assess whether it can be sufficiently upgraded to meet all reporting requirements in a timely manner or whether a new system would need to be developed.

10. The challenging environment and the nature of our financial sector call for additional measures to further strengthen the capabilities of our crisis preparedness toolkit. We plan to define and agree upon detailed procedures describing the responsibilities of and the coordination between responsible institutions in the event of a systemic financial crisis (a new structural benchmark for end-December 2013). The members of the Standing Committee on Financial Stability will be responsible for the development of such over-arching contingency plans for financial stability. This will instill confidence that the members can ensure an orderly resolution in their responsible areas. We will request further technical assistance from the IMF to support us in the preparation of these procedures as well as in conducting crisis simulation exercises. In dealing with any problem banks, we will aim to limit potential costs to public finances and real economy while ensuring adequate safeguards to financial sector stability.

11. High levels of NPLs continue to pose a significant risk to our banking sector, adversely affecting financial intermediation. Together with IMF staff, we have conducted a thorough review of our NPL resolution framework. We have identified a number of areas for improvement in our

legal and regulatory frameworks that we plan to implement over time with further assistance from the IMF:

- We will clarify the tax treatment of loan loss provisioning by banks in the new corporate income tax to be adopted in the Federation, to encourage provisioning. The RS will also review its tax treatment of loan loss provisioning to achieve the same objective.
- We will facilitate the operation of a secondary loan market by submitting legislation in line with IMF staff recommendations regulating the establishment and supervision of asset management companies to the respective entity parliaments (new structural benchmarks for end-June 2014). This new legislation will not only regulate the specifics of loan sales, but will also clarify the supervision, accounting, taxation, and provisioning rules as well as the duties and responsibilities of the parties involved. Related laws will also be reviewed and amended as necessary to ensure consistency.
- We will also consider amendments to other legislation influencing our NPL resolution framework. In particular, we will review our corporate insolvency laws to strengthen restructuring provisions, reduce barriers to entry into bankruptcy, and speed up bankruptcy proceedings.
- Moreover, we will assess the feasibility of establishing an out-of-court restructuring mechanism so that viable companies have a better chance of remaining productive.
- In addition, a proposal of the law on protection of consumers of financial services, in line with IMF recommendations, will be submitted to parliament in the Federation by end-September 2013, and we expect its approval by end-December 2013. This law will clarify the rights and obligations of such consumers with a view to ensuring well-functioning and efficient banking and legal systems in the Federation.

12. As financial markets become ever more complex, we are mindful of the need to keep our laws in line with the latest developments. To ensure a proper regulation of our financial sector, we will proceed with a comprehensive review of our banking laws over the next year. The entities' Ministries of Finance and Banking Agencies, and the Deposit Insurance Agency, with assistance of the IMF staff, will prepare and submit to the respective entity parliaments new laws on banks and other lending institutions in line with IMF staff recommendations (new structural benchmarks for end-June 2014). These laws, meant to replace the existing banking laws, will represent a significant step forward to modernize and harmonize BiH's legal and regulatory framework on banks with EU legislation and will also further expand the toolkit for dealing with problem banks. The Deposit Insurance Agency Law will also be reviewed as needed to guarantee full consistency with the new laws. Meanwhile, we will maintain a single payment system in BiH, including the Single Registry of Accounts at the CBBH.

13. With persistently high unemployment, job creation has always been one of the greatest challenges facing BiH. In recent months, despite the first tentative signs of a turnaround in the economy, unemployment continued to creep up, only adding urgency to taking decisive actions.

We are moving ahead with facilitating the start-up of new businesses, including by creating one-stop registration in the RS and drafting the new company law to achieve a similar objective in the Federation. Nevertheless, outdated labor laws continue to hinder employment growth. In this context, we have started the process of drafting new labor laws, both in the Federation and in the RS, with a view to creating an environment more conducive to job creation while safeguarding appropriate workers' rights. Given the fundamental importance of these laws, which requires careful design and extensive consultation with stakeholders, we aim to have these new labor laws adopted by the respective parliaments by end-December 2013 (new structural benchmarks for end-December 2013).

14. Good progress has been made toward WTO accession. We have signed bilateral agreements with many WTO members, including the EU, and hope to conclude membership negotiations later this year. WTO accession is expected to help boost our external trade and further integrate our economy with the rest of the world. The tariff reductions are likely to reduce government revenues in the short term, however, underscoring the need to strengthen tax administration. In preparation for Croatia's accession to the European Union, we are finalizing procedures for the harmonization of standards on agricultural products with EU requirements and are preparing border control points to ensure uninterrupted trade flows.

### **Program Modalities**

15. We believe that our economic program continues to be on course and that our policies set forth in our Letter of Intent of September 11, 2012, and supplemented by the policies described in the supplementary Letters of Intent of December 6, 2012 and April 23, 2013, and this supplementary letter remain 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.

16. In light of the continuing difficulties in assessing observance of the end-March 2013 ceiling on the accumulation of domestic arrears, for which data are not yet available for the lower-levels of government but for which there is no evidence that it was not observed, we request a waiver of applicability of this performance criterion. We also request the Executive Board to complete the third review under the SBA and approve the fourth purchase under the arrangement in the amount of SDR 33.82 million.

17. We authorize the IMF to publish this supplementary 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-December		End-March		End-June	End-September	End-December
	EBS/12/120	Act.	EBS/12/161	Act.	EBS/12/161		
<b>Performance Criteria</b>							
Floor on the net lending of 1/							
Institutions of BiH	-38.2	44.5	-15.0	6.1	-15.0	-20.0	-25.0
Federation central government	44.0	74.1	0.0	9.1	60.0	120.0	179.0
RS central government	-77.7	-33.0	10.0	17.2	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
Federation general government	0	0	0	0	0	0	0
RS general government	0	0	0	0	0	0	0
CBBH	0	0	0	0	0	0	0
Ceiling on accumulation of domestic arrears by							
Institutions of BiH	0	0	0	0	...	...	...
Federation general government 2/	0	...	0	...	...	...	...
RS general government 2/	0	...	0	...	...	...	...
Ceiling on accumulation of domestic arrears by 3/							
Institutions of BiH	...	0	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
Federation general government	0	0	0	0	0	0	0
RS general government	0	0	0	0	0	0	0
CBBH	0	0	0	0	0	0	0
<b>Indicative targets</b>							
Floor on the net lending of the general government of BiH 1/	-237.6	-375.9	-50.9	-68.0	-24.6	-97.1	-17.1
Ceiling on changes in the stock of "other accounts payable" 3/							
Federation general government	...	...	...	...	100.0	100.0	100.0
RS general government	...	...	...	...	160.0	160.0	160.0

1/ Excluding foreign financed projects as defined in TMU.

2/ The Executive Board approved modification of this performance criterion in April 2013 (EBS/13/45).

3/ Starting end-June 2013 (EBS/13/45).

4/ Continuous.

Table 2. Bosnia and Herzegovina: Structural Conditionality

Actions	Test date	Status
<b>Existing structural benchmarks</b>		
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 with delay
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 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-May 2013	Not met; reset to end-September 2013
6 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	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-June 2013	
8 Amend the banking law in the RS to limit provisional administration to one year with a possible six month extension	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-June 2013	
10 Establish a one-stop shop process for business registration in RS	End-September 2013	
11 Amend legislation in the RS to eliminate the take-home pay protection for public sector employees	End-December 2013	
<b>Newly proposed structural benchmarks</b>		
1 Adopt by the Federation parliament a new labor law with a view to facilitating job creation	End-December 2013	
2 Adopt by the RS parliament a new labor law with a view to facilitating job creation	End-December 2013	
3 Prepare the contingency plans for crisis preparedness and management in line with paragraph 10 of the supplementary Letter of Intent of [June xx], 2013.	End-December 2013	
4 Submit legislation in line with IMF staff recommendations regulating the establishment and supervision of asset management companies to the Federation parliament	End-June 2014	
5 Submit legislation in line with IMF staff recommendations regulating the establishment and supervision of asset management companies to the RS parliament	End-June 2014	
6 Submit to the Federation parliament a new draft law on banks and other lending institutions in line with IMF staff recommendations	End-June 2014	
7 Submit to the RS parliament a new draft law on banks and other lending institutions in line with IMF staff recommendations	End-June 2014	