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Ex ante evaluation statement – Macro-financial Assistance to Bosnia and Herzegovina

Accompanying document to the

Proposal for a COUNCIL DECISION providing macro-financial assistance to Bosnia and Herzegovina

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1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1. Background

Bosnia and Herzegovina relies on external macro-economic assistance to face the current crisis and to restore the sustainability of its fiscal and external accounts. In recent years, the country followed an unsustainable growth model characterised by high domestic demand, fed by high credit growth, external financing and expansionary pro-cyclical fiscal policies. This was increasingly accompanied by macroeconomic imbalances, in particular a widening current account deficit, which exacerbated Bosnia and Herzegovina's exposure to the global economic and financial crisis. As in most emerging economies, medium-term growth prospects have been severely dampened, and the economy will be in recession in 2009.

Economic activity started to fall in the final quarter of 2008 and continued this fall in the first half of 2009. Trade dynamics slowed significantly and only the re-opening of a large oil refinery in December 2008 prevents country-wide industrial output to fall into double-digit negative year-on-year growth rates. Annual inflation rates turned negative in May 2009 and the country's official foreign exchange reserves shrank fast. Financial stability was threatened in October 2008 when some 12% of deposits were withdrawn in only one month. Nonetheless, the situation in the domestic financial market stabilised quickly. Credit growth has been flat since September 2008 and deposits have been shrinking.

The constitutional set-up of the country following the Dayton/Paris peace agreement with two largely autonomous entities, the Muslim-Croat Federation of Bosnia and Herzegovina and the Serbian Republika Srpska, has important impacts on the fiscal framework of the country, as the main fiscal competence lies with the entities. Due to a more ambitious privatisation and structural reform agenda, the fiscal space was larger in the Republika Srpska than in the Federation. Nevertheless, fiscal policy has been pro-cyclical in both entities and fiscal discipline was loosened in previous years when especially social transfers and public sector wages were unsustainably increased. The system of generous non-targeted benefits for war veterans, demobilised soldiers and other social groups and their wide-spread misuse continued to be a drag on the budget, especially in the Federation where social transfers absorb approximately one third of the budget.

In early 2009, the repercussions of the economic slowdown were increasingly felt in public budgets. In an attempt to mitigate this effect, the National Fiscal Council unblocked some EUR 90 million from succession funds of former Yugoslavia's assets which are part of the central bank's reserves. Nonetheless, this proved to be insufficient as public finances increasingly came under stress on the back of falling revenues and high spending commitments. Faced with the deteriorating economic environment and the legacy of poor fiscal policies, the authorities of all government levels, represented by the National Fiscal Council, therefore concluded in early May 2009 negotiations with the International Monetary Fund on a Stand-By Arrangement. The authorities committed to rebalance the budgets and to adopt a three-year budget framework as prior action before the EUR 1.15 billion loan for a three-year period was approved by the IMF board on 8 July 2009. The first instalment of around EUR 203 million was disbursed immediately afterwards and was channelled to the budgets of the Federation (2/3) and the Republika Srpska (1/3). The proposed Community macro-financial assistance will contribute to covering Bosnia and Herzegovina's residual external financing needs in 2010 as identified by the International Monetary Fund and may be channelled to the budgets in order to alleviate acute budgetary needs.

According to the latest household budget survey from 2007 18.6% of the population in Bosnia and Herzegovina can be regarded as poor, virtually unchanged since the beginning of the decade despite robust economic growth. The projected decline in GDP is likely to affect poor parts of the population particularly hard. However, in the context of the IMF programme it was agreed to replace the highly inefficient system of non-targeted social transfers by a means-tested scheme over the medium-term which is meant to target those really in need. This may alleviate the impact of the crisis on poor households over the medium term.

1.2. Recent economic developments and prospects

Between 2003 and 2008 real GDP grew by 6% in an annual average. This strong economic growth was accompanied by a widening current account deficit and increasing private sector debt. Although exports grew rapidly, domestic demand grew even faster which resulted in very high import levels and consequently a trade deficit reaching about 38% of GDP in 2008. Foreign direct investments (FDI) were quite volatile in recent years, closely linked to the privatisation agenda. In 2008, FDI accounted for 5.5% of GDP, declining sharply (by 55%) compared to 2007, mainly as the result of a high base due to major privatisation deals implemented in 2007. Domestic overheating and external imbalances have been exacerbated by expansionary fiscal policies and a worsening fiscal position since 2006. The fiscal balance of the consolidated government sector moved from a surplus of 2.2% of GDP in 2006 to a small deficit of 0.1% of GDP in 2007 and then further to a deficit of 4% of GDP in 2008.

In 2008, real GDP growth fell to 5.5% from 6.8% in 2007. The global economic and financial crisis started to reveal its impact on Bosnia and Herzegovina in the last quarter 2008. Economic activity in the construction, metal and automobile industries, but also in the services sector slowed down and companies started to lay off workers. The slowdown of economic activity continued in 2009, as domestic demand contracted. Nonetheless, available short-term indicators such as industrial production suggest a rather mixed situation: While in the Federation of Bosnia and Herzegovina (which accounts for roughly two thirds of the country's economy) industrial production fell by 10.4% annually in the first half of 2009, it grew by 17.1% in the Republika Srpska (which accounts for roughly the remaining third of the economy). However, the increase in the Republika Srpska is almost entirely due to the re-opening of an oil refinery in December 2008.

The current account deficit widened to 14.7% of GDP in 2008, up from 12.7% in 2007, mainly driven by developments of global prices and internal demand during the first half of 2008. It was more or less equally financed by foreign direct investments and drawings of new loans from abroad. While the trade deficit was still slightly growing in 2008, the development of other components of the current account showed somehow reversing trends as compared to previous years: The income balance increased by only 3.5% (24% in 2007) and current transfers fell by 6.7% (after an increase of 11.3% in 2007), mainly because of falling remittances that dropped by 4%. However, trade dynamics slowed down towards the end of 2008 on the back of reduced demand, with imports shrinking faster than exports. The monthly trade deficit improved for the first time in more than two years in November 2008. In the first half of 2009, the drop in imports (25.3%) exceeded the one in exports (23.4%), resulting in an improvement of the trade deficit by 26.7%. Consequently, the current account deficit more than halved year-on-year in the first quarter, falling to only around 10% of GDP. This drop was mainly due to developments in trade described above, but also a slightly rising current transfer balance contributed to it, as remittances were 6.4% higher year-on-year. In the first half of 2009, FDI shrank by 32% year-on-year as a result of worsened investors' sentiments in the context of the global economic crisis. Official foreign exchange reserves declined by 16.8% until June 2009 since their peak in September 2008. However, they still stand at 23% of GDP, covering more than five months of imports.

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 (some 12% of the stock of deposits) were withdrawn. Foreign parent banks injected liquidity to their local subsidiaries and the Central Bank of Bosnia and Herzegovina 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 € 10,200 in early 2009 and a further increase is planned with the support of the EBRD. Despite the repercussions of the global financial crisis on Bosnia and Herzegovina, the financial sector remained sound and well-capitalised and its liquidity position was not seriously undermined. It is based on a relatively conservative business model and has weathered the effects of the global financial crisis well.

Annual credit growth is still positive (5.6% in June 2009) but has come down significantly from the excessive rates of between 25% and 30% recorded until July 2008. Between September 2008 and June 2009 the stock of loans grew by only 1%. Both private enterprises and households reported a moderation of their indebtedness' growth. Restrictions came from both the demand and supply side. Total deposits decreased by 9.8% from their peak in September 2008 until June 2009, after the monthly deposit growth had always been positive since the introduction of the currency board in 1997. The drop was mainly caused by withdrawals from private sector agents. As a result, deposits fell by 6.2% year-on-year in June. Due to the falling deposits, the loans to deposit ratio increased from 110% in September to 124% in June.

Bosnia and Herzegovina's monetary policy is based on a currency board arrangement with the euro as the anchor currency. The arrangement enjoys a high level of confidence and credibility and has functioned smoothly since its induction in 1997. It has so far also succeeded under the hard peg to the euro in sheltering the economy from balance sheet risks caused by fluctuations in the exchange rate and a currency mismatch in the loan portfolio.

The annual country-wide change of the consumer price index turned negative in May 2009 and fell to -1.8% in June, down from its peak of nearly 10% in July 2008. The 12-month moving average inflation rate fell to 3.8% in June, compared to 7.4% in 2008.

The outlook for the current year and beyond remains difficult. The macroeconomic scenario depicted in the IMF programme for 2009 is characterised by zero credit growth, low FDI and fiscal retrenchment, leading to a sharp drop in domestic demand, equally distributed between investment and consumption. GDP is expected to contract by 3% in 2009 and only slightly pick up by 0.5% in 2010. This is on account of a sharp drop in external and domestic demand (limited access to credit, recession in the EU). According to IMF calculations, the consolidated fiscal deficit will reach 4.7% of GDP in the current year and then gradually decrease to 4.0% in 2010 and 2.7% in 2011. The current account deficit will fall from 14.7% of GDP in 2008 to 9.7% in 2009 and 9.5% in 2010. Both imports and exports will decrease, and so will remittances and capital inflows, including FDI which are set to reach 50% of their 2008 level and roughly one third of the average of the years 2004-2008. No privatisation proceeds are foreseen for 2009. A drop of official foreign exchange reserves by 9% year-on-year is assumed and inflation is expected to be low at 1.6%, roughly in line with the euro area.

Table 1: Key macroeconomic data

Indicators	**2008**	**2009**	**2010**	**2011**	**2012**
GDP real growth	5.5	-3.0	0.5	4.0	6.0
Investments, % GDP	24.4	20.2	23.1	24.8	24.9
CPI inflation (average), %	7.4	1.6	2.3	2.5	2.5
Public Finance					
Revenue and grants (% GDP)	45.8	45.0	45.9	45.9	45.7
Expenditure (% GDP)	49.9	49.7	49.9	48.6	47.3
Fiscal Balance, after grants (% GDP)	-4.0	-4.7	-4.0	-2.7	-1.5
External Position					
Current account balance (% GDP)	-14.7	-9.7	-9.6	-9.5	-9.1
Gross reserves (months of imports)	5.5	4.7	4.5	4.4	4.5
Debt					
Public Debt (% GDP)	27.8	34.7	39.8	40.3	38.0
External debt service (% of exports)	8.0	11.3	12.3	12.5	11.5

Source: IMF

1.3. The Government's economic and fiscal reform agenda

The strategic setting for reforms in Bosnia and Herzegovina has been and is to large extent defined by the ongoing work on Bosnia and Herzegovina’s integration into the EU. The EU provides guidance to the authorities of Bosnia and Herzegovina on reform priorities as part of the European Partnership which was adopted in February 2008. The Stabilisation and Association Agreement (SAA) was signed in June 2008, together with an Interim Agreement which focuses on trade and trade-related areas. The Interim Agreement entered into force on 1 July 2008. Bosnia and Herzegovina has developed an Action Plan and established joint bodies between the State level and Entity institutions for implementation of the SAA and the Interim Agreement. The National Fiscal Council started operating in September 2008 and has gradually taken over a coordinating role for fiscal policies.

The programme with the IMF that was negotiated by the National Fiscal Council included a set of prior actions: a) the adoption of rebalanced budgets in the Federation and the Republika Srpska and savings in the 2009 state budget; b) the increase of excise taxes; and c) the adoption of a global budgetary framework. Fiscal adjustments are aimed at bringing down the consolidated budget deficit from 7.8% of GDP without modification to 4.7% of GDP. Adjustments amount to 2.3% of GDP on the expenditure side, the bulk of which (1.7% of countrywide GDP or EUR 212 million) is to be borne by the Federation, while the Serb Republic contributes 0.5% of GDP (EUR 60 million, including municipalities and health funds) and the state level 0.2% of GDP (EUR 20 million). Corrections take place mainly via reductions of wages, allowances and social transfers. Current spending is reduced by approximately 10% while capital expenditures are not affected. On the revenue side, a law of increased excises on tobacco, coffee and petroleum was adopted and entered into force as of 1 July 2009. It has an estimated impact of EUR 83 million in 2009 (0.7% of GDP).

Box 1 – Short-term measures of fiscal adjustment under the IMF programme

Measures on the expenditure side are intended to save EUR 292 million (2.3% of GDP). These include:

- On the <u>state level</u> (EUR 20 million): a reduction of spending on wages by 8%, meal allowances by 35% and vacation allowances by 20%;
- In the <u>Federation</u> (EUR 212 million): a 10% reduction of all budget users and of all transfers to different social groups; a ceiling of 1% of the average wage on meal allowances; a reduction of the vacation allowance to 50% of the average wage from 75% of the individual wage; a suspension of allowances for participation in commissions, overtime work and contractual services, additional savings by cantons, municipalities and social funds;
- In the <u>Republika Srpska</u> (EUR 60 million): a reduction of the salaries of highest paid civil servants by 10%; lowering daily allowances for business trips; unifying the rulebook on compensation; a hiring freeze for one year; reduction of veteran and disability benefits; expenditure cuts on wages in municipalities and health funds; a redefinition of early retirement requirements.

Measures on the revenue side are intended to raise an additional EUR 83 million (0.7% of GDP):

- Increased excises on tobacco, coffee and petroleum

In addition, the global medium-term budgetary framework was adopted by the National Fiscal Council on 29 June despite opposition from the state level that voted against it. The state Minister of Finance and Treasury explained his refusal in a letter to the international community, stating that the adopted document was not a real fiscal framework because relevant data were missing, and that the share of the state level from indirect taxes in 2010 would be too low.

Additional commitments to be implemented after the adoption of the SBA include structural reforms, especially in the Federation where needs are highest while the Republika Srpska had already carried out more ambitious structural reforms in recent years. Public administration reforms in both entities will be pursued and the coordinating National Fiscal Council will be strengthened. It was agreed that the Federation would move forward with privatisation, reform its system of rights-based transfers to a means-tested system, pursue pension reforms and centralise its system of registration, control and collection of taxes and social contributions. Concerning the financial sector supervision, the authorities will set up a Standing Committee for Financial Stability comprising the Banking Agencies, the Central Bank, the National Fiscal Council and the Deposit Insurance Agency, in order to improve the exchange of information, the analytical capacity and crisis preparedness and management. Last but not least, the authorities will continuously adhere to the Currency Board Arrangement as constituted under the law.

1.4. External and budgetary financing needs in Bosnia and Herzegovina

Under the assumptions of the IMF programme, aiming at keeping the official foreign exchange reserves at their level of end-May 2009, gross financing needs of EUR 1,411 million in 2009 will produce a financing gap of approximately EUR 433 million. For 2010, a strong adjustment programme will reduce the budget's financing needs substantially, thus allowing maintaining reserves to the equivalent of 4.5 months of prospective imports of goods and services. With the current account continuing to adjust and roll-over rates and FDI improving due to enhanced confidence in economic policies and the projected recovery in the world economy, gross financing needs during 2011 and the first half of 2012 are projected to decline substantially. The total financing gap under the program would amount to EUR 1,488 million. The IMF will provide about EUR 1,145 million (600% of quota) during the programme period, while the World Bank has indicated commitments of EUR 189 million.

In this context the Commission is proposing an MFA operation for Bosnia and Herzegovina amounting to a maximum of EUR 100 million. Given Bosnia and Herzegovina's moderate level of indebtedness it is deemed appropriate to provide this assistance in the form of loans. The assistance is intended to contribute to covering the residual financing needs in 2010 — beyond World Bank and IMF assistance — and would correspond to 77% of the projected EUR 130 million needed as identified by the IMF. The remainder of EUR 30 million will come from other sources, including London Club debt deferment. Given the time profile of the needs, the IMF support will be more or less equally distributed during the programme period, while more than half of the World Bank support will be disbursed in 2009 and the macro-financial assistance is planned in two tranches for 2010.

Table 2: Summary of Financing Needs

	2008	2009*	2010*
(in millions of euro)			
Gross financing requirement	1,986	1,411	1,471
Current account deficit	1,842	1,201	1,234
Amortisation	143	211	237
Government (excl. IMF)	60	114	117
Other	83	97	120
Financing	1,986	1,411	1,471
Capital transfers	202	218	230
Foreign direct investments	529	258	500
Net bank financing	655	82	50
Foreign loans	590	210	315
Government	380	215	245
Other	210	-5	70
Gross international reserves (- = increase)	206	287	-75
Other	-199	-76	-111
Financing gap	…	433	563

Fiscal	…	433	292
Augmentation of reserves	…	0	271
IMF	…	305	382
World Bank	…	103	51
EU	…	0	100
Other (including London Club)	…	24	30
Memorandum Item:			
Gross Domestic Product (in millions of euro)	12,550	12,423	12,801

Source: IMF staff estimates

*2009 and 2010 data are forecasts.

Besides the external financing gap, the IMF also identifies uncovered budgetary financing needs: Without adjustment, the consolidated budget deficit would reach 7.8% of GDP in 2009. The IMF and the authorities have agreed to reduce it to 4.7% of GDP in the current year (EUR 584 million) and to 4.0% of GDP in 2010 (EUR 512 million). Available domestic and foreign financing adds up to 1.2% of GDP in 2009 (EUR 150 million) and to 1.7% of GDP in 2010 (EUR 220 million). This would leave an uncovered budgetary financing gap as calculated by the IMF of 3.5% of GDP in 2009 (EUR 435 million) and 2.3% of GDP in 2010 (EUR 294 million), before the intervention of the international community.

The IMF funds will be disbursed to the Central Bank. The first tranche of around EUR 200 million was disbursed in July and the second one of almost EUR 100 million is planned for December 2009. These funds are expected to be allocated entirely to the budgets of the Federation (2/3) and the Republika Srpska (1/3). As the heavy burden on the budget will ease out, in 2010 only part of the EUR 375 million that will be disbursed is expected to be channelled to the budgets, while the remainder would be kept at the Central Bank to strengthen foreign reserves.

2. OBJECTIVES AND RELATED INDICATORS OF THE MACRO-FINANTIAL ASSISTANCE

2.1. Objectives

The objectives of the proposed macro-financial assistance operation are the following:

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

Detailed macro-economic and structural reform objectives will be further defined in the context of a Memorandum of Understanding, to be agreed with the authorities.

2.2. Indicators

To monitor the fulfilment of the objectives of the programme throughout the implementation period of the assistance, the Commission will use two types of indicators:

- Adherence to the IMF-supported programme; it will be a condition sine qua non for the implementation of the assistance;

- Progress in the implementation of specific actions that will be part of the conditions for disbursement. Those actions will be specified in the aforementioned Memorandum of Understanding. They will be consistent with the policy lines anchored in the IMF programme, as well as the European Partnership Priorities.

3. ALTERNATIVE DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1. Delivery mechanisms

Given Bosnia and Herzegovina's moderate level of indebtedness it is deemed appropriate to provide the foreseen macro-financial assistance in the form of loans.

Macro-financial assistance is an untied and undedicated macroeconomic support, which helps the beneficiary meet its external financing needs, and may contribute to alleviating budgetary financing needs. The loan will be denominated in euro and transferred to the Central Bank which converts it into local currency. The loan may then be fully or partly transferred to the budgets of the Federation and the Republika Srpska. Moreover, as experienced with similar operations, including in Bosnia and Herzegovina, the economic policy conditionality attached to this support strengthens the stabilisation and reform process.

3.2. Risk assessment

There are both fiduciary and policy risks related to this macro-financial assistance operation.

There is a risk that this assistance, which is not dedicated to specific expenses (contrary to project financing, for example), would be used in a fraudulent way, like any other type of assistance. Generally speaking, this risk is related to factors such as the independence of the central bank, the quality of systems and procedures related to the management, control and oversight functions in the financial circuits and processing of such assistance, IT security and internal/external audit capacity of the beneficiary authorities.

To mitigate the risks of fraudulent use, several measures will be taken. The Memorandum of Understanding and the loan agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to clearly identified accounts at the Central Bank of Bosnia and Herzegovina. Moreover, before the agreement on the Memorandum of Understanding is reached, the Commission services will assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in Bosnia and Herzegovina (for details, see Financial Statement, section 7). In the light of this assessment, specific mechanisms applying to the management of the funds by the beneficiaries may be introduced in agreement with the national authorities. The Commission may also use other assistance instruments at its disposal to help the beneficiary authorities improve their public finance management systems if this area is not sufficiently covered by other donors.

Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

As regards policy risks, the main assumption is that the Governments of the different state levels of Bosnia and Herzegovina will remain committed to fiscal adjustment and remain in compliance with their agreement with the IMF. This will be validated on the basis of IMF's quarterly monitoring of performance indicators and structural benchmarks. There is a risk that the political will to pursue agreed reforms at one or the other level of government may fade as the pressure from lobby groups that are affected by the adjustment measures may rise.

While seriously taking into account these risks, the Commission services consider that there are sufficiently strong grounds to proceed with MFA to Bosnia and Herzegovina. The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

4. ADDED VALUE OF COMMUNITY INVOLVEMENT

By providing financing complementary to resources made available to Bosnia and Herzegovina by the IMF and the World Bank, the Community would support Bosnia and Herzegovina's domestic efforts of responding to the impact of the current global economic crisis. It would encourage and strengthen the implementation of the necessary and overdue structural reform and fiscal adjustment agenda. This will be particularly important in the areas targeted by the programme's conditionality, in particular the fiscal consolidation effort aimed at reducing public expenditures to a sustainable level.

The macro-financial assistance is a policy-based instrument and would therefore also contribute to support the European Union's strategy towards Bosnia and Herzegovina, in particular in the context of the European Partnership.

5. GENVAL CRITERIA

The Commission services have given due consideration to the five Genval criteria.

- ***Exceptional character:***

Bosnia and Herzegovina's financing requirements in 2009-2011 result from the country's high external and fiscal imbalances that severely aggravated the impact of the global economic crisis on Bosnia and Herzegovina. The ongoing economic adjustment, the anchor of the EU perspective and the conditionality of the IMF programme will contribute to reducing these imbalances over the medium term.

The exceptional character of the foreseen MFA is further stressed by the limited timeframe of the programme. The Commission services intend to limit the duration of the implementation of the assistance to one year. When deciding about the disbursement of the funds under the MFA programme, the Commission services intend to take into consideration the progress in the implementation of the IMF programme and of the World Bank development policy loans.

- ***Scope:***

Bosnia and Herzegovina is a potential candidate country for EU membership which respects democracy and human rights and as such can be considered as eligible for EC MFA support.

- ***Complementarity:***

The Community MFA will be complementary to the external financing coming from the International Monetary Fund and the World Bank. It will cover the residual financing gap over and above the support of these institutions by 77%. The remaining funds will be provided by other sources, including London Club debt deferment. In this context and in the short run, MFA will both increase substantially the European Union's leverage on Bosnia and Herzegovina's policy making bringing the country onto a more sustainable path of economic and fiscal policies.

- ***Conditionality:***

The macro-financial assistance to Bosnia and Herzegovina will be linked to an IMF stand-by arrangement. As usual with this type of assistance, disbursements under this macro-financial assistance will be subject to progress in the implementation of the IMF arrangement, in particular related to macroeconomic performance and structural adjustments. It will also be conditional upon further reform measures that will be defined in the context of a Memorandum of Understanding to be jointly agreed between the Commission and the Bosnian authorities.

Given the nature of the planned operation, in defining the conditionality in the area of structural policies, particular attention will be paid to public finance management with a view to strengthening efficiency, transparency and accountability, and because of its importance for fiscal consolidation. As Bosnia and Herzegovina is a potential candidate country, some measures with high priority on the EU integration agenda may also be included in the conditionality framework. In addition, the Commission may consider targeting specific sectoral policies of particular importance, identified as such in the European Partnership and 2009 Progress Report.

- ***Financial discipline:***

The Commission services propose to limit the macro-financial assistance to Bosnia and Herzegovina to up to EUR 100 million. This corresponds currently to 77% of the amount (ex-ante) of the residual financing gap foreseen after IMF and World Bank support as identified by the IMF for the year 2010. Forward looking data on the balance-of-payments gap are by their very nature volatile. Additional bilateral financing may materialise in the course of the programme that cannot yet be included in the current programme assumptions.

Concerning sound financial management, the Commission services are taking action in order to fulfil the requirements of the Financial Regulation. The Commission will launch an Operational Assessment (OA) of the reliability of financial circuits and administrative controls at the Ministries of Finance of the state level, the Federation and the Republika

Srpska, and the Central Bank of Bosnia and Herzegovina. Based on the OA report's findings, the Commission services will determine whether the framework for sound financial management is sufficiently effective in Bosnia and Herzegovina. Also, the results of the OA will contribute to the definition of appropriate conditionality in the area of public finance management.

6. PLANNING FUTURE MONITORING AND EVALUATION

This assistance is of exceptional and macro-economic nature and its monitoring and evaluation will be undertaken in line with the standard Commission procedures.

6.1. Monitoring

The monitoring system will be ensured by the provision of reports and data by the authorities, as to be set out in the Memorandum of Understanding, and the organisation of review missions to Bosnia and Herzegovina by Commission staff. This assistance will be managed centrally. The Commission Delegation will also be called to provide additional reporting, where appropriate.

In particular, the monitoring of the action by the Commission services will take place on the basis of a system of macro-economic and structural policy indicators to be agreed with the authorities of Bosnia and Herzegovina. In this process, the Commission services may also monitor key areas to be identified in the above-mentioned Operational Assessment on public finance management.

An annual report to the European Parliament and to the Council on the implementation of this assistance is foreseen in the proposed text of the Council Decision on MFA to Bosnia and Herzegovina.

6.2. Evaluation

In the context of DG ECFIN's Multi-annual Evaluation Programme, two to three ex-post evaluations of MFA operations are planned per year. It is in this framework that an independent evaluation of the assistance will be carried out by duly authorised representatives of the Commission in due course. A provision foreseeing an ex-post evaluation will be included in the Memorandum of Understanding. Financial resources for this evaluation would be drawn from the corresponding MFA budget line.

7. ACHIEVING COST-EFFECTIVENESS

In implementing the programme, the Commission will be guided by the following principles:

- The assistance will be made available by the Commission to Bosnia and Herzegovina in principle in two instalments. Each instalment will be released on the basis of a satisfactory track record in implementing the macro-economic agenda under the IMF-supported programme and the specific economic policy conditions attached to the assistance. The latter will be negotiated with the authorities as soon as possible and laid down in a Memorandum of Understanding concluded to this effect.

- As soon as the Council has adopted the proposal, the Commission will negotiate with the Bosnian Authorities a Memorandum of Understanding laying out the conditions for the release of the EU assistance, as well as a loan agreement. The disbursements of the proposed assistance by the Commission will further be conditional upon a satisfactory track record of the implementation of the IMF programme and the economic policy and financial conditions attached to the assistance.

- In negotiating specific policy conditions, the Commission will draw on all available expertise, including of the IMF, the World Bank and of bilateral and multilateral aid agencies active in the same areas. In addition, the Commission will aim at synergies with other Community policies and instruments (notably the Instrument for Pre-Accession) that could be used to support the implementation by the beneficiary of the relevant measures (notably in the area of public finance management). Where appropriate, links to any related action under the European Partnership or findings of the Progress Reports can also be established.

- This action is exceptional by nature and will not involve an increase in the number of Commission staff.