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

Executive Summary

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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in a "mini bank-run" in October 2008, when EUR 420 million of deposits (12 per cent of the stock of deposits) were withdrawn.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[1]. 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 Republika Srpska (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)[2] 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

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

[2] 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*[3].

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[4].

In line with DG ECFIN's Evaluation Guidelines[5], 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;

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

[44] According to Article 30 of the Financial Regulation, *"all programmes or activities, including pilot projects and preparatory actions, where the resources mobilised exceed EUR 5 000 000 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".*

[5] 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[6]. 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[7]. 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

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

[7] In order to fully make up for the lack of MFA financing, the Federation would have needed to issue additional EUR 60 million (around BAM 117 million) of debt instruments during 2013 and Republika Srpska 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 the 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 percent 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; and
- 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, the 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 even once in 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 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 objective 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[8] 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

[8] 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.