SUPPLEMENTARY LETTER OF INTENT

Sarajevo and Banja Luka, Bosnia and Herzegovina

December 6, 2012

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

Dear Ms. Lagarde:

1. The Stand-By Arrangement (SBA) for Bosnia and Herzegovina (BiH) that was approved in September 2012 by the Executive Board of the International Monetary Fund (IMF) provides us with a valuable anchor for our economic policies and helps us address the challenges created by the difficult external and domestic economic environment. The key objectives of our economic program that is supported by the SBA remain to: (i) improve policy coordination; (ii) ensure fiscal sustainability and advance public sector reforms; (iii) safeguard financial sector stability; and (iv) improve the business environment to support growth and job creation.

2. We remain committed to implementing the policies described in our Letter of Intent dated September 11, 2012. This supplementary Letter of Intent provides information on our recent efforts and achievements, as well as on additional policy measures we plan to undertake during the remainder of 2012 and in 2013 to help ensure that the objectives of the SBA will be met.

3. The overall economic situation is proving more difficult than we expected at the time the program was designed. Recent indicators point to a decline in economic activity, owing to lower demand from our main trading partners, a drought affecting our agricultural production, and weak domestic demand. Thus, we expect real GDP to fall by about l’ percent in 2012. Moreover, with only modest growth projected for the Euro zone and our other main export markets in 2013, we expect that growth in BiH will remain below 1 percent next year, with risks tilted toward the downside. Inflation, meanwhile, is expected to remain at around 2 percent.

4. Despite the more difficult economic environment, we have made good progress in implementing our program. All but one of the quantitative performance criteria for end-September 2012 were met. The performance criterion on the Federation’s fiscal balance was missed due to earlier-than-anticipated payments of planned agricultural support related to the drought. The indicative target for the balance of the general government was also missed, as

spending by extra-budgetary funds and public companies was somewhat faster than anticipated. We are confident, however, that the end-2012 fiscal targets will be met, given that indirect tax collection is slightly higher than projected and our commitment to limit spending to the budget envelopes. We are furthermore taking steps to improve our control over—and monitoring of—the operations of lower levels of government, extra-budgetary funds, and public companies (see below).

5. We have also met the continuous and quarterly structural benchmarks, albeit with delays in some cases. We have continued to adhere to the Currency Board Arrangement (CBA) as constituted under the law. In addition, we have refrained from introducing new privileged or special rights for retirement. Similarly, we have published on the website of the Institutions of BiH quarterly consolidated general government accounts and we have carried out and published results from eligibility audits for war benefit recipients. Moreover, we are making good progress to meet the end-December benchmarks by preparing the amendments to the relevant legislation.

Fiscal Policies

6. Our fiscal policies remain anchored by the need to maintain fiscal discipline and ensure fiscal sustainability. We are convinced that progressing with fiscal consolidation provides the best assurance that BiH's economy will successfully weather the current difficult environment and will be able to recover faster once the global economy improves. Against this backdrop, the 2013 budgets for the Institutions of BiH and the central governments of the Federation and the Republika Srpska that have been adopted by the respective parliaments are consistent with a reduction in the overall general government deficit to about 2 percent of GDP (prior actions for this review). These budgets have been based on conservative revenue assumptions. More specifically, the central government budgets of the Federation and the Republika Srpska each target a primary surplus (excluding foreign-financed projects) that combined is equivalent to more than 1″ percent of GDP.[1] This is achieved mainly by firmly containing current spending. Respective wage bills are contained or even reduced to make room for an increase in social and private sector support, to help foster growth and protect the poor.

7. We remain firmly committed to maintaining the integrity of our system of indirect taxation, including by maintaining the single account of the ITA; maintaining a single VAT rate; and refraining from introducing any form of tax expenditure. Meanwhile, we are stepping up our efforts to increase tax collection, including the collection of tax arrears. In this regard, and in line with IMF staff recommendations:

[1] The primary surplus is defined as revenues minus expenditures, excluding debt service.

- We will further improve the exchange of information between the Entities' tax administrations and the Indirect Taxation Authority (ITA) by signing a joint Memorandum of Understanding on data exchange by end-May 2013 (a new structural benchmark), and with automated systems of information exchange becoming operational later in 2013.
- We will strengthen the large taxpayers units in each tax administration by end-September 2013 to ensure that the largest taxpayers and employers are captured, including by deploying additional large taxpayer auditors, and investigating compliance risks in the large taxpayer segment.
- We will also establish a unit in ITA headquarters by end-June 2013 with the responsibility for detection and coordination of activities for the prevention of VAT fraud.

8. Ensuring medium-term fiscal sustainability will also require further efforts in pension, benefit, and health care reforms:

- With regard to privileged pensions, no new benefit categories will be introduced at the level of the Institutions of BiH or the Republika Srpska, and neither will this be done in the Federation until the adoption of a new law on privileged pensions consistent with the principles described below (an existing continuous benchmark).
- The Republika Srpska already introduced far-reaching pension and benefit reforms earlier this year. To further improve the financial health of its pension system, it will broaden the collection base. No additional amounts will be allocated in the 2013 budget to compensate beneficiaries for earlier reductions in benefits, and the existing allocations are expected to gradually decline over time.
- The recession has put a heavy toll particularly on the Health Fund in the Republika Srpska, worsening its financial position. To tackle this problem we will seek to broaden the collection base, increase the transfer from the central budget, and accelerate the collection of contribution arrears. To contain health care spending, we will adjust the network of health centers in line with our Primary Health Care Strategy by reducing the number of organizational units of the Health Fund and by optimizing the number of employees in the health care system.
- A comprehensive pension reform strategy is being prepared in the Federation, in consultation with the IMF and the World Bank, in light of the challenging demographic trends. This reform will be aimed at keeping people longer in the active workforce, including by raising the retirement age, deterring early retirement, and rewarding later retirement. We expect to adopt this strategy by end-March 2013.
- The Federation will also adopt a new law on privileged pensions to consolidate them with the aim to establish a system that is financially sustainable and socially just. This new law will be designed to ensure that it: (i) separates the payments for contributory

pensions from those obtained under special rights (i.e., pension fund obligations would cover only pension entitlements based on years of contributions and age, while any form of special benefits would be paid from the central government budget); (ii) does not significantly broaden eligibility beyond what has already been legislated and increases targeting to the most vulnerable; (iii) introduces penalties for early retirement; (iv) harmonizes benefits across categories and gradually reduces the average levels of privileged pensions closer to the levels of average contributory pensions; (v) continues to allow for the use of the rationing coefficient to guarantee that privileged pension payments will not exceed the amount allocated in the central government budget; and (vi) does not increase the annual budgetary cost of privileged pensions above KM 197 million (a new structural benchmark for end-January 2013). We will also step up the pace of eligibility audits.

- A centralized database of all beneficiaries of social transfers will be set up in the Federation by end-January 2013.

9. Control over and monitoring of government finances of lower levels of government, extra-budgetary funds, and public companies remains a challenge, particularly in the Federation due to its more complex constellation.

- To improve monitoring, the Federation finance ministry will expand its consolidation unit and seek additional assistance to train its staff. The ministry will also seek technical assistance from the IMF to strengthen its cash management.
- Moreover, the Federation will strengthen its law on budgets in consultation with IMF staff with a view to increase its ability to enforce spending limits of lower levels of government, extra-budgetary funds, and public companies (a new structural benchmark for end-March 2013).
- In the Republika Srpska, a centralized payroll system for all employees in the public sector will be set up for improved recording, control, and planning. We will start this process in July 2013 and it will be fully implemented by July 2014.
- In addition, the planned elimination of the take-home pay protection for public sector employees in the Republika Srpska will be completed by end-December 2013, by amending the relevant laws to ensure that future changes in income tax rates and social contributions do not automatically lead to changes in the gross pay of public employees (a new structural benchmark for end-December 2013).

10. We are also strengthening our arrangements for servicing external debt obligations:

- The Law on Financing of the Institutions of BiH will be amended by end-2012 to ensure that external debt service obligations can continue to be made in the absence of an approved government budget (an existing structural benchmark). In this regard, the amendments agreed with IMF staff will secure that: (i) payments to meet international financial obligations of BiH and repayments of foreign debt can continue regardless of the status of approval of the budget; and (ii) the Institutions of BiH and its ministries ensure that sufficient balances are accumulated and available in the relevant accounts held with the Central Bank of Bosnia and Herzegovina (CBBH) to service foreign debt. Within one month of the adoption of these amendments, the Ministry of Finance and Treasury of BiH and the CBBH will sign a contract to ensure the timely payment of external debt service obligations.

- In line with IMF safeguards policy requirements for direct budget financing, the Ministry of Finance and Treasury of BiH, the Ministry of Finance of the Federation of BiH, the Ministry of Finance of the Republika Srpska, and the CBBH will sign a Memorandum of Understanding to regulate the disbursements from and servicing of all related obligations to the IMF, including that all disbursements under the SBA will be exchanged in domestic currency by the CBBH and deposited in the subaccounts of the Federation (two thirds) and the Republika Srpska (one third) at the CBBH for budgetary purposes (a new structural benchmark for end-December 2012). This memorandum will provide the CBBH a standing authorization to execute debt obligations vis-ŕ-vis the IMF as they fall due using the designated IMF payment account and the Indirect Tax Authority accounts designated for debt servicing. We— upon approval by the CBBH Governing Board—intend to further strengthen the CBBH's safeguards framework in line with the recommendations of the IMF's recent safeguards assessment mission.

Monetary and Financial Policies

11. We reaffirm our commitment to maintaining the CBA as constituted by law (an existing continuous structural benchmark) and to safeguard the independence of the CBBH. As such, we will continue to refrain from any actions that would weaken, or cast doubt on, the CBA and the institution entrusted with its operation: the CBBH.

12. We will further increase our crisis preparedness and contingency planning:

- The CBBH and the Banking Agencies are in the process of identifying financial institutions that are considered systemically important. This list of systemically important banks will serve as a platform to monitor developments in the financial sector more closely and discuss possible risks. On the basis of this assessment, the CBBH and Banking Agencies will also enhance communication and cooperation with the identified institutions and develop bottom-up stress tests for these institutions.

- The CBBH and the Banking Agencies have set up a Working Group to formalize stress testing procedures with a view to ensuring the credibility, objectivity, and timeliness of top-down stress tests. We expect to sign a joint Memorandum of Understanding on the stress-testing procedures by end-March 2013.

- The CBBH and Banking Agencies will also request technical assistance from the IMF to conduct practical crisis simulation exercises to drill down on the necessary steps and procedures in the event of a banking crisis.

13. The high level of non-performing loans (NPLs) in the banking sector represents a key financial vulnerability and a significant drag on economic activity. While banks have attempted to reduce their portfolio of NPLs, progress has been slow. We will seek technical assistance from the IMF in early 2013 to strengthen our legal and regulatory framework for NPL resolution. In this context, we will also review our legislation on personal bankruptcy.

Improving the Business Environment

14. BiH's economic recovery will not be possible without a vibrant private sector. Improving the business environment will encourage private investment, both foreign and domestic, and will support medium-term growth. We continue to make progress in streamlining procedures and enhancing transparency regarding business regulation, but much more remains to be done. In the period ahead, we will, partly with the assistance also from the World Bank and the International Finance Corporation:

- Establish a one-stop shop process for business registration in Republika Srpska by end-September 2013 (a new structural benchmark).
- Adopt a new Law on Companies in the Federation that will streamline the business registration process, by end-September 2013.
- Ensure that business registries are harmonized and easily accessible.
- Complete enabling laws and regulations for digital signature and allow for its application throughout BiH by early 2014.
- Ensure that a unified set of rules and procedures to guarantee food and animal safety, consistent with EU requirements, are in place by end-May 2013, to facilitate the continued export of agricultural products to neighboring countries acceding to the EU. In this context, the relevant authorities and agencies—among them the Entity Ministries of Agriculture, State Veterinary Office, Food Safety Agency, and respective inspectorates—will closely cooperate in order to facilitate a timely inspection and approval by the European Commission's (EC) Food and Veterinary Office, and the approval of the Residue Monitoring Plan by the EC.

Program Modalities

15. We believe that our economic program is off to a good start, despite a difficult environment, and that our policies set forth in our Letter of Intent of September 11, 2012 and supplemented by the policies described in this supplementary Letter of Intent are adequate to achieve the objectives of our program. We request the IMF's Executive Board to grant a waiver of the non-observance of the end-September 2012 performance criterion for the fiscal balance of the Federation central government, given the reason for the non-observance and our re-affirmation that the annual spending envelope as defined in the approved budget will not be exceeded, as well as our efforts to improve spending controls. We also request the Executive Board to complete the first review under the SBA and approve the second purchase under the arrangement in the amount of SDR 50.73 million.

16. We are fully aware of the many challenges ahead and we will take any additional measures that may be needed to achieve the objectives of our economic program. We will closely coordinate fiscal policy issues through the Fiscal Council, which will meet at least quarterly, and with the Advisory Group of the Fiscal council continuing to coordinate all issues related to program implementation and monitoring. We will consult with the IMF on the adoption of additional policy measures and in advance of any revision to the policies contained in our economic program, in accordance with IMF policies on such consultation. We will continue to provide IMF staff with the necessary information for assessing progress in implementing our program and will maintain a close policy dialogue with IMF staff.

17. The program will continue to be monitored through quarterly reviews based on quantitative performance criteria, indicative targets, and structural benchmarks. Quantitative performance criteria and indicative targets for end-March 2013, end-June 2013, end-September 2013, and end-December 2013 are proposed for establishment in Table 1. Existing and new prior actions and structural benchmarks against which to measure progress under the program are summarized in Table 2. The second review is expected to take place on or after March 15, 2013; the third review on or after June 15, 2013, the fourth review on or after September 15, 2013; the fifth review on or after December 15, 2013; and the sixth review on or after March 15, 2014. We authorize the IMF to publish this Letter of Intent and its attachments, as well as the related staff report on the IMF's website following consideration of our request by the IMF's Executive Board.

/s/	/s/	/s/
Vjekoslav Bevanda Chairman of the Council of Ministers Bosnia and Herzegovina	Nermin Nikšić Prime Minister Federation of Bosnia and Herzegovina	Aleksandar Džombić Prime Minister Republika Srpska
/s/	/s/	/s/
Nikola Špirić Minister of Finance and Treasury of Bosnia and Herzegovina	Ante Krajina Minister of Finance Federation of Bosnia and Herzegovina	Zoran Tegeltija Minister of Finance Republika Srpska

/s/

Kemal Kozarić
Governor
Central Bank of Bosnia and Herzegovina