European Commission

# Ex-post Evaluation of the EU's Macro Financial Assistance to Bosnia and Herzegovina (2009-2013)

*European Commission, Directorate-General for Economic and Financial Affairs*

*Final Report*

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# ABSTRACT

On 30 November 2009, the Council of the European Union adopted a decision providing Macro-Financial Assistance (MFA) - in the form of a loan of EUR 100 million - to Bosnia and Herzegovina (BiH). The MFA was provided to support the country's recovery from the adverse impact of the 2009 global financial crisis. The implementation of the MFA operation was significantly delayed due to political developments in BiH and the government's difficulties in fulfilling certain reform conditions. The assistance was eventually disbursed in two equal tranches in February and September 2013 alongside the 2012 IMF Stand-by Arrangement (SBA). The disbursement of the two tranches was linked to the fulfilment of structural reforms conditions related, *inter alia*, to reforms in the areas Public Finance Management (PFM), financial sector stability, pension system and official statistics.

This independent evaluation examines the added value, impact, design and implementation of the MFA operation in BiH. It also draws a series of wider lessons from this experience that could be applied more generally to the future design and application of the MFA instrument.

# RÉSUMÉ

Le 30 novembre 2009, le Conseil de l'Union européenne a adopté une décision accordant une assistance macrofinancière (AMF) - sous la forme d'un prêt de 100 millions EUR – à la Bosnie-Herzégovine. L'AMF était destinée à aider le pays à faire face aux conséquences de la crise financière mondiale de 2009. Le déploiement de l'AMF a été considérablement retardé du fait de la situation politique en Bosnie-Herzégovine et des difficultés du gouvernement à remplir certaines conditions en matière de réformes. Le prêt a finalement été versé en deux tranches égales en février et septembre 2013, en plus des ressources mises à disposition par le FMI dans le cadre de l'accord de confirmation de 2012. Le versement des deux tranches a été déclenché par la satisfaction des conditions de réformes structurelles, notamment dans les domaines de la gestion des finances publiques, de la stabilité du secteur financier, du système de retraite et des statistiques officielles.

Cette évaluation indépendante analyse la valeur ajoutée, l'impact, la conception et la mise en œuvre de l'opération d'AMF en Bosnie-Herzégovine. Elle tire également quelques enseignements de cette expérience, qui pourraient être appliqués plus généralement à la conception et à l'utilisation de l'instrument d'AMF à l'avenir.

# COUNTRY PROFILE

Bosnia and Herzegovina (BiH) is a small country in South East Europe. It has a population of 3.8 million people (2013), covers an area of 51,200 square km and has a narrow coastline (20 km).

### Figure (i) Map of Bosnia and Herzegovina


*Source: United Nations (2007) Map No. 3729 Rev. 6. [online] Available at: http://www.un.org/depts/Cartographic/map/profile/bosnia.pdf*

In 2013, the GDP of BiH was EUR 13.4 billion in current prices and GDP per capita was EUR 3,550 (Table i). BiH is classified by the World Bank as an upper middle income country[1].

### Table (i) Key macroeconomic statistics for Bosnia and Herzegovina, 2009-2013

| | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| Nominal GDP (EUR bn) | 12.4 | 12.7 | 13.2 | 13.2 | 13.4 |
| Real GDP (%yoy) | -2.7 | 0.8 | 1 | -1.2 | 2.5 |
| GDP per capita (EUR) | 3,236 | 3,312 | 3,430 | 3,426 | 3,550 |
| GDP per capita (EUR at PPP) | 6,400 | 6,700 | 7,000 | 7,100 | 7,200 |
| Household consumption (real, % yoy) | -4.6 | 0.1 | 0 | -0.8 | 0.3 |
| Gross fixed capital formation (real % yoy) | -28.8 | -15.9 | 15.8 | 3.5 | -3 |
| Industrial output (% yoy) | -3.3 | 1.6 | 5.6 | -5.2 | 6.7 |
| Producer prices (avg, % yoy) | -3.2 | 0.9 | 3.7 | 1.9 | -1.8 |
| Consumer prices (avg, % yoy) | -0.4 | 2.1 | 3.7 | 2.1 | -0.1 |
| Average gross wages (LCY, % yoy) | 8.2 | 1.1 | 4.4 | 1.1 | 0.4 |
| Unemployment rate (avg, %) | 24.1 | 27.2 | 27.6 | 28 | 27.5 |
| General budget balance (% of GDP) | -4.4 | -2.5 | -1.3 | -2 | -2.2 |
| Public debt (% of GDP) | 36.2 | 39.3 | 40.8 | 44.6 | 42.5 |
| Trade balance (% of GDP) | -32.0 | -30.7 | -32.4 | -32.8 | -29.7 |
| Current account balance (% of GDP) | -6.5 | -6.2 | -9.6 | -9.2 | -5.9 |
| Official FX reserves (EUR bn) | 3.2 | 3.3 | 3.3 | 3.3 | 3.6 |
| Gross foreign debt (% of GDP) | 53.5 | 57.3 | 66.8 | 63.1 | 62.5 |
| EUR/LCY (avg) | 1.96 | 1.96 | 1.96 | 1.96 | 1.96 |
| USD/LCY (avg) | 1.4 | 1.47 | 1.41 | 1.52 | 1.47 |

*Source: Agency for Statistics of B&H, Central Bank of B&H*

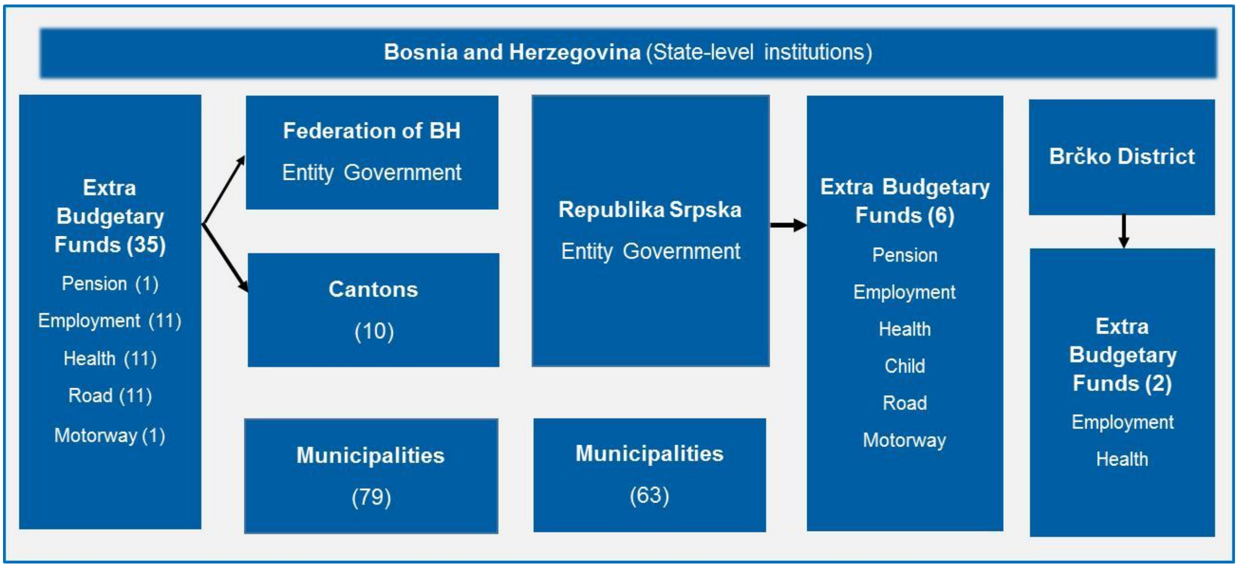
BiH has a complex, multi-layer governance structure. This is a legacy of the 1995 Dayton Peace Accord, which ended the war of 1992-1995. The country has a bicameral legislature and a three-member Presidency composed of representatives of each major 'constitutive' ethnic group (Bosniaks, Serbs and Croats). The central government's power is highly limited, as the country is largely decentralised and comprises two autonomous Entities: The Federation of Bosnia and Herzegovina (FBiH) and Republika Srpska (RS), and a self-governing administrative unit of Brčko District - figure (ii). Moreover, FBiH itself has a complex governance structure that consists of 10 cantons and 79 municipalities. In addition to a high degree of decentralisation, the division of competencies between the cantons and FBiH is unclear. This renders the Entity more difficult to govern. The RS is more centralised and is sub-divided only into municipalities, and is thus easier to govern. This multi-layer governance structure causes duplication of many domestic policy functions and makes it difficult to achieve consensus on policy issues.

Public budgetary arrangements reflect these features. While the direct taxes are in direct purview of the Entities, all indirect taxes are collected at a single location (the Indirect Tax Authority of Bosnia and Herzegovina). The revenues from indirect taxation are used for debt service and funding of the BiH State budget. The remaining revenue is split

[1] World Bank data on Bosnia and Herzegovina. Available at: http://data.worldbank.org/country/bosnia-and-herzegovina

according to the shares of final consumption among the two Entities and Brčko District. In FBiH, much of the public spending takes place at the cantonal level. These arrangements make it difficult to achieve consensus on the overall budget framework and tend to leave the State level with a residual share of resources.

**Figure (ii) Administrative and fiscal structure in Bosnia and Herzegovina**



# List of Abbreviations and Acronyms

| | |
|---|---|
| **BAM** | Convertible Mark |
| **BHAS** | Bosnia and Herzegovina Agency for Statistics |
| **BiH** | Bosnia and Herzegovina |
| **BoP** | Balance of Payments |
| **CARDS** | Community Assistance for Reconstruction, Development and Stabilisation |
| **CBBH** | Central Bank of Bosnia and Herzegovina |
| **CHU** | Central Harmonisation Unit |
| **CIT** | Corporate Income Tax |
| **DPL** | Development Policy Loan |
| **DG ECFIN** | Directorate General for Economic and Financial Affairs |
| **DG ELARGE** | Directorate General for Enlargement |
| **EBRD** | European Bank of Reconstruction and Development |
| **EC** | European Commission |
| **ESA 95** | European System of National and Regional Accounts |
| **EU** | European Union |
| **EU DEL** | EU Delegation |
| **EUR** | Euro |
| **FBiH** | Federation of Bosnia and Herzegovina |
| **FC** | Fiscal Council |
| **FDI** | Foreign Direct Investment |
| **FIS** | Federal Institute of Statistics of the Federation of Bosnia and Herzegovina |
| **FYROM** | Former Yugoslav Republic of Macedonia |
| **GBMIS** | Government Budget Management Information System |
| **GDP** | Gross Domestic Product |
| **GFS** | Government Finance Statistics |
| **IBRD** | International Bank for Reconstruction and Development |
| **IDA** | International Development Association |
| **IMF** | International Monetary Fund |

| | |
|---|---|
| **IPA** | Instrument for Pre-accession Assistance |
| **MFA** | Macro-Financial Assistance |
| **MoU** | Memorandum of Understanding |
| **NPL** | Non-Performing Loan |
| **OA** | Operational Assessment |
| **PEDP** | Public Expenditure Crisis Development Policy |
| **PIFC** | Public Internal Financial Control |
| **PIT** | Personal Income Tax |
| **PFM** | Public Finance Management |
| **PPP** | Purchasing Power Parity |
| **PPS** | Purchasing Power Standards |
| **RS** | Republic of Srspka |
| **RSIS** | Republika Srpska Institute of Statistics |
| **SAA** | Stabilisation and Association Agreement |
| **SAP** | Stabilisation and Association Process |
| **SBA** | Stand-By Arrangement |
| **SDR** | Special Drawing Rights |
| **SITC** | Standard International Trade Classification |
| **T-bill** | Treasury Bill |
| **USAID** | United States Agency for International Development |
| **USD** | United States Dollar |
| **VAT** | Value Added Tax |
| **WB** | World Bank |
| **WEO** | World Economic Outlook |
| **YTM** | Average Yields to Maturity |

# Executive summary

This Report presents the results of the *ex-post* evaluation of the Macro-Financial Assistance (MFA) provided to Bosnia and Herzegovina (BiH) over the period 2009-2013. The evaluation was commissioned by the Directorate-General for Economic and Financial Affairs (DG ECFIN). The work was undertaken by ICF with inputs from local economists based in Sarajevo and Banja Luka.

## The MFA operation in Bosnia and Herzegovina

The Bosnian economy was severely affected by the global economic crisis: real GDP growth contracted sharply from 5.6 per cent in 2008 to -2.7 per cent in 2009 as domestic consumption slumped and demand for Bosnian exports fell sharply. In parallel, pressure on public finances mounted due to pre-crisis expansion of public expenditures and a crisis-driven slowing of government revenues. As a result, the consolidated budget deficit nearly doubled, reaching 4.4 per cent of the GDP in 2009. Tensions on the global financial markets spilled over to BiH and resulted in a "mini bank-run" in October 2008, when EUR 420 million of deposits (12 per cent of the stock of deposits) were withdrawn. The country however, managed to avoid a full-blown financial crisis thanks to decisive action by the Central Bank. The authorities' immediate policy response to the unfolding crisis focused on: safeguarding the stability of the financial system; and carrying out the necessary fiscal adjustment including a reduction in public sector wages. In addition, the authorities requested international assistance from various sources, including the International Monetary Fund (IMF), the World Bank and the European Union (EU).

On 22 May 2009, the State Minister of Finance of BiH requested for macro financial assistance of EUR 100 million from the EU[2]. With the IMF Stand-By Agreement (SBA) in place in June 2009, the formal conditions were met for the EU to provide the MFA. Following the European Commission's proposal of October 2009, the Council took a decision on 30 November 2009 to provide MFA to BiH (2009/891/EC). It was agreed that the proceeds would be transferred to the State and the Entity budgets as follows:

- 10 per cent to the State level;
- 60 per cent to the Federation of Bosnia and Herzegovina (FBiH); and
- 30 per cent to Republic of Srspka (RS).

Disbursement of the MFA was however, significantly delayed due to delays in signature of the Memorandum of Understanding (MoU) between the EU and Bosnian authorities; non-fulfilment of conditions attached to the disbursement of the first tranche; and *de facto* suspension of the IMF SBA following the October 2010 general elections that resulted in a political stalemate. Some normalisation was reached in mid-2012 which allowed the authorities to resume negotiations with the IMF and the EU. In July 2012, a new IMF SBA was approved, making available SDR 338.2 million (~ EUR 398 million)[3] to the authorities. On 29 October 2012, a Decision (2012/674/EU) to extend the availability of the MFA to BiH by one year was adopted by the European Commission. The first EUR 50 million loan tranche was eventually disbursed in February 2013. This was followed by a second and final disbursement of equal size at the end of September 2013. The total size of the MFA

[2] ECFIN/D/1/Ares (2010)439787 – Note for the Economic and Financial Committee regarding Macro-Financial Assistance to Bosnia and Herzegovina, 19.07.2010.

[3] The 2012 SBA was augmented by SDR 135.28 million (about EUR153.1 million) on 31 January 2014 to meet the country's additional financing needs. The IMF SBA was further augmented by SDR 84.55 million (about EUR 95.7million) on 30 June 2014 to meet the country's urgent balance of payments need caused by severe floods in May 2014.

operation was relatively small, corresponding to 0.7 per cent of BiH's GDP in 2013, although it accounted for 17 per cent of the financing gap estimated by the IMF *ex ante*[4].

The disbursement of the MFA was, *inter alia*, dependent on the satisfactory fulfilment of ten reform conditions agreed in the MoU between the EU and the Bosnian authorities. The MFA conditionality targeted the following areas:

- Public finance management (7 conditions);
- Financial supervision and co-ordination (1 condition);
- National statistical system (1 condition); and
- Pension system (1 condition).

## Evaluation objectives

Each MFA operation is subject to an independent ex-post evaluation one to two years after the end of its implementation period with a view to support organisational learning and to enable DG ECFIN to discharge its obligations in terms of transparency and accountability[5].

In line with DG ECFIN's Evaluation Guidelines[6], an ex-post evaluation typically focuses on the following areas of analysis:

- The *macroeconomic impact of the MFA operation* on the recipient country's economy (e.g. GDP growth, Balance of Payments, fiscal balances);
- The *impacts of the structural reforms* supported through the MFA operation;
- *Design and implementation of the operation* encompassing issues such adequacy of financing, timing of disbursements, selection of conditionality; and
- The *value added of EU intervention* (stand-alone and/or in combination with IMF intervention).

And although each MFA operation is unique in terms of its context and content, the ex-post evaluations – where relevant – also seek to draw out lessons which could be applied more broadly to the design and implementation of future interventions. An ex-post evaluation of an MFA is therefore, both summative and formative in nature.

## The method of approach

The present evaluation was based on a mixed-methods approach. A variety of quantitative and qualitative techniques were used to build a comprehensive evidence base for the evaluation and to provide the basis for triangulation of results, most notably:

- A review of relevant literature and official documentation;
- Semi-structured interviews with key informants during two missions to BiH, missions to Brussels and Washington DC. During these missions, consultations were conducted with European Commission officials, officials in the relevant ministries and departments at the State and the Entity level, representatives from other public institutions including the Central Bank of BiH, international financial institutions/ multilateral development banks (IMF, World Bank, EBRD), and the EU Delegation in BiH;

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[4] IMF Country Report No. 12/282 dated October 2012

[55] According to Article 30 of the Financial Regulation, *"all programmes or activities, including pilot projects and preparatory actions, where the resources mobilised exceed EUR 5 million shall be the subject of an interim and/or ex post evaluation in terms of the human and financial resources allocated and the results obtained in order to verify that they were consistent with the objectives set".*

[6] European Commission (2010) Guidelines for the Ex Post Evaluation of MFA and BoP assistance Operations, DG ECFIN, May 2010.

- A Delphi survey among key selected stakeholders and experts to establish the most likely counterfactual scenarios;
- Focus group discussions with non-governmental stakeholders in Sarajevo and Banja Luka; and
- Analysis of macroeconomic statistics and desk based analysis of macroeconomic outcomes and impacts of structural reforms.

## Main findings and conclusions of the evaluation

The main conclusion of the evaluation is that the MFA had a positive impact on BiH's economy and it also contributed to promoting structural reforms in the country. The overall added value and impact of the operation was however, quite modest. The implementation of the operation was severely delayed for reasons already mentioned and which were beyond DG ECFIN's control or even sphere of influence. DG ECFIN devised the MFA operation at a time of uncertainty and at the peak of the economic crisis in 2009. By the time the MFA was actually disbursed (in 2013), BiH's economic situation had considerably evolved and to some extent, improved; but the Commission could not readily adapt the operation to BiH's changing context and needs, given the EU' s political decision making processes[7]. This reduced the overall relevance and added value of the operation as it was initially designed and consequently, it had a limited impact on BiH's economy and the reform process.

The above 'headline' findings and conclusions are elaborated below.

### (i) Impact of the MFA on macroeconomic stabilisation and external sustainability

The MFA operation made a positive – albeit rather limited – contribution to macroeconomic stability in BiH in 2013. This was primarily because of the small size of the operation relative to the country's GDP (the MFA corresponded to 0.7 per cent of BiH's GDP in 2013), but also because the MFA was entirely substitutable by domestic debt issuance. All available evidence suggests that there was sufficient liquidity and capacity in the local banking sector to absorb an additional EUR 90 million of domestic debt issuance (bonds and T-bills) had the MFA not been available to the Entities[8]. The authorities effectively 'switched' domestic debt issuance with MFA as the latter was available on more favourable terms. The net effect of the MFA was therefore, marginal: it is expected to have lowered the cost of public debt servicing by an estimated EUR 12.4 million (the difference in the borrowing conditions offered by the MFA and those that could have hypothetically been available in the domestic debt market).

The MFA was closely linked to the IMF's 2012 SBA. Given the scale of the latter, the combined macroeconomic impact of these two operations was found to have been substantially larger than the impact of the MFA alone. These two programmes combined were assessed to have provided a significant boost to economic activity during 2012-2014. The cumulative impact of the EU MFA and IMF SBA on BiH's GDP over this period is estimated to be the range of 2.6 – 5.1 per cent (more precise estimates cannot be obtained as it was not possible to build a reliable macroeconomic model due to issues with

[7] The Commission does not have the flexibility to make changes to an MFA operation after it has been approved by the co-legislators.

[8] In order to fully make up for the lack of MFA financing, the FBiH would have needed to issue additional EUR 60 million (around BAM 117 million) of debt instruments during 2013 and RS an additional EUR 30 million (around BAM 59 million). No policy response and no macroeconomic implications are assumed at the State level. This is due to the surplus in the State level budget (slightly exceeding the amount of MFA assistance going to the State, i.e. EUR 10 million) and the fact that the State level budget has been in surplus for the last few years, coupled with the limited amount of money involved in the MFA tranches to the State level.

availability and quality of macroeconomic statistics). This was primarily driven by avoiding a significant fiscal adjustment on the expenditure side that would have been necessary in the absence of the external assistance.

The MFA however, slightly added to the country's external debt. The level of public debt – at around 40 per cent of GDP – is deemed sustainable although it makes an emerging economy like BiH with a fixed exchange rate and no access to international capital markets potentially vulnerable to shocks. The IMF and the authorities recognise the need to bring debt-to-GDP ratio on a firm downward path towards the pre-crisis level of 30 per cent of GDP.

## (ii) Impact of the MFA in promoting structural reforms

The conditionality attached to the MFA was selected on the basis of: (i) an operational assessment of financial circuits and procedures in BiH carried out in November 2009 by an external consultancy on behalf of the European Commission; and (ii) discussions with BiH's authorities, the EU Delegation, and other development partners, in particular the IMF.

The choice of conditionality was mainly based on:

- Reforms in the area of Public Finance Management (PFM) as identified in the Operational Assessment;
- Cross-conditionality and in some cases, complementarity with the reforms prescribed in the IMF SBAs;
- Reform priorities identified by the authorities themselves.

Although there was broad consensus among all parties involved that the consultation process was carried out appropriately, the degree of ambition of the reform package was regarded as low to modest by most stakeholders interviewed in the context of this evaluation. Due to delays in the implementation of the MFA, some conditions had already been fulfilled prior to the signature of the MoU, namely: (i) adoption of the pension system reform strategy by the Parliament of Republika Srpska; (iii) implementation of a new cash management system for public finances in the Federation; and (iii) enhanced surveillance of the banking system including quarterly stress tests.

In addition, most of the reforms (6 out of 10 conditions) closely 'mirrored' the prior actions and structural benchmarks included in the IMF SBAs. In these cases, the MFA mainly played a reinforcing role rather than the one that galvanised or drove the new set of reforms.

Notably, the MFA package did not include any reforms related to business environment in BiH, which is chronically weak by international standards and widely acknowledged as the most important priority for reform in the country.

Overall, it can be concluded that MFA conditions were relevant and addressed important issues, but not the most pressing areas requiring reforms. With the benefit of hindsight, MFA could have promoted more far reaching reforms in the area of private sector development / improvement in the business environment rather than seek to reinforce or duplicate IMF conditionality (although admittedly, it is important to bear in mind the size and form of the instrument as a potential incentivising factor when designing conditionality).

Conditions were not precisely formulated, which left room for interpretation by the authorities. The country's authorities technically, implemented the necessary actions, but scratching beneath the surface, there is clear evidence of an implementation deficit (gap between *de jure* reform and *de facto* reform) in 7 out of the 10 conditions. For example, the Coordination Board for PIFC has been set up in accordance with the MFA MoU, but it has not met once in either 2012 or 2013.

Notwithstanding the gaps noted in the implementation of several MFA conditions, some benefits of these reforms are evident:

- Availability of quarterly GDP statistics (at the national level) necessary for macroeconomic surveillance and policy making;
- The enhanced surveillance of the banking system, including regular quarterly stress tests of the banking system which has contributed to better information flow between agencies, Central Bank and banking institutions;
- An availability of the more complete picture of public debt of FBiH, specifically covering obligations related to old foreign currency savings totals;
- Better quality and more timely information for public administration units performing management control functions as a result of the adoption of the two rulebooks on the new chart of public financial accounts by the Ministry of Finance of RS.

The potential gains from reforms have, however, not fully materialised due to the implementation deficit noted in several conditions (which means that benefits could not be optimised) and considering the short time that has elapsed since the implementation of some reforms (e.g. the Law on Fiscal Responsibility).

Moreover, while assessing the impact of the MFA reforms, it is also important to consider the unique socio-cultural context of BiH reflected in its highly complex institutional framework and the nature of relations between the State and the Entities. These characteristics make it more challenging to implement reforms in BiH. It is worth highlighting here that one of the objectives of the MFA was to tackle this issue by setting conditions that involved policy dialogue and coordination between the State and the Entities.

## (iii) Design and implementation issues

### Timetable

The commitment for EU MFA was made at the end of November 2009 when the Council Decision on providing the MFA came into force, while the signature of Loan Agreement took place in November 2010. Actual disbursement took place after a time lag of 26 months. This was predominantly due to a lack of progress on reforms necessary for the disbursement of the first tranche and the political stalemate that followed the October 2010 general elections.

As a consequence, the MFA arrived after the two recessions were over (2009 and 2012). Nonetheless, BiH's tentative economic recovery and fragile fiscal situation in 2013 still implied financing needs. Although as previously pointed, the deficit financing needs covered by the MFA could have been met domestically.

### Size and form of assistance

The assistance was provided on highly concessional terms (interest rate of 2 per cent p.a. accompanied by a long maturity period) which were considered favourable by the Ministries of Finance of the State as well as the two Entities. This made the MFA an attractive form of financing. The moderate level of indebtedness of the country at the time when the operation was being designed along with its level of development (classified as an "upper middle income" country by the World Bank) justified the choice of loan form as oppose to a grant or a loan/ grant combination.

### Visibility

The study revealed that the visibility and awareness of the MFA instrument was negligible, even among stakeholders who closely follow the economic developments in the country.

Instrument for Pre-Accession Assistance (IPA) seems to be slightly better recognised in BiH's context.

### (iv) EU Value Added

From the perspective of the national authorities, the main attractiveness of the MFA was the cost and tenure of financing provided by the instrument. The MFA allowed the authorities to reduce its costs of debt servicing by an estimated EUR 12 million[9] over the period 2013-2015, which would have to be otherwise been borne by Republika Srpska, the Federation and the State. And as previously mentioned, the MFA played a discernible role in reinforcing the reforms promoted by the IMF.

In addition, given BiH's status as a potential EU candidate country, the MFA demonstrated the EU's political commitment and solidarity towards BiH in times of crisis. Moreover, it provided the EU 'a place at the table' while discussing macroeconomic policies in BiH.

Finally, the MFA fostered dialogue between the State and the Entities by setting conditionality that required consensus-building and coordination (there were four such conditions). Although through the evaluation exercise, it was also evident that coordination between the State and the Entities often phased out as soon as the specific condition was fulfilled.

## Lessons learned

The lengthy timetable for disbursement of MFA is in clear contradiction with its primary objective (anti-crisis support). This has been a recurring issue in previous MFA operations, and is applicable to this one too – although in this instance, the delay was caused by BiH authorities rather than the EU's decision making processes. In the case of BiH, the long time-lag between approval and disbursement of the MFA undermined its impact and added value: the macro-economic impact of the operation was limited as it arrived at a time when the authorities could have replaced the MFA with domestic debt issuance; and reform conditions had a limited impact as some of them had already been fulfilled prior to the signature of the MoU. Thus, more flexibility in the design of individual MFA operations would be desirable going forward. Specifically, it would be beneficial if conditionality could be adapted to evolving circumstances during the MFA implementation period (e.g. dropping already fulfilled conditions, adjusting conditions that become infeasible / controversial in view of changed macroeconomic and /or political realities). It is recognised that any change in this direction would require high level political decisions within the EU.

The quick-disbursing nature of the MFA instrument implies that conditions will need to continue being specified in terms of expected short-term outputs. However, it is recommended that expected longer-term outcomes and impacts of conditionality should also be explicitly set out. This would strengthen domestic ownership, minimise the risk of implementation deficit (the difference between *de jure* and *de facto* reforms), and provide the basis for future ex-post evaluations and where applicable, follow-up through EU budget support.

Moreover, in designing conditionality, a balance has to be struck between addressing an immediate financing need and the desire to promote reform, while also considering the size and form of the instrument as a potential incentivising factor for the recipient country's authorities to pursue reform.

In addition, along with the level of magnitude of the crisis, the deployment of the MFA should be analysed in the context of potential alternative sources of financing available to the recipient country. In the case of BiH, the most plausible scenario in the absence of the

[9] ICF estimation

MFA, would have been additional issuance of the public debt in domestic markets by both Entities. As the cost of such debt would have been very reasonable, it raises the question about the level of urgency in a given country that should trigger the deployment of the MFA. If such level of urgency is comparatively low, this should be compensated by negotiating a more ambitious reform package.

Due to a highly complex socio-political structure and existing tensions between the State and the Entities, implementation delays and 'half completed' reforms were a feature of 2009-2013 MFA operation. Hence, more active involvement of the European Commission in monitoring the implementation of reform conditions, ideally associated with access to technical assistance, could be considered as a way forward to improve the effectiveness of the MFA conditionality. One way could be through closer alignment between the EU delegation and/ or the IMF which could support DG ECFIN in the monitoring of the implementation process (and provide technical assistance, if necessary). Another alternative would be closer involvement of DG ECFIN itself, for instance in the form of more frequent missions to the recipient country. The latter would however, be more resource intensive.

Finally, it should be considered whether better communication of the MFA to both targeted stakeholder groups and general public (as an element of the broader package of EU assistance) is needed. The visibility of the instrument among these groups is negligible and as such, it is unlikely to have any influence on their perceptions and attitudes towards the EU.

# 1 Introduction

This is the Final Report for the *ex-post evaluation of the EU's macro-financial assistance to Bosnia and Herzegovina (2009 – 2013)*. The evaluation was launched by the Directorate-General for Economic and Financial Affairs (DG ECFIN) in June 2014 and was undertaken by ICF Consultancy Services Ltd. with inputs from local economists and experts.

The Final Report details the work undertaken, the evidence collected within the framework of this evaluation, and the findings and conclusions emerging from this evidence. It also draws out some broader lessons that can be applied to the design and implementation of future MFA operations.

## 1.1 The scope and objectives of the ex-post evaluation

The present evaluation covers the EU's Macro-Financial Assistance (MFA) to Bosnia and Herzegovina (BiH) over the period of 2009-2013[10]. The MFA to BiH, consisting of a loan of EUR 100 million, was approved by the Council Decision in November 2009 and was released in two tranches as follows:

- The first tranche of EUR 50 million was disbursed in February 2013;
- The second and final tranche of EUR 50 million was disbursed in September 2013.

The overall objective of this evaluation is to provide an independent assessment of the above operation, focusing in particular on the following areas of analysis:

- The *macroeconomic impact of the MFA operation* on the economy of the recipient country (e.g. GDP growth, Balance of Payments, fiscal balances).
- The *impact of the structural reforms* supported through the MFA operation.
- *Design and implementation of the operation* encompassing issues such adequacy of financing, timing of disbursements, selection of conditionality.
- *Value added of EU intervention* (stand-alone and/or in combination with IMF intervention).

In support of the above objectives, the Terms of Reference (ToR) listed a series of specific evaluation questions for this Study to address. Table 1.1 summarises the method of approach that was adopted to answer each of these evaluation questions. The detailed methodological framework for the evaluation can be found in Annex 1.

**Table 1. Summary of the methodological framework for the evaluation**

| Core Issue | Evaluation Question | Approach to answering the | Methods used |
|---|---|---|---|
| Macro-economic impact of the MFA operation | Q1. How would the economy of Bosnia and Herzegovina have evolved in the absence of MFA (and IMF) assistance | ▪ Identification of all potential counterfactual scenarios<br>▪ Assessment of the likelihood of occurrence of each counterfactual scenario<br>▪ Assessment of Bosnia and Herzegovina's expected economic adjustment path under the most likely/ plausible counterfactual scenario(s) | ▪ Documentary review<br>▪ Analysis of macroeconomic statistics<br>▪ Literature review<br>▪ Interviews with key informants<br>▪ Delphi panel |
| | Q2. To what extent has the MFA assistance been effective in terms of the | ▪ Description of actual macroeconomic outcomes (as observed in macroeconomic data) | ▪ Documentary review<br>▪ Analysis of |

[10] Council Decision 2009/891/EC of 30 November 2009 providing macro-financial assistance to Bosnia and Herzegovina, OJ L 320, 5.12.2009, p. 6. [online] Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009D0891&from=EN

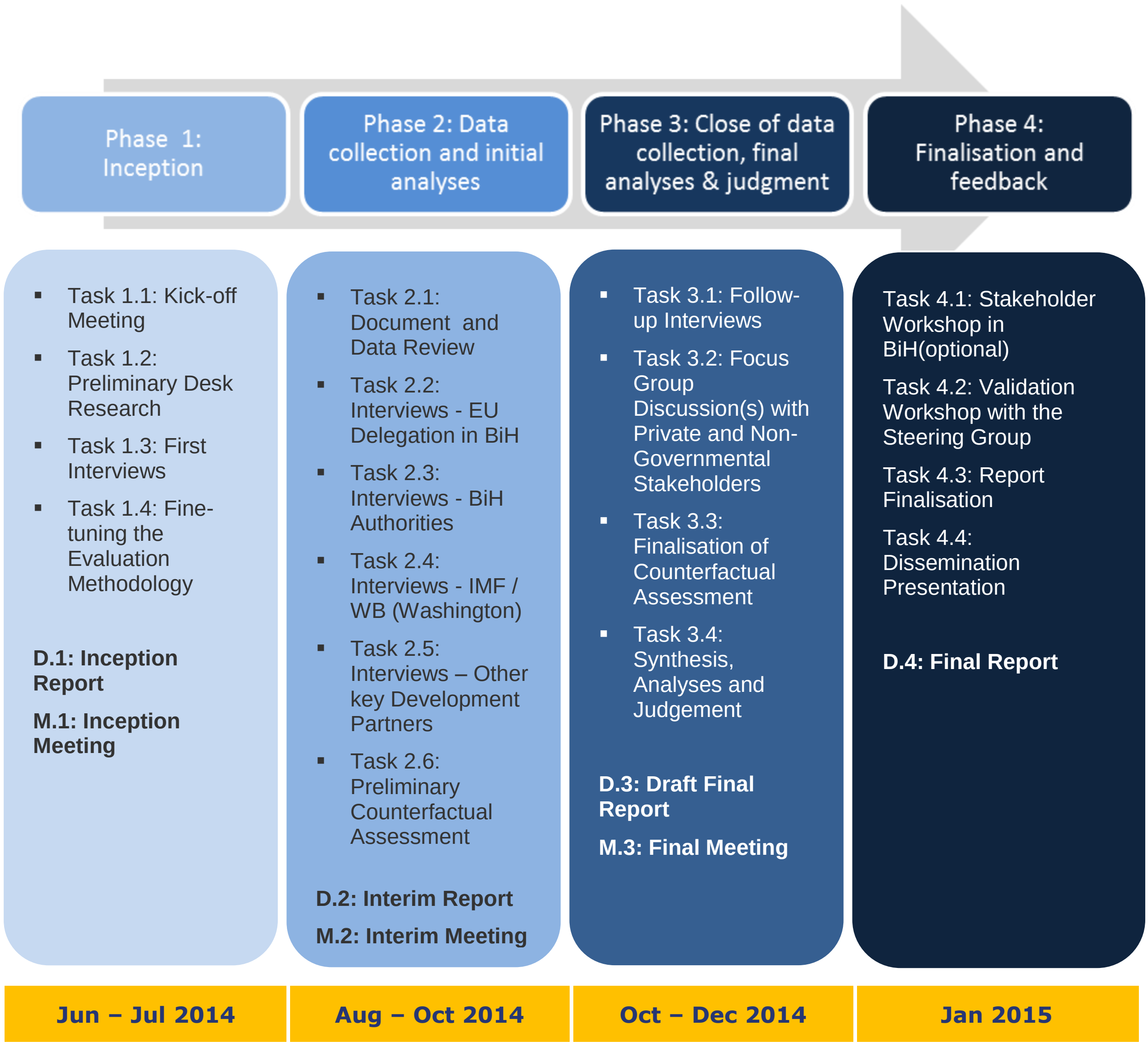
| Core Issue | Evaluation Question | Approach to answering the | Methods used |
|---|---|---|---|
| | short-term macroeconomic stabilisation of Bosnia and Herzegovina? | ▪ Assessment of the net impact of the MFA (the difference between observed outcomes and counterfactual outcomes) | macroeconomic statistics<br>▪ Literature review<br>▪ Interviews with key informants<br>▪ Delphi panel |
| Impact on external sustainability | Q3. To what extent has the MFA contributed to returning the external financial situation of Bosnia and Herzegovina to a sustainable path over the medium to longer-term? | ▪ Analysis of trends in key external indicators: before and after the MFA<br>▪ Qualitative assessment of the net impact of the MFA | ▪ Documentary review<br>▪ Analysis of macroeconomic statistics<br>▪ Literature review<br>▪ Interviews with key informants<br>▪ Delphi panel |
| Impact on structural reforms | Q4. To what extent has the MFA assistance been effective in terms of supporting structural reform in Bosnia and Herzegovina? | ▪ Assessment of the relevance, fulfilment, durability, additionality and impact of MFA reforms<br>▪ Assessment of any implementation deficit (i.e. the gap between *de jure* implementation and *de facto* implementation) | ▪ Documentary review<br>▪ Interviews with key informants<br>▪ Focus group discussions |
| | Q5. What have been the indirect and/ or unexpected effects of the MFA assistance? | ▪ Elaboration of the ex-ante intervention logic of all structural reform measures<br>▪ Ex-post validation of the intervention logics<br>▪ Comparison between the ex-ante intervention logic and ex-post outcomes to identify actual indirect and/ or unintended effects<br>▪ Identification of unexpected macroeconomic outcomes | ▪ Documentary review<br>▪ Interviews with key informants<br>▪ Focus group discussions |
| Design and implementation | Q6. How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency? | Assessment of design features:<br>▪ Whether the size of the assistance was appropriate in relation to Bosnia and Herzegovina's financing needs<br>▪ Whether the form in which assistance was provided was appropriate (loan versus grant)<br>▪ Whether scope of reforms promoted were appropriate considering the size and form of the MFA operation and reform priorities<br>▪ Whether the design of the MFA operation was flexible i.e. it adjusted to changes in context and/or feedback mechanisms<br>Implementation issues e.g.<br>▪ Timeliness of MFA disbursements<br>▪ Dialogue between the European Commission, the IMF and Bosnia and Herzegovina authorities<br>▪ Monitoring of the MFA operation | ▪ Documentary review<br>▪ Interviews with key informants<br>▪ Focus group discussions |
| Added value | Q7. To what extent has EU added value been maximised? | Assessment of the financial and non-financial added value of the MFA operation e.g.<br>▪ Confidence boosting effects; | ▪ Documentary review<br>▪ Interviews with key informants |

| Core Issue | Evaluation Question | Approach to answering the | Methods used |
|---|---|---|---|
| | | ▪ Complementarities with other types of assistance;<br>▪ Role in accelerating/ reinforcing reforms in specific areas;<br>▪ Allowing for a smoother economic adjustment path etc. | ▪ Focus group discussions |

## 1.2 Structuring of the evaluation

The overall study design is illustrated in Figure 1. In line with the ToR, the evaluation was structured in four distinct and sequential phases, each of which comprised a series of tasks and deliverables.

**Figure 1. Structuring of the evaluative tasks**




## 1.3 Caveats and limitations

A variety of methods were used to build a rich evidence base for the evaluation and to provide the basis for triangulation of results. Table 2 critically assesses the methods used and the validity of the data collected as part of this evaluation.

**Table 2. Strengths and limitations of the methods used in the ex-post evaluation of MFA to BiH**

| Method | Scope | Caveats and limitations |
|---|---|---|
| Desk research | European Commission files relating to the MFA operation, notably:<br>▪ Council Decision 2009/891/EC;<br>▪ Ex-ante assessment;<br>▪ Operational Assessment;<br>▪ Preparatory documents submitted to the Economic and Financial Committee;<br>▪ Compliance statements and supporting documentation submitted by BiH authorities.<br>Documentation published by the BiH authorities such as economic strategies, reform programmes, action plans and progress reports, annual reviews;<br>IMF documents namely, the Letters of Intent submitted by BiH authorities to the IMF and IMF Country Reports;<br>World Bank documents such as Country Partnership Strategies, program documents relating to the Bank's Development Policy Operations in BiH, documents relating to projects supporting relevant reforms;<br>Academic and grey literature on political and economic developments in BiH and its progress with the implementation of structural reforms;<br>Macroeconomic data and statistics compiled from various sources:<br>▪ Gross Domestic Product (GDP) and its components;<br>▪ Balance of Payments (BoP) statistics;<br>▪ Public finances;<br>▪ Monetary statistics.<br>See Annex 2 for a complete list of references. | *There were gaps in the official documentation available with DG ECFIN* e.g.<br>▪ Letter from BiH authorities requesting for MFA in 2009;<br>▪ Letter from BiH authorities requesting extension of the validity period of MFA;<br>▪ Mission reports.<br>Non-availability of the above documents does not however, affect the quality of the evaluation – although a useful source of background and contextual information, these documents were of a non-critical nature for the evaluation.<br>*Poor quality and limited availability of macroeconomic statistics:* Statistical functions are spread across different levels of government in BiH. There are two statistical institutes at the level of the Entities-the Federal Institute of Statistics of the FBiH (FIS) and RS Institute of Statistics (RSIS). In 1998, the State created its own statistical institute, the Bosnia & Herzegovina Agency for Statistics (BHAS), with a view to compiling country-wide statistics in accordance with internationally-accepted methodologies, consolidating data produced by the Entities' Statistical Institutes. In addition to the three statistical institutions, the Central Bank of BiH (CBBH) compiles monetary and balance of payments and financial statistics for BiH.<br>There are issues with accuracy, reliability, coverage and timeliness of statistics. For instance, the IMF notes that there are: (i) significant discrepancies between the production and expenditure measures of GDP; (ii) poor BoP data coverage in areas of foreign grants, workers' remittances, income received by residents working for international organizations in the country, spending by their non-resident staff, informal trade, and changes in foreign currency cash holdings; (iii) issues with the quality of public debt figures which does not include unrecognised liabilities.<br>Quarterly national accounts are only available from 2006 onwards, are produced with a considerable time lag and subject to frequent and sizeable revisions.<br>Given the poor quality of statistics and limited availability of time series data, a model based (quantitative) approach to counterfactual analysis could not be adopted in the case of this evaluation. |
| Interviews with key | Semi-structured interviews with: | Interviews covered key informants who were closely involved in the |

| Method | Scope | Caveats and limitations |
|---|---|---|
| informants | ▪ Relevant State authorities<br>▪ Relevant authorities at Entity level<br>▪ European Commission officials<br>▪ IMF/ World Bank officials<br>See Annex 3 for a list of interviewees. | negotiation and/or implementation of the IMF/MFA assistance. The official responses were measured and cautious. |
| Delphi Panel | Due to methodological issues with using standard techniques such as macroeconomic modelling (e.g. shortcomings with statistical data described above), the Delphi survey technique was used to develop counterfactual scenarios. The Delphi survey is a technique used to gather views and generate consensus among a group of expert (the Delphi panel). It is organised as a structured process for soliciting and synthesising knowledge from the panel in an iterative process. The iteration consists of a series of questionnaires distributed to experts accompanied by controlled opinion feedback from the previous round.<br>A panel of 60 experts (based on their knowledge of country context and macroeconomic situation) was set-up in the context of this evaluation to gather their views on the most probable counterfactual scenario(s). The structure of the questionnaire was largely driven by the insights gathered during key informant interviews. Pilot test of the research instrument was also conducted before launching the survey.<br>Thirty-seven respondents provided their feedback (a 62 per cent response rate). Survey respondents comprised both public and private institutions, including representatives from Ministries of Finance in each Entity and at the State level, CBBH, Indirect Tax Authorities, International Donors (IMF, the WB, EBRD, DG ECFIN), EU Delegation, academia, national think-tanks, as well as limited number of individuals from other type of organisations such as local chamber of commerce, banking association and selected group of independent fiscal consultants.<br>The first round of survey results yielded a high level of consensus among the participants in terms of most likely alternative for the MFA. Therefore a second iteration was not deemed necessary.<br>Annex 4 provides a summary of the results of the Delphi survey. | Although a substantial effort was made to ensure highest relevance and validity of responses, Delphi surveys in general exhibit certain weaknesses. In the context of the MFA, the major risks related to an insufficient familiarity of participants with the aspects of the MFA operation and the tendency to stick to their own strong views based on their interpretation of historical developments. Therefore, the findings from this exercise should be considered with certain degree of caution. |
| Focus Group Discussions | Two focus group discussions were organised (one in Sarajevo and another in Banja Luka) to collect the views and opinions of a wider group of | The scope of the focus group discussions was limited by definition. The discussions focussed on issues such as visibility of EU support, its role in |

| Method | Scope | Caveats and limitations |
|---|---|---|
| | stakeholders i.e. those 'outside' the government and not directly involved in the operation.<br><br>The group dynamic was particularly useful in triggering an informative and thought provoking discussion on the reform process and its outcomes.<br><br>Focus group discussions also provided an indication of the visibility of the MFA among wider stakeholder groups and their perceptions of the role of MFA in promoting reforms.<br><br>Finally, the focus group discussions were particularly useful in determining if the MFA had any confidence boosting effects and / or impact on EU-BiH relations, public opinion of the EU. | promoting reforms and the overall assessment BiH's progress with reforms since the implementation of the MFA.<br><br>In Banja Luka, the views of the participants were not entirely objective and to a certain degree politically motivated. |

## 1.4 This Report

The remainder of the document is structured as follows:

- Section 2: The context and content of the MFA operation;
- Section 3: Macroeconomic impact of the MFA operation;
- Section 4: Impact on structural reforms;
- Section 5: Design and Implementation Issues;
- Section 6: EU added value;
- Section 7: Conclusions and lessons learned.

Annexes:

- Annex 1: Overall methodological framework for the evaluation;
- Annex 2: List of references;
- Annex 3: List of interviews conducted;
- Annex 4: Results of the Delphi survey;
- Annex 5: Summary of the focus group discussions;
- Annex 6: Evolution of BiH's credit rating;
- Annex 7: Overview of past MFA operations in BiH.

# 2 The context and content of the MFA operation

This section provides an overview of the economic situation in BiH in the run-up to the 2009 economic crisis. Specifically, the causes and consequences of the crisis are examined. This is followed by a description of the main features of the assistance provided by the IMF, the World Bank and the EU to restore macroeconomic stability and to facilitate BiH's recovery from the crisis.

## 2.1 The background to the crisis

**Box 1 Headline overview of BiH's pre-crisis economic context**

- Following the heavy losses and destruction during the war period, the country experienced strong economic growth - in excess of 10 per cent per annum - during the second half of the 90s (1996-1999), albeit from a low base[11]. This impressive economic growth was driven by post-war reconstruction activity financed by large aid inflows. Once these funds gradually diminished, growth moderated (when compared to the previous decade), but still remained relatively robust during the 2000s (averaging 4.8 per cent per year during 2001-2008).
- The following factors played an important role in fuelling the economic expansion during this period:
- Large remittances inflows in the range of 15-18 per cent of GDP between 2000 and 2008[12].
- Steady inflows of foreign direct investment (FDI) averaging around 6 per cent of the GDP during 2001-2008[13]. Key sectors benefiting from FDI inflows were aluminium, steel, automotive and financial services. FDI inflows peaked at around 12 per cent of GDP in 2007 on the back of one large privatisation transaction when Telekom Srpske (a telecommunication company in the RS) was acquired by Telekom Srbija.
- Rapid credit expansion stimulating private demand. Credit to non-financial enterprises and households grew at an annual average rate of 29 per cent and 44 per cent respectively, during 2001-2008[14].
- Expansionary fiscal policies, particularly during 2007-2008 when revenue windfall from the successful introduction of VAT in 2006 was used to increase current spending, in particular social transfers.
- Despite the continuous expansion of the economy over this period, there were significant underlying structural weaknesses. These included, high levels of unemployment, politically motivated public spending and a weak business environment.
- In the run-up to the crisis BiH's economy exhibited typical signs of overheating. With capital inflows driving a domestic demand boom, credit expanded sharply, core inflation accelerated, and the current account deficit widened. Looser fiscal and incomes policies in 2008 further exacerbated these imbalances, limiting the space for manoeuvre when the crisis hit.

The sub-sections below look at recent macroeconomic developments in BiH in further detail, examining in particular the build-up of vulnerabilities and macroeconomic imbalances during the pre-crisis period and the immediate consequences of the crisis.

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[11] According to some estimates, the GDP of BiH amounted to around 1/5 of its pre-war value in the first year after the conflict

[12] IMF. (2010). Selected Issues: Cyclical Adjustment and Fiscal Policy Design. [online] Available at: http://www.imf.org/external/pubs/ft/scr/2010/cr10347.pdf

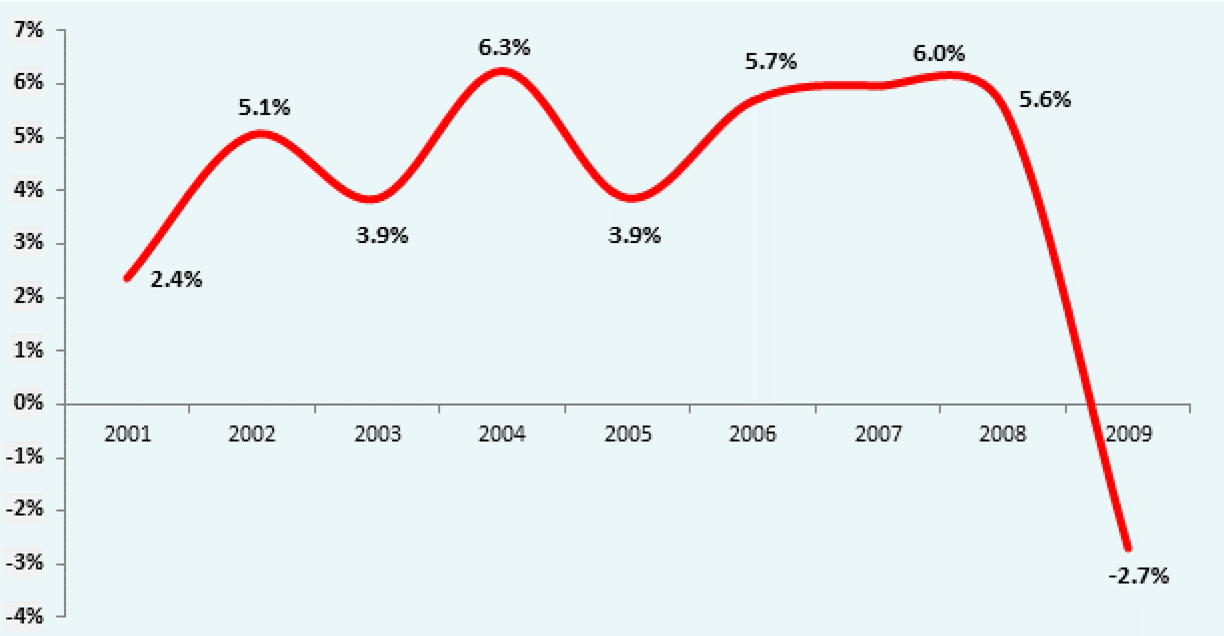
[13] Based on macroeconomic statistics compiled in the European Commission's 2009 Progress Report on BiH. [online] Available at: http://ec.europa.eu/enlargement/pdf/key_documents/2009/ba_rapport_2009_en.pdf

[14] Central Bank of Bosnia and Herzegovina, Structure of Loans by Sector in Commercial Banks of BiH. Available on the Bank's website: http://cbbh.ba/index.php?id=33&lang=en&sub=mon&table=sektorska_struktura_kreditaa_komercijalnih_banaka_bih

### 2.1.1 Real GDP growth

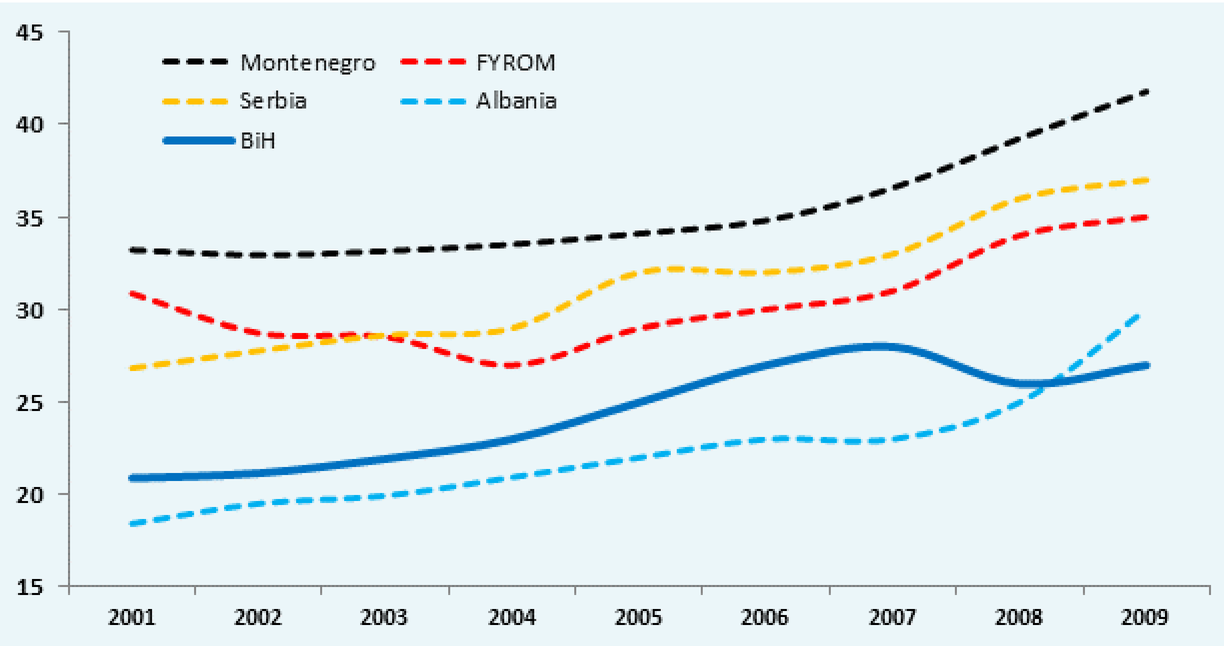
In the seven-year period preceding the 2009 crisis (i.e. between 2001 and 2008), output grew on average by 4.8 per cent per year in real terms. Economic growth was particularly strong and stable during the last three years of this period, averaging at 5.8 per cent per year (Figure 2).

**Figure 2. Real GDP growth in BiH, 2001-2009 (per cent)**




Source: Agency for Statistics of B&H - National Accounts Statistics

**Figure 3. GDP per capita in PPS – BiH compared to regional peers, 2001-2009 (index; EU28 =100)**

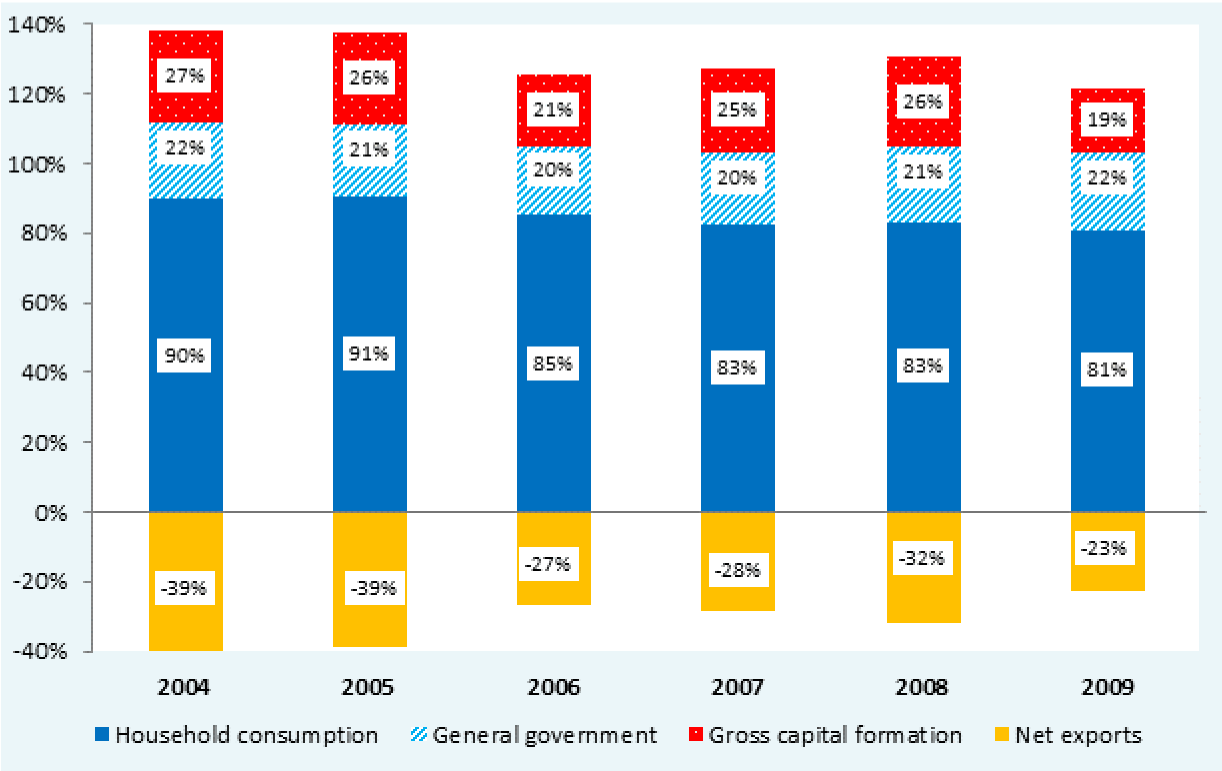


The GDP per capita more than doubled in nominal terms between 2001 and 2008, from USD 1,528 to USD 4,891[15]. However, this still implied slower pace of convergence with EU average GDP per capita in purchasing power standards (PPS) compared to BiH's regional peers (Figure 3). BiH remained among the poorest European countries by this measure, only surpassing Albania in the Western Balkans.

### 2.1.2 GDP and its components

During the pre-crisis period from 2004 to 2008[16], economic growth was mostly fuelled by increasing household consumption, a common characteristic of all economies in the Western Balkans. Household consumption on average accounted for 85.5 per cent of GDP during this period while imports stood at 58.7 per cent of GDP (on average) during the same period. The share of exports and government consumption remained relatively stable during this period (averaging at 21 per cent and 27 per cent of GDP, respectively). Gross Capital Formation also remained stable at 23 per cent of GDP during 2004 to 2008, while the 2009 recession strongly hit gross private and public investment, resulting in a drop in its total share to 19 per cent of GDP.

*Figure 4. Developments of GDP structure by expenditure approach (2004-2009)*




*Source: Agency for Statistics of B&H – National Accounts Statistics. Notes: The above figure does include Final consumption expenditure of NPISH which represents ~1% of GDP. Gross Capital Formation = Gross Fixed Capital Formation + change in inventories + valuables*

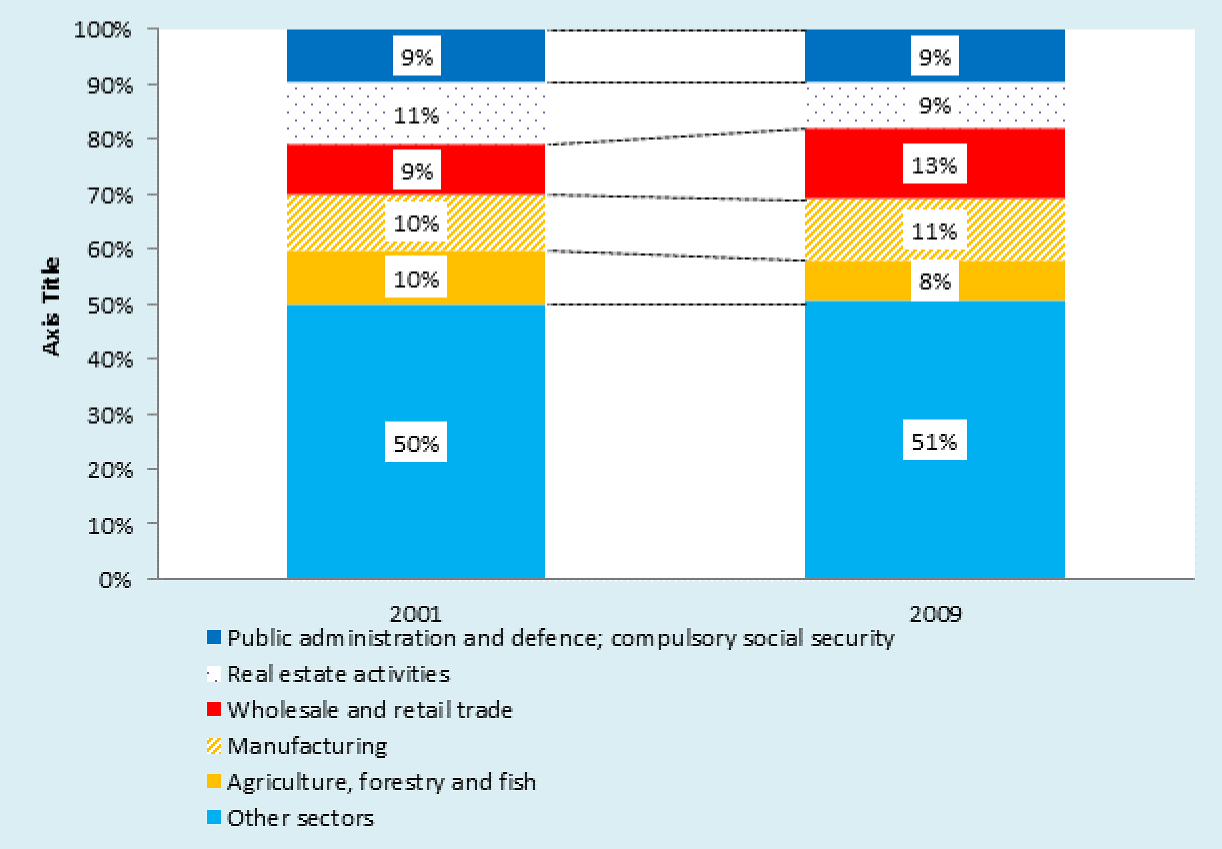
Looking at the share of specific sectors in national GDP, they have remained mostly unchanged during the period 2001-2009. Approximately 50 per cent of GDP was produced by five sectors: Wholesale and Retail, Manufacturing, Public administration,

[15] The Agency for Statistics of B&H – National Account Statistics; Available at: http://www.bhas.ba/index.php?option=com_publikacija&view=publikacija_pregled&ids=2&id=11&n=Nacionalni%20računi&Itemid=&lang=enl

[16] Data are only available for the years 2004-2013 for the expenditure side of GDP from national sources

Real Estate and Agriculture, Forestry and Fishing (Figure 5). The only sector which substantially increased its share in GDP between 2001 and 2009 was the Wholesale and Retail trade sector, which became the most important in terms of share of GDP in the run up to the crisis. This was due to the dynamics of private consumption and imports.

**Figure 5. Developments of GDP structure by production approach (2001-2009)**




_Source: Agency for Statistics of B&H – National Accounts Statistics_

### 2.1.3 Public finances

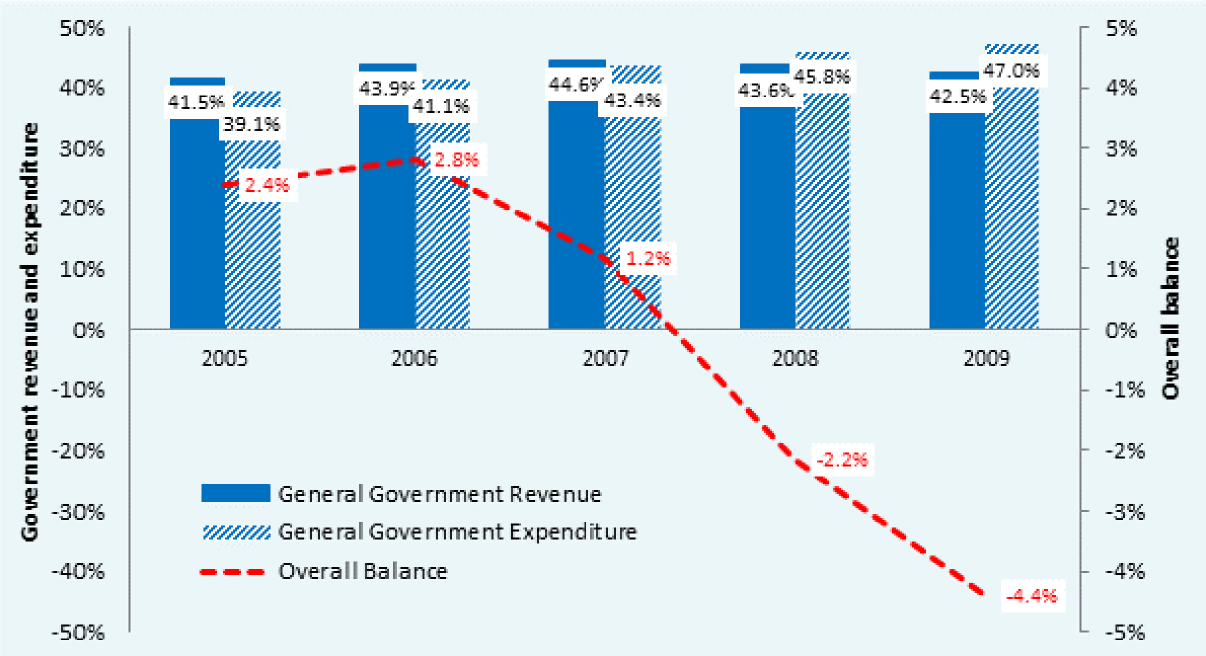
Fiscal policies remained fairly prudent during the period 2005 to 2007, when BiH reported an overall budget surplus of 2.1 per cent of GDP on average[17]. The introduction of VAT (2006)[18], income tax reforms[19] and large privatisations in RS (2007) strengthened public finances during this period. However, expansionary fiscal policies in 2007 and 2008 (increases in public sector wages and social benefit) alongside declining revenues resulted in a sharp deterioration in public finances in 2008 – see Figure 6. In addition to rising expenditure, the global economic crisis strongly hit Bosnian economy and substantially pressured tax collection and overall budget revenues. These developments resulted in a further widening of the budget deficit to 4.4 per cent of the GDP in 2009 - prompting BiH authorities to seek international financial assistance.

[17] Based on GFS methodology published by the CBBH

[18] In 2006, one of the major fiscal reforms was successfully implemented i.e. the introduction of VAT (indirect taxes are collected at the State level) with a single rate of 17 per cent resulting in the increase of tax revenues to the tune of 2 per cent of GDP

[19] After the indirect tax reform, the two Entities undertook substantial reform of their Personal Income Tax (PIT) and Corporate Income Tax (CIT) during 2006-2009

**Figure 6. General government revenues and expenditures, 2005-2009 (per cent of GDP)**

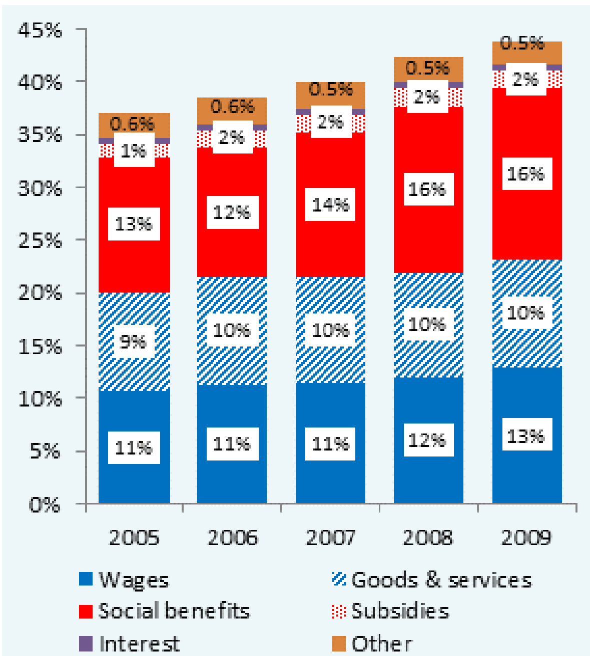



*Source: CBBH. NB: Expenditures also include net acquisition of fixed assets.*

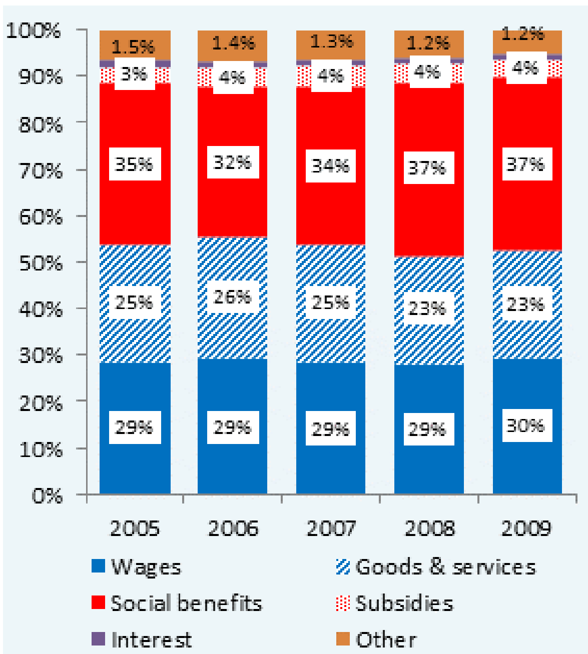
At all levels (consolidated BiH, FBiH and RS) current expenditure represents the vast majority of budget expenditure; capital expenditure represented only 4 per cent (in case of consolidated BiH and FBiH) and 9 per cent (consolidated RS) of budgets on average during 2003 to 2009. Current expenditures mostly comprise three expenditure categories (social transfers, wages and the use of goods and services) which collectively represent 88 per cent of all current expenditures on average (Figure 7).

**Figure 7. Structure of consolidated general government's current expenditures, 2005-2009**

(i) As a share of GDP




(ii) As a share of total revenue




*Source: CBBH – GFS Statistics. Other includes grants*

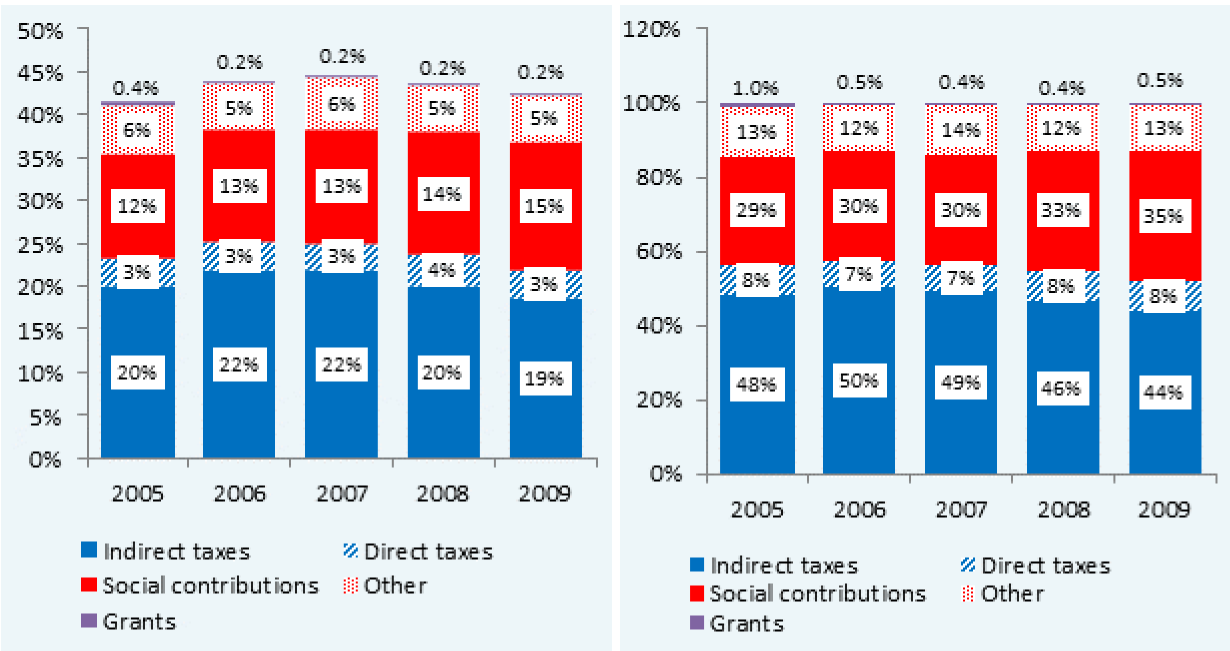
Overall, in the period prior to the crisis, public expenditure grew faster than GDP, with spending on social transfers and public sector wages leading the way. During the pre-crisis period, there was a continuous upward pressure on social transfers which rose to 37 per cent of total current expenditures in 2009. During the pre-election campaign in 2006, several laws were adopted introducing new and unusually generous entitlements (rights-based benefits). Consequently, non-insurance transfers in the FBiH increased from 4.8 per cent of FBiH's GDP in 2006 to 7.5 per cent in 2008, while those in the RS remained in the range of 3-3.5 per cent of RS GDP. The developments in the FBiH rendered the fiscal situation unsustainable and FBiH budgetary arrears mounted to 1.4 per cent of BiH GDP by end-2008[20].

Moreover, public administration employment was very high in both Entities with the share of public administration employment surpassing 11 per cent of total employment, a level not seen among any of the EU Member States[21]. As of 2007, public administration wages were 30 per cent higher than the average wage for the whole BiH economy. One significant difference between the two Entities was that proceeds from privatisation in RS constituted a substantial source of financing, while privatisation in FBiH advanced little.

On the revenue side of the budget, the government relied heavily on indirect taxes (VAT, Customs Tariffs, Excise Duties). Following a reform of the indirect taxation system and successful introduction of VAT in 2006, the share of indirect taxes in total government revenues rose to 50 per cent. The economic crisis however, resulted in a significant decline in indirect tax collection during 2008 and 2009. The share of indirect taxes fell from 22 per cent of the GDP in 2007 to 19 per cent of the GDP in 2009. Social contributions - the second largest revenue category - remained stable at 14 per cent of the GDP (on average) during the same period.

**Figure 8. Consolidated general government's revenue structure, 2005-2009**

(i) As a share of GDP (ii) As a share of total revenue



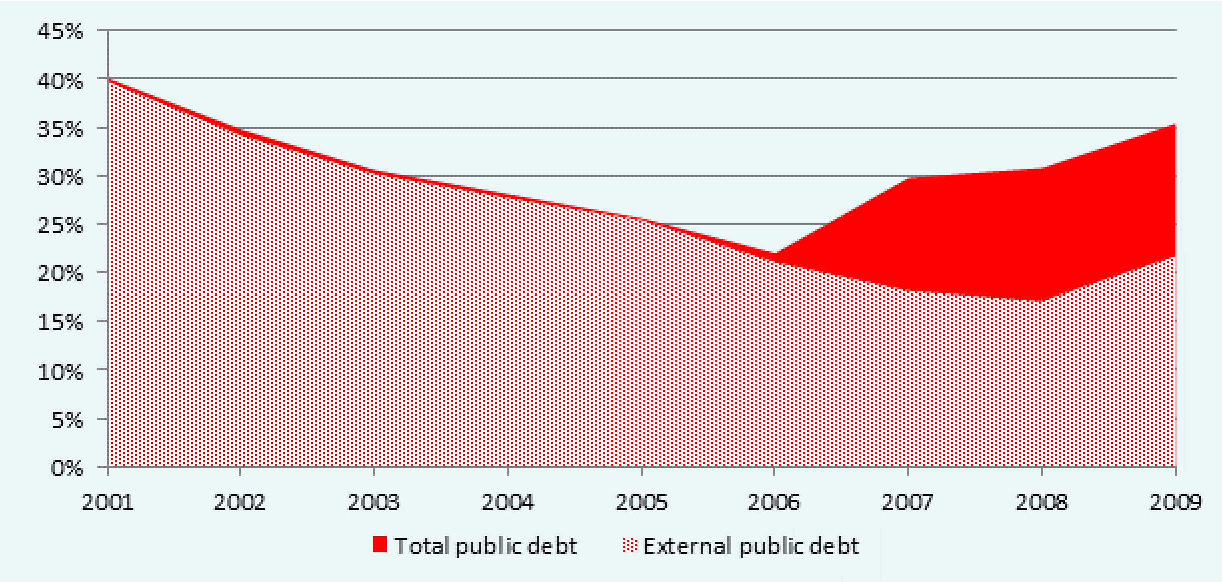

*Source: CBBH – GFS Statistics*

[20] World Bank (2010) Program Document for a Proposed First Programmatic Public Expenditure Development Policy Loan/Credit to Bosnia And Herzegovina

[21] IMF. (2008). Country Report. Available at: https://www.imf.org/external/country/BIH/index.htm?pn=4

BiH's public debt-to-GDP ratio and external debt-to-GDP ratio steadily declined during 2001 to 2006, reflecting the country's strong economic performance and public finances during this period (Figure 9). Although external public debt of BiH continued its downward trajectory during 2007-2008, domestic public debt grew as the two Entities implemented legislation on the settlement of liabilities from frozen foreign currency deposits and from war damages. Despite the jump in 2007, public debt stood at a comfortable level of 30.8 per cent of the GDP in 2008.

*Figure 9. Public debt 2001-2009 (per cent of GDP)*

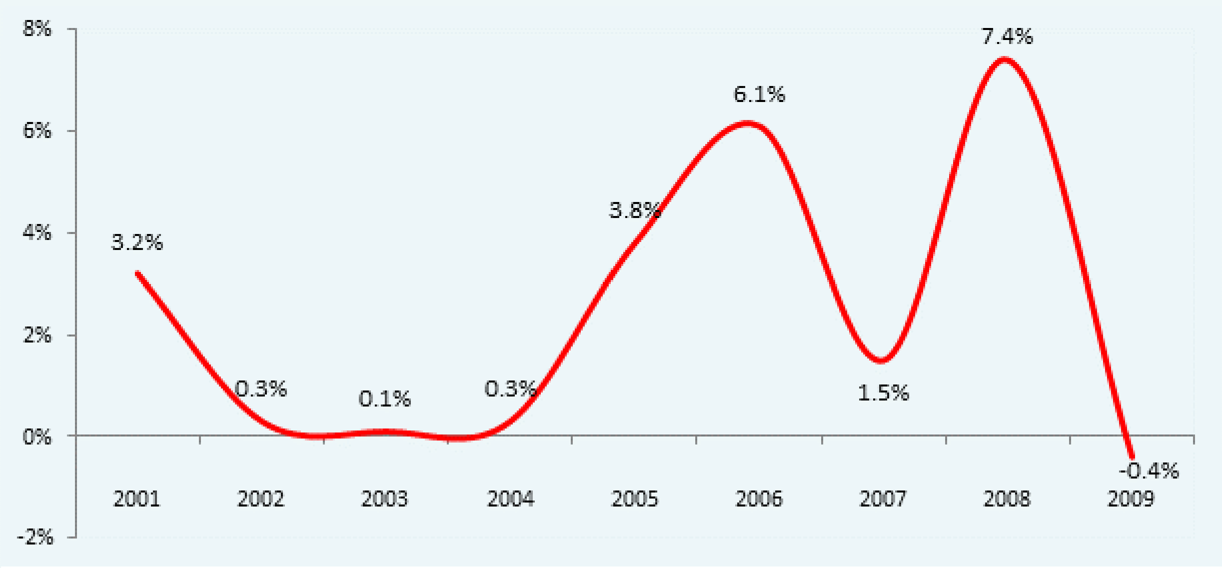



*Source: IMF Country Reports No. 05/199 (2001), 06/371 (2002-2004), No. 05/199 (2000-2001), 09/226 (2005-2007), 10/348 (2008-2009). Notes: According to the IMF, public debt figures should be treated with caution as there are uncertainties about the size of the government's contingent liabilities*

### 2.1.4 Monetary policy

The Central Bank of BiH (CBBH) was established in August 1997 and the single currency (konvertibilna marka - BAM) was introduced in June 1998. BiH's monetary policy has been anchored by the currency board arrangement, with the currency pegged to the euro. The only monetary policy instrument available to the Bank is the required reserves ratio. In accordance with the Law on the Central Bank of BiH, the Bank is not allowed to pursue the lender of last resort function, and it is prevented from conducting open market operations. Therefore, the Bank is completely insulated from the possibility of influencing interest rates and the money supply. This also implied that inflationary developments were largely reflecting global price movements of important commodities and domestic policies affecting wages and social benefits. Inflation remained subdued until 2004, but then two sharp increases took place (Figure 10). The first one in 2006 could be partly explained by the introduction of the VAT that year; while the spike in 2008 reflected a sharp rise in global food and energy prices.

**Figure 10. Average annual inflation, 2000-2009 (per cent)**




*Source: CBBH. Main Economic Indicators.*

### 2.1.5 External sector

High levels of domestic demand, fuelled by a boom in bank lending and steady inflows of remittances from abroad resulted in persistently high external imbalances in the run up to the crisis – Table 3. BiH's strong demand for imports - driven by wage growth and domestic credit expansion – contributed to a growing trade deficit during the pre-crisis period. The mounting trade deficit was partially offset by increasing inflows of remittances from abroad (which mitigated around 50 per cent of the trade deficit on average). However, given the typical transitional macroeconomic framework of BiH (where remittances represents a major source of purchasing power of domestic citizens), an increase in remittances fuelled demand for imports. Consequently, the current account deficit remained high – averaging at 14 per cent per year – during the pre-crisis years (the highest among CE and SEE countries).

**Table 3. Key external indicators, EUR billion unless stated otherwise**

| Categories | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|---|
| C/A deficit | 0.8 | 1.3 | 1.4 | 1.3 | 1.5 | 0.8 | 1.0 | 1.8 | 0.8 |
| C/A deficit [in % of GDP] | 12.9 | 17.5 | 19.1 | 16.1 | 17.0 | 7.9 | 9.0 | 14.1 | 6.5 |
| Trade deficit - BoP data | 3.3 | 3.5 | 3.7 | 3.7 | 4.0 | 3.4 | 4.6 | 5.5 | 4.0 |
| Trade deficit [in % of GDP] | 51.0 | 49.3 | 48.8 | 45.0 | 45.0 | 34.2 | 40.6 | 42.7 | 32.0 |
| Export of goods (BoP data) | 1.3 | 1.2 | 1.3 | 1.7 | 2.1 | 2.7 | 1.4 | 1.7 | 1.6 |
| Import of goods (BoP data) | 4.6 | 4.7 | 5.0 | 5.4 | 6.0 | 6.1 | 6.0 | 7.2 | 5.6 |
| Capital account | 0.45 | 0.43 | 0.41 | 0.24 | 0.23 | 0.23 | 0.21 | 0.20 | 0.18 |
| Remittances | 1.63 | 1.50 | 1.46 | 1.60 | 1.64 | 1.78 | 1.99 | 1.96 | 1.71 |
| Remittances [in % of GDP] | 0.25 | 0.21 | 0.19 | 0.20 | 0.19 | 0.18 | 0.18 | 0.15 | 0.14 |
| Official FX reserves | 1.4 | 1.3 | 1.4 | 1.8 | 2.2 | 2.8 | 3.4 | 3.2 | 3.2 |
| Official FX reserves [in % of GDP] | 21.1 | 17.8 | 19.0 | 21.7 | 24.5 | 28.0 | 30.4 | 25.2 | 25.6 |

*Source: CBBH. Main Economic Indicators. Note: Current account data differ between sources (e.g. because of divergence between two GDP series – expenditure- and production-based), but broad picture remains identical to the one presented above.*

Despite the enormous current account deficit, the pre-crisis period was also characterised by the notable investment in all areas (FDI, portfolio and other investment), due to privatization and booming turnover on stock exchanges. Net FDI reached its peak in 2007 (BAM 2.6 billion) – Table 4. Given the positive developments in the capital and financial account, the overall balance of payment was positive in the pre-crisis period (as reflected in an increase in the reserves assets). However, the overall balance of payments picture in that period clearly shows BiH's vulnerability to external factors (remittances, import, FDIs etc).

**Table 4. Select Balance of Payment indicators, 2007 – 2009, million BAM**

| | 2007 | 2008 | 2009 |
|---|---|---|---|
| Exports of goods & services | 5,827 | 6,559 | 6,009 |
| Imports of goods & services | 12,444 | 14,842 | 11,895 |
| Trade balance | -6,618 | -8,283 | -5,886 |
| Current account balance | -2,047 | -3,513 | -1,590 |
| Net FDI | 2,560 | 1,315 | 344 |
| Net Portfolio investment | 4 | 29 | 274 |

*Source: CBBH. Balance of Payments*

### 2.1.6 Financial sector

The financial sector in BiH experienced profound changes in early 2000s. Banks' privatisation and regulatory reforms coupled with improved growth prospects attracted huge capital inflows[22]. Banks from Austria were particularly vigorous in entering the market and their market share rose from zero to around 40 per cent between 2000 and 2010[23].

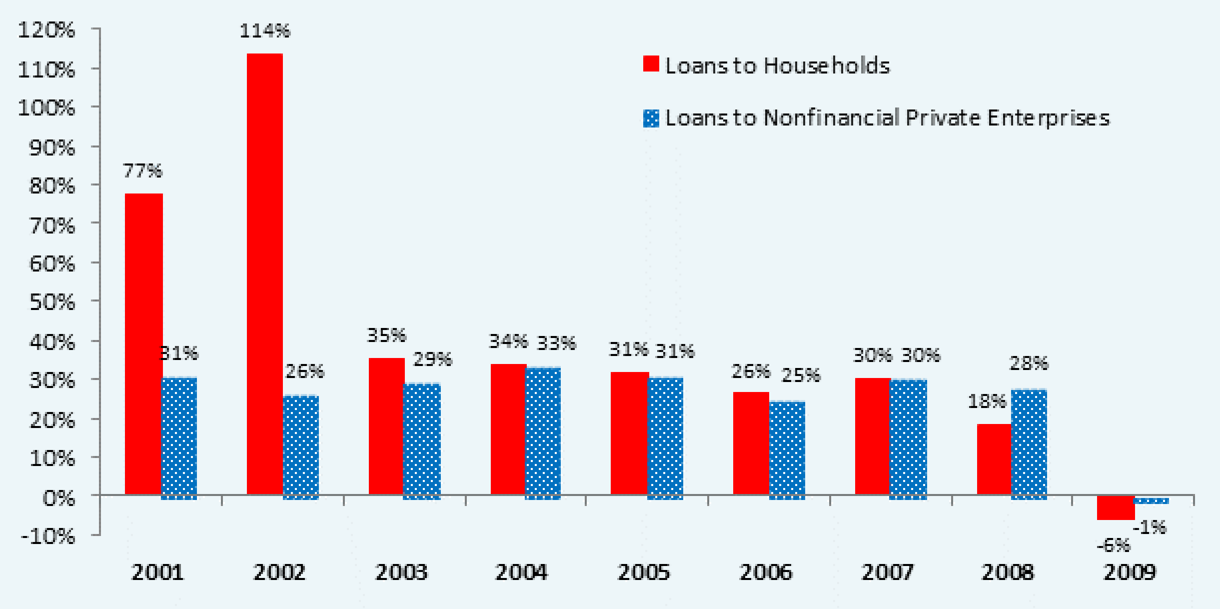
Private sector credit grew at an average rate of 35 per cent annually during 2001-2008, driven by increases in credit to households – Figure 11. The rapid credit growth was stimulated by the availability of the long-term borrowing provided by foreign-owned parent banks[24].

[22] IMF. (2009). Country Report. Available at: https://www.imf.org/external/country/BIH/index.htm?pn=4

[23] Causevic, F. (2012). Economic perspectives on Bosnia and Herzegovina in the period of global crisis. Oxford University. Available at: http://www.sant.ox.ac.uk/seesox/opinionpieces/Causevic-Economicperspectives.pdf.

[24] IMF. (2008). Country Report. Available at: https://www.imf.org/external/country/BIH/index.htm?pn=4

**Figure 11. Growth in lending to households and enterprises, 2001-2009 (yoy, per cent)**

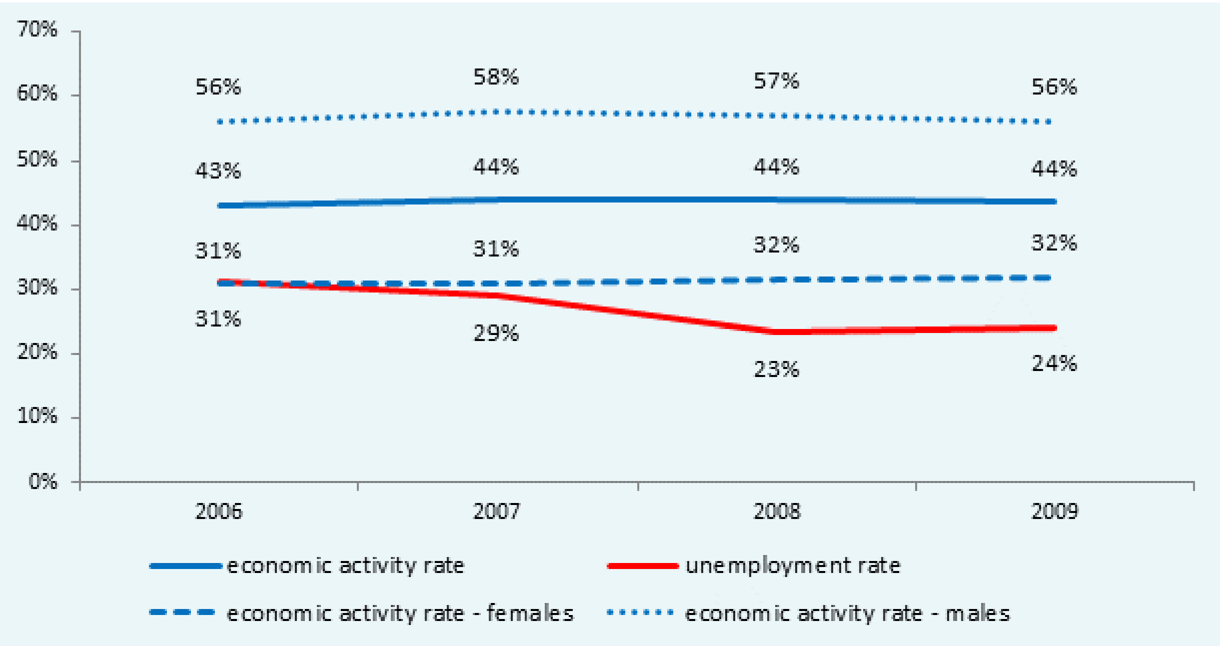



*Source: CBBH. Structure of Loans by Sector in Commercial Banks of BiH*

### 2.1.7 Labour market situation

The labour market situation has remained difficult, becoming one of the most pressing social issues in BiH. Labour market participation was among the lowest in Europe – around 44 per cent between 2006 and 2008, compared to approximately 60 per cent in the region and the EU average of more than 70 per cent[25]. This was particularly driven by exceptionally low female labour force participation (due to cultural factors). Moreover, despite some improvement the BiH unemployment rate (in the range of 23 to 31 per cent up until the crisis – Figure 12), remained among the highest in the region.

**Figure 12. Selected labour market indicators in BiH, 2006- 2010 (per cent)**




[25] Labour Force Survey data; Eurostat, [lfsi_act_a]. See also EBRD. (2014), Strategy for Bosnia and Herzegovina. Available at: http://www.ebrd.com/downloads/country/strategy/bosnia2014.pdf

### 2.1.8 Pre-crisis vulnerabilities

As described above, BiH was not particularly well positioned to weather the impact of the global financial and economic crisis. The key underlying vulnerabilities and structural weaknesses are summarised below:

**Weak public finances**: Although the public debt was still relatively low (31 per cent of GDP in 2008), it was on a clear upward trend. Expansionary, pro-cyclical fiscal policies of 2007-2008 left little fiscal space for cushioning the adverse shock of the global crisis when it hit BiH. The structure of expenditures was not favourable for growth prospects with large public sector wage bill and substantial social transfers.

**Large public sector**: Public sector spending stood at 46 per cent of GDP in 2008, while employment in the public sector exceeded 11 per cent of the total employment in the economy. As a result, the already large discrepancy between average wages in the public sector and the private sector increased sharply in 2007 and 2008, just before the onset of the crisis. This exerted pressure on wage-setting in the private sector and (in addition to the fixed exchange rate) further limited the scope for a flexible response to the crises in terms of adjusting the external prices.

**Unsustainable external imbalances:** Current account deficit had remained at very high level since early 2000s, reaching around 14 per cent of GDP in 2008. This was driven by private credit expansion, loose fiscal and income policies and low competitiveness – trade deficit reached BAM 8.2 billion (EUR 4.1 billion or close to 44 per cent of GDP in 2008).

**Complex socio-political situation**: There are deep factional divisions along ethnic lines in BiH. In addition to this, BiH has a highly complex political and institutional structure where lack of consensus can relatively easily lead to political and institutional paralysis. Both of these factors remained underlying risk factors.

**Difficult environment for private sector development**: As of 2008, the World Bank ranked BiH 105th out of 178 countries on "ease of doing business". Among several indicators taken into account, starting the business in BiH was assessed as particularly challenging[26].

**Difficult situation in the labour market**: Economic activity rates in 2008 were very low (44 per cent), particularly among women (32 per cent). Unemployment rates for the same period, despite some improvement in previous years, stood at 23 per cent. Youth unemployment was particularly high (48 per cent as of 2008)[27]. The difficult labour market situation was stimulating the growth of already large informal economy[28].

**High dependence of national financial sector on foreign capital:** Although BiH was quite well capitalised during the pre-crisis period, banks operating in the country were dependent on foreign parent banks to a considerable extent. Reduction of exposure to BiH by foreign banks in the event of the crisis could potentially lead to liquidity and in the extreme case, solvency problems for some banks operating in the country.

[26] The World Bank. (2008). Doing Business 2008. Available at: http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB08-FullReport.pdf

[27] The World Bank. (2014). Unemployment, youth total. Available at: http://data.worldbank.org/indicator/SL.UEM.1524.ZS?page=1

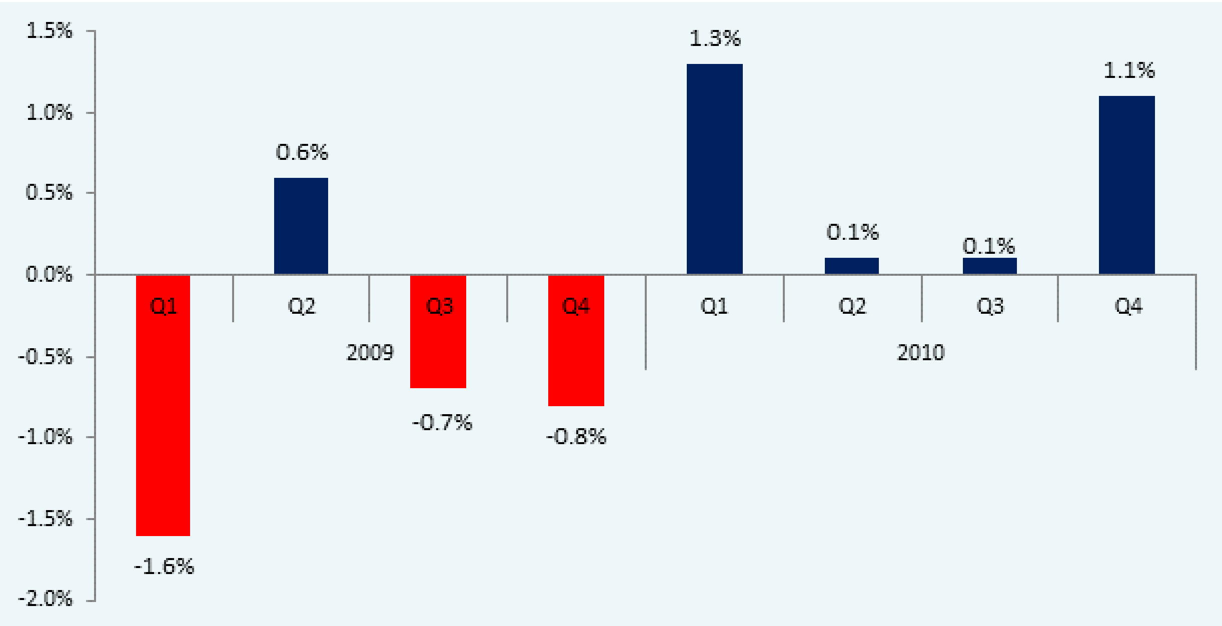
[28] ILO. (2011). Employment diagnosis analysis: Bosnia and Herzegovina. Available at: http://www.ilo.org/wcmsp5/groups/public/@ed_emp/documents/publication/wcms_158485.pdf

**High reliance of remittances:** With money transfers from relatives reaching EUR 1.3 billion in 2008[29], severe worsening of economic environment abroad could have had a significant impact on domestic demand.

### 2.1.9 The immediate impact of the crisis

The BiH economy had possibly entered into a recession in 2008 (quarterly GDP data are not reliable for that year[30]) and certainly from the beginning of 2009. The recession continued during the entire 2009 with the exception of the second quarter (Figure 13). Rapidly worsening macroeconomic environment in Europe triggered a sharp decrease in demand for BiH exports. Exports of goods[31] and services dropped by 18 per cent between 2008 and 2009. At the same time, the weakening internal demand translated into a substantial decrease of imports (which declined by around 25 per cent) – see Table 4 on page 18. This resulted, *inter alia*, in an adjustment in the trade balance and a reduction of the current account deficit from 14 per cent of GDP in 2008 to around 7 per cent of GDP in 2009 (Table 3 on page 18). Inflow of remittances – a very important factor fuelling the growth during the pre-crisis period – shrank by 17 per cent from EUR 1.28 billion to EUR 1.06 billion according to the estimation of the Central Bank of BiH[32].

**Figure 13. Quarterly GDP dynamics in BiH, 2009-2010 (per cent quarter on quarter, seasonally adjusted data)**




*Source: Agency for Statistics of Bosnia and Herzegovina, GDP quarterly data – preliminary data. First release, 24.7.2014.Note: The recent publications of the Agency for Statistics of BiH provide quarterly GDP data since 1Q 2008. However, reported quarterly growth dynamics during 2008 do not seem to be consistent with annual growth figures and hence are not reported here. Updated quarterly data published on 07.01.2015 also do not look reliable for the same reasons and hence not reported here*

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[29] Oruc. N. (2013). Social Transfers and Remittances in Bosnia-Herzegovina: Exploring Dynamics of the 'Crowding Out' Effect. Available at: http://www.gdn.int/admin/uploads/editor/files/2013Conf_Papers/NerminOruc_Paper.pdf

[30] The recent publications of the Agency for Statistics of BiH provide quarterly GDP data since 1Q 2008. However, reported quarterly growth dynamics (based on seasonally adjusted data) during 2008 does not seem to be consistent with annual growth figure for that year.

[31] Mainly aluminium, metals and steel products

[32] Oruc, N. (2013). Social Transfers and Remittances in Bosnia-Herzegovina: Exploring Dynamics of the 'Crowding Out' Effect. Available at: http://www.gdn.int/admin/uploads/editor/files/2013Conf_Papers/NerminOruc_Paper.pdf

Fiscal pressure increased considerably as a result of the recession. Public debt rose from 31 per cent of GDP in 2008 to 35 per cent in 2009 (Figure 9), while the government deficit started deteriorating in 2008 and widened to 4.4 per cent of GDP in 2009 (Figure 6). FBiH found itself under much stronger fiscal pressure than RS. Declines in output and the associated drop in tax revenues exacerbated fiscal outcomes and led to a full-blown fiscal crisis in FBiH. RS had a lower deficit than the FBiH and was able to finance it from privatisation revenues. The FBiH, on the other hand, had to turn to commercial banks in February 2009 for an emergency line of credit to cover the financing gap in the 2008 budget. The drop in indirect taxes, the main source of public revenues, started in the last quarter of 2008 and continued into 2009 (averaging -14.5 per cent during the first six months)[33]

Despite an initial scare (Box 2), the financial sector however, remained sound and well-capitalised and its liquidity position was not seriously undermined by the crisis. The largely foreign owned national banking sector could rely on capital supply from parent companies. Nonetheless, the crisis highlighted shortcomings of the national financial supervisory system with insufficient coordination between Entities.

**Box 2 Immediate Impact of the crisis on BiH's financial sector**

Tensions on the global financial markets spilled over to the country and resulted in a "mini bank-run" in October 2008 when some EUR 420 million of deposits (12 per cent of the stock of deposits) were withdrawn. Foreign parent banks injected liquidity to their local subsidiaries and the Central Bank of BiH reacted firmly and adequately by inter alia gradually reducing the minimum reserve requirements for banks so that the situation stabilised quickly. The value of guaranteed bank deposits was more than doubled in a first step to around EUR 10,200 in early 2009 and further increased to EUR 25,500 in 2010 with support from the EBRD[34].

*Source: SEC(2009) 1459*

## 2.2 Policy response

The immediate response of the authorities was largely focused on safeguarding the stability of the financial system and consisted of the following measures[35]:

- A relaxation of the required level of banks reserves (from 18 to 14 per cent) in October 2008;
- The threshold for bank deposit guarantees was increased twice.
- In June 2009, after a series of meetings in Vienna and Sarajevo, nine foreign-owned banks operating in BiH and holding 85 per cent of the banking sector assets committed to maintain their exposure to the country to ensure that subsidiaries were sufficiently capitalised.

Moreover, in response to revenue shortfalls the Entity central governments and cantons started to exercise restraint in spending. However, recognising the limits to the efforts that could be made with internal capacities, BiH authorities turned to the IMF, the World Bank and also to the EU in 2009 for international assistance.

## 2.3 IMF programmes

### 2.3.1 The 2009 IMF Stand-By Arrangement

The negotiations with the IMF led to a staff level agreement on the new programme in early May 2009. In June 2009, the IMF approved the three year Stand-By Arrangement (SBA) for BiH '*to mitigate the effect of the global financial crisis*'. The planned financial assistance was SDR 1.01 billion (EUR 1.15 billion) with SDR 182.6 million (approximately

[33] World Bank (2010) *op cit*

[34] EBRD. (2010). B&H Deposit Insurance. Press Office. Available at: http://www.ebrd.com/pages/news/press/2010/100127.shtml

[35] IMF. (2010). Country Report. Available at: https://www.imf.org/external/country/BIH/index.htm?pn=3

EUR 195 million) to be available immediately[36]. The programme had the following objectives[37]:

- Reduce the structural fiscal balance to limit the government's financing needs and bring public finances on a sustainable medium-term path;
- Re-establish public wage restraint; reform the system of transfers and improving public finance management; increase capital spending and strengthen the social safety net to protect the most vulnerable;
- Support adequate liquidity and capitalisation of banks; and
- Secure sufficient external financing and improve confidence.

The programme was monitored through quantitative performance criteria and structural benchmarks during quarterly reviews. Its initial signature was conditioned on five so-called 'prior actions', measures that needed to be implemented before the IMF SBA was approved (Table 5)[38].

**Table 5. 'Prior actions' of the 2009 IMF programme – conditions to be fulfilled before the programme approval**

| Prior Action | Rationale |
|---|---|
| Adoption of the rebalanced budgets by Entity governments and submit to Parliament | Fiscal adjustment necessary for reestablishment of macroeconomic stability |
| Adoption of amendments to the wage bill legislation by the Council of Ministers | Fiscal adjustment necessary for reestablishment of macroeconomic stability and ongoing viability of the currency board |
| Adoption of the Intervention law in the Federation | Enabling of the Federation government to initiate necessary reforms in the near horizon |
| Adoption of a new Excises Law | Tax harmonisation with EU that will also allow to compensate for some of the revenue loss from phase-out of trade taxes |
| Adoption of the Global Framework by the Fiscal Council | Fiscal policy coordination; reinforce the importance of adherence to established timeline for budget and medium-term budget framework elaboration |

*Source: IMF (2009). Country Report 09/226.*

Table 6 outlines the reforms/ structural benchmarks as defined in the initial agreement and after the first SBA review as well as their rationale. As summarised by the IMF report from December 2010: '*Progress was made on the program's structural reform benchmarks, albeit with delays*'. There were delays in the implementation of some reforms, namely preparation of a Strategy for Pension Reform (at the FBiH level), adoption of wage legislation consistent with fiscal policy objectives (at the FBiH level) or eligibility audits for civil and war benefits recipients (at the FBiH and RS level). The progress in the implementation of the programme was also monitored by a range of quantitative performance criteria[39]. Between March and October 2010, three reviews of the IMF SBA were completed leading to disbursement of two loan tranches in March and October 2010 (following the initial disbursement in mid-2009). The parliamentary deadlock following the October 2010 general elections and the lack of progress in implementation of reforms de-facto terminated the 2009 programme with no further reviews taking place.

[36] IMF. (2009). Press release: IMF Executive Board Approves US$ 1.57 billion Stand-By Agreement for B&H. Available at: http://www.imf.org/external/np/sec/pr/2009/pr09258.htm

[37] Ibidem.

[38] IMF. (2009). Country Report. Available at: https://www.imf.org/external/country/BIH/index.htm?pn=4

[39] List with the specific quantitative criteria can be consulted here: http://www.imf.org/external/np/loi/2010/bih/030510.pdf

**Table 6. Structural reform benchmarks attached to the 2009-2012 programme**

| Reform | Defined in Initial agreement | Defined in the first review | Rationale |
|---|---|---|---|
| Continued adherence of the Currency Board Arrangement as constituted under the law (continuous) | ✓ | ✓ | Anchor for macroeconomic policy; Contribute to economic and political stability |
| Publish on the State government's web site quarterly consolidated general government accounts with a 5 week lag (continuous). | ✓ | ✓ | Enhance fiscal transparency and program ownership |
| Agree on an action plan acceptable to the World Bank and IMF staffs to reform the system of rights-based transfers in the Federation (end of August 2009) | ✓ | | Ensure fiscal sustainability and improve the composition of public spending |
| Submit to the Federation Parliament a Law forbidding passing of unfunded legislation (end of November 2009) | ✓ | | Ensure fiscal discipline |
| 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) (continuous) | | ✓ | Reduce recurrent spending through better targeting of transfer programs |
| Adopt by Parliament wage legislation consistent with the 2010 fiscal policy objectives (Federation) (end of March 2010) | | ✓ | Harmonization of remuneration policies across levels of government with the view of containing the public wage bill |
| Reform privileged pensions by Entity governments (Federation, RS) (end of March 2010). | | ✓ | Steps toward containing the cost to central governments of financing the pension systems |
| Prepare a strategy for pension reform by Entity governments (Federation, RS) (end of March 2010) | | ✓ | As above |
| The Deposit Insurance Agency to impose a principle of universal membership requirements, including for partially State-owned banks (end of February 2010) | ✓ | | Strengthen banking system stability |
| Form a standing committee of financial stability and sign the MoU on financial stability, crisis preparedness and crisis management (end of November 2009) | ✓ | | Strengthen financial sector supervision and improve policy coordination |
| Approval of the rebalanced budgets by the Entity Parliaments (by the end of August 2009) | ✓ | | |

_Source: IMF. (2009 and 2010). Country Report 09/226 and Letter of Intent and Technical Memorandum of Understanding, March 05, 2010_

### 2.3.2 The 2012 IMF Stand-By Arrangement

Higher chances for political normalisation and improvement in socio-economic environment triggered the activation of a second IMF SBA in September 2012.

More specifically, shortly after receiving parliamentary approval in February 2012, the government requested for new IMF assistance. A staff-level agreement was reached in July 2012 and the IMF's Executive Board approved a new two-year SBA on 26 September 2012 with total available financing of around SDR 338.2 million (approximately EUR 398 million)[40]. As with the previous SBA, the programme was accompanied by prior actions that had to be met before approval by the IMF's Board (Table 7).

**Table 7. 'Prior actions' of the 2012 IMF programme – conditions to be fulfilled before programme approval**

| Prior Action | Rationale |
|---|---|
| Adoption by the FBiH Parliament of a revised 2012 Federation budget, incorporating agreed measures | Fiscal sustainability |
| Adoption by the RS Parliament of a revised 2012 RS budget, incorporating agreed measure | Fiscal sustainability |
| Repeal of the amendments to the Federation Banking Agency law, Articles 15 and 27, that were adopted in 2012 | Fiscal sustainability |
| Adoption of a decision on the settlement of any disputed indirect tax amounts through end-2011 | Fiscal sustainability |

*Source: IMF. (2012). Country Reports from October and December 2012*

The objectives of the new programme were as follows:

- Improving national policy coordination, which is important in a country with many government levels, like BiH;
- Maintaining fiscal discipline while advancing structural fiscal reforms: helping BiH reduce the size of current expenditure and allow more space for capital spending as well as increase in efficiency of social spending;
- Safeguarding financial stability within the context of the currency board; further improvement of the crisis preparedness, banking supervision, and resolution frameworks;
- Intensification of reforms to improve the business environment to support growth, investment, and job creation.

Table 8 presents the structural conditions defined in the initial agreement and after first SBA review.

[40] IMF. (2012). IMF Reaches Staff-Level Agreement with Bosnia and Herzegovina on a Stand-By Agreement. Available at: http://www.imf.org/external/np/sec/pr/2012/pr12267.htm

### Table 8. Structural performance criteria attached to the 2012 IMF programme

| Reform | Defined in Initial agreement | Defined in the First review | Rationale |
|---|---|---|---|
| Continue to adhere to the Currency Board Arrangement as constituted under the law (continuous) | ✓ | ✓ | Anchor for macroeconomic policy; contributing to economic and political stability |
| Refrain from introducing new privileged or special rights for retirement (continuous) | ✓ | ✓ | Reducing recurrent spending through better targeting of transfer programs |
| Publish on the web site of institutions of BiH quarterly consolidated general government accounts with a 6 week lag (quarterly). | ✓ | | Fiscal transparency |
| Carry out eligibility audits for war benefit recipients; publish results (quarterly within 4 weeks after the end of each quarter) of audits (Entities) (quarterly) | ✓ | | Reducing recurrent spending through better targeting of transfer programs |
| 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) | ✓ | ✓ | Arrear clearance |
| Amend the law on financing of Institutions of BiH to allow for continued servicing of foreign debt in the absence of an adopted Budget (end December 2012) | ✓ | ✓ | Contributing to economic and political stability as well as to investor confidence |
| Amend the banking law in FBiH to limit provisional administration to one year with a possible six month extension (end December 2012) | ✓ | ✓ | Strengthening bank supervision as well as the bank resolution framework |
| Amend the banking law in the RS to limit provisional administration to one year with a possible six month extension (end December 2012) | ✓ | ✓ | Strengthening bank supervision as well as the bank resolution framework |
| Amend the legal frameworks related to the treatment of confidential information to align them with EU requirements (end December 2012) | ✓ | ✓ | Improving information sharing and policy coordination |
| Submit to the BiH Parliament a revised law governing the Deposit Insurance Agency along the lines specified in 28 of the Letter of Intent of 11 Sep 2012 (end March 2013) | ✓ | ✓ | Improving crisis preparedness and contingency planning |
| Sign a Memorandum of Understanding by the Ministry of Finance and Treasury of BiH, the Ministry of Finance of the FBiH , 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 20120) | | ✓ | Safeguarding Fund Resource |
| Adopt a new law on privileged pensions in the FBiH in line with IMF staff recommendations (end January 2013) | | ✓ | Reducing recurrent spending through better targeting of transfer program |
| Adopt a new law on budget in the FBiH that improves data reporting and enhancing control over lower level governments, extra-budgetary funds, and public companies (end March 2013) | | ✓ | Fiscal sustainability |
| Sign a joint Memorandum of Understanding between the Entities' tax administrations and the ITA on data exchange to further improve the exchange of information (end May 2013) | | ✓ | Reducing tax evasion and enhancing policy cooperation |

| Reform | Defined in Initial agreement | Defined in the First review | Rationale |
|---|---|---|---|
| Establish a one-stop shop process for business registration in RS (end September 2013) | | ✓ | Improving business environment |
| Amend legislation in the RS to eliminate the take-home pay protection for public sector employees (end December 2013) | | ✓ | Controlling the public sector wage bill in the medium term |

*Source: IMF. (2012). Country Reports from October and December 2012*

In general, the second programme remains on track at the time of writing this Report, despite some delays. The fifth review was completed in January 2014 and apart from approving the SDR 42 million (approximately EUR 48 million) disbursement, it also extended the programme to the end of June 2015 and augmented available funds by additional SDR 135.28 million (approximately EUR 153 million). Completion of the sixth and seventh review, originally scheduled for February 2014, was delayed until June 2014 when the IMF programme was further augmented by SDR 84.55 million (approximately EUR 96 million) to meet the BiH's financing needs arising from severe flooding that affected large parts of the country in May 2014[41]. The most recent IMF visit in December 2014 highlighted the need for continuous effort to contain the government's current expenditures, improve tax compliance/ fight tax fraud and strengthen financial sector stability. At the same time, the IMF observed that '*the economic recovery appeared to be more resilient than initially thought to the impact of natural disaster'.* The eight review of the SBA is expected to take place in January 2015[42].

## 2.4 EU Macro Financial Assistance

On 22 May 2009, the State Minister of Finance of BiH requested an MFA of EUR 100 million[43]. With the IMF programme in place, the formal conditions were met for the EU to provide the MFA. Following the European Commission's proposal dated October 2009, the Council took a decision on 30 November 2009 to provide MFA to BiH (2009/891/EC). The assistance, up to EUR 100 million was to be provided in the form of a loan in order to: '…*support BiH's economic stabilisation and alleviate its balance of payments and budgetary needs*'.

**Box 2 Objectives of the 2009 MFA operation in BiH**

- To contribute to covering BiH's external financing needs;
- To alleviate budgetary financing needs;
- To support the fiscal consolidation effort in the context of an IMF programme;
- In this respect, help BiH reduce the financial constraints on the implementation of its comprehensive socio-economic reform programme;
- To facilitate and encourage efforts of the authorities of BiH to implement measures identified under the European Partnership;
- To reinforce the EU's role in the economic policy dialogue with the authorities of BiH on the programme of reforms.

*Source: SEC(2009) 1459*

The choice of loan instead of a loan/grant combination was based on a number of considerations including BiH's income status (classified by the World Bank as an upper middle income country) and its moderate level of indebtedness.[44].

During 2010, the pre-election environment in BiH complicated discussions on the Memorandum of Understanding (MoU). The main stumbling blocks for the signing of the MoU were the distribution of funds available from the MFA between the different levels of

[41] IMF. (2014). IMF Press release No. 14/320. Available at: http://www.imf.org/external/np/sec/pr/2014/pr14320.htm

[42] IMF, (2014), IMF Press release No. 14/569. Available at: http://www.imf.org/external/np/sec/pr/2014/pr14569.htm

[43] ECFIN/D/1/Ares(2010)439787 – Note for the Economic and Financial Committee regarding Macro-Financial Assistance to Bosnia and Herzegovina, 19.07.2010.

[44] SEC. (2009). 1459 - Ex-ante evaluation statement – Macro-Financial Assistance to Bosnia and Herzegovina. Available at: http://www.ipex.eu/IPEXL-WEB/dossier/document.do?code=SEC&year=2009&number=1459&extension=FIN

government and one of the technical conditions related to the cooperation of the Statistical Institutes at State and Entity level[45].

The MoU that was finally signed in November 2010, after the State and the Entities agreed amongst themselves on all policy conditions negotiated with the Commission. The MoU stipulated that the MFA would be disbursed in two tranches and that the proceeds may be transferred to the State and Entity budgets according to the following distribution key:

- 10 per cent to the State,
- 60 per cent to the FBiH, and
- 30 per cent to RS.

Following the general elections of October 2010, the Loan Agreement was signed in November 2010. However, partly because of the lengthy period taken for government formation (16 months) after the October 2010 general elections, the Loan Agreement was only ratified by the Bosnian Presidency in August 2011.

The MoU contained two policy reform conditions linked to the disbursement of the first loan tranche (apart from satisfactory implementation of the IMF SBA) and eight conditions for the second loan instalment. The specific conditions are presented in the next section.

Despite the ratification of the Loan Agreement in mid-2011, no MFA disbursements were made for the remainder of the year given that the political stalemate after the October 2010 general elections had *de facto* derailed the IMF Programme. Moreover, one of the two policy conditions attached to the disbursement of the first MFA tranche – the approval of the *Global Framework of Fiscal Policies* by the Fiscal Council of BiH – was not met during 2011 (see Box 3). This was an important condition given the role of the Framework as a key instrument for medium-term budgetary planning and an indispensable element of the annual budgetary process. This was of particular relevance in BiH given the federal structure of the country.

### Box 3 Coordination of fiscal policy in BiH

Establishing an effective mechanism for coordinating fiscal policy is critical in a country like BiH, which is extraordinarily decentralised for its size. Its many governments (14) and off-budget units (43) have a large degree of autonomy over expenditure planning, but their willingness to adopt budgets to support overall macroeconomic stability is undermined when others fail to do likewise. If left unchecked, the aggregate outcome could be excessive expenditure levels and macroeconomic instability.

A durable and effective fiscal coordination mechanism is therefore needed to balance the objectives of individual administrative units against the broader ones of the country as a whole. Fiscal coordination is even more important in the case of BiH, with a currency board which offers no scope for independent monetary policy. Consequently fiscal policy is the only instrument left to manage aggregate demand.

After years of delay, the Fiscal Council (FC) was finally established in 2008. The FC is made up of three prime ministers and three ministers of finance and two non-voting members (the governor of the Central Bank and representative of Brcko District). The main responsibility of the FC, although not the only one, is to adopt the so-called Global Framework of Fiscal Balance and Policies (Fiscal Framework). This document is a key input for 3-year Framework Budget Documents of each of the State and Entity governments which in turn forms the basis for adoption of their respective annual budgets. .

The FC has no enforcement mechanisms and depends on the good will of the Entities and the State level for its work. In reality, optimal functioning of the FC is often impeded by political differences. For example, the FC did not adopt the Global Fiscal Framework for 2011-2013 (due

[45] COMMISSION STAFF WORKING PAPER Background analysis per beneficiary, /* SEC/2011/0873 final */. The presentation in this subsection follows the publicly available sources, especially annual Reports from the Commission to the Council and to the European Parliament on the implementation of macro-financial assistance (MFA) and associated working documents.

in May 2010) as well as one for 2012-2014 (due in May 2011). Consequently, the State-level institutions operated without a budget for 2011 and on basis of Decisions on Temporary Financing that can fund operations on the same level as appropriated in the 2010 Budget. The Entities adopted their own budgets for 2011 and 2012 outside the coordinating mechanism of BiH Fiscal Council which was a direct contradiction of the law (Article 12 of the Law on Fiscal Council in BiH requires that in absence of agreement on the Global Fiscal Framework, BiH Council of Ministers, FBiH government and RS government undertake to pass Decisions on Temporary Financing until agreement is reached. Under this scenario, governments can fund operations on the same level as appropriated in the last adopted budget.)

The situation stayed broadly unchanged in early 2012 as the MFA condition was still not met. The availability of the MFA was to expire on 7 November 2012. However, in view of the BiH authorities' steps towards improving public finance sustainability, the adoption of a new SBA by the IMF Board on 26 September 2012 and the difficult budget and balance of payments situation of the country, the European Commission adopted on 29 October 2012 a Decision (2012/674/EU) to extend the availability period of the EU MFA to BiH by an additional year, until 7 November 2013. As a consequence, the MoU was extended until 7 November 2013 by an addendum signed by the BiH's authorities and the European Commission on 21 November 2012. Also in November 2012, the European Commission received a compliance report on the fulfilment of the structural reform criteria related to the first instalment and in January 2013, a request for funds. Consequently, the disbursement of the first EUR 50 million tranche took place in February 2013 and the second tranche was disbursed at the end of September 2013, following satisfactory compliance with the attached policy conditions.

## 2.5 Other EU Assistance to BiH during 2009 – 2013

EU assistance to BiH since 2009 has to be viewed in the context of its long term engagement with the country. The EU has been an active player in the country's reconstruction since the Dayton/Paris Peace Agreement was signed in 1995[46]. Institutionalised contacts between the EU and BiH started in June 1998. At the EU's initiative, the Stability Pact for South Eastern Europe (BiH, other Western Balkan countries, other countries of the region, the EU and several other countries, international financial institutions and regional initiatives) was adopted on 10 June 1999 in Cologne. As its main contribution to the Stability Pact, the EU launched the Stabilisation and Association Process (SAP) for the countries of the Western Balkans in 1999. It established a strategic framework for their relations with the EU, combining a new contractual relationship (Stabilisation and Association Agreement) (SAAs) and an assistance programme (CARDS). The purpose of SAP was to establish special relations "*between the countries concerned and the Union in exchange for reforms with a view to accession, which will involve aligning their legislation more closely with that of the Community*[47]".

Later, the Thessaloniki Summit held in June 2003 confirmed the EU perspective for BiH. It introduced new instruments to the SAP aiming to enforce the support of the reform process in the Western Balkan countries and to approach them to the European Union[48]. The Council also adopted Regulation 2666/2000, on Community Assistance for Reconstruction, Development and Stabilisation (CARDS). This was a technical assistance program designed for the SAP countries that covered several sectors: justice and home

[46] European Parliament. (2004). Title V TEU, articles 133 and 310. Available at: http://www.europarl.europa.eu/facts_2004/6_3_3_en.htm

[47] European Parliament. (2004). Title V TEU, articles 133 and 310. Available at: http://www.europarl.europa.eu/facts_2004/6_3_3_en.htm

[48] European Commission. (2009). EU delegation. Available at: http://eeas.europa.eu/delegations/kosovo/eu_kosovo/political_relations/stabilisation_and_assocation_process/index_en.htm

affairs, economic and social development, administrative capacity building, environment, customs, transport and energy[49].

Some of the key developments since then are summarised below:

### Table 9. Timeline of the key developments in EU's relations with BiH

| Date | Development |
|---|---|
| 2004 | First European Partnership for BiH |
| November 2005 | Stabilisation and Association Agreement (SAA) negotiations officially opened in Sarajevo |
| September 2007 | Visa facilitation and readmission agreements with the European Community signed |
| February 2008 | BiH signs the IPA Framework Agreement |
| June 2008 | Stabilization and Association Agreement and Interim Agreement on trade and trade-related issues signed[50] |
| July 2008 | Interim Agreement on trade and trade-related issues enters into force |
| December 2010 | Visa free regime for Schengen area introduced for all BiH citizens having a biometric passport |
| June 2012 | The EU and BiH launched the High Level Dialogue on the Accession Process |

Since 2007, most of EU assistance to BiH has been channelled through the Instrument for Pre-accession Assistance (IPA). This is the EU instrument to support reforms in 'enlargement countries' with financial and technical assistance. The IPA funds build up the capacities of the countries throughout the accession process, resulting in progressive, positive developments in the region.

Of the total IPA funding stream of around EUR 11.5 billion over the period 2007-13, EUR 665 million was allocated to BiH, with the bulk of it dedicated to transition assistance and institution building[51]. This EU assistance is managed by the EU Delegation in BiH. It *"aims to provide assistance primarily in the following sectors: Public Administration Reform, Justice and Home Affairs, Private Sector Development, Transport, Environment and Climate Change, and Social Development"*[52]. The total financial allocation for the period 2007-2012 was EUR 546.7 million. Figure 14 shows details of the distribution of assistance per sector.

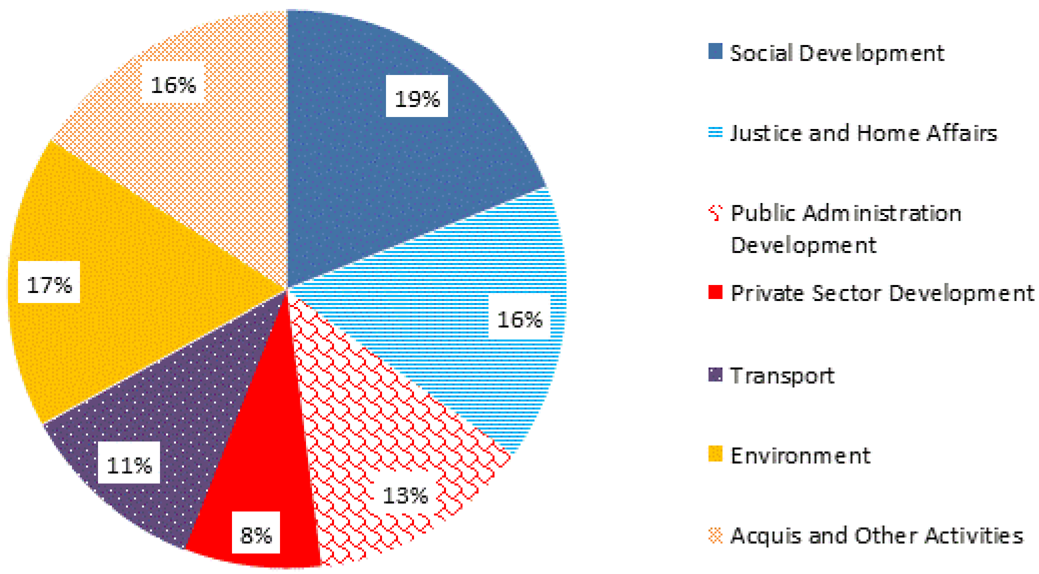
[49]European Commission. (2004). Evaluation of the implementation of Regulation 2666/2000 (CARDS) –EC support to the Western Balkans- ref.951651. Available at: http://ec.europa.eu/europeaid/how/evaluation/evaluation_reports/evinfo/2004/951651_ev_en.pdf

[50] While the SAA was signed in 2008 and has been ratified, it has not yet entered into force.

[51] European Commission. (2012). Instrument for Pre-Accession Assistance (IPA) Revised Multi-Annual Indicative Financial Framework for 2013, 581 final. Available at: http://ec.europa.eu/enlargement/pdf/key_documents/2012/package/miff_adopted10-10-12_en.pdf

[52] European Commission. (2011). Adopting a National Programme for Bosnia and Herzegovina under the IPA – Transition Assistance and Institution Building Component for the year 2011. Available at: http://ec.europa.eu/enlargement/pdf/bosnia_and_herzegovina/ipa/2011/comm_pdf_c_2011_9104_f_en_decision_execution_commision.pdf

**Figure 14. IPA assistance per sector 2007-2012, in per cent**




*Source: Schroeder, H. (2013). Instrument for Pre - Accession Assistance (IPA) to Bosnia and Herzegovina, presentation, Sarajevo.*

In October 2013, the European Commission launched procedures for reducing the initial IPA 2013 programme for BiH by 54 per cent and to postpone discussions on IPA II until the country got back on track in the EU integration process (Table 10). At the EU Council meeting on 17 December 2013 it was noted that it was the inability of the leaders of BiH to meet EU requirements that led to "a loss in IPA funds for 2013" and to "postponement of further discussions on IPA II". "Serious concern that the EU integration process has stalled due to a lack of political will on the part of the BiH political leadership"[53] were raised at the meeting.

**Table 10. IPA financial allocation for BiH, 2007-2014, EUR million**

| 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 planned | 2013 actual |
|---|---|---|---|---|---|---|---|
| 62.1 | 74.8 | 89.1 | 105.4 | 107.4 | 107.9 | *108.8* | 47.3 |

*Source: Schroeder, H. (2013). Instrument for Pre - Accession Assistance (IPA) to Bosnia and Herzegovina, presentation, Sarajevo. Available at: http://europa.ba/documents/delegacijaEU_2013121012030960eng.pdf and European Commission. (2014). Enlargement. Bosnia and Herzegovina –financial assistance. Available at: http://ec.europa.eu/enlargement/instruments/funding-by-country/bosnia-herzegovina/index_en.htm*

The finalisation of the agreement on IPA II assistance for the period 2014-2020 was conditioned on establishing an effective EU coordination mechanism and adoption of country-wide strategies, in particular in relation to investment needs[54].

Apart from assistance from the EU institutions, BiH has received substantial bilateral assistance from several EU Member States in the past decade. The main bilateral EU donors during 2001-2008 were Spain, Germany, Sweden, and Austria providing aid in the region of EUR 30-40 million annually[55]. Following the devastating floods in May 2014

[53] EBRD. (2014), Strategy for Bosnia and Herzegovina. Available at: http://www.ebrd.com/downloads/country/strategy/bosnia2014.pdf

[54] Schroeder, H. (2013). Instrument for Pre - Accession Assistance (IPA) to Bosnia and Herzegovina, presentation, Sarajevo. Available at: http://europa.ba/documents/delegacijaEU_2013121012030960eng.pdf.

[55] Calculations based on World Development Indicators.

a donor conference was held following the initiative of the European Commission, France and Slovenia. Pledges of assistance for BiH exceeded EUR 800 million from various countries and institutions[56].

## 2.6 The World Bank Development Policy Loan

In 2010, the Bosnian authorities also negotiated a programmatic series of three Development Policy Loans (DPLs)[57], referred to as the "Public Expenditure Crisis Development Policy" (PEDP) loans/credits. The first PEDP (PEDP-1) was for an amount of USD 111 million (approximately EUR 80 million), and it was made up of a USD 66 million International Development Association (IDA) credit and a loan of US$45 million from the International Bank for Reconstruction and Development (IBRD). The loan/credit was allocated on a 60/40 basis to FBiH and RS, respectively.

The PEDP consisted of three pillars.

(i) **Pillar I. Reform of Social and Unemployment Benefits:** The reforms focused on improving the targeting and means testing of social programmes by shifting away from a "rights-based" to a "targeted" social safety net system, as well as on achieving more effective and efficient administration of social benefits.

(ii) **Pillar II. Reform of Public Sector Pay and Wage Bill Management:** The reforms aimed to lower the burden of the budget on the economy by lowering public sector wage expenditures to a level closer in line with the EU average (as a per cent of GDP). The reforms were also aimed at creating a more transparent and internally equitable performance-based public sector pay system.

(iii) **Pillar III. Social Contribution and Indirect Tax Measures in Support of Competitiveness:** The reforms aimed at lowering the tax wedge and thereby improving competitiveness and promoting formal employment. The indirect tax measures pursued under the reform were meant to have a lower direct tax burden on firms while, at the same time, raising additional revenue for the budget

The PEDP aimed to tackle reforms in those areas of public sector expenditure which had been the main driver of pro-cyclical, growth-hindering, and unsustainable fiscal policies, notably very high and poorly targeted expenditure on social transfers and a high public sector wage bill. In addition, the programme sought to improve external competitiveness of the private sector by lowering health insurance contributions in formal sector employment.

The PEDP had seven specific objectives:

- A shift from rights-based to needs-based, targeted social safety net system improving overall distribution of social transfers.
- Improved benefits incidence (targeting accuracy).
- More effective and efficient administration of social benefits equipped to substantially reduce transfers that are the result of abuse and fraud.
- Lowering of the public sector wage bill to levels more in line with EU averages.
- Increased pay system transparency, internal equity, and performance incentives

[56] More details is available in the note MEMO/14/490 (16/07/2014) available at http://europa.eu/rapid/press-release_MEMO-14-490_en.htm

[57] DPLs support government policy and institutional reforms and are available to IBRD and IDA borrowers. DPLs are quick-dispersing in one or more stages (tranches). Funds are released upon compliance with certain conditions and require coordination with the IMF.

- Improved social contribution fairness, firm competitiveness and formal sector employment.
- A fairer health financing system.

PEDP-1 was appraised on 16 November 2009; approved by the Bank Board on 8 April 2010; became effective on 1 October 2010; and was closed on 31 December 2010. The first DPL was disbursed as a single tranche on the basis of the government's enactment of key legislation regarding targeting, means testing, and benefits auditing as "prior actions". The latter two operations were however, cancelled in October 2012 following policy reversals of the new government in the face of push back by beneficiaries (e.g. means testing for veteran's benefits); challenges by the constitutional court regarding changes in the social safety net system; and little or no progress on several other reforms.[58]

[58] Independent Evaluation Group website: http://lnweb90.worldbank.org/oed/oeddoclib.nsf/DocUNIDViewForJavaSearch/8525682E0068603785257B640070887A?opendocument

# 3 Impact of the MFA on macroeconomic stability and external sustainability

The macroeconomic impact of the MFA operation can be assessed at two levels:

- Gross impact as observed in actual macroeconomic outcomes;
- Net impact which is the difference between what actually happened and what might have happened in the absence of the IMF/ MFA support and involves the construction of counterfactual scenarios.

This section first provides an overview of macroeconomic developments during the period of implementation of the MFA (Q4 2009 – Q3 2013) and following the end of the operation (until data are available, in most cases until 2Q 2014). This provides an overview of actual developments and the extent to which MFA objectives have been achieved, irrespective of the driving factors for these developments and the specific role of the MFA.

In the second subsection, macroeconomic counterfactual scenarios are explicitly developed separately for the case of no MFA assistance and for the case of lack of combined MFA and 2012 IMF programme. This then enables speculative assessment of net impacts.

## 3.1 Macroeconomic developments in BiH during the implementation of the MFA operation (2009-2013)

### 3.1.1 GDP growth

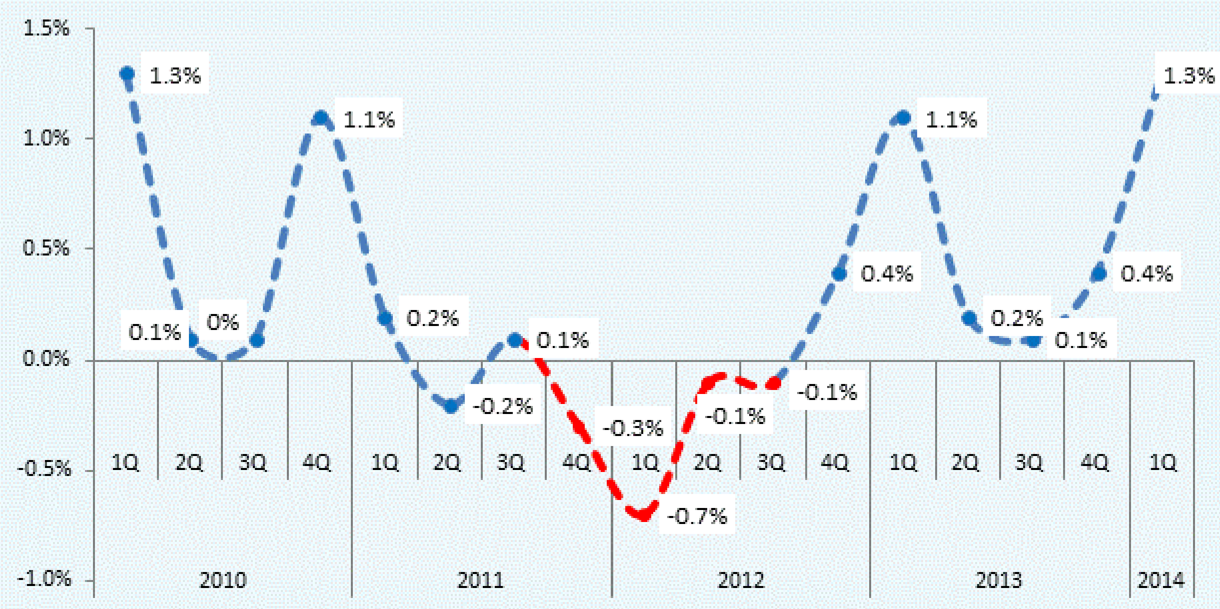
After the 2009 recession, a weak recovery - mainly driven by external demand - followed in 2010 (Figure 15). This recovery was however, short-lived. In Q2 2011, the economy slipped back into a recession which persisted - with the exception of Q3 2011 - until Q4 2012. In 2013, the economy returned to growth, expanding by nearly 2 per cent. The gradual rebound observed during 2013 was adversely affected by severe floods during May 2014 (quarterly GDP data for Q2 and Q3 2014 released on 7 January 2015 does not look reliable as it is not consistent with annual rates of growth) that are provisionally estimated to have reduced GDP by 5–10 per cent[59]. GDP growth in 2014 will be negatively affected. In its latest forecast published in July 2014, the IMF revised GDP growth estimates for 2014 from 2 per cent to 0.7 per cent[60] whereas some other estimates are more pessimistic, projecting the GDP to grow by a 0.5 per cent[61] yoy in real terms.

[59] IMF Country Report No. 14/189 dated July 2014

[60] Ibid.

[61] Raiffeisen Bank (2014) Bosnia and Herzegovina: Economic Report, Issue No. 12, December 2014.

### Figure 15. Quarterly dynamics of real GDP, 1Q2010-1Q2014 (per cent change quarter on quarter)




*Note: seasonally adjusted data. Source: Agency for Statistics of Bosnia and Herzegovina, GDP quarterly data – preliminary data. First release, 24.7.2014. Note: Quarterly GDP data have been subject to significant revisions thus raising major doubts about the reliability of these statistics*

### 3.1.2 GDP and its components

Like elsewhere in the region, BiH's pre-crisis growth model relied on booming domestic demand financed from foreign capital inflows (remittances from family members working abroad, foreign direct investment, unrequited transfers to government, and a credit boom funded by foreign banks). Since the 2009 crisis however, BiH has slowly been moving towards an export driven growth model. Consequently, household consumption now represents a smaller share of the country's economic output. The share of household consumption declined from 85.5 per cent of GDP during 2004-2009 to 81.6 per cent of GDP during 2010-2013. High unemployment and low net wages contributed to this decline; while continuing high levels of remittances and retail credit lines by the banking sector (two key sources of the purchasing power for BiH citizens) cushioned the fall. Moreover, the share of Gross fixed capital formation in BiH's GDP dropped by 6.6 per cent (from 23.8 per cent to 17.2 per cent). Governmental spending remained almost unchanged in years after the crisis compared to years before. The share of exports in GDP rose from 27.5 per cent during the pre-crisis period to 29.3 per cent during 2010-2013, with the EU being the largest export market for BiH.

Looking in more detail at the GDP structure by production, there were no major changes compared to the pre-crisis period. Retail sales is the largest category within the GDP structure (13.2 per cent on average during 2010-2013), followed by Manufacturing (10.8 per cent on average), Public administration (9.2 per cent on average) and Agriculture (6.5 per cent on average). The largest drop of share within the GDP structure was in the Construction sector. Since the start of the crisis, Construction has been on a constant downfall and in 2013, accounted for a modest 3.9 per cent of GDP.

### 3.1.3 External sector

The economic crisis and the decrease in domestic demand resulted in a temporary fall in imports in 2009, but in subsequent years they picked up again. Relatively strong exports rebounded in 2010 and contributed to a current account adjustment – the deficit fell to 6.5 per cent of GDP – below half the level seen in 2008. The decrease in current account deficit was reversed from 2011 onwards, when somewhat stronger domestic demand led to a significant increase in imports. The current account deficit remained around EUR 1 billion, close to 10 per cent of GDP. More recently, the current account deficit narrowed in

2013 (5.4 per cent of GDP) as a consequence of strong export growth and weaker domestic demand. However, the May 2014 floods damaged infrastructure and interrupted supply chains affecting export capacity; this coupled with growth in imports due to reconstruction process are projected to increase the current account deficit to 11 per cent in 2014 (Table 11).

**Table 11. Trends in current account deficit and trade deficit, 2001-2013 (in EUR bn unless stated otherwise)**

| Categories | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| C/A deficit | 0.8 | 1.3 | 1.4 | 1.3 | 1.5 | 0.8 | 1.0 | 1.8 | 0.8 | 0.8 | 1.3 | 1.2 | 0.8 |
| C/A deficit [in % of GDP] | 12.9 | 17.5 | 19.1 | 16.1 | 17.0 | 7.9 | 9.0 | 14.1 | 6.5 | 6.2 | 9.6 | 9.2 | 5.9 |
| Trade deficit - BoP data | 3.3 | 3.5 | 3.7 | 3.7 | 4.0 | 3.4 | 4.6 | 5.5 | 4.0 | 3.9 | 4.3 | 4.3 | 4.0 |
| Trade deficit [in % of GDP] | 51.0 | 49.3 | 48.8 | 45.0 | 45.0 | 34.2 | 40.6 | 42.7 | 32.0 | 30.7 | 32.4 | 32.8 | 29.7 |
| Export of goods (BoP data) | 1.3 | 1.2 | 1.3 | 1.7 | 2.1 | 2.7 | 1.4 | 1.7 | 1.6 | 2.2 | 2.6 | 2.6 | 2.8 |
| Import of goods (BoP data) | 4.6 | 4.7 | 5.0 | 5.4 | 6.0 | 6.1 | 6.0 | 7.2 | 5.6 | 6.1 | 6.9 | 6.9 | 6.8 |
| Capital account | 0.45 | 0.43 | 0.41 | 0.24 | 0.23 | 0.23 | 0.21 | 0.20 | 0.18 | 0.2 | 0.2 | 0.2 | 0.2 |
| Remittances | 1.63 | 1.50 | 1.46 | 1.60 | 1.64 | 1.78 | 1.99 | 1.96 | 1.71 | 1.8 | 1.8 | 1.9 | 1.9 |
| Remittances [in % of GDP] | 0.25 | 0.21 | 0.19 | 0.20 | 0.19 | 0.18 | 0.18 | 0.15 | 0.14 | 0.14 | 0.14 | 0.14 | 0.14 |
| Official FX reserves | 1.4 | 1.3 | 1.4 | 1.8 | 2.2 | 2.8 | 3.4 | 3.2 | 3.2 | 3.3 | 3.3 | 3.3 | 3.6 |
| Official FX reserves [in % of GDP] | 21.1 | 17.8 | 19.0 | 21.7 | 24.5 | 28.0 | 30.4 | 25.2 | 25.6 | 26.0 | 24.9 | 25.3 | 26.9 |

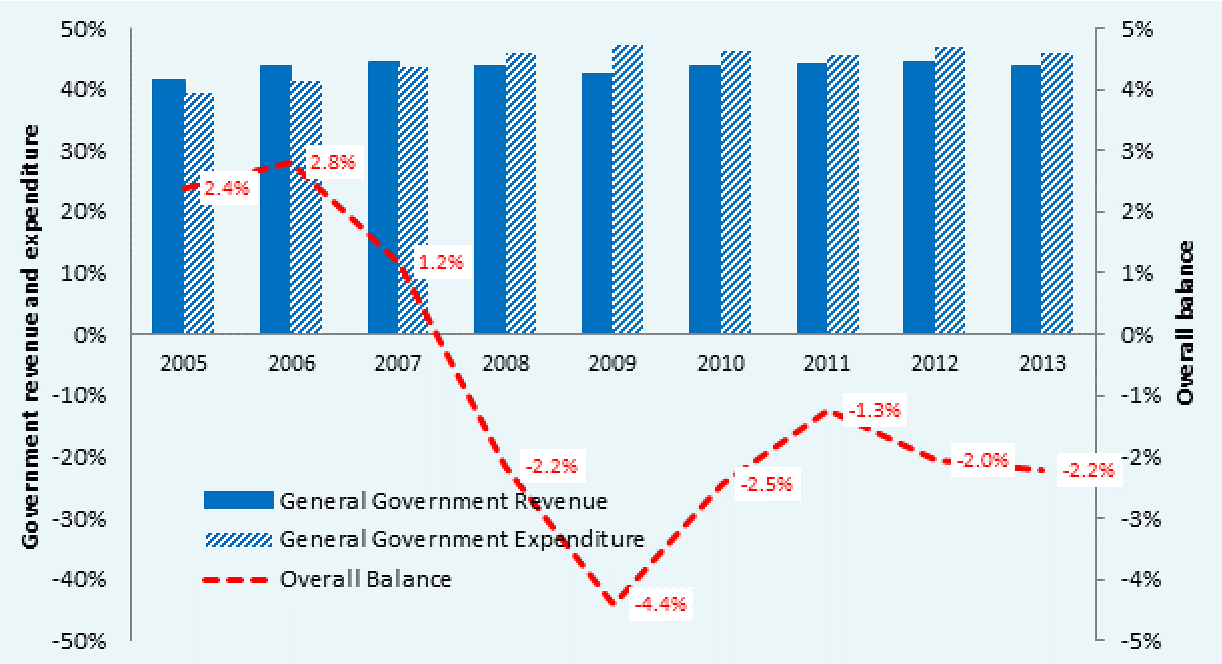
*Source: Agency for Statistics of Bosnia and Herzegovina. BoP statistics*

### 3.1.4 Public finances

Following pro-cyclical fiscal expansion in 2008 and the slowing of revenues during the crisis, BiH's consolidated budget deficit widened to 4.4 per cent in 2009. Adjustment measures implemented under the 2009 IMF SBA alongside rising revenues (due to economic recovery and increases in tax contribution and excise rate) helped bring the budget deficit down to 2.5 per cent of GDP in 2010. Fiscal consolidation continued in 2011, although budget planning for that year (and beyond) was seriously hampered by the non-adoption of the Global Framework for Fiscal Policies for the periods 2011-2013 and 2012-2014. Consequently, in 2011, fiscal consolidation was dictated by the lack of foreign financing for the Entities and by the temporary financing rules—that limit spending in the absence of an adopted budget—for the Institutions of BiH. The consolidated budget deficit increased from 1.3 per cent in 2011 to 2 per cent in 2012 as post 2009 recovery stalled; rising further to 2.2 per cent in 2013 as the economy slipped back into recession. Sizable revenue shortfalls—including lower-than-budgeted indirect tax revenues, a delay in the distribution of dividends from the electricity transmission company TRANSCO, and lower receipts from the sale of military assets—combined with delays in securing external financing forced the authorities to significantly compress non-priority spending toward the end of 2013. The severe flooding in May 2014 has however, interrupted the authorities' efforts at fiscal consolidation and consequently, the budget deficit is projected to rise above 4 per cent in 2014[62].

[62] IMF, (2014). Country Report. Available at: http://www.imf.org/external/pubs/cat/longres.aspx?sk=41707.0

**Figure 16. Overview of public finances, 2005 - 2013 (per cent of GDP)**



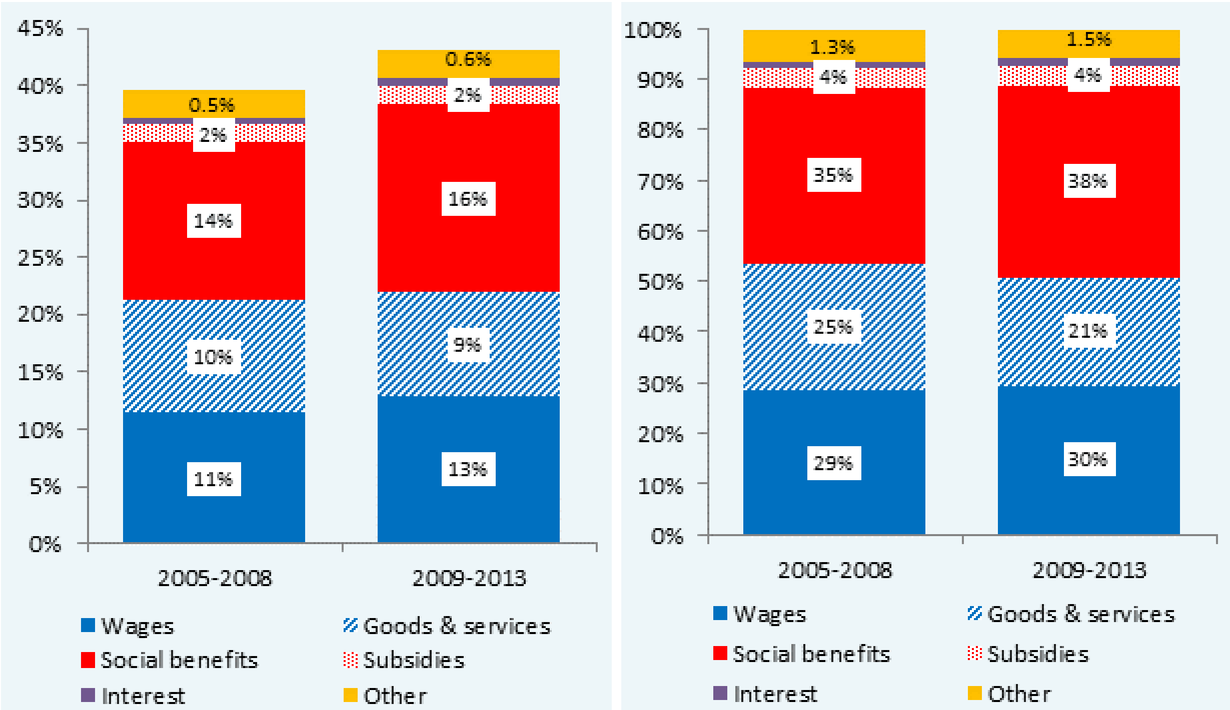

*Source: CBBH – GFS Statistics.*

Despite several years of fiscal restraint, the share of general government spending in GDP remains high (averaging 44 per cent during 2009-2013). In order to streamline both the size and structure of BiH's public spending, the adjustment measures implemented as part of the 2012 IMF SBA included cuts in public sector wages, measures to improve the efficiency of healthcare spending, reform of war-related benefits and old age pension. However, the composition of expenditure has shown no improvement so far, as spending on public wages and social transfers (particularly, war-related benefits) remains high[63]. The adjustment measures on the expenditure side – if fully implemented – should be successful in the coming years.

63 During 2010-2013, there was an increase in social transfers, especially in RS. The share of social transfers in total expenditure increased by 13.8 per cent (reaching almost half of the total spending) in RS during 2010-2013 as a result of increases in the benefits going to various social groups' (war veterans, pensioners). In FBiH and at the State level, social benefits rose by 6 and 4 per cent respectively, during the same period to (rising to an overall level of 39 per cent of government spending).

**Figure 17. Structure of consolidated general government's current expenditures, 2005-2009**

(i) As a share of GDP (ii) As a share of total revenue




*Source: CBBH – GFS Statistics. Other includes grants*

On the revenue side, steps were taken by the authorities – under the aegis of the 2012 IMF SBA – to improve revenue performance by strengthening tax administration and compliance (particularly by addressing VAT fraud and collecting tax arrears) and broadening the tax base. Nonetheless, the share of indirect taxes in the consolidated budget fell sharply during the crisis period (2009-2013) as compared to the pre-crisis period (2005-2008). This was largely due to the weak state of domestic consumption and falling prices, but it also reflected delays in the full implementation of measures to improve tax collection[64].

[64] IMF Country Report No. 14/189 dated July 2014

### Figure 18. Structure of consolidated general government's revenue, 2005-2008 and 2009-2013

(i) As a share of GDP (ii) As a share of total revenue


*Source: CBBH – GFS Statistics*

### 3.1.5 Public debt

BiH's public debt has been on an upward trajectory since 2007, expanding rapidly from 30 per cent of the GDP in 2007 to 45 per cent of the GDP in 2012. There was a slight reduction in 2013 primarily thanks to the reduction in domestic debt, but total public debt is expected to increase in 2014. This is due to the financing needed to make up for revenue losses and to cover the costs related to the after post-flood recovery and reconstruction process. The current level of public debt – at around 40 per cent of GDP – is moderate and sustainable. However, according to the IMF, it makes an emerging economy like BiH, with a fixed exchange rate and no access to international capital markets potentially vulnerable to shocks. The IMF is working with the authorities to bring debt-to-GDP ratio toward the pre-crisis level of 30 per cent of GDP.

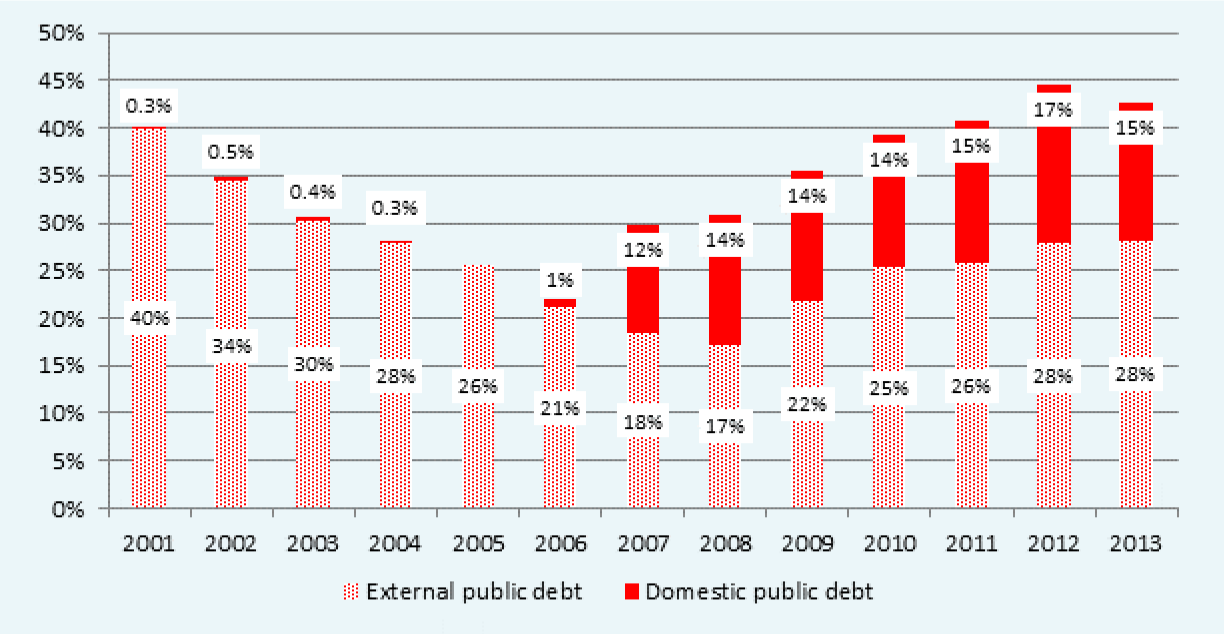
In terms of its composition, BiH's public debt consists largely of concessional external debt to IFIs[65], with 28 per cent of 2013 GDP, and of domestic debt in form of long-dated bonds (15 per cent of the 2013 GDP). The largest share of the public external debt (30 per cent) is towards the World Bank Group and specifically, the International Development Association (IDA). Much of this debt was acquired during the post-conflict reconstruction phase (1996-2002). The remainder of the external debt is to the IMF (13 per cent), European financial institutions such as the EIB (18 per cent), the EBRD (9 per cent), the Paris club (9 per cent) and others[66]. Domestic debt is in form of bonds that were issued to settle pre-war frozen foreign currency savings and war damage claims by citizens. Given the limited development of local financial markets, governments in BiH did not turn to them for regular issuance of bonds and bills for deficit financing until 2011.

[65] With average interest rate of all debt being 1.44% . Source: SWD (2013) 425 final – Bosnia and Herzegovina, 2013 Progress Report, p.23

[66] Based on CBBH statistics on Stock of foreign debt BH government sector. Figures for end of 2014

Gross external financing needs are expected to rise from USD 3.6 billion in 2013 to USD 4.8 billion in 2014 (or from 19.9 per cent to 25.1 in GDP terms)[67] In addition, 2014 is also the time of the concentration of repayment obligations[68] to international donors from already functioning assistance programmes.

**Figure 19. Public debt developments, 2001-2013 (per cent of GDP)**




*Source: IMF Country Reports No. 05/199 (2001), 06/371 (2002-2004), No. 05/199 (2000-2001), 09/226 (2005-2007), 10/348 (2008-2009), 14/39 (2010), 14/189 (2011-2013)*

### 3.1.6 Employment

The labour market situation in the country has remained difficult. Economic activity rate has not changed significantly (it has remained stagnant at around 44 per cent) and continues to be not only the lowest in Western Balkans but also in the European context[69]. Labour market reforms that could have boosted job creation faced resistance and youth unemployment increased from 48.7 per cent in 2009 to 57.5 per cent[70] in 2013 according to the World Bank data[71].

[67] IMF. (2013). Country Report. Available at: https://www.imf.org/external/country/BIH/index.htm

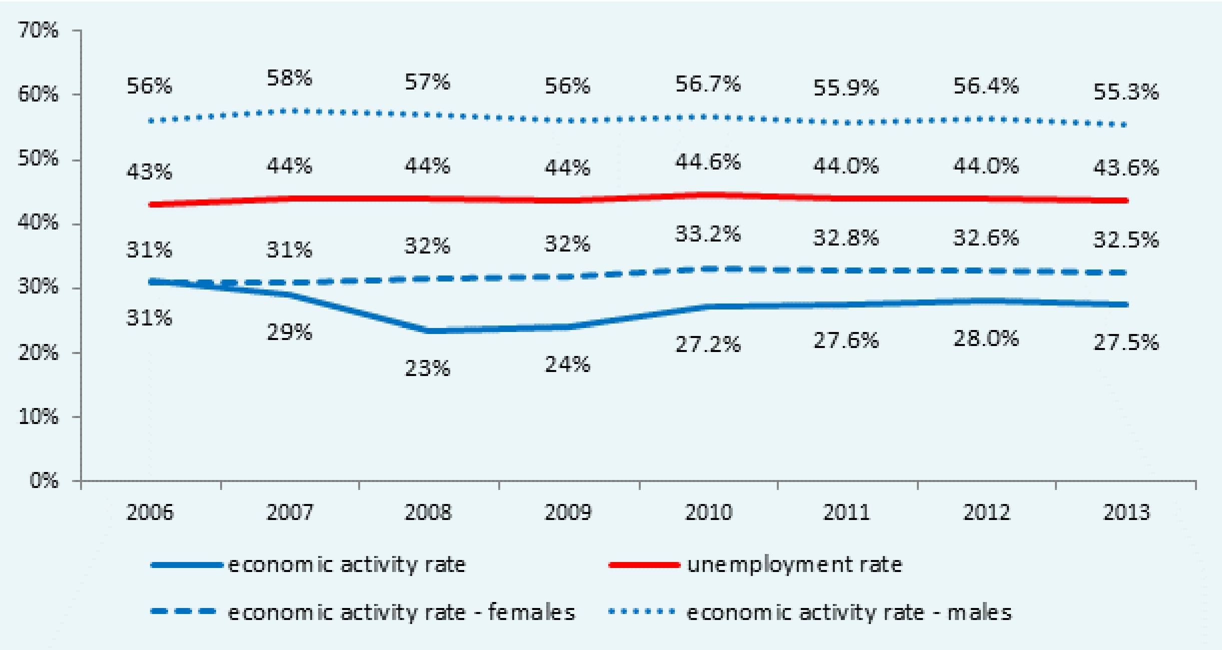
[68] According to the BiH Central Bank estimation, costs related to foreign debt servicing were BAM 340 million, BAM 413 million, BAM 684 million, BAM 472 million as of 2011, 2012, 2013 and 2014 respectively.

[69] See for instance World Bank, (2014). Boosting Job Growth in the Western Balkans. Available at: https://www.imf.org/external/pubs/ft/wp/2014/wp1416.pdf

[70] Note that according to the Labour Force Survey carried out by Agency of Statistics of Bosnia and Herzegovina in April 2013, the youth unemployment was 59.1 per cent. Available at: http://www.bhas.ba/saopstenja/2013/LFS%202013%20Preliminarni%20bos.pdf

[71] World Bank, (2014). Youth unemployment data. Available at: http://data.worldbank.org/indicator/SL.UEM.1524.ZS

**Figure 20. Labour market characteristics in Bosnia and Herzegovina from 2010 onwards - key indicators**

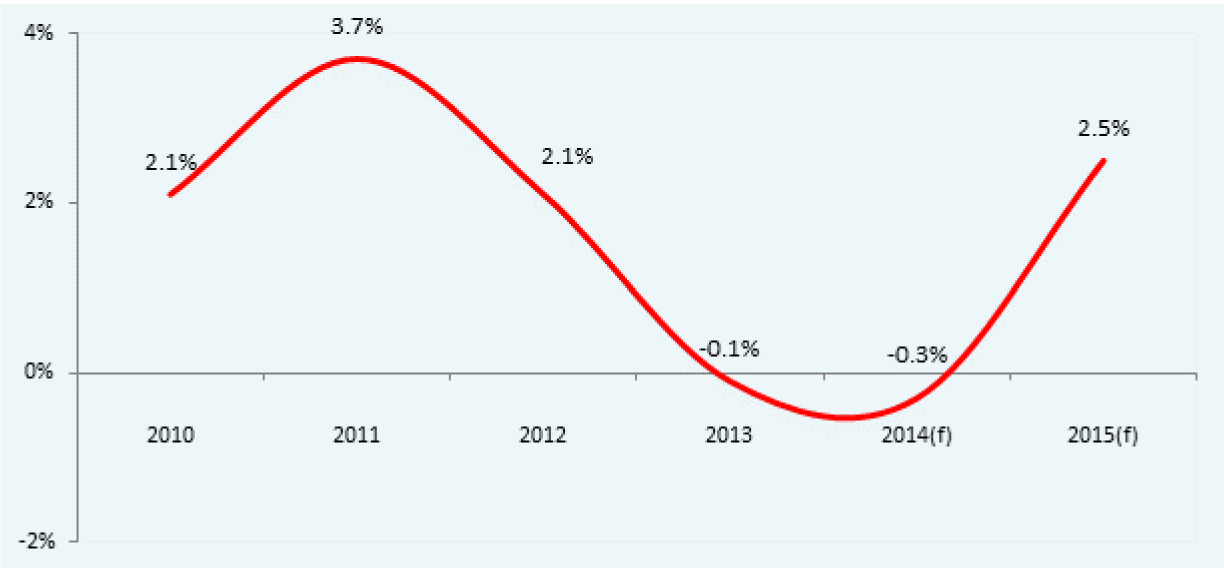



*Source: Agency for Statistics of Bosnia and Herzegovina.*

### 3.1.7 Monetary policy developments

As opposed to the pre-crisis period when inflation level was erratic and occasionally reached high levels (6.1 per cent in 2006 and 7.4 per cent in 2008); inflationary pressures have remained subdued in recent years, reflecting the weak domestic demand and falling commodity prices. High unemployment, fiscal consolidation, and weak consumer confidence have continued to dampen domestic demand, resulting in deflation during 2013, which is likely to continue in 2014 based on the Central Bank's forecast. As economic growth is likely to accelerate in 2015, inflation is projected to increase (see Figure 21).

**Figure 21. Inflation rate, 2010 to 2015**

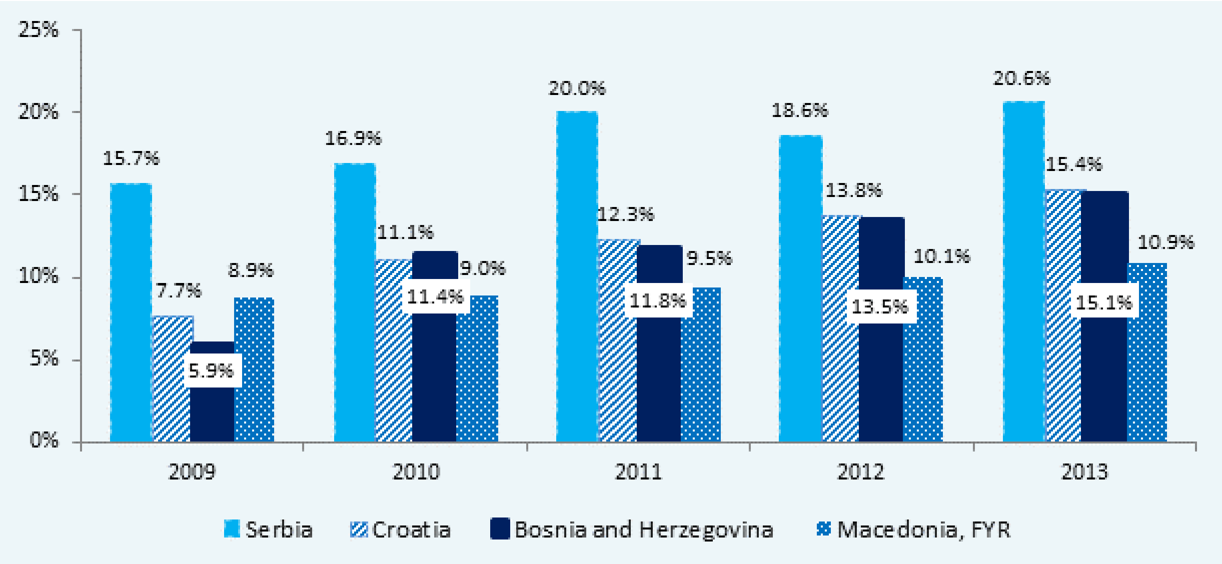



*Source: Central Bank of Bosnia and Herzegovina. Forecast data (f) for 2014 and 2015.*

### 3.1.8 Financial sector

The banking system in the country remains stable, the capitalisation is appropriate[72] and there are no problems with liquidity in the system. Yet, the share of non-performing loans (NPLs) has been continuously rising since 2009 reaching 15.1 per cent at the end of 2013 (this has been largely driven by corporate liabilities)[73]. Although this has been a common trend in the region, it has raised particular concerns in BiH's context. This is because of the potential side effects and particularly the risk to the ability of local banks to support the enterprise sector. It is also plausible that as a result of recent flooding, NPLs may rise considerably[74].

**Figure 22. Evolution of the share of Non-Performing Loans: BiH compared to regional peers, 2009-2013**




*Source: World Bank data on bank non-performing loans to total gross loans*

## 3.2 Construction of the counterfactual scenario

To determine the 'net' macroeconomic impact of the MFA a comparison between actual macroeconomic developments and a counterfactual scenario that describes what would have happened (or not happened) in its absence is required. By definition, a counterfactual cannot be observed and has to be constructed, thus involving an element of judgement.

In line with DG ECFIN's evaluation guidelines[75], assessment of net economic impact of the MFA operation requires the explicit construction of at least two counterfactual scenarios:

- One where MFA operation does not take place ("no MFA" scenario); and
- Another where MFA operation does not take place and in addition, the IMF SBA also does not take place ("no MFA and no IMF" scenario).

In the case of MFA to BiH, the period between the approval of the MFA and actual disbursement of MFA tranches coincided with two BiH agreements with the IMF:

- A three-year SBA approved in June 2009; and
- A two-year SBA approved in September 2012.

72 Capital adequacy ratio was 17.7 per cent in Q2 2013.

73 World Bank. (2014). Bosnia and Herzegovina. Partnership: Country Program Snapshot. Available at: http://www.worldbank.org/content/dam/Worldbank/document/eca/BH-Snapshot.pdf

74 IMF, (2014). Country Report. Available at: http://www.imf.org/external/pubs/ft/scr/2014/cr1439.pdf

75 European Commission (2010) Guidelines for the Ex Post Evaluation of Macro-Financial Assistance and Balance of Payments Assistance Operations, May 2010.

The first one opened the possibility for the EU to approve the provision of MFA. The second one opened the possibility that – after a period of political deadlock and delay in implementation of reforms included the MFA conditionality – the validity of MFA operation could be extended and eventually loan tranches could be disbursed during 2013.

The definition of the "no MFA" counterfactual is relatively straightforward. In this counterfactual scenario, assistance from other sources, including the IMF is assumed to remain as in the actual scenario.

The definition of the "no MFA and no IMF" assistance counterfactual scenario requires making certain assumptions given the two IMF programmes in place during the life of the MFA operation. Available evidence does not give any indication of MFA effects materialising following the EU decision to provide the assistance (from December 2009), especially considering that the MoU and the Loan Agreement followed only in November 2010. Hence the MFA impact was mainly expected to materialise in relation to:

- The reform progress following the formulation of MFA conditionality (November 2010) and especially in 2012-2013, and
- The actual disbursement of MFA loan tranches during 2013.

It follows that the period of most interest for the assessment of MFA impact starts at the end of 2010 (signature of MoU defining the MFA conditions) and runs until 2013 and beyond. This is the period after the first IMF agreement was effectively halted and coincides with the implementation of the second IMF programme approved in September 2012.

Taking the above into account, the definition of the "no MFA and no IMF" counterfactual scenario is as follows:

- The MFA operation does not take place;
- The IMF programme agreed in June 2009 is implemented as originally specified, i.e. is *de facto* terminated in October 2010; and
- There is no September 2012 IMF programme and no other IMF programme is agreed until end of the period covered by the assessment (i.e. during 2013-2014).

### 3.2.1 Development of counterfactual scenarios

A three-step approach was followed to the further elaboration of the two counterfactual scenarios ("no MFA" and "no MFA and no IMF"):

- A long list of all potential counterfactual policy choices and outcomes was developed on the basis of literature review and macroeconomic data analysis;
- The long list of all potential counterfactual policy choices and outcomes was then tested with key stakeholders (most notably, the State and Entity authorities, the IMF and the World bank) and experts via the Delphi survey; and
- The results of the desk research, key stakeholder interviews and Delphi survey were cross-checked and triangulated to determine the most likely or plausible counterfactual policy choices and outcomes .

The sub-sections below describe the most likely economic developments that would have occurred under the two counterfactual scenarios of "no MFA" and "no MFA and no IMF".

#### 3.2.1.1 "No MFA" counterfactual scenario

This scenario assumes that MFA is not granted to BiH in 2009 and there are no disbursements of loan tranches totalling EUR 100 million during 2013. The IMF lending is assumed to be unaffected in the absence of the MFA. It should be noted that at the time of negotiating the 2012 SBA, the IMF was actually very interested in securing financing from other sources in line with its burden-sharing principles. Therefore, the EUR 100 million MFA was taken into account when designing the IMF programme. However, the insights gathered during interviews suggest that the IMF would have gone ahead with its 2012 SBA even in the absence of the MFA (given its strong interest in recovering the amounts disbursed as part of the 2009 SBA). Hence, and also in order to ensure a clear separation from the "no MFA and no IMF" scenario described below, IMF lending is assumed unaffected in the "no MFA" counterfactual scenario.

The "no MFA" counterfactual scenario could potentially have evolved as follows:

- The authorities maintain spending and deficit at the levels observed in actual macroeconomic data, replacing the MFA with domestic borrowing;
- The authorities maintain spending at observed levels, but finance it by raising additional revenue from changes in taxation and/or, privatisation receipts; or
- The authorities do not replace the 'lost' MFA funding with financing from elsewhere. Without additional sources of deficit financing (or any scope for raising additional revenue), the authorities have to reduce the deficit through spending cuts.

The information gathered from various sources suggests that the most plausible adjustment path in the absence of the MFA would have been deficit financing through higher issuance of domestic debt, both in the FBiH and in RS, to replace the 'lost' MFA. Given the relatively small size of the MFA (EUR 100 million), a corresponding reduction of expenditures in both Entities would have been unnecessary and thus, very unlikely. Interviews with the Entities' authorities also revealed that such hypothetical option was not discussed at any point. Increasing revenue collection to offset the 'loss' of financing from MFA was disregarded as a potential counterfactual scenario due to:

- The complex and politically sensitive arrangement, which does not allow smooth and quick increases of VAT[76];
- Concerns that an increase in excise would incentivise higher tax evasion;
- A lack of political will to raise direct tax base for individuals and corporations in a context of high unemployment and reduced purchasing power;
- A low possibility of successful and substantial privatisation.

Therefore, the most plausible "no MFA" counterfactual that emerges from the desk research, key stakeholder interviews and the Delphi survey is as follows:

- In the absence of MFA financing in 2013, both Entities would have maintained their expenditures and deficits at levels observed in actual data (instead of reducing either); and
- The deficit would have been financed through additional domestic debt issuance, (and therefore, at a slightly higher cost).

The text box below provides an overview of developments in the domestic debt markets in both Entities during 2012-2014, thus confirming that domestic debt markets had the capacity to absorb the extra government debt issued to replace the 'lost' MFA financing.

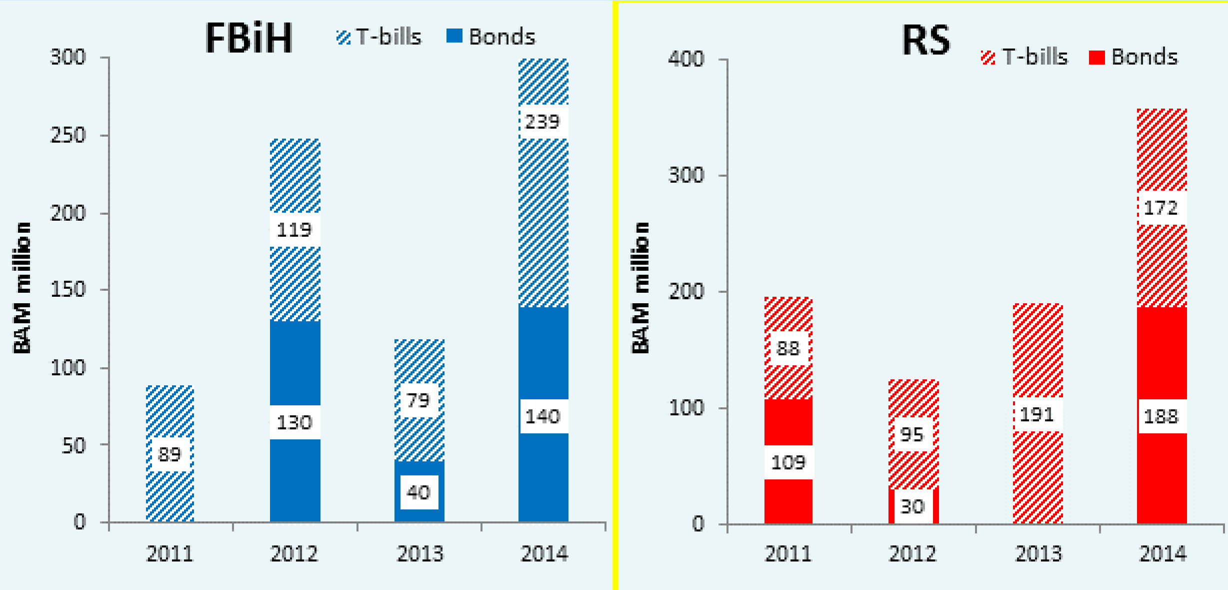
[76] Increase in VAT requires consensus at Entities and State level.

### Box 4 Developments on the primary debt market in BiH (2012-2014)

During 2012-2014, the Ministries of Finance of the two Entities (FBiH and RS) were major creators of debt instruments[77]. Corporate and municipalities bonds were still in the initial phase of development. Moreover, the debt securities issued by the Entity governments have been major drivers of total turnover on both BiH stock exchanges, accounting for more than 50 per cent of total trade value of BiH capital markets.

During the period 2012-2013, FBiH raised total of BAM 368 million (BAM 170 million in bonds and BAM 198 million in T-bills) while RS auctioned total of BAM 316 million (BAM 30 million in bonds and BAM 286 million in T-bills) – see Figure 23.

**Figure 23. Primary debt issuance of FBiH and RS governments in 2012-2014**




*Source: Data compiled by Raiffeisen Research*

It is worth noting that prior to the negotiations with the IMF regarding the 2012 SBA, both Entities planned to finance their 2012 deficit mostly through the primary issues of the debt instruments in local currency (BAM 290 million in FBiH – BAM 230 million bonds and BAM 60 million of T-bills; while RS planned BAM 100 million – BAM 70 million in T-bills and BAM 30 million of bonds).

Consequently, there was a lot of activity in the primary debt market between March and May 2012. This was in line with the preliminary announced "Plans of the Primary Debt Issuances" adopted within the Budgets 2012. Hence, in March and April 2012, FBiH successfully placed the 4th and 5th issue of the 6M T-bills amounting to BAM 25 million and 15 million respectively (Table 12). The average yields to maturity (YTM) were under downward pressure, and at 2.28 per cent and 2.20 per cent had the lowest cost of financing in SEE region. This was due to high excess liquidity in local banking sector (98 per cent of investors were banks). In addition, FBiH began the first issues of their primary long-term debt instruments in May 2012. The first auction of 3Y bonds (BAM 80 million), were successfully placed at a low yield of 5.25 per cent. This was the first out of a planned 5 auctions of a total amount of BAM 230 million, which had been planned to be implemented until September 2012. However, FBiH's 4Y auction in June 2012 of BAM 30 million had low take-up (57 per cent). This reflected the rising risk-aversion of local banks which have a limited tolerance of credit exposure to one issuer, and lowering appetite for investing in long-term instruments by the end of the year. The low take-up

[77] Due to the limited development of local financial markets, Governments in BiH did not turn to them for regular issuance of bonds and bills for deficit financing until 2011.

of 4Y bonds was the major reason why the Federal Ministry of Finance and Treasury decided to amend the Budget 2012 and changed the structure of deficit financing. The budget was re-orientated towards the IMF SBA and new issuances of shorter-term instruments (3M-6M T-bills). However, the situation improved after a few months.

Given the access to financing from the IMF SBA and EU-MFA, in 2013 the authorities effectively "switched" domestic debt issuance with external debt which was available on more favourable terms. This was reflected in the 'dip' in primary debt issuances in 2013 compared to 2012. The downward pressure on yields and high cover ratios for issuances in 2013 were indicative of a growing appetite for bonds and T-bills among local banks.

*Table 12.* **Primary debt auctions of FBiH and RS governments in 2012-2013**

| Security type | Maturity | Issue date | Amount Planned | Amount collected | Average Yield | Bid to cover ratio |
|---|---|---|---|---|---|---|
| Federation of B&H | | | | | | |
| T-bills | 6M | 28.02.2012 | 20,000,000 | 19,758,710 | 2.45% | 1.83 |
| T-bills | 6M | 27.03.2012 | 25,000,000 | 24,718,996 | 2.28% | 1.29 |
| T-bills | 6M | 24.04.2012 | 15,000,000 | 14,836,858 | 2.21% | 2.88 |
| Bonds | 3Y | 29.05.2012 | 80,000,000 | 79,983,899 | 5.26% | 1.36 |
| Bonds | 5Y | 26.06.2012 | 30,000,000 | 17,134,078 | 6.10% | 0.78 |
| Bonds | 5Y | 28.08.2012 | 12.835,000 | 12,815,196 | 6.10% | 1.49 |
| Bonds | 2Y | 25.09.2012 | 20,000,000 | 19,999,388 | 4.30% | 1.57 |
| T-bills | 6M | 27.11.2012 | 30,000,000 | 29,969,600 | 2.05% | 2.66 |
| T-bills | 6M | 11.12.2012 | 30,000,000 | 29,702,723 | 2.01% | 2.06 |
| T-bills | 6M | 19.03.2013 | 30,000,000 | 29,720,305 | 1.89% | 2.67 |
| T-bills | 6M | 03.09.2013 | 30,000,000 | 29,740,351 | 1.75% | 4.41 |
| T-bills | 9M | 17.09.2013 | 20,000,000 | 19,792,562 | 1.40% | 4.21 |
| Bonds | 3Y | 23.12.2013 | 40,000,000 | 39,977,304 | 4.57% | 1.46 |
| Republic of Srpska | | | | | | |
| T-bills | 6M | 27.03.2012 | 35,000,000 | 26,699,959 | 3.51% | 1.15 |
| Bonds | 7Y | 26.04.2012 | 30,000,000 | 23,500,000 | 6.00% | 1.44 |
| T-bills | 9M | 07.06.2012 | 17,000,000 | : | : | : |
| Bonds | 7Y | 27.06.2012 | 6,500,000 | 6,500,000 | 6.00% | 1.62 |
| T-bills | 6M | 18.07.2012 | 25,000,000 | 24,605,000 | 3.20% | 1.24 |
| T-bills | 9M | 22.08.2012 | 17,500,000 | 17,062,500 | 3.44% | 1.7 |
| T-bills | 6M | 01.10.2012 | 27,000,000 | 26,622,000 | 2.85% | 1.32 |
| T-bills | 12M | 21.01.2013 | 25,000,000 | 24,080,000 | 3.83% | 1.48 |
| T-bills | 6M | 28.03.2013 | 27,000,000 | 52,194,197 | 3.98% | 2.3 |
| T-bills | 6M | 15.04.2013 | 27,000,000 | 20,103,325 | 3.96% | 1.11 |
| T-bills | 12M | 23.05.2013 | 24,500,000 | 21,557,108 | 4.20% | 0.88 |
| T-bills | 6M | 26.09.2013 | 53,000,000 | 52,167,900 | 3.22% | 2.2 |
| T-bills | 6M | 23.12.2013 | 21,000,000 | 20,784,288 | 2.08% | 2.47 |

One important observation is that over the 2012-2013 period the Ministries of Finance in BiH issued debt instruments at very low cost and yields, even compared to other countries with much better credit ratings. In RS, the YTM was 3.26 per cent, 3.44 per cent and 4.02 per cent for 6 month (6M), 9M and 12M T-bills respectively. The average YTMs in FBiH were even lower settling at 2.09 per cent for 6M and at 1.40 per cent on 9M T-bills on average. The primary debt auctions of both Ministries met significant demand with overly liquid local banks being the main buyers. The banks mostly held debt instruments until maturity. The excess liquidity of the banking sector in FBiH and RS is a result of the very strict bylaws of the Entity banking agencies on currency and term-structure of the banking system which result in excess short-term liquidity in local currency.

Not only were average yields very low in the 2012-2013 period but yields actually declined over time especially on short-term instruments, settling at record lows by the end of 2013. The last 2013 auction of T-bills in FBiH resulted in YTMs of 1.4 per cent, while YTM on last 2013 auction of T-bills in RS went down to 2.08 per cent.

In 2014, the Finance Ministries continued with the relatively large primary debt auctions. It is likely that 2014 will set a record in terms of the total value of primary debt issuance. This was driven inter alia by the limited progress of implementation of the SBA programme with the IMF, the floods in May 2014 and large credit repayments to the IMF falling this year.

The local banks showed sufficient demand to absorb the increasing issuance at further declining yields. In the first three quarters of 2014, the FBiH collected BAM 270 million (BAM 50 million in bonds and BAM 219 million In T-bills) while the RS collected total of BAM 273 million (BAM 136 million and BAM 137 million in T-Bills). The trend of declining cost yields continued in the first half of 2014, especially in FBiH where average YTMs on all T-bills (3M, 6M, 9M and 12M) declined below 1 per cent for the first time since FBiH government started issuing T-bills. At the same time, decline in yields on bonds have been much more muted.

**Table 13. Primary debt auctions of FBiH and RS governments in 2014**

| Security type | Maturity | Issue date | Amount Planned | Amount collected | Average Yield | Bid to cover ratio |
|---|---|---|---|---|---|---|
| Federation of B&H | | | | | | |
| T-bills | 3M | 18.02.2014 | 20,000,000 | 19,949,040 | 1.02% | 4.08 |
| T-bills | 3M | 04.03.2014 | 20,000,000 | 19,960,076 | 0.80% | 4.4 |
| T-bills | 3M | 18.03.2014 | 20,000,000 | 19,970,315 | 0.60% | 3.39 |
| T-bills | 6M | 01.04.2014 | 15,000,000 | 14,940,087 | 0.80% | 2.32 |
| T-bills | 6M | 15.04.2014 | 15,000,000 | 14,939,928 | 0.81% | 3.29 |
| T-bills | 6M | 06.05.2014 | 20,000,000 | 19,926,234 | 0.74% | 2.37 |
| T-bills | 12M | 17.06.2014 | 20,000,000 | 19,848,388 | 0.77% | 3.41 |
| T-bills | 3M | 22.07.2014 | 30,000,000 | 29,955,581 | 0.59% | 1.28 |
| T-bills | 6M | 19.08.2014 | 20,000,000 | 19,882,581 | 1.19% | 1.3 |
| T-bills | 3M | 26.08.2014 | 20,000,000 | : | : | : |
| Bonds | 3Y | 02.09.2014 | 50,000,000 | 49,989,991 | 4.21% | 1.67 |
| T-bills | 9M | 09.09.2014 | 20,000,000 | 19,798,383 | 1.36% | 1.11 |
| T-bills | 9M | 23.09.2014 | 20,000,000 | 19,736,988 | 1.78% | 0.99 |
| Republic of Srpska | | | | | | |
| T-bills | 12M | 27.01.2014 | 25,000,000 | 24,041,000 | 4% | 1.29 |
| T-bills | 3M | 26.03.2014 | 25,000,000 | 24,812,400 | 3% | 1.32 |
| Bonds | 4Y | 10.04.2014 | 65,000,000 | 65,000,000 | 4.50% | 1 |
| T-bills | 6M | 29.04.2014 | 15,000,000 | 14,763,450 | 3.20% | 1.66 |
| T-bills | 6M | 26.05.2014 | 20,000,000 | 19,702,040 | 3.00% | 2.22 |
| Bonds | 5Y | 16.06.2014 | 40,000,000 | 40,420,000 | 5.60% | 1.5 |
| T-bills | 6M | 25.06.2014 | 20,000,000 | 19,760,000 | 2.42% | 2.46 |
| T-bills | 9M | 21.07.2014 | 10,000,000 | 9,837,530 | 2.20% | 1.99 |
| T-bills | 6M | 18.08.2014 | 15,000,000 | 14,854,050 | 1.95% | 2.64 |
| T-bills | 9M | 15.09.2014 | 15,000,000 | 9,267,400 | 3.50% | 1.09 |
| Bonds | 4Y | 22.09.2014 | 30,000,000 | 30,693,000 | 4.98% | 2.12 |

*Source: Data compiled by Raiffeisen Research*

In order to fully make up for the lack of MFA financing, the government of FBiH would have needed to issue additional EUR 60 million (around BAM 117 million) of debt instruments during 2013 and the government of RS an additional EUR 30 million (around BAM 59 million). No policy response and no macroeconomic implications are assumed at the State level. This is due to the surplus in the State level budget (slightly exceeding the amount of MFA assistance going to the State, i.e. EUR 10 million) and the fact that the State level budget has been in surplus for the last few years, coupled with the limited amount of money involved in the MFA tranches to the State level (EUR 10 million).

The actual debt issuance in 2013 was around BAM 119 million in FBiH and BAM 191 million in RS. In the case of FBiH, the majority of actual issuance during 2013 was in the form of short-term T-bills. In RS only T-Bills with maximum maturity of 12 months were issued. Moreover, there was a clear difference between yields on T-bills (below 2 per cent in FBiH) and 3 year bond issue with an average yield of 4.57 per cent.

The figures for domestic debt issuance in 2011 and 2012 suggest that the domestic debt market would have most likely been able to absorb the additional issuance needed in 2013 to make up for the lack of MFA. However, the financing terms would have been less favourable: significantly shorter maturity and lack of a grace period.

It is not possible to confidently estimate the increase in yields that would be needed to replace MFA borrowing by the issuance of 3 year bonds for example. One can speculate that this could be possible at yields higher by around 1 percentage point than those actually achieved in FBiH during 2013. This implies average yield of around 5.6 per cent. Moreover, this could drive up yields on other debt instruments, including short-term T-bills and bonds issues during 2013-2014. Again, there is no information base that would enable meaningful estimation of this effect. It can be speculated that the impact could be to the tune of 0.5 percentage points, i.e. T-bill issued during 2013 would need to have average yields higher by around 0.5 percentage points than actually was the case. This effect could gradually disappear over time, e.g. in 2014 average T-bills and bonds interest rates could be higher by some 0.25 percentage points in the counterfactual scenario compared to actual outcomes. The effect could disappear on debt instruments issued from 2015 onwards.

The above impacts in terms of lending can be compared to the conditions of MFA loans. The Loan agreement (signed on 17 November 2010) indicates that the interest rate applicable to MFA lending was 2 per cent.

On the basis of the above information along with some simplifying assumptions, the additional debt servicing cost that would need to be borne by both Entities' governments in the counterfactual scenario are estimated to be EUR 12.4 million (at current prices) during 2013-2015 (Table 14). To put this figure into perspective, annual interest payments in the consolidated BiH general government operations amounted to around EUR 100 million in 2013, projected to rise to some EUR 118 million in 2014[78]. Hence, in the counterfactual scenario annual interest spending could increase by 3-4 per cent per annum during 2013-2015.

**Table 14. Indicative calculations of additional debt servicing burden in the no MFA counterfactual scenario**

| Interest rate differential (counterfactual vs. actual) (percentage points) | Applicable to the volume of lending (EUR million) | With approximate average maturity | Description of debt instruments |
|---|---|---|---|
| 0.5 | 41 | 6 months | FBiH T-bills in 2013 |
| 0.5 | 95 | 9 months | RS T-bills in 2013 |
| 1 | 20 | 3 years | FBiH bonds in 2013 |

[78] IMF Country report 14/189, July 2014, Table 5.

| Interest rate differential (counterfactual vs. actual) (percentage points) | Applicable to the volume of lending (EUR million) | With approximate average maturity | Description of debt instruments |
|---|---|---|---|
| 4 | 90 | 3 years | RS & FBiH bonds replacing MFA |
| 0.25 | 273 | 1 year | RS debt issuance 1-3Q 2014 |
| 0.25 | 270 | 6 months | FBiH debt issuance 1-3Q 2014 |

*Notes: an assessment of approximate maturity is based on analysis of actually issued debt instrument (an assumption is made that these would stay unaffected in the counterfactual scenario).*

*The bond issuance replacing MFA is assumed to consist of 3-year bonds. The effects on this instrument are only considered until its maturity, i.e. for the first three years. This is equivalent to assuming that after that date Entities would be able to refinance at conditions comparable to those offered by MFA loans.*

*Source: Own elaboration.*

This counterfactual increase in the costs of debt servicing is deemed too low to translate into broader macroeconomic implications, including the balance of payment position of the country. Higher public borrowing on the domestic market (in practice from BiH banks) could crowd out some funds that could be channelled to private sector projects. Also, higher interest rates on government bonds and T-bills could have an impact on interest rates of loans offered to the private sector. This might have certain negative impact on economic activity, but the scale of this effect would likely be negligible.

In terms of public and external debt sustainability the counterfactual scenario involves shifting from external to domestic borrowing. However, due to the credibility of the currency board this is not expected to be associated with any impacts for public debt and external sustainability. Therefore, the main effects are due to higher interest payments, but again, the scale of this increase is not very significant. Table 15 provides a summary of macroeconomic and external sustainability implications of the no MFA counterfactual scenario.

**Table 15. "No MFA" counterfactual scenario – a summary**

| Period | Policy response | Net macroeconomic outcomes |
|---|---|---|
| 2013 | Higher borrowing on the domestic market | Higher interest rates on domestic debt market. As a result, governments of RS and FBiH face higher debt servicing cost to the tune of EUR 12.4 million spread over the 2013-2015 period<br><br>No sizeable impact on macroeconomic conditions (GDP growth, inflation, etc.)<br><br>Balance of payment position – lower reserve accumulation and a slight contraction in imports<br><br>It is difficult to conclude that lack of MFA would have changed market sentiments towards BiH and led to capital outflow. The presence of foreign capital is limited, and most of the inflows comprise donors' funds; foreign direct investment (FDI) or portfolio investments comprise a much smaller proportion<br><br>Some crowding out of private investment possible, but the size of the effect cannot be significant given the excess liquidity in the banking system<br><br>No significant impact on public debt sustainability – minimally deteriorated outcome due to higher cost of debt servicing |

*Source: own elaboration*

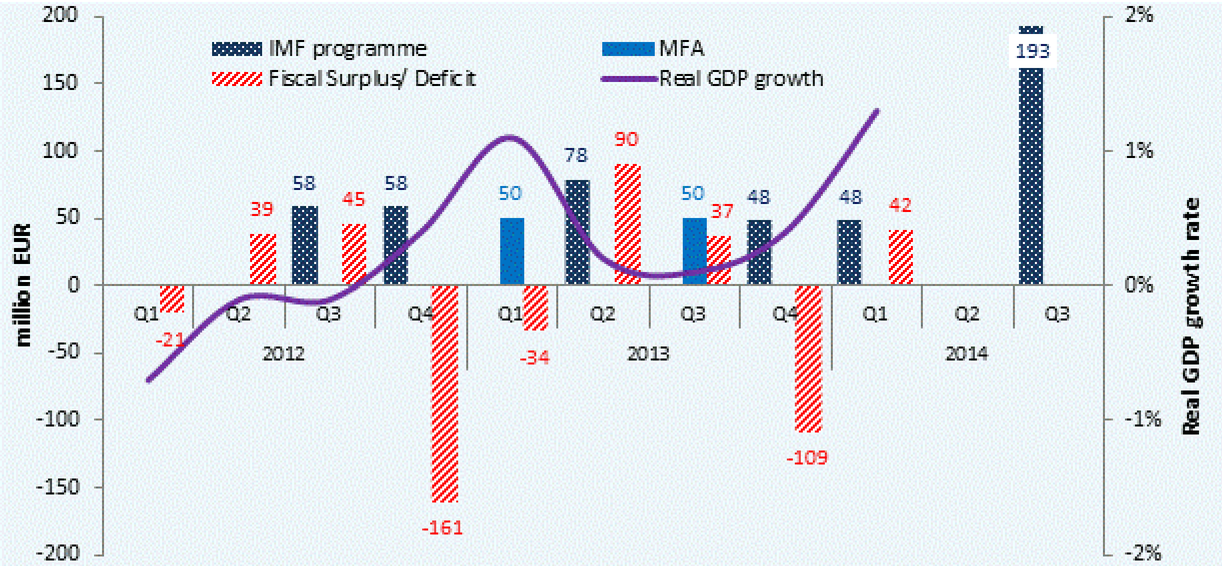
### 3.2.1.2 "No MFA and no IMF" counterfactual scenario

This scenario is defined as the one in which:

- MFA operation does not take place;
- IMF programme agreed in June 2009 is implemented as originally planned, i.e. is *de facto* terminated following the October 2010 elections which resulted in a political deadlock; and
- There is no September 2012 IMF programme and no other IMF programmes is agreed until end of the period covered by the assessment (in practice during 2013-2014).

The key difference between this counterfactual scenario and the no MFA scenario described above is in the scale of missing external financing. IMF disbursements equalled around EUR 116 million in 2012, EUR 126 million in 2013 and EUR 240 million during the first three quarters of 2014 (see Figure 24).

**Figure 24. Disbursement of IMF and MFA loans, 2012-2014 (EUR million)**




*Source: IMF (BiH Transactions with the Fund between 2012-2014), EC documents, macroeconomic data sourced from CBBH .*

The domestic debt market did not have the appetite to absorb issuance of debt instruments at comparable scale (see Box 4 above)[79]. Given BiH's lack of access to international markets, the counterfactual 'loss' of external financing would need to be associated with fiscal adjustment.

The mobilisation of additional tax revenues is not deemed as a feasible option. This is due, *inter alia*, to difficulty reaching the political compromise needed for any changes of indirect taxes (mainly VAT) collected at the State level. In addition, the relatively large scale of the unregistered economy and various weaknesses of tax collection institutions make substantial tax increases unlikely to generate matching rise in revenues.

Hence, the most plausible adjustment would have involved cuts in public spending. It is assumed, for simplicity, that other sources of financing are not affected in the counterfactual scenario. The required adjustment on the expenditure side would need to be in the range of 0.9 per cent of BiH GDP in 2012 and around 1.7 per cent of GDP in 2013 and in 2014. The latter figure (for 2014) takes the end of August 2014 as a cut-off date of when actual IMF disbursements are removed in the counterfactual scenario. This

[79] In theory, domestic banks had the capacity to absorb any domestic debt issued to replace IMF funding. According to local financial regulation, any individual financial institution's exposure to government debt cannot exceed 300% of its core capital. Therefore, in theory, the ceiling imposed by the financial regulations would not have been an obstacle for absorption of the debt instruments comparable to the size of IMF assistance.

is explained by practical considerations (the fact that this analysis was conducted in November 2014), but the IMF statement after the Fund's visit to BiH in mid-September 2014 suggests that next disbursements may not be immediately available to BiH.

Having decided on the most likely policy response that would be required under this counterfactual scenario, the key question is about its macroeconomic and external sustainability implications. These are discussed below.

The first important issue concerns the most likely structure of public expenditure cuts. Delays in certain wage and social spending and in transfers with State-owned enterprises appear the most likely short-term response. However, it is questionable whether in the longer term these spending cuts would translate into a permanent reduction of excessive (and poorly targeted) social expenditure or would return to the original path at the expense of public investment expenditure. The latter scenario might be more plausible.

No studies have been identified that would try to estimate fiscal multipliers for BiH. Economic theory based on the Mundell-Fleming model predicts sizeable fiscal multipliers for countries with fixed exchange rate regimes. Empirical evidence remains somewhat mixed, reflecting *inter alia* various methodological challenges in estimating fiscal multipliers, for example where the multipliers appear to be larger during recessions than during expansions (for instance Auerbach and Gorodnichenko, 2012[80]). Given lack of consensus view on the size of fiscal multipliers that could be relevant for BiH during 2012-2014 the assumption is made that it could be in the range suggested by the recent study by Born et al (2013)[81]. This study reports the point estimate of the (short-run) fiscal multiplier of about 1.2 in countries with fixed exchange rate regimes. Due to the inherent uncertainty of any estimates and the fact that emerging economies and countries with high trade openness may have lower multipliers (Ilzetzki, 2009)[82] two multiplier values have been applied: 1.2 and half of that figure (0.6) to assess the indicative range of counterfactual implications for GDP growth in BiH during 2012-2014.

Subdued economic activity in the counterfactual scenario would likely be associated with lower imports and a lower current account deficit. The quantification of this adjustment is difficult. It can be speculated that income elasticity of import demand may be at least 1, suggesting counterfactual imports and current account adjustments to the tune of up to 0.5 per cent of GDP in 2012, and 1 per cent of GDP in 2013-2014[83].

Public and external sector indebtedness would be lower in the counterfactual scenario, with the accumulated stock lower by some 4.3 per cent of GDP by the end of 2014. However, this apparent counterfactual improvement in external and public debt sustainability would not necessarily translate into longer-term improvement. This is because it cannot be taken for granted that the fiscal adjustment necessitated by lack of access to MFA and IMF funds would translate into lasting improvement in the structure of public spending. If this was not the case, then the need to repay accumulated arrears and pressing public investment needs would require turning to external financing sources to raise additional money in the future. Therefore, the counterfactual improvement in debt sustainability outlook could prove rather short-lived. Any assumptions in this respect would be highly speculative making the assessment of counterfactual longer term public and external debt sustainability particularly difficult.

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[80] Auerbach, A J and Y Gorodnichenko (2012), Measuring the Output Responses to Fiscal Policy, *American Economic Journal: Economic Policy*, 4(2): 1–27.

[81] Born, Benjamin, Juessen, Falko and Mueller, Gernot J. (2013), Exchange rate regimes and fiscal multipliers, *Journal of Economic Dynamics and Control*, Elsevier, Elsevier, vol. 37(2), pp 446-465.

[82] Ilzetzki, E., Mendoza, E.G., Vegh, C.A. (2009), 'How big are fiscal multipliers?', Centre for Economic Policy Research Policy Insight, 39.

[83] Goods and services imports as reported in the balance of payments statistics corresponded to approximately half of GDP in 2013. An overview of literature estimating trade demand elasticities in countries similar to Bosnia and Herzegovina can be found e.g. in B Jovanovic (2012), Estimating trade elasticities for ex-socialist countries: the case of Macedonia, mimeo, University of Rome Tor Vergata, http://www.eiit.org/WorkingPapers/Papers/TradePatterns/FREIT444.pdf

The results for this scenario are summarised in Table 16. They are subject to large margin of uncertainty, but are nevertheless likely to provide a realistic approximation of the scale of counterfactual outcomes.

**Table 16. No MFA and no IMF assistance counterfactual scenario – a summary**

| Period | Policy response | Macroeconomic outcome |
|---|---|---|
| 2012 | Reduction of public spending by around EUR 116 million (0.9 per cent of GDP) | GDP growth rate lower by between 0.5 and 1.1 percentage point, i.e. deeper recession: GDP falling by 1.7-2.3 per cent<br>Imports and consequently, current account deficit lower by equivalent of some 0.2- 0.5 per cent of GDP<br>Public and external debt stock lower by around 0.9 per cent of GDP |
| 2013 | Reduction of public spending by around EUR 126 million (1.7 per cent of GDP) | GDP growth rate lower by between 1 and 2 percentage point, i.e. economy between stagnation (GDP decline by 0.2 per cent) and slow growth (0.8 per cent)<br>Imports and current account deficit lower by equivalent of some 0.5- 1 per cent of GDP<br>Public and external debt stock lower by around 2.6 per cent of GDP |
| 2014 | Reduction of public spending by around EUR 240 million (1.7 per cent of GDP) | GDP growth rate lower by between 1 and 2.1 percentage point, i.e. recession with GDP declining by between 0.3 per cent and 1.4 per cent)<br>Imports and current account deficit lower by equivalent of some 0.5- 1 per cent of GDP<br>Public and external debt stock lower by around 4.3 per cent of GDP. NB, the improvement in longer term debt sustainability is likely much less pronounced or at the extreme, around zero. |

*Source: own elaboration*

## 3.3 Macroeconomic and external sustainability impacts

The construction of counterfactual scenarios in the previous section allows an assessment of an indicative net macroeconomic impact of the MFA (and a combination of the MFA and IMF assistance) on the BiH economy. It is calculated as the difference between an observed macroeconomic path in BiH (what has actually happened) and the counterfactual path (what would have happened without MFA assistance or without both MFA and IMF assistance).

The largely qualitative approach to the construction of the counterfactual macroeconomic scenarios clearly suggests that any results should be interpreted with caution. They may indicate direction and likely order of magnitude of effects. With these caveats in mind, the tables below summarise the findings from the interim stage of the evaluation.

### Table 17. Net impact of the MFA operation (observed outcomes – counterfactual outcomes)

| Macroeconomic variable | Likely net impact of the MFA operation |
|---|---|
| Economic growth | No significant impact; potentially marginal positive contribution due to more domestic funds being available to finance private sector development – the scale of this effect is likely to be very small |
| Labour market | No significant impact |
| Inflation | No significant impact |
| Balance of payment position | No significant impact - lower reserve accumulation and a slight contraction in imports |
| Fiscal position | No significant impact - MFA lowered debt servicing costs by around EUR 12.4 million during 2013-2015 |
| Public sector debt sustainability | No significant impact – minimally lower debt servicing costs (a decrease of around 3-4 per cent during 2013-2015); small change in debt structure: lower share of domestic debt and higher share of (concessional) external public debt |
| External debt sustainability | No significant impact – slightly higher (concessional) public external debt |

*Source: own elaboration.*

### Table 18. Net impact of the combined MFA operation and IMF's 2012 SBA programme (observed outcomes – counterfactual outcomes)

| Macroeconomic variable | Likely combined impact of MFA and IMF assistance |
|---|---|
| Economic growth | Significant boost to economic activity over the period 2012-2014. Cumulative impact on GDP level by end of 2014 could be in the range of 2.6 – 5.1 per cent |
| Labour market | Improved labour market situation – no quantitative estimate available |
| Inflation | No significant impact (potentially a minor increase) |
| Balance of payment position | Boost to imports fuelling higher current account deficits during 2012-2014 – by up to 1 per cent of GDP during 2013-2014 |
| Fiscal position | Assistance prevented significant fiscal consolidation on the expenditure side that would otherwise be necessary. The assessment of implications depends on the structure of spending cuts and whether these would be permanent (e.g. involving changing the rules of allocation of social spending to make them better targeted and in aggregate lower) or temporary (e.g. running arrears) in the counterfactual scenario |
| Public sector debt sustainability | Public sector debt increased by up to 4.3 per cent of GDP in the short-term (till end-2014). Longer term deterioration of public debt sustainability expected to be potentially much lower or even going down to zero if fiscal adjustment was not in the form of permanent changes reducing current expenditures and leaving more room for investment spending. In the latter case, at some future date pressing public investment needs would require raising additional financing by the government(s) |
| External debt sustainability | External debt increased by up to 4.3 per cent of GDP in the short-term (till end-2014). Longer term impact on sustainability not necessarily that significant or potentially close to zero (see discussion above) |

*Source: own elaboration*

## 3.4 Conclusion

On the basis of available evidence, it can be concluded that the EU MFA operation made a marginal positive contribution to macroeconomic developments in BiH in 2013. The economic growth dynamics in the period 2009-2014 were primarily driven by factors not directly related to the MFA operation. The potential net effect of the MFA was two-fold. First, it is expected to have lowered the costs of public debt service by an estimated EUR 12.4 million over the period 2013-2015. Second, it may have made access to credit somewhat easier for BiH businesses (by avoiding any crowding out effect of increased domestic borrowing by the government). This suggests a very small, but positive net MFA impact on macroeconomic situation.

The MFA is best seen as an element of broader international assistance to BiH and in particular the MFA was closely linked to the IMF programme. Given the significantly larger size of the IMF's 2012 SBA, it is not surprising that the combined macroeconomic impact of these two operations is found to have been substantially larger than the impact of the MFA alone. The two programmes combined are assessed to have provided a significant boost to economic activity during 2012-2014. Cumulative impact on the GDP level by end of 2014 could be in the range of 2.6 – 5.1 per cent. This was primarily driven by avoiding the significant fiscal adjustment on the expenditure side that would be necessary without external assistance.

The combined MFA and IMF support, by maintaining higher economic activity level also prevented a reduction in imports that typically accompanies weakening domestic demand stemming from expenditures cuts (particularly wage cuts). This contributed to higher current account deficits than would otherwise have been the case in the counterfactual scenario. However, no clear evidence has been identified of any medium to long-term impact on current account. The direct impact of assistance was an increase of the public external debt. However, this does not necessarily imply worsening of longer-term debt sustainability. This is because public spending contraction in the counterfactual scenario could have occurred in the form of running arrears and other forms of delaying expenditure rather than permanently reducing them. This would then lead to the need for generating resources to eliminate the arrears, which would imply the need for additional borrowing. The conditions of this funding might not match those available under the IMF SBA and EU MFA programmes. Set against such a counterfactual, the long-run net MFA and IMF impact on external debt sustainability could be close to zero or even slightly positive.

# 4 Impact of the MFA on Structural Reforms

The Memorandum of Understanding signed in November 2010 defined a number of policy conditions that needed to be met to enable disbursement of MFA tranches. This section provides an assessment of the impact of the MFA on structural reforms. The analysis is based on extensive desk research and interviews with key stakeholders among the BiH authorities, European Commission, the IMF and the World Bank as well as consultations with a wider group of stakeholders (e.g. economists, think tanks, business representatives) during two workshops held in Banja Luka and Sarajevo.

The policy reform conditions attached to the MFA are presented in Table 19.

**Table 19. Conditions attached to the MFA operation**

| Tranche | Area of reform | MFA Condition |
|---|---|---|
| First | Co-ordination of fiscal policies | The approval of *Global Framework for Fiscal Policies* by the Fiscal Council, including an overview of total revenue, expenditure and financing consolidated for BiH and disaggregated for the State, FBiH, RS and Brĉko District. |
| First | Public Finance Management | The Government Budget Management Information System will be tendered. |
| Second | Public Finance Management | The draft Law on Fiscal Responsibility will be approved by the government of the FBiH. |
| Second | Public Finance Management – co-ordination of policies | The Heads of the Central Harmonisation Unit in the Ministry of Finance of the FBiH and the State level will be appointed. In addition, Coordination Board for Public Internal Financial Control (PIFC) will be established. |
| Second | Public Finance Management | The new cash management system for public finances in the FBiH will be put in operation. |
| Second | Debt management | An updated overview of public domestic debt will be produced by the FBiH. |
| Second | Financial supervision – co-ordination | Enhanced surveillance of the banking system will be continued including quarterly stress tests of the banking system that will be performed by the Central Bank of BiH and two Banking Agencies. |
| Second | Statistics – co-ordination | The Agency for Statistics of BiH and the Statistical Institutes of the RS and the FBiH will agree on modalities of the cooperation in order to develop quarterly national accounts in accordance with the requirements of the ESA 95 system and commitments under the Stabilisation and Association Agreement. |
| Second | Public Finance Management | Two rulebooks on the new chart of public financial accounts will be adopted by the Ministry of Finance of RS. |
| Second | Pension reform | Strategy on pension reforms will be adopted by the Parliament of RS. |

## 4.1 Reform Context

The Council decision on MFA assistance took place when the BiH reform agenda was gaining momentum. This was driven by the pressure resulting from the crisis situation and recommendations of the international financial institutions (IMF, World Bank) and agreed structural reform conditionality linked to the budgetary support. Reform progress slowed during 2010 in the pre-election period, especially since the macroeconomic situation in 2010 turned out to be better than earlier anticipated. Following the elections and up until early 2012, public policies were negatively affected by the lack of the State-level government. After mid-2012 reform efforts intensified again, although progress remained slow relative to the existing challenges. The October 2014 elections again acted as a barrier slowing reforms, for example delaying the eighth review under the IMF's SBA[84].

During 2010-2011, limited structural reforms were implemented in the area of public finance management. High labour taxation continued to hamper job creation and labour market participation, while increasing the incentives for the existence of the informal labour market. The privatisation process stalled, in particular due to unfavourable international market conditions and lack of investors' interest. There was slow progress in the planned restructuring and liquidation of socially-owned enterprises.

MFA reforms focused predominantly on areas that are highly relevant for macroeconomic stability: public finance management (PFM) and financial sector stability. A distinctive feature of the construction of the MFA conditionality for BiH was that four conditions directly supported the co-ordination of policies and actions between Entities and Entity and State-level institutions.

In particular, the requirement to approve a *Global Framework for Fiscal Policies* was important in this respect. This is because it comprised budget frameworks of all levels of government (central and the two Entities) and aimed at enhancing transparency and coherence of fiscal policies in the country. In practice this is the main mechanism of fiscal policy co-ordination within the country, although the document is often seen as needing improvement.

Another example of a condition that aimed at stimulating co-operation and co-ordination of actions between Entity and central level institutions was the requirement to develop quarterly national accounts (something that did not exist before and for which Entity-level data were needed).

The choice of the policy conditions in the area of public finance management was mainly based on the findings of the operational assessment of financial circuits and procedures in BiH carried out in November 2009. For example, the assessment explicitly referred to: the weaknesses of the public cash management system used in FBiH; the need of the amendment of the Law on Fiscal Responsibility in FBiH; strengthening of the ex-ante internal control (establishment of the Coordination Board for Public Internal Financial Control (PIFC); and improvement in the public Entities financial reporting standards (adoption of two rulebooks on the new chart of public financial accounts by the Ministry of Finance of RS).

The conditions attached to the MFA operation were agreed in consultation with other Commission services, notably DG ELARG. They were also discussed with the IMF (in Sarajevo and during videoconferences with IMF headquarters in Washington, DC) and with the World Bank. This was to ensure that there were no contradictions between the objectives promoted and supported by various donors, as well as to enable reinforcement of various conditions. The conditionality was also negotiated with BiH authorities and there was consensus among authorities on appropriateness of this process. Separate negotiations were held with representatives of the State and Entity-level ministries of finance as well as joint meetings where the European Commission side insisted on achieving a joint agreement of all involved parties.

There was a high level of cross-conditionality between the MFA and the IMF programme (7 out of 10 MFA conditions reflected areas of reforms also promoted by the IMF either directly as a prior action/ structural benchmark in its programme or indirectly, via the provision of Technical Assistance). For instance, the approval of *Global Framework for Fiscal Policies* by the Fiscal Council (in 2009) was a prior action in the 2009 IMF SBA and the practically identical MFA condition concerned subsequent year(s).

[84] Following the mission in September 2014 IMF staff team in its statement said that: "*The authorities need more time to implement policies that had been agreed under the SBA. This includes policies aimed at reining in government spending not directly related to addressing the impact of the floods; improving tax compliance and fighting tax fraud; and strengthening financial sector stability and enhancing banking supervision. We hope to see strong progress in the implementation of these policies in order to pave the way for consideration of the eighth review under the SBA by the IMF Executive Board.*""

The analysis of structural conditions presented in this section focuses on the following elements:

- The nature and scope of the conditionality attached to the MFA operation;
- The rationale for each condition;
- The implementation of the conditionality by the BiH authorities;
- Evidence for reform impact; and
- Evidence of MFA contribution to the reform progress.

The figures and tables below provide an assessment of the following aspects of structural reforms conditionality. They present:

- The intervention logic underpinning the selection of conditions as reconstructed by the evaluation team;
- The expected outputs, i.e. actions or products expected as the fulfilment of conditions;
- The level of implementation, i.e. actions related to fulfilling conditions;
- The level of implementation deficit, i.e. whether there is any evidence on implementation problems, e.g. discrepancy between de jure and de facto situation;
- The immediate outcomes, i.e. what benefits were expected quickly after fulfilment of conditions and whether there is any evidence of their materialisation;
- The longer-term outcomes and impacts, i.e. what changes / benefits were expected in the longer-term and whether there is any evidence of their materialisation;
- The domestic ownership of reforms and donor support, i.e. to what extent reforms were part of the domestic policy agenda and which other actors promoted reforms in a given area; and
- The MFA value added, i.e. to what extent any effects can be attributed to the MFA.

**Figure 25. Intervention logic of the condition on reforms related to the Global Framework of Fiscal Policies**

**Rationale for the Reform**

Fiscal policy is strongly decentralised and implemented at entity level.

The law requires the annual adoption of the Global Framework of Fiscal Policies for a period of three years by 31 May at the latest. This is the main tool for fiscal policy co-ordination in BiH to enhance its transparency, coherence, and predictability.

**Output(s)**

In 2010 and 2011 the Fiscal Council failed to adopt the Framework.

In the first half of 2012 the Fiscal Council adopted Frameworks for 2012-2014 and 2013-2015.

**Immediate Benefits**

A document in place setting up the macroeconomic outlook for a three-year period, projections of revenues from indirect taxes (main revenue source; state-level policy) and a snapshot of projected total revenue, expenditure and financing consolidated for the country and disaggregated for the State, the Federation of Bosnia and Herzegovina, the Republika Srpska and Brčko District.

2014 budgets adopted by both entities before end-2013.

**Outcomes & Impacts**

Expected: better fiscal policy co-ordination within the State.

Improved chances for fiscal reforms.

Political benefits – one more area where co-ordination between entities and the state can be improved.

**Condition 1.1 (first tranche):** The approval of Global Framework for Fiscal Policies by the Fiscal Council, including an overview of total revenue, expenditure and financing consolidated for BiH and disaggregated for the State, FBiH, the RS and Brĉko District.

| | |
|---|---|
| **Implementation** | The Global Framework of Fiscal Policies for 2013-2015, which served as a basis for the 2013 government budgets, was approved by the Fiscal Council on 15 June 2012. |
| **Evidence of Implementation deficit** | It 2010 and 2011, the Fiscal Council failed to adopt the framework within the deadlines[85]. The main issue was the allocation of revenues from indirect taxes and the amount of funds allocated to the State-level budget. In addition, the agreement on the Framework adoption was impeded by the prolonged political stalemate in the country following the 2010 general elections[86]. The Global Framework for Fiscal Policies was eventually adopted in June 2012, shortly after the formation of the new central government. The authorities agreed on a medium-term expenditure ceiling for the State-level budget. According to the reached agreement, endorsed by the Fiscal Council, expenditures of the State institutions are to remain fixed over the medium-term at BAM 950 million (representing 3.2 per cent of the estimated countrywide GDP in 2011). The allocation from the Single Account of the Indirect Tax Authority – making the bulk of State budget revenues – is to remain constant at BAM 750 million.<br><br>While the Frameworks have since been agreed, there remains large room for improvement in the quality of the document that to some extent just compiles independently produced fiscal projections.<br><br>According to some of the stakeholders interviewed, _"this conditionality was implemented by the authorities in letter, but not in spirit."_ |
| **Relevance** | High. Despite its weaknesses the Framework is the only document setting up the medium-term framework for fiscal policies in a highly decentralised fiscal system. It contains: (i) fiscal objectives e.g. revenue projections and targets by level of governments; (ii) macro-economic analysis and policy on indirect taxes; and (iii) upper limits of debt. |
| **Importance** | High The IMF (as part of the 2004 SBA) was instrumental in the setting up of the Fiscal Council. While the IMF had a Belgium like arrangement in mind, what was implemented in practice was quite different (according to stakeholders, the Fiscal Council is essentially a "rubber stamping" body).<br><br>The Global Framework for Fiscal Policies was therefore, seen as an important tool to make the Council work. It provides a medium term fiscal framework setting out the country's spending priorities, expected expenditure, revenue and deficit. |

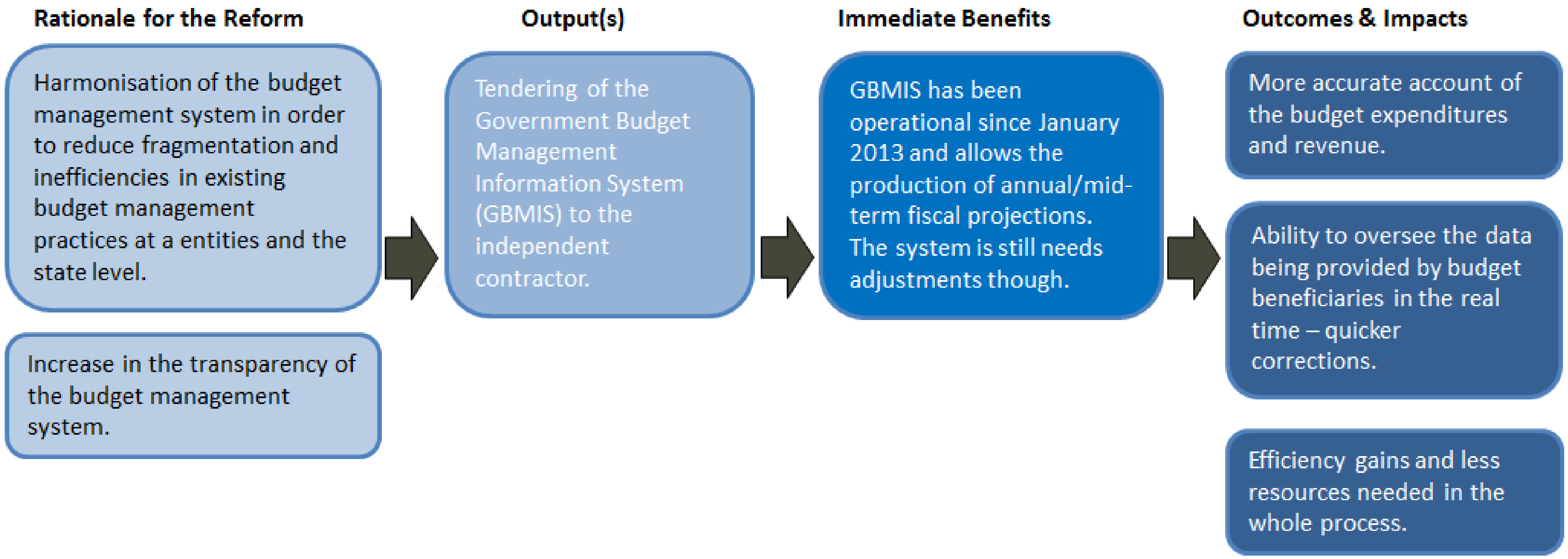
[85] in the absence of which the FBiH and RS, adopted their 2012 budgets (in January 2012 and December 2011, respectively) in violation of the country's legal framework for a second consecutive year. Source: European Commission (2012) 2012 Economic and Fiscal Programmes of Albania, Bosnia and Herzegovina: EU Commission's overview and country assessments, Occasional Papers 97, June 2012. Available at: http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp97_en.pdf

[86] European Commission, 2012. Note on Bosnia and Herzegovina's compliance with the conditionality for disbursing of the first loan instalment under the European Union MFA.

| | |
|---|---|
| | Despite its weaknesses the Framework supports more organised budget planning and provides more transparency and coherence in fiscal policies. Operational Assessment indicated improvement in the budget preparation, in particular at the FBiH level, as an area of high priority. For instance, it drew special attention to the absence of sufficient transparency and the fact that Budget Beneficiaries tended to request much higher allocations. These allocations were also '…*a subject of political influence and bargaining*'[87]. |
| **Domestic ownership & donor support** | The IMF was strongly involved in the creation of the Fiscal Council. The 2009 IMF programme included the condition ('prior action') of the Council agreeing the Global Framework and this was achieved in 2009. MFA 'borrowed' this condition from the IMF. Reaching an agreement on the Framework has been difficult for internal political reasons. In particular, the estimation of proceeds from indirect taxation serving as a basis for further redistribution between Entities was a problematic/controversial issue. Forming the State-level government after the long stalemate following 2010 elections acted as a trigger for eventually reaching the agreement on the Framework. |
| **Added Value of MFA** | The MFA condition is believed to have played a politically reinforcing role. The condition is best seen as an element of international support / pressure on BiH stakeholders to introduce more elements of fiscal policy coordination, and improve transparency and predictability of budgeting. As such it could claim some degree of success. |
| **Evidence of benefits** | The preparation and adoption of the 2013 State and Entity budgets happened before the expiration of previous budget years – a clear improvement over past practice. |
| **Evidence of long-term Impacts** | Global Frameworks have been agreed in 2013 and 2014.Timely preparation and adoption of the 2014 budgets has happened. Expected benefits mainly relate to more predictable and coherent fiscal policy planning enabling making strategic socio-economic policy choices. These benefits are not currently visible. |

[87] PwC, 2010. Bosnia and Herzegovina Operational Assessment.

**Figure 26. Intervention logic of the condition on the common Government Budget Management Information System**




| **Condition 1.2 (first tranche):** | The Government Budget Management Information System will be tendered. |
|---|---|
| **Implementation** | The common Government Budget Management Information System (GBMIS) project was tendered in April 2011. The authorities and the selected tenderer signed a contract in July 2011 and the implementation of the project began. The system has been operational since January 2013. |
| **Evidence of Implementation deficit** | Although it has been operational since January 2013, the system is still not optimal and needs adjustment[88]. |

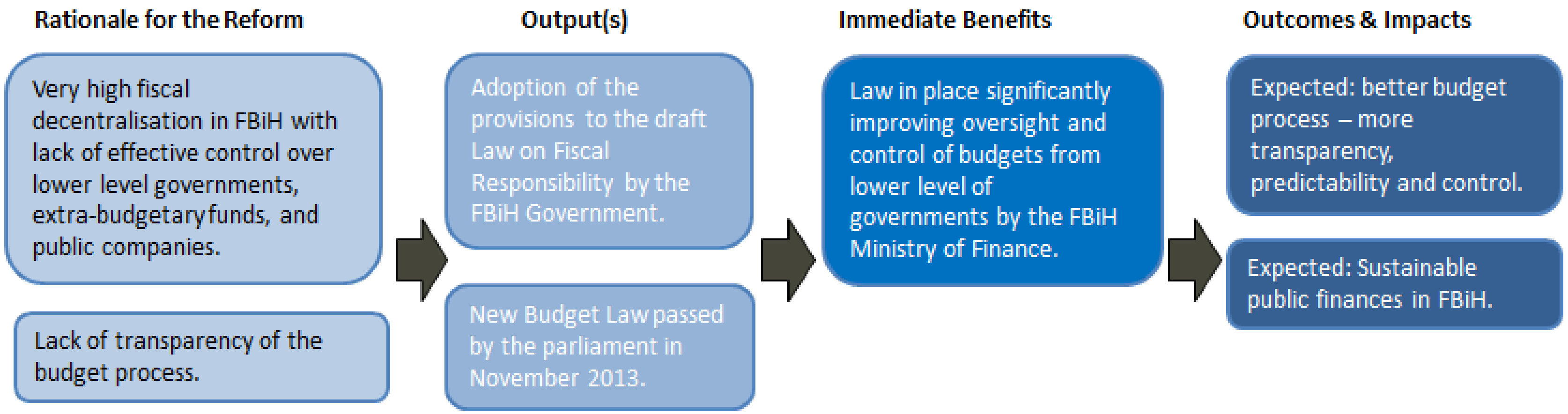
[88] Information provided by the Ministry of Finance of RS

| | |
|---|---|
| **Relevance** | The GBMIS is standardised at all levels of government (central and the two Entities). It aims at harmonising the treasury information systems, reducing current fragmentation and increasing the effectiveness and efficiency of budget management. Prior to the MFA there was already a system in place, though it had limited capacities. |
| **Importance** | Low. System would allow the production of annual and mid-term fiscal projections. |
| **Domestic ownership & donor support** | The authorities received some bilateral assistance (funding from Sweden and UK) to improve the system[89]. |
| **Added Value of MFA** | The system would have been implemented even without MFA conditionality, though it is believed that the programme speeded up the process. |
| **Evidence of benefits** | The system as it currently stands functions well[90] and allows the staff responsible for the budget management to see when budget users (i.e. municipalities) start providing the information (i.e. regarding expected expenditures) and whether the required information is complete. This gives the Ministry, inter alia, more time for the budget preparation including ability to send specific inquiries to budget beneficiaries to clarify the data. However, the Ministry acknowledged that the system (as of January 2015) still requires some upgrade. |
| **Evidence of long-term Impacts** | Improved efficiency and accuracy of budgets - once the system is fully upgraded, it shall reduce the resources and time needed for the budget management and in parallel increase the accuracy of the information provided by the budget beneficiaries. |

[89] Information provided by the Ministry of Finance of RS

[90] As stated by the Ministry of Finance of FBiH in January 2015.

**Figure 27. Intervention logic of the condition on drafting new fiscal responsibility law in FBiH**

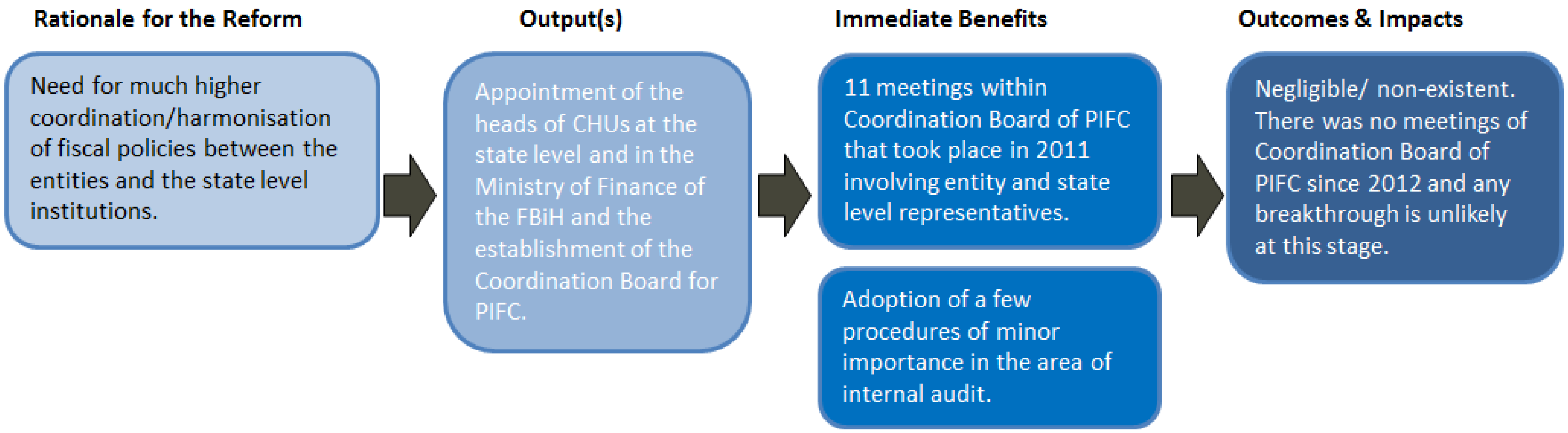



| **Condition 2.1 (second tranche):** The approval of the draft law on Fiscal Responsibility by the government of the FBiH. | |
|---|---|
| **Implementation** | The government of the FBiH integrated the provisions of the draft Law on Fiscal Responsibility into the draft FBiH organic budget law. This is considered as strengthening the impact given that the latter law is of higher order and applies to all levels of government in the FBiH. The new draft organic budget law was adopted by the government of the FBiH on its session on June 13, 2013[91]. The passing of the law was adopted by the Parliament in December 2013 and entered into force in early 2014. |
| **Evidence of Implementation deficit** | None. Possibly too early to assess given that the law entered into force only in early 2014. |

[91] DG ECFIN, December 2012. Note on Bosnia's and Hercegovina's compliance with the conditionality for disbursing of the first loan instalment under the European Union Macro-Financial Assistance.

| | |
|---|---|
| **Relevance** | High. The budget process in FBiH was complex, non-transparent and highly fragmented leading to lack of co-ordination and inefficiencies. FBiH level governments had limited tools to monitor, control and enforce limits on lower levels of government, extra-budgetary funds, and public companies. OA (2010) made several recommendations as regards strengthening the capacity of budget preparation in FBiH. |
| **Importance** | High. The new law was needed to put limits to the excessive fiscal decentralisation within FBiH and the lack of a mechanisms effectively constraining planning of budgets.<br>The three important elements of the law were:<br>▪ Setting up of a coordination body for FBiH;<br>▪ It applies to all levels; it prohibits borrowing for current spending; and<br>▪ Specifies and imposes reporting requirements. |
| **Domestic ownership & donor support** | The IMF was strongly involved: IMF staff provided assistance at the stage of drafting the law by the government. A stronger condition requiring passing of the law by the parliament became part of 2012 IMF programme conditionality (this was one of the structural benchmarks of the 2012 IMF programme - see letter of Intent).<br>The original deadline (March 2013) for this structural benchmark was extended several times.<br>The consultative process during the work on the draft involved cantons, municipalities and the parliament. Different positions of domestic stakeholders were sought given that the draft law was changing the relative powers of FBiH Ministry of Finance and lower levels of governments. |
| **Added Value of MFA** | Reinforced reform mainly led by the IMF. Combined IMF and EU conditions provided much needed political weight to the reform. |
| **Evidence of benefits** | The law has been in place since early 2014. It provides a better legal framework for work on 2015 budget, but it is still too early to identify and assess specific benefits already materialising. |
| **Evidence of long-term Impacts** | The impact if the draft law on Fiscal Responsibility is expected in the future, as law entered into force only in 2014. Key benefits are likely to be related to improved fiscal policy co-ordination in FBiH and in particular better oversight and control of budgets from lower level of governments by the FBiH Ministry of Finance. The functioning of rules that should much limit the room for emergence of budget deficits should also improve, especially for unexpected budget deficits. This should improve fiscal policies and specifically should limit room for unjustified fiscal deficits. |

**Figure 28. Intervention logic of the condition on the reform related to the appointment of the Heads of the Central Harmonisation Unit (CHU) in the Ministry of Finance of the FBiH and at the State level, and the establishment of the Coordination Board for Public Internal Financial Control (PIFC)**



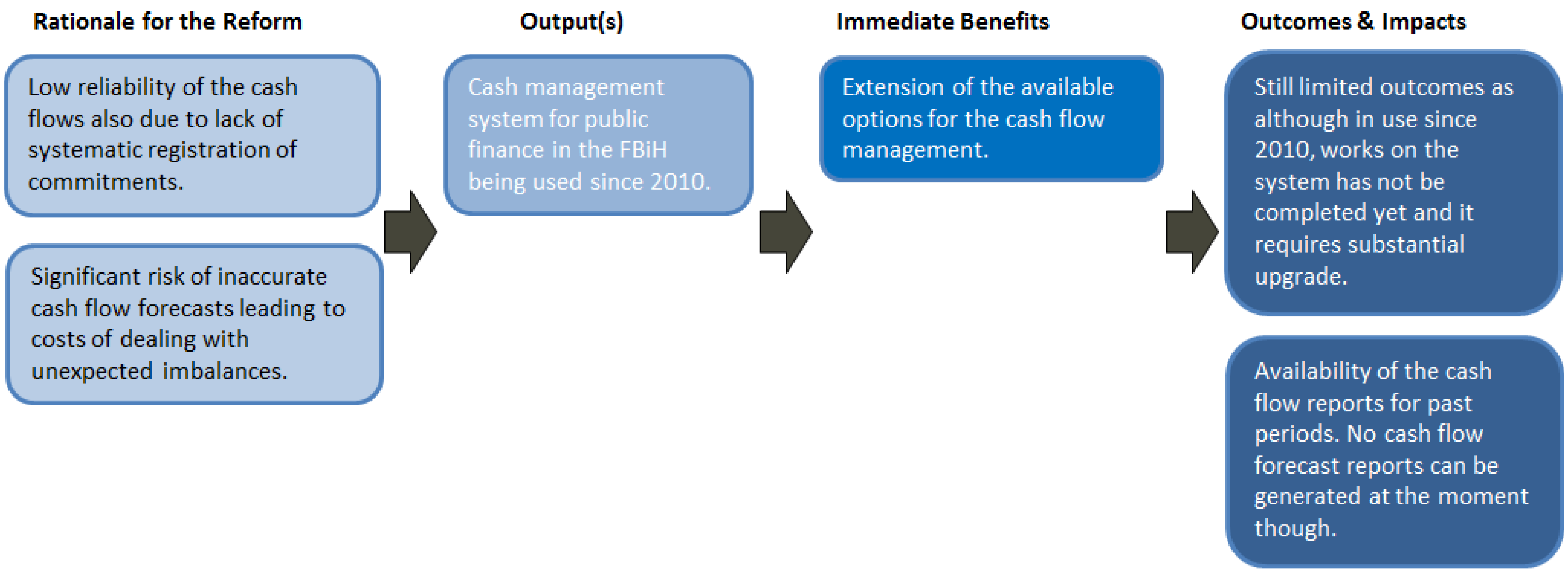

**Condition 2.2 (second tranche):** The Heads of the Central Harmonisation Unit (CHU) in the Ministry of Finance of the FBiH and the State level will be appointed. In addition, Coordination Board for Public Internal Financial Control (PIFC) will be established.

| | |
|---|---|
| **Implementation** | The Head of the Central Harmonisation Unit (CHU) in the Ministry of Finance of the FBiH was appointed in March 2011. The permanent Head of the Central Harmonisation Unit in the Ministry of Finance at State level has been appointed in July 2012. The two Entities and the State have established the Coordination Board for Public Internal Financial Control (PIFC) in January 2011. |
| **Evidence of Implementation deficit** | This condition was formally met in the sense that the Coordination Board for PIFC was established and heads of CHU at the State and FBiH level were appointed. However, based on the available information the Coordination Board for PIFC has not met in 2012 and 2013. |

| | |
|---|---|
| **Relevance** | High considering very limited coordination of fiscal policies at Entities and State level. Also, as indicated in the Operational Assessment undertaken in 2010: '…*at all three levels, no ex-ante control is carried out in the Treasuries*'[92]. |
| **Importance** | High. The importance and potential positive externalities from this reform could have been very meaningful. However, due to complex socio-political configurations and general difficulties in dialog/coordination between Entities and the State, very limited progress has been made. |
| **Domestic ownership & donor support** | This reform was already on the agenda of the national authorities prior to the MFA. There was no other international donor who would explicitly push for the establishment of the Coordination Board for PIFC other than European Commission. |
| **Added Value of MFA** | The MFA played the major role in terms of contributing to the agreement on this condition. |
| **Evidence of benefits** | The benefits (as of November 2014) have been very limited so far and reduced almost entirely to the temporary dialog within Coordination Board of PIFC which took place in 2011 (11 meetings took place during that year) and the adoption of a few procedures of minor importance in the area of internal audit. |
| **Evidence of long-term Impacts** | Uncertain. The Coordination Board for PIFC is an inactive body (no meetings took place since 2012) and there seems to be no evidences for the time being that this impasse can be broken. |

[92] PwC, 2010. Operational Assessment of Bosnia and Hercegovina.

**Figure 29. Intervention logic of the condition on the reform related to the new cash management system for public finance in the FBiH**

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| **Condition 2.3 (second tranche):** | The new cash management system for public finances in the FBiH will be put in operation. |
| **Implementation** | The new cash management system for public finances in the FBiH has been in use since July 2010, allowing better planning and budget execution on the basis of the cash flow projections. The new system provides for obligatory registration of commitments, thus eliminates the significant shortcomings of the previous practice where lack of systematic commitment registration had impaired efficient cash management[93]. |

[93] DG ECFIN, June 2013. Note on Bosnia's and Hercegovina's compliance with conditionality for disbursing the second loan instalment under the European Union Macro-Financial Assistance.

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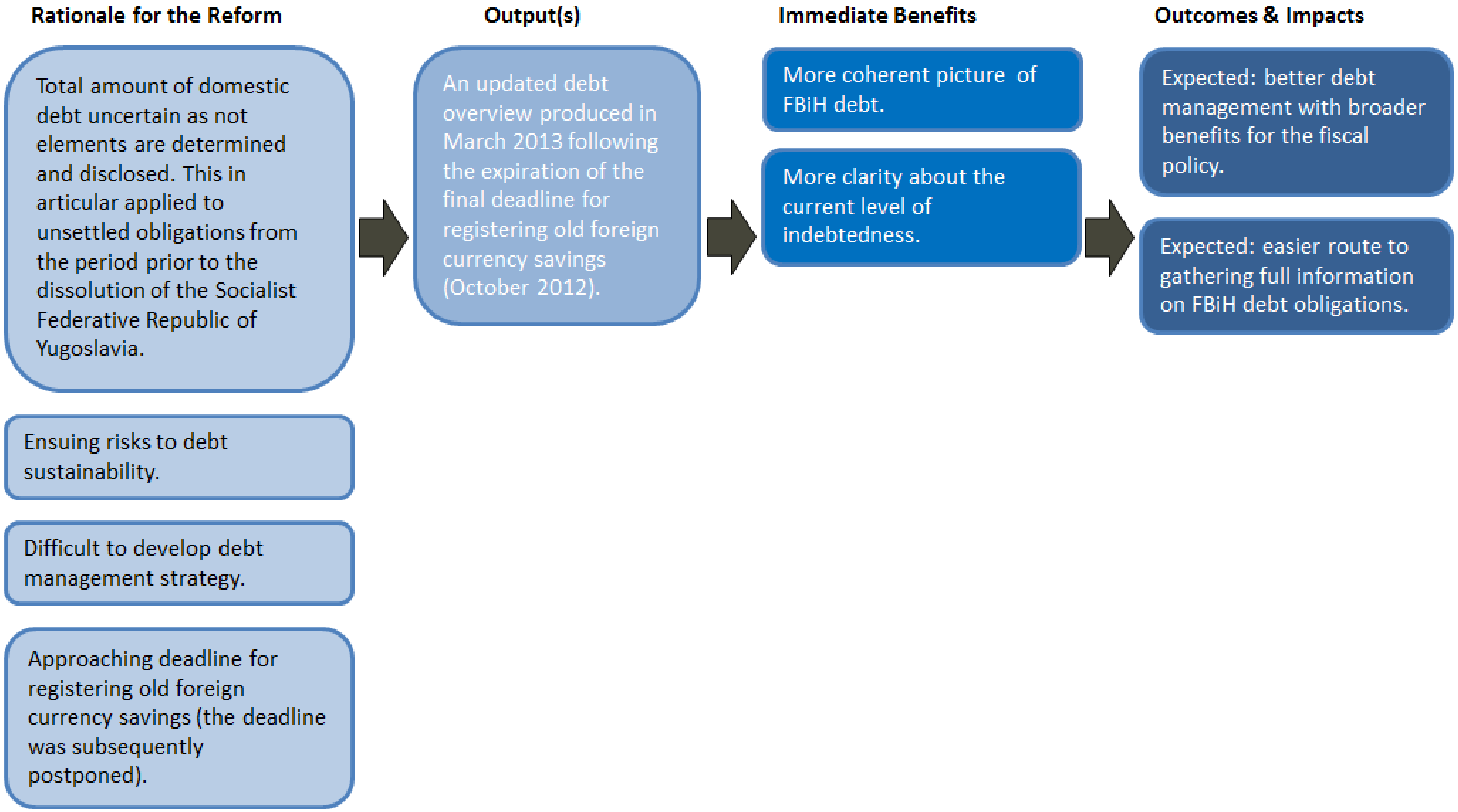
| **Evidence of Implementation deficit** | The system is still not fully operational. For example, although it allows the production of reports for previous periods, it still does not offer the possibility to produce cash flow forecasts/ projections. These have to be prepared manually in excel.<br><br>The IT department in the Ministry of Finance of the FBiH stated that the system requires 'a substantial upgrade which requires considerable resources' both in human and financial terms. There is also a need for specifically tailored training to allow staff to use the maximum potential of the system. |
| **Relevance** | High. In the past, cash flow management was characterised by high uncertainty, especially due to significant number of unexpected commitments. |
| **Importance** | High. As indicated by the Operational Assessment: '…*The absence of systematic commitment registration at the FBiH (and State level) heavily impairs efficient cash management*.' |
| **Domestic ownership & donor support** | No other donor support was identified, although there was high domestic ownership as the Ministry of Finance had been working on the system prior to the MFA. |
| **Added Value of MFA** | The role of the MFA in the implementation of the condition on the cash-flow management system was limited, given the high domestic ownership of this reform. |
| **Evidence of benefits** | Still limited as the system is not fully operational and there is a lack of appropriately trained staff for its usage. |
| **Evidence of long-term Impacts** | ▪ More efficient cash flow management allowing more accurate planning of revenue and expenditures and reducing the risk of ad hoc, more expensive borrowing to fill in the gaps stemming from inaccurate wrong cash management.<br><br>▪ Increased transparency and accountability of the public finance management system and for the future, the ability to produce cash flow forecasts as oppose to only overview of historical cash flows. |

**Figure 30. Intervention logic of the condition related to the reform on updating the overview of public domestic debt in FBiH**

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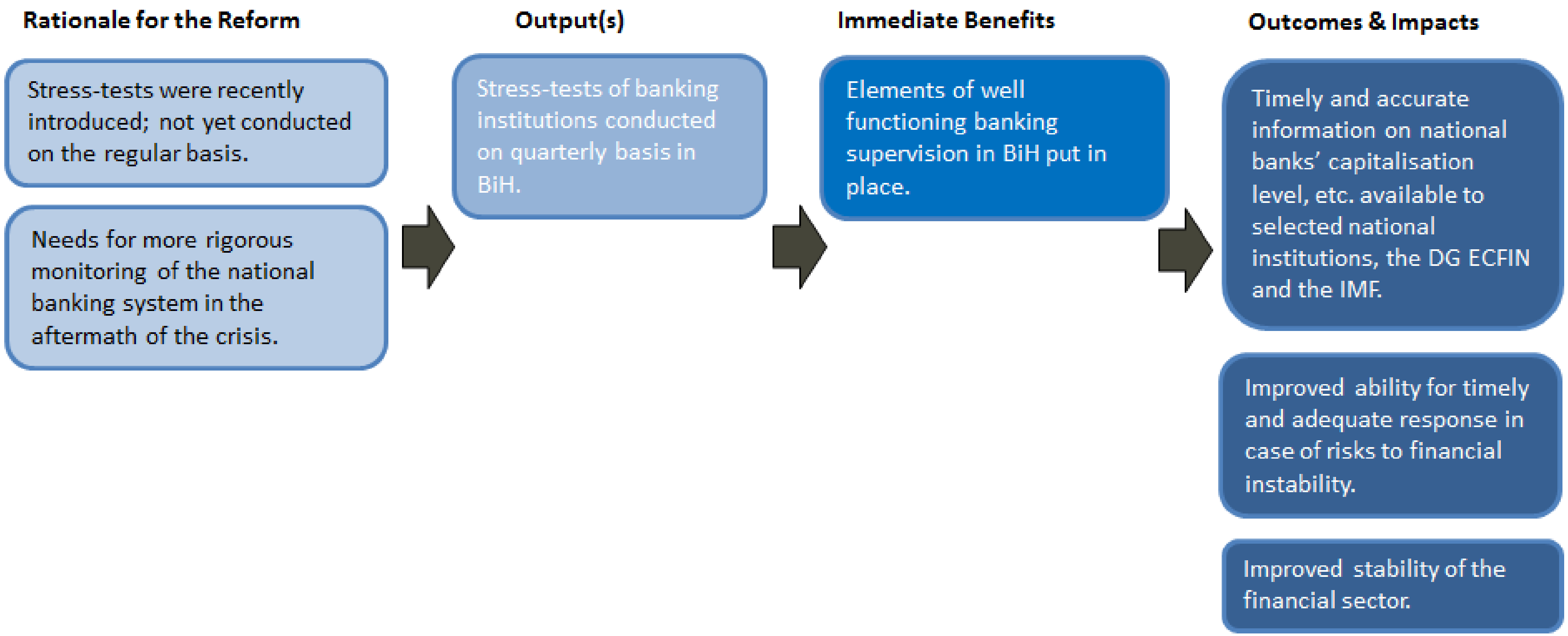
| **Condition 2.4 (second tranche):** An updated overview of public domestic debt produced by the FBiH. | |
| **Implementation** | A comprehensive overview of the total domestic debt of FBiH was produced by the FBiH Ministry of Finance on 31 March 2013. As of March 2013, the outstanding domestic debt of FBiH related to old foreign currency savings totals about BAM 873 million, |

| | |
|---|---|
| | representing approximately 58 per cent of total domestic debt of the FBiH[94]. |
| **Evidence of Implementation deficit** | While, the coverage of public debt data has been improving over time there is still an incomplete picture of public debt level in FBiH. |
| **Relevance** | High. The Operational Assessment assigned its recommendation calling for preparing a comprehensive overview of the total domestic debt a high priority.<br>While a relative good picture is available at central level in FBiH, there is poor and untimely reporting at canton level. There are many unrecognised liabilities relating to war damage, liabilities from State operated enterprises and frozen bank deposits. The government has to recognise these liabilities, but has the option when to recognise them. |
| **Importance** | High. While known stock of public debt level remains modest by international comparison (around 45 per cent), uncertainty as to the true size of debt is a major concern. The quality of these figure is a concern alongside the many unrecognised liabilities. |
| **Domestic ownership & donor support** | The IMF played an important role in supporting and encouraging FBiH government to improve debt data reporting.[95]<br>The overview would likely have been produced in the absence of the MFA condition as a result of a completion of registrations of old foreign currency savings. The World Bank has also been involved with issues related to debt statistics (more at State level than Entity level) providing technical assistance to help improve coverage of debt data. |
| **Added Value of MFA** | Reinforced reform mainly led by the IMF. |
| **Evidence of benefits** | More complete picture of public debt of FBiH, specifically covering obligations related to old foreign currency savings totals. |
| **Evidence of long-term Impacts** | It is hoped that over time various efforts and initiatives supporting building of comprehensive public debt data will enable complete information on public debt in BiH to be gathered, limiting market risk and enabling better informed debt management and improving the quality of fiscal policy. |

94 DG ECFIN, June 2013. Note on Bosnia's and Hercegovina's compliance with conditionality for disbursing the second loan instalment under the European Union MFA.

95 Based on information provided during interviews with the representatives of the EU Delegation in BiH and advisors to the FBiH government.

**Figure 31. Intervention logic of the condition on enhancement of financial supervision including quarterly stress-tests**



| **Condition 2.5 (second tranche):** Enhanced surveillance of the banking system will be continued including quarterly stress tests of the banking system that will be performed by the Central Bank of BiH and two Banking Agencies. | |
|---|---|
| **Implementation** | Banking sector surveillance has continued in co-operation between the Central Bank of BiH and the two Banking Agencies. Stress-tests have started in 2009 and in more recent periods have been conducted regularly on a quarterly basis. |
| **Evidence of Implementation deficit** | None identified. |
| **Relevance** | Medium to high. During the crisis and in the post-crisis period the condition of the banking sector has been one of the important factors determining financial risks and macroeconomic risk outlook. Stress-tests serve as a useful tool helping regular monitoring of the stability of the banking system and its resilience to potential adverse shock. The enhanced surveillance process started before the MFA conditions had been agreed. |
| **Importance** | High. Although systemic stability of the banking system during the crisis was not really at risk, in the initial period after their introduction (2009) stress-tests were not conducted less frequently. A rising share of non-performing loans (14-15 per cent during 2013) has increased the importance of timely monitoring and surveillance and improvements of the risk management in the banking sector. |
| **Domestic ownership & donor support** | The co-operation between the Central Bank and the Banking Agencies has generally been good. The IMF played a leading role in the process of establishment and formalisation of the stress-tests. The support from the IMF included the methodological assistance and provision of the specific models used during stress-test exercises. USAID has provided technical assistance to help implement Basel II requirements. |
| **Added Value of MFA** | Limited. Stress-tests were already introduced prior to the agreement on the MoU of the MFA and the IMF played crucial role in this respect. MFA might have played certain role in establishment of the practice of running the stress test exercise on a quarterly basis.<br>The IMF provided technical assistance to support implementation of stress tests and the methodology for the stress tests. |
| **Evidence of benefits** | Better information flow between agencies, Central Bank and banking institutions (for example regular meetings hosted by agencies where results from the stress-tests are shared). |

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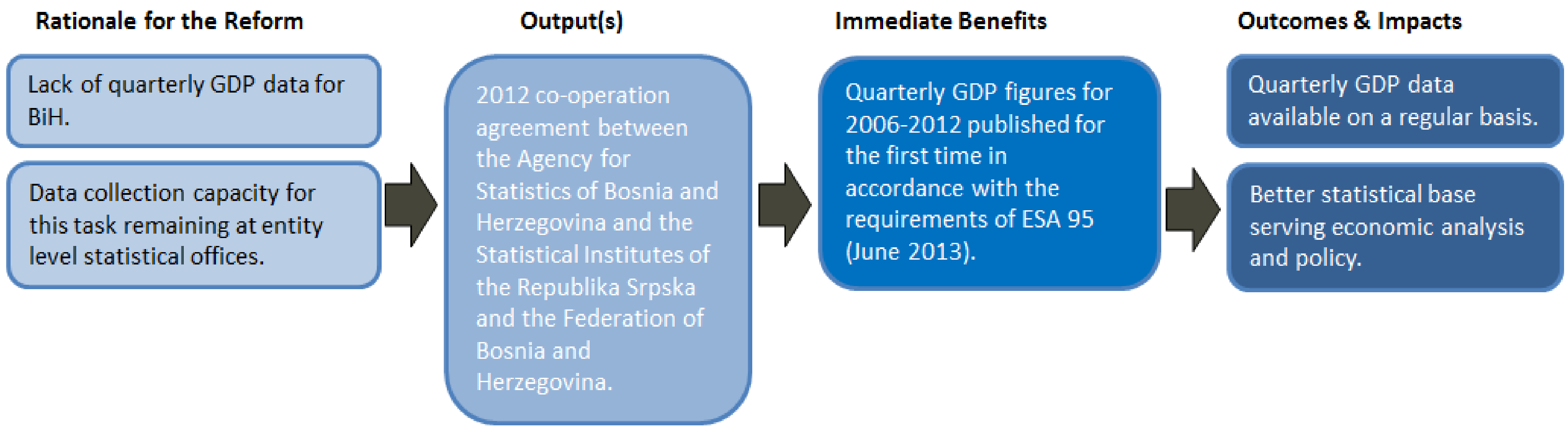
| | More up-to date and accurate information about the banks' situation. As the stress-tests based on the same methodology were introduced in other countries of the region with the assistance of the IMF, IMF and DG ECFIN haves now access to timely and comparable data from all countries of the region, including BiH. |
| **Evidence of long-term Impacts** | Increased monitoring capacity and ability for the timely and adequate response in the event of the problems in the national banking sector. |

**Figure 32. Intervention logic of the condition on cooperation between statistical institutes for developing quarterly national accounts**



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| **Condition 2.6 (second tranche):** The Agency for Statistics of BiH and the Statistical Institutes of the RS and the FBiH will agree on modalities of the cooperation in order to develop quarterly national accounts in accordance with the requirements of the ESA 95 system and commitments under the Stabilisation and Association Agreement. | |
| **Implementation** | The State-level Agency for Statistics of BiH and the two Entity statistical offices agreed in 2012 to cooperate in the development of quarterly national accounts. In 2012 quarterly GDP data were published for the first time. |
| **Evidence of Implementation deficit** | Questionable quality of quarterly data (and consistency between Entity and State-level annual GDP figures), although there has been gradual improvement in this area.<br>There are still large discrepancies in methodologies between the State and the Entities. Moreover, methodologies need to be aligned with Eurostat. |
| **Relevance** | The link between MFA objectives and this specific condition is indirect, although potentially relevant. A better statistical picture of the economy clearly matters for the ability to carry better informed economic policies that can support macroeconomic stability. |
| **Importance** | High. Creating conditions for access to data showing up-to-date picture of economic developments, which enables better informed policy making. |
| **Domestic ownership & donor support** | The IMF has worked with statistical institutions for a long time, in particular on quarterly national accounts. The condition related to statistics was unlikely to become part of IMF programmes (difficult to claim its 'macro-criticality'). IMF support reinforced MFA condition by providing necessary technical assistance. Government of Japan provided funding for IMF technical assistance. |
| **Added Value of MFA** | Lack of sufficient co-operation between Entity and State level statistical organisations was driven politically and by institutions' own interests.<br>MFA condition is believed to have mobilised stakeholder effort in this area and accelerated the pace of work on quarterly GDP data. |
| **Evidence of benefits** | As a result of this cooperation, the three statistical offices managed to agree modalities enabling the production of quarterly GDP data. Data for the period 2006-2012 were published in June 2013. Since then quarterly national account are published on a regular basis by the Agency for Statistics of BiH. These are monitored and used by various stakeholders in BiH including policymakers. |

| | |
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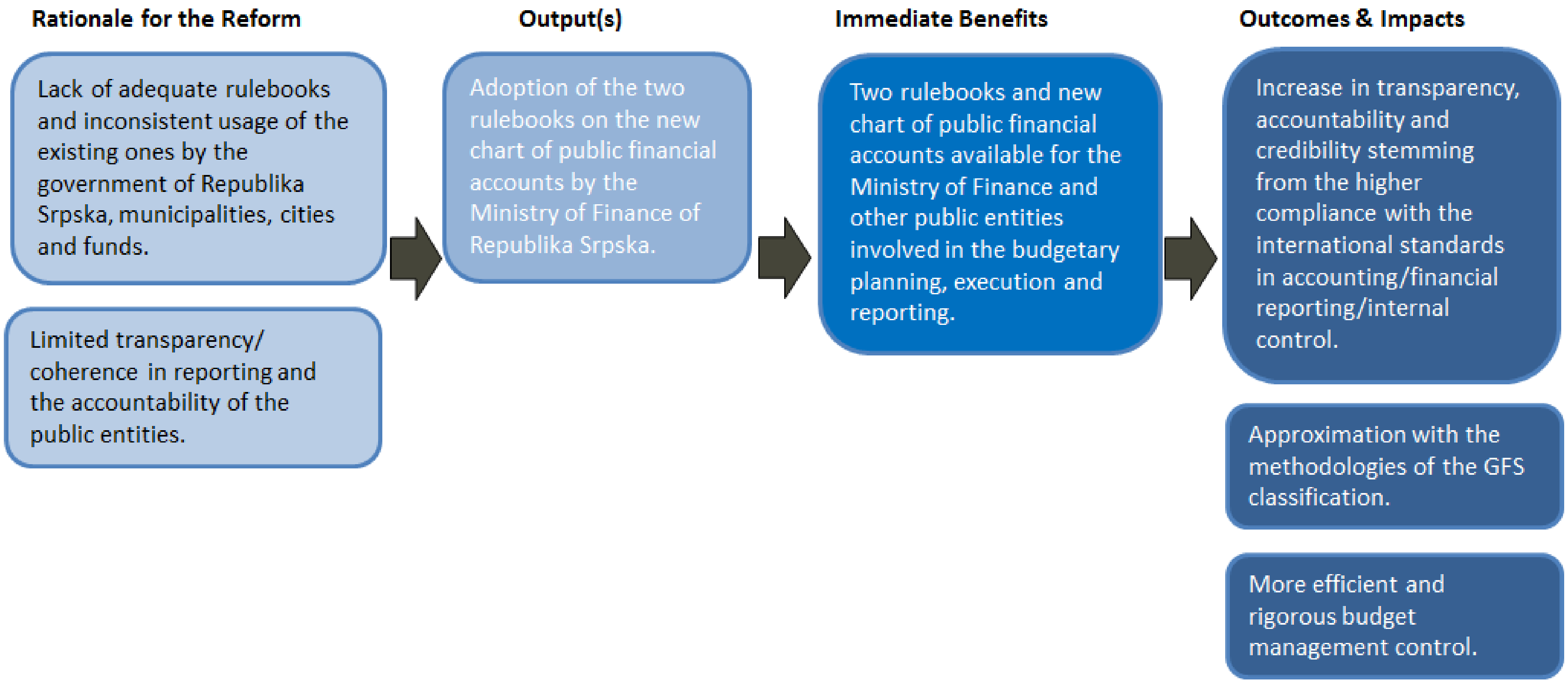
| **Evidence of long-term Impacts** | Expected to enable more informed analysis and forecasts of economic situations, and better informed policies leading to more favourable outcomes. |

**Figure 33. Intervention logic of the condition on the reform related to the adoption of the two rulebooks on the new chart of public financial accounts by the Ministry of Finance of RS**




**Condition 2.7 (second tranche):** The adoption of the two rulebooks on the new chart of public financial accounts by the Ministry of Finance of RS.

**Implementation** In late-2010 and early-2011, the Minister of Finance of RS adopted the following rulebooks: i) _Rulebook on budget classification, content of accounts and implementation of control plan for users of budget revenues of Republika Srpska, municipalities, cities and funds_ and ii) _Rulebook on financial reporting for users of Republika Srpska, municipalities, cities and funds_. Both rulebooks

| | |
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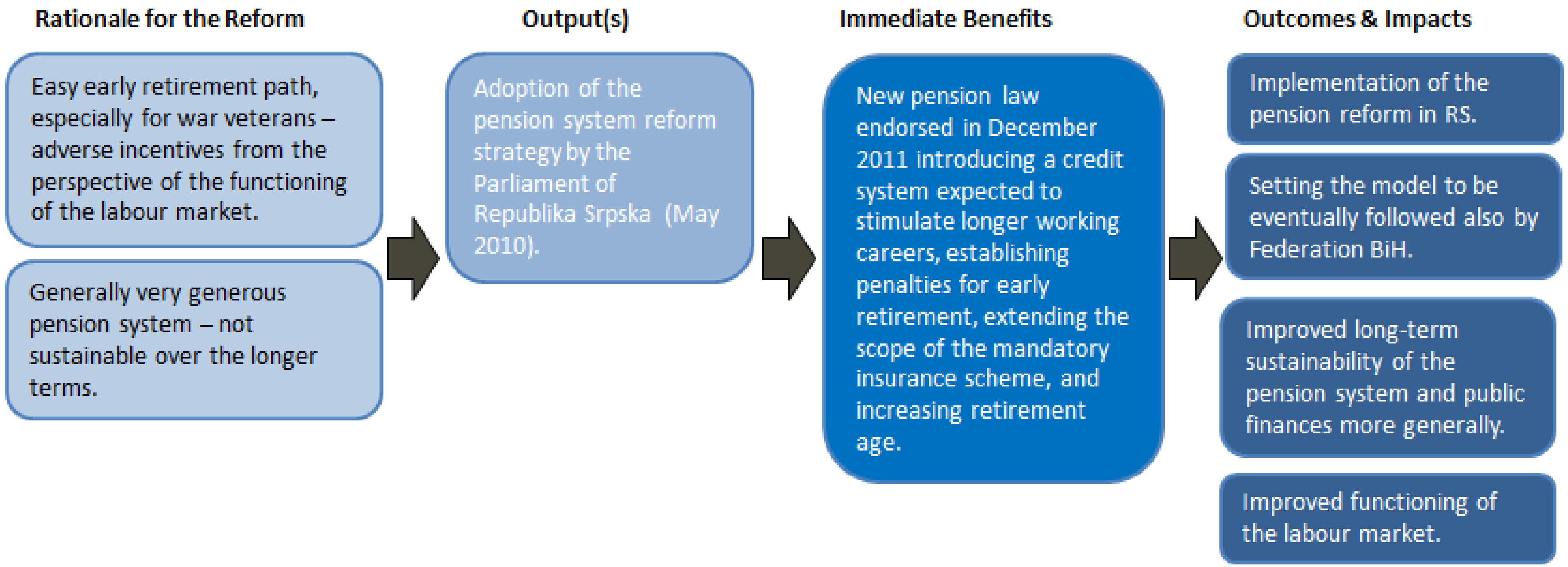
| | have been applicable since January 1, 2011[96]. |
| **Evidence of Implementation deficit** | None. |
| **Relevance** | High. OA identified the development of the rulebooks/guidelines on internal control as a high priority. More specifically, it pointed out that '*Not all budget users have developed their rulebooks on internal control or apply them properly*'[97]. |
| **Importance** | High. The reform was seen by the Ministry of Finance of RS as 'meaningful' due to insufficient coherence and transparency of public financial accounts and need to reduce inconsistent practices in reporting applied by various public Entities. |
| **Domestic ownership & donor support** | The IMF was also involved in support of the fulfilment of this condition[98]. Yet, the IMF support was not provided within the framework of technical assistance and had less formal character (ad hoc guidance provided by IMF experts). |
| **Added Value of MFA** | It is highly plausible that the rulebook would have been adopted without MFA, yet the evidences suggest that MFA speeded up the process. |
| **Evidence of benefits** | ▪ Approximation with the international financial accounting/reporting and internal control standards;<br>▪ Approximation with the methodologies of Government Finance Statistics (GFS) classification;<br>▪ Higher frequency of production of aggregated public finance account figures (on the monthly basis);<br>▪ Better quality and more timely information for public administration units performing management control functions. |
| **Evidence of long-term Impacts** | ▪ Higher budget control capacities of Ministry of Finance of RS (and potentially some efficiency gains) as a result of increase in transparency and comparability of the public financial accounts data. |

[96] DG ECFIN, June 2013. Note on Bosnia's and Hercegovina's compliance with conditionality for disbursing the second loan instalment under the European Union MFA.

[97] PwC, 2010. Operational Assessment of Bosnia and Hercegovina

[98] Interview with the Ministry of Finance of the RS

**Figure 34. Intervention logic of the condition on the pension reform strategy in RS**




| **Condition 2.8 (second tranche):** Strategy on pension reforms will be adopted by the Parliament of RS | |
|---|---|
| **Implementation** | The Parliament of RS adopted a pension system reform strategy in May 2010. |
| **Evidence of Implementation deficit** | The approved law reforming the pension system is less ambitious than initial versions – see World Bank (2012) *Bosnia and Herzegovina, Challenges and Directions for Reform, A Public Expenditure and Institutional Review*. According to the Bank's assessment, the reformed law, while a step forward, is unlikely to bring the pension system to full fiscal sustainability. |

| | |
|---|---|
| **Relevance** | Indirect link to MFA objectives. Pension reforms bring benefits mostly in the long-term perspective. |
| **Importance** | High. Pension system was not sustainable. Although the pension reform was not subject to separate analysis in the Operational Assessment, issues related to outstanding liabilities of the Federal Pension Fund as well as a high number of poorly verified benefit claims from war veterans were highlighted as burdens requiring attention. |
| **Domestic ownership & donor support** | The World Bank was involved in pension reform in both RS and FBiH. |
| **Added Value of MFA** | Very limited or none. The pension reform strategy was adopted before the signing of the MoU defining conditions. Nevertheless, stakeholders in RS indicted that in the debates concerning pension reform the argument of EU support for reforms could be used and that this mattered.<br>This was also an IMF structural benchmark in the first review (which also included a similar condition for FBiH) |
| **Evidence of benefits** | In December 2011, a new pension law was endorsed. The law introduced a credit system, which is expected to stimulate longer working careers, established penalties for early retirement, extended the scope of the mandatory insurance scheme, and increased retirement age.<br>Moreover, old-age pension reform was initiated also in FBiH. |
| **Evidence of long-term Impacts** | Expected to be substantial, although the World Bank assessment of the version of the law that was adopted concluded that while it improved the situation, the law is still unlikely to bring the pension system to full fiscal sustainability[99]. |

[99] World Bank (2012), Bosnia and Herzegovina Challenges and Directions of Reform. A Public Expenditure and Institutional Review, Report No. 66253-BA

### Table 20. Summary of the main findings

| Condition | The rationale for reform | The main driver of reform | Added value and role of MFA | Month/ Year of implementation | Evidence (level) of implementation deficit | Evidence of benefits | Net impact attributable to MFA |
|---|---|---|---|---|---|---|---|
| 1. The approval of *Global Framework for Fiscal Policies* by the Fiscal Council, including an overview of total revenue, expenditure and financing consolidated for BiH and disaggregated for the State, FBiH, the RS and Brĉko District. | To provide a medium-term framework for fiscal policies – sets the boundaries for State budget, lays out the country's spending priorities and fiscal targets. | IMF- prior action in 2009 SBA | Political reinforcing role | Jun 2012 *(met before decision to extend MFA – Oct 2012)* | Yes (high) | Yes | Limited |
| 2. The Government Budget Management Information System will be tendered. | To reduce fragmentation and inefficiencies in existing budget management practices at the Entities and the State-level. | Existing domestic ownership and bilateral assistance from SE & UK | Operational reinforcing role (acceleration of pace of implementation) | Jan 2013 | Yes (medium) | Yes – very limited | Limited |
| 3. The draft Law on Fiscal Responsibility will be approved by the government of the FBiH. | To promote fiscal sustainability. | IMF | Political reinforcing role | Jun 2013 | Could not be assessed within the scope of the evaluation | Too early to identify and assess specific benefits as the law was adopted in early 2014 | None |
| 4. The Heads of the CHU in the Ministry of Finance of the FBiH and the State-level will be appointed. In addition, Coordination Board for PIFC will be established. | To increase the fiscal coordination and cooperation between Entities and the State level institutions. | High domestic ownership | Political reinforcing role | *Appointment of Heads*<br>State: Jul 2012<br>FBiH: Mar 2011<br>*Establishment of Board*<br>2011<br>*(met before decision to extend MFA – Oct 2012)* | Yes (high) | None | None |
| 5. The new cash management system for public finances in the FBiH will be put in operation. | To increase the reliability of the cash flows management including the | High domestic ownership | Some reinforcing role | Jul 2010 (prior to signature of MoU) | Yes (low) | Yes | Limited |

| Condition | The rationale for reform | The main driver of reform | Added value and role of MFA | Month/ Year of implementation | Evidence (level) of implementation deficit | Evidence of benefits | Net impact attributable to MFA |
|---|---|---|---|---|---|---|---|
| | increase in the cash commitments. | | | | | | |
| 6. An updated overview of public domestic debt will be produced by the FBiH. | Identified as a high priority in the Operational Assessment.<br><br>The public debt figure is questionable due to existence of many unrecognised liabilities. | Jointly promoted by the EU-MFA and IMF | Some reinforcing role mobilising the authorities along with the IMF | Mar 2013 | Yes (low) | Yes | Limited |
| 7. Enhanced surveillance of the banking system will be continued including quarterly stress tests of the banking system that will be performed by the CBBH and two Banking Agencies. | During the crisis and in the post-crisis period, the condition of the banking sector has been one of the important factors determining financial risks and macroeconomic risk outlook. | IMF | Some reinforcing role mobilising the authorities along with the IMF | 2009 (prior to signature of MoU) | No | Yes | None |
| 8. BHAS and the RSIS and the FBiH will agree on modalities of the cooperation in order to develop quarterly national accounts in accordance with the requirements of the ESA 95 system and commitments under the Stabilisation and Association Agreement. | Essential for macroeconomic surveillance and policy making. | Jointly promoted by the EU-MFA and IMF | A political and operational reinforcing role is detected - MFA condition is believed to have mobilised stakeholder effort in this area and accelerated the pace of work on quarterly GDP data | 2012 | Yes (high) | Yes- very limited | Limited |
| 9. Two rulebooks on the new chart of public financial accounts will be adopted by the Ministry of Finance of RS. | To increase the transparency and coherence of the financial reporting and as well as | Existing domestic ownership with some involvement (ad hoc, informal | Some operational reinforcing role though domestic ownership seemed | Late 2010/ early 2011<br><br>*(met before* | None | Yes | Limited |

| Condition | The rationale for reform | The main driver of reform | Added value and role of MFA | Month/ Year of implementation | Evidence (level) of implementation deficit | Evidence of benefits | Net impact attributable to MFA |
|---|---|---|---|---|---|---|---|
| | increase of the efficiency of the internal control. | advisory) of the IMF and the World Bank | to be substantial | _decision to extend MFA – Oct 2012)_ | | | |
| 10. Strategy on pension reforms will be adopted by the Parliament of RS | To bring pension law in line with international standards and to make it sustainable. | IMF (structural benchmark in first review); also supported by the World Bank | Potentially, provided domestic political leverage to authorities to pursue a politically difficult reform | May 2010<br>(prior to signature of MoU) | Yes (medium) | Potentially, yes- but have not been quantified | No |

## 4.2 Conclusions

The selection of MFA reform conditions was carried out in consultation with other European Commission services, the IMF and the World Bank and involved all relevant BiH authorities. There was a broad consensus among all parties involved that this process was carried out appropriately.

The degree of ambition in the finally negotiated package of conditions can be described as low to modest. BiH authorities were often asked to effectively implement already existing legislation (the approval of the amended fiscal responsibility law by the government) or processes/systems (e.g. tendering of budget management information system). Such type of conditions can be thought of as a reinforcing process rather than a new process attempting to achieve real changes or outcomes with independent policy roles. Another common observation was that most of the MFA conditions followed and potentially complemented conditions agreed in the IMF programmes. There were some exceptions, like the condition related to the establishment of the Coordination Board for PIFC which had a clear 'EU stamp'.

The reform conditions were formulated in terms of outputs and not explicitly stating specific longer term objectives and expected outcomes. Therefore, it was much more difficult to verify actual impact of MFA conditions on reform processes in the targeted areas (i.e. the appointment of the Heads of the CHU in the Ministry of Finance of the FBiH and the State level and the establishment of the Coordination Board for PIFC).

There were procedural rigidities of the MFA instrument, in particular the limited possibility to amend conditions during the duration of the programme. In this context, it was encouraging to see that conditions defined in 2010 generally remained relevant until 2012-2013 when many of them were eventually fulfilled leading to disbursements of the loan tranches. Importantly, all of the procedures could have been met, despite initial delays. Therefore, the question is to what extent the MFA speeded-up the implementation process rather than acting as a primary catalyst for the reform.

The requirement for the Fiscal Council to agree on the Global Framework for Fiscal Policies was particularly interesting. The condition was identical to the IMF condition (it was a prior action in the 2009 IMF programme). The political stalemate made it impossible to fulfil this condition for the two years. The agreement was eventually reached in 2012, but its attribution to MFA conditionality remains rather speculative.

There were three conditions that were not explicitly formulated by any other development partner. These were: the agreement on the modalities of the co-operation between Entity level and State statistical institutes in order to produce regularly the quarterly GDP data; tendering of the Government Budget Management Information System; and the appointment of the Heads of CHU and establishment of Coordination Board for PIFC.

The first one is believed to have mobilised stakeholder effort in this area and accelerated the pace of work on quarterly GDP statistics. In this case, MFA condition reinforced efforts of BiH developments partners, especially the IMF which had been providing technical assistance to statistical institutions in BiH. The IMF was particularly appreciative of the role of the European Commission within this condition. The IMF is only able to include macro-critical conditions in its programmes. It is therefore useful from its perspectives that the MFA could include conditions that are highly important but not necessarily macro-critical. Overall, the interviewed IMF officials expressed the opinion that cross-conditionality between the IMF and MFA is important as it provides joint leverage. The interviewed representatives of the EU delegation saw the joined approach as a very effective way to 'get the place at the negotiating table', despite relatively low size of MFA assistance in comparison to the IMF packages.

The second condition concerning the tendering of Government Budget Management System did not involve any international donors, although once the system was set up, there was evidence of some bilateral assistance from Denmark, Sweden and the

UK. This bilateral support was provided in order to improve the system. In the last case, the EC was the only international partner supporting the reform.

The condition for pension reform strategy in RS had already been met by the time of signing the MoU. While the specific contribution or value added by the MFA appears minimal in this case, it may have had a positive effect. The information gathered from relevant RS authorities suggests that the inclusion of pension reform agenda in the agreement with the European Commission was used as an argument in the public debate (i.e. during the discussions with trade unions and representatives of war veterans' association). This helped to preserve certain provisions of the reform. Therefore, despite its de facto empty content (a requirement to carry an action that was already completed) it was presented as way of signalling EU's interest in the important policy reform area. This example illustrates also the multiplicity of channels of influence as well as inherent difficulty in attributing progress in any given area to specific MFA conditions.

Finally, the MFA conditionality was discussed with non-government representatives during two workshops, one in Sarajevo and the second in Banja Luka. The majority of non-government stakeholders gathered in Sarajevo stated that the MFA conditionality could have been more ambitious given the substantial leverage the IMF and the EU had in mobilising national authorities to pursue the reforms. A second common view during both consultations related to the selection of the specific conditions. The absence of reforms focusing on the improvement of business environment in the country, chronically weak by European standards, raised doubts whether selection was optimal. Examples of business environment's reforms that could have been tackled included, inter alia, reduction of the number and duration of requirements to start the business, streamlining of corporate tax regime and reduction of administrative requirements concerning hiring, in particular young people[100].

The view that both IMF and EU-MFA's approach to conditionality had softened over time was presented. This is particularly evident in the case of the MFA. The 2002 MFA operation in BiH was more ambitious in its approach to reforms as it included conditionality relating to private sector development and the business environment. The ex-post evaluation of the 2002 MFA operation[101] recommended the Commission to adopt a more selective approach to conditionality respecting the principles of macro-criticality and parsimony.

[100] It should be noted that these and other reforms related to the improvement of the business environment have been included in the priorities of the recent strategy 'Compact for Growth and Jobs in Bosnia and Herzegovina' promoted by the Delegation of the European Union to BiH. Document is available at: http://europa.ba/Live.aspx?lang=EN

[101] ECORYS (2007) Ex post evaluation of Macro-Financial Assistance to Bosnia and Herzegovina

# 5 Design and implementation issues

The discussion in this section covers the timing of the operation, its design features and issues related to monitoring and implementation.

## 5.1 Timing of the operation

The calendar of action (Table 21) shows considerable delays at various stages of the MFA operation to BiH. These were mainly in the implementation of the operation rather than the preparation stage. More specifically, there was a time lag of around 26 months between the signature of the Loan Agreement and actual disbursement of the first tranche. This was a consequence of political standstill and the lengthy government formation after October 2010 general election as well as a failure to fulfil the first condition of the approval of the Global Framework of Fiscal Policies by the Fiscal Council of BiH. In 2010 and 2011, the Fiscal Council failed to adopt the Framework within the deadline.

**Table 21. Timeline of the MFA operation**

| Timing | Event |
|---|---|
| May 2009 | BiH request for MFA assistance |
| November 2009 | Council approves MFA to BiH |
| November 2010 | Signature of MoU |
| November 2010 | Signature of Loan Agreement |
| October 2012 | Commission decision on extending of the MFA availability until November 2013 |
| 7 November 2012 | Expiration of the availability of the initially approved MFA |
| February 2013 | Disbursement of the first loan tranche |
| September 2013 | Disbursement of the second loan tranche |

## 5.2 Design of the operation

The unique and complex socio-cultural and administrative division of BiH and interactions between the Entities had to be reflected in the architecture of the MFA instrument (e.g. conditions assigned to different Entities and dividing the MFA loans between Entity and State level). This made the preparation and implementation of the programme more challenging. The situation with the first tranche condition concerning the approval of the Global Framework for Fiscal policies suggests that in BiH, the attractiveness of the MFA loan was not sufficient to overcome impasse between different political factions. This may be due to the relatively limited size of the MFA and the loan form of the assistance.

The size of the financial assistance provided through the MFA instrument was based on considerations of BiH's residual financing needs. The assistance was provided entirely in the form of loan reflecting the level of development of BiH (classified as an upper middle income country by the World Bank). The size of the operation appears reasonable compared to needs and the size and character of engagement of other development partners. The form of the loan was assessed as adequate given the level of development of the country and the fact that it has been receiving substantial assistance often in the grant forms for several years.

## 5.3 Visibility of the operation

The visibility of the operation – beyond those involved in design and implementation – was tested through focus group discussions in Sarajevo and Banja Luka. The general opinion of the participants was that the instrument lacked visibility and transparency. For instance, many participants were not aware that the MFA was provided by the EU on the request of the Bosnian authorities and that this 'assistance' was provided in loan format.

## 5.4 Monitoring and implementation

The monitoring of the operation was based on progress reports on reforms submitted by BiH's authorities, and field missions performed on a regular basis by DG ECFIN officials. The latter were not specifically focused on MFA monitoring, but initial interviews confirmed that progress of MFA-related conditions was part of mission agenda.

There has been a major difference between the European Commission's approach and the approach adopted by the IMF. These included frequent visits to the country and in-depth analysis of specific reform areas, as well as on-going technical assistance in several fields. Several stakeholders expressed the view that more active involvement of the European Commission in monitoring the implementation of reform conditions, ideally associated with access to technical assistance could improve the effectiveness of the MFA conditionality. This appears plausible. However, finding an efficient way of implementing such a change could be challenging. One solution would require more resources enabling a more active involvement of the European Commission either through the DG ECFIN country desk or through stronger reliance on EU Delegation. An alternative approach would be a stronger engagement with the IMF and asking the IMF to play a monitoring and support role also in relation to MFA conditions.

It is, however, not obvious that this could work be for all future MFA operations. Instead, a decision on whether more active monitoring of MFA conditionality is required (and if so how best to arrange it) would need to be taken on a case by case basis. This would take into account factors such as domestic ownership of MFA conditionality, the character of expected difficulties in its implementation, the attractiveness of the MFA package relative to the needs of a recipient country. However, these factors often vary over time and it may be difficult to anticipate them at the time of design of new operations, adding a layer of complexity.

# 6 EU value added

This report has identified added value of the EU assistance provided in the form of the MFA operation in several areas that are described below.

**Financial value added**. Despite the substantial delay of loan disbursements compared to the original schedule, the fiscal situation in 2013 implied substantial financing needs that were partly met by the MFA. The MFA loans were highly concessional and simplified calculations carried out for this evaluation suggest that the additional cost of interest payments for borrowing that could be an alternative to the MFA could be in the range of EUR 12 million over the 2013-2015 period. This means the disbursement of MFA loans enabled BiH to limit its public expenditure. The unanimous view of the State as well as the Entity level authorities – expressed during interviews – was that the main attractiveness of the MFA versus alternative sources of financing (e.g. domestic issuance of T-bills and bonds) was the cost and tenure of financing.

**MFA being an element of broader international assistance (especially IMF).** The key argument here is that it is very difficult to analyse the MFA impact in isolation as it became an important element of IMF assistance. The IMF interest in 'burden sharing' arguably could have made it somewhat easier for the Fund to decide on the 2012 programme because MFA was factored-in as contributing to closing of the financing gap.

**MFA as the only instrument providing de-facto budget support to BiH.** The vast majority of substantial EU support for BiH came in the form of IPA funds that finance individual projects. These funds do not flow through the State and Entity budgets and that are partly spent on buying goods and services from outside the country. There are various reasons for such a design of the IPA that are not further analysed in this report. However, it is plausible that EU leverage in terms of promotion of certain macroeconomic policy reforms rises significantly with an instrument that has a character of a budget support, such as the MFA.

**Showing the EU commitment to the country on the EU integration path.** Given BiH's status as potential EU candidate country, the degree of its economic integration with the EU and the consequences of the crisis (emerging more from within the EU than from BiH) justified EU engagement in and support for BiH.

**MFA giving the EU 'place at the table' discussing macroeconomic strategies and policies in BiH.** Domestic macroeconomic policies play an important role for BiH's EU aspirations and macroeconomic dialogue between EU members is an important element of EU governance. However, MFA was the only tool effectively engaging EU institutions (especially EU Delegation) in such dialogue.

**Political statement.** The allocation of part of the MFA to the State is seen as an important political/ symbolic gesture indicating the EU's desire to strengthen the State and to see it emerge as the 'one common address' for dialogue with the BiH authorities. It is argued by some that Sate level institutions have considerably weakened in recent years and this gesture by the EU was perceived as an important political signal by most stakeholders interviewed in the context of this evaluation (with the notable exception of RS authorities and non-governmental stakeholders who argue that State level spending is inefficient). By allocating part of the MFA to the State, the EU was also able to provide it with the necessary incentives to pursue reforms

**Promoting coordination between the State and Entities.** The MFA (and specifically, the conditionality relating to Global Fiscal Framework, development of quarterly statistics, establishment of the Board for PIFC, enhanced baking surveillance) is perceived as an instrument that has helped to coordinate policy-making and foster dialogue between the State and the two Entities.

**Contribution to promotion of certain reforms**. As discussed in section 4, the MFA played a role in promoting certain reforms and in reinforcing such efforts from other stakeholders. The progress in these areas, even if it can only partly be attributed to the MFA opens the possibility of long-term benefits, apart from certain smaller gains that have materialised already.

# 7 Conclusions and lessons learnt

This section sets out the main conclusions emerging from the evaluation and potential consideration for design of future MFA operations.

## 7.1 Conclusions

### How would the economy of BiH have evolved in the absence of MFA (and IMF) assistance?

The most plausible adjustment path to the lack of MFA would be higher issuance of domestic debt (both in the FBiH and in RS) to maintain public spending at observed levels. The cost of domestic debt would be higher than the debt servicing cost of the MFA. The counterfactual increase in the costs of debt servicing is however, deemed too low to translate into broader macroeconomic implications, including the balance of payment position of the country. Higher public borrowing on the domestic market (in practice from BiH banks) could crowd out some funds that could potentially be channelled to private sector projects. Also, higher interest rates on government bonds and T-bills could have certain impact on interest rates of loans offered to the private sector. This might have certain negative impact on economic activity, but the scale of this effect would likely be negligible.

The most plausible adjustment in the absence of both the MFA and the IMF SBA would be a fall of public spending. Assuming for simplicity that other sources of financing are not affected in the counterfactual scenario, the required adjustment on the expenditure side would need to be in the range of 0.9 per cent of BiH GDP in 2012 and around 1.7 per cent of GDP in 2013 and in 2014. Subdued economic activity in the counterfactual scenario would likely be associated with lower imports and hence lower current account deficit. The quantification of this adjustment is difficult. It can be speculated that income elasticity of import demand may be at least around 1, suggesting counterfactual imports and current account adjustments to the tune of up to 0.5 per cent of GDP in 2012, and 1 per cent of GDP in 2013-2014.

### To what extent has the MFA assistance been effective in terms of the short-term macroeconomic stabilisation of BiH?

The EU MFA operation made a marginal positive contribution to macroeconomic developments in BiH in 2013. The economic growth dynamics in the period 2009-2014 were primarily driven by factors not directly related to the MFA operation. The potential net effect of the MFA was two-fold. First, it is expected to have lowered the costs of public debt service by an estimated EUR 12.4 million over the period 2013-2015. Second, it may have made access to credit somewhat easier for BiH businesses (by avoiding any crowding out effect of increased domestic borrowing by the government). This suggests a very small, but positive net MFA impact on macroeconomic situation as well as external sustainability.

The MFA was closely linked to the IMF programme. Given the significantly larger size of the IMF's 2012 SBA, it is not surprising that the combined macroeconomic impact of these two operations is found to have been substantially stronger than the impact of the MFA alone. The two programmes combined are assessed to have provided a significant boost to economic activity during 2012-2014. Cumulative impact on the GDP level by end of 2014 could be in the range of 2.6 – 5.1 per cent. This was primarily driven by avoiding the significant fiscal adjustment on the expenditure side that would be necessary without external assistance.

### To what extent has the MFA contributed to returning the external financial situation of BiH to a sustainable path over the medium to longer-term?

Given that the MFA was provided entirely in loan form, it contributed slightly to external debt accumulation and debt-servicing costs.

### To what extent has the MFA assistance been effective in terms of supporting structural reform in BiH?

The selection of MFA reform conditions was based on policy dialogue with all relevant BiH authorities and coordinated with other European Commission services, the IMF and the World Bank. There was broad consensus among all parties involved that this process was carried out appropriately.

The degree of ambition in the finally negotiated package of conditions can be described as low to modest. BiH authorities were asked to effectively implement already existing legislation (the approval of the amended fiscal responsibility law by the government) or processes/systems (e.g. tendering of budget management information system) for several conditions. Most of the MFA conditions followed and potentially complemented conditions agreed in the IMF programmes with a few exceptions. These exceptions included the condition related to the establishment of the Coordination Board for PIFC which had a clear 'EU stamp'. With the benefit of hindsight, the MFA could have promoted more far reaching reforms in the area of private sector development / improvement of business environment rather than seek to reinforce/ duplicate IMF conditionality (although one also has to bear in mind the size and form of the instrument as a potential incentivising factor when designing conditionality).

There is clear evidence of implementation deficit (gap between de jure reform and de facto reform) in case of 7 out of 10 conditions e.g. the Global Fiscal Framework which has been "implemented in letter, but not in spirit" to borrow the words of an informed stakeholder; the Coordination Board for PIFC which has been set up, but has not met in 2012 and 2013; the Strategy on pension reforms adopted in RS which does not go far enough in achieving full fiscal sustainability, to name a few.

There have been some benefits from implementation of MFA conditionality:

- The adoption of the two rulebooks on the new chart of public financial accounts by the Ministry of Finance of RS has resulted in better quality and more timely information for public administration units performing management control functions;
- A more complete picture of public debt of FBiH is now available, specifically covering obligations related to old foreign currency savings totals;
- The enhanced surveillance of the banking system including quarterly stress tests of the banking system has contributed to better information flow between agencies, Central Bank and banking institutions (e.g. regular meetings hosted by agencies where results from the stress-tests are shared). As stress-tests based on the same methodology were introduced in other countries of the region with the assistance of the IMF, the IMF has now access to timely and comparable data from all countries of the region, including BiH.
- Availability of quarterly GDP statistics necessary for macroeconomic surveillance and policy making.

The potential gains from reforms have, however, not fully materialised due to the implementation deficit noted in several conditions (which means that benefits could not be optimised) and considering the short time that had elapsed since the implementation of some reforms (e.g. Law on Fiscal Responsibility).

### What have been the indirect and/ or unexpected effects of the MFA assistance?

No indirect and/or unexpected effects were identified through this evaluation.

### To what extent has EU added value been maximised?

This evaluation has identified the following elements of added value of the MFA operation:

- The financing cost and tenure of the MFA loan were more favourable as compared to alternative sources of financing available to BiH authorities (e.g. domestic issuance of T-bills and bonds).
- The availability of MFA loan made it somewhat easier for the IMF to secure board approval for the 2012 SBA (due to burden sharing with the EU).
- MFA as the only EU instrument providing de-facto budget support to BiH.
- Showing the EU commitment to a country on the path of EU integration.
- Giving the EU 'place at the table' discussing macroeconomic strategies and policies in BiH.
- The allocation of a part of the MFA to the State is seen as an important political/ symbolic gesture indicating the EU's desire to strengthen the State.
- The MFA is perceived to have helped to coordinate policy-making between the State and the two Entities and fostered policy dialogue.
- The MFA played a role in promoting certain reforms and in reinforcing such efforts from other stakeholders. The progress in these areas, even if it can only partly be attributed to the MFA opens the possibility of long-term benefits, apart from certain smaller gains that have materialised already.

## 7.2 Lessons learned

A few lessons can be drawn from the MFA operation in BiH. Several of the points mentioned below echo recommendations that have been previously made as part of past evaluations of other MFA operations.

- The European Commission should ideally be granted greater flexibility to adapt specific MFA operations to changing context. It would be beneficial if conditionality could be adapted to evolving circumstances during the MFA implementation period (e.g. dropping already fulfilled conditions, adjusting conditions that become infeasible / controversial in view of changed macroeconomic and /or political realities). Although it is recognised that these recommendations would require high level political decisions.
- The relatively short time-span of the MFA instrument implies that conditions will need to continue being specified in terms of expected short-term outputs. However, it is recommended that expected longer-term outcomes and impact of conditionality should be explicitly and precisely articulated to strengthen domestic ownership, minimise the risk of implementation deficit (the difference between de jure and de facto reforms). This would also provide the basis for future ex-post evaluations and follow-up through EU budget support.
- In designing conditionality, the Commission should try to strike a balance between addressing an immediate financing need and the desire to promote reform, while also considering the size and form of the instrument as a potential incentivising factor for the recipient country's authorities to pursue reform.
- In the case of BiH, the MFA substituted (more expensive) domestic financing. All available evidence (desk research, interviews with Bosnian authorities, IMF and Delphi) suggests that it could have been comfortably replaced by the additional issuance of domestic debt (combination of bonds and T-bills) by both Entities while the State had a budget surplus at the time of the operation. A

more rigorous ex-ante assessment of the deficit financing options available to the authorities of the recipient country in future should be carried in future to ensure that the MFA is necessary/ critical for macroeconomic stabilisation and is not used by the authorities as source of low cost deficit financing.

- Due to highly complex socio-political structure and existing tensions between the State and Entities, potential delays and/ or risk of 'half completed' reforms was an issue in the context of this operation. Therefore, more active involvement of the European Commission in monitoring the implementation of reform conditions could be considered. Ideally this would be associated with access to technical assistance. This could improve the effectiveness of the MFA conditionality. One approach to this could be closer alignment with the EU delegation and/ or IMF which could support DG ECFIN in monitoring of the implementation process (and provide technical assistance if needed). Another alternative would be closer involvement of DG ECFIN itself, for instance in the form of more frequent visits. The latter would be more resource intensive.
- The European Commission should consider putting more effort into improving the visibility and transparency of the MFA instrument. Efforts should be made to make available basic information about the operation in the Commission's local press releases and on the EU delegation website. For example, the amount of assistance, reasons and expected benefits, the interest rate that applies to the loan, when the loan will be repaid and the conditionality attached to it could be published in a press release.

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