
# Analysis on Public Debt
# Bosnia and Herzegovina

CSOs as equal partners in monitoring public finances

September 2017

BALKAN MONITORING PUBLIC FINANCES

www.wings-of-hope.ba

# CREDITS

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This document has been produced as a part of the project "CSOs as equal partners in the monitoring of public finance" which started beginning of 2016 and is implemented by a consortium of 10 organizations from 7 countries and will last for four years.

The aim of the project is to improve the transparency and accountability of policy and decision making in the area of public finances through strengthening the role and voice of NGOs in monitoring the institutions that operate in the area of public finances. In this way, the project will strengthen CSO knowledge of public finance and IFIs and improve CSO capacities for monitoring. Additionally, it will help advocate for transparency, accountability and effectiveness from public institutions in public finance. Moreover, this project will build know-how in advocating for sustainability, transparency and accountability of public finance and IFIs. This project will also increase networking and cooperation of CSOs on monitoring of public finance at regional and EU level. Lastly, it will increase the understanding of the media and wider public of the challenges in public finance and the impacts of IFIs.

Key project activities are research and monitoring, advocacy, capacity building and transfer of knowledge/practices and networking in the field of the 4 specific topics: public debt, public-private partnerships, tax justice and public infrastructure.

More information about the project can be found on [http://wings-of-hope.ba/balkan-monitoring-public-finance/](http://wings-of-hope.ba/balkan-monitoring-public-finance/) and on the Facebook Page Balkan Monitoring Public Finances



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# CONTENT





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## INTRODUCTION

Since the global financial crisis, the idea of sustainable public finance has been presented by the International Financial Institutions (IFIs) as a problem of fiscal discipline and public spending. Bosnia and Herzegovina (BiH) is no different. The IFIs blame the public finance crisis on a lack of fiscal discipline and excessive government spending. Within the framework of the Standby Agreements (SBAs) with the IMF (2009-16), and the Reform Agenda (2015), fiscal sustainability is related to downsizing the public sector and public spending, combined with business-friendly labour market, taxation and administrative reform. Once this equation of fiscal restriction and economic liberalisation is made, all that is then left is to define the legal and regulatory framework, the fiscal and debt management strategies, the planning and administrative modalities - to operationalize fiscal preferences in relation to existing revenues.

It is questionable whether excessive public spending as such is the problem. In fact BiH had an average budget surplus of 2.2% of GDP in the 2003-2005 period, and ran a budget surplus based on rising tax receipts right up to the crisis. The key fact is that the increase in tax base was caused by the credit bubble which in the period from 2004 to 2008 added an additional aggregate increase in purchasing power of EUR 4.5 billion, the equivalent of 40% of GDP in 2008. In other words, foreign debt stimulated the consumption bubble that fed economic growth, which in turn provided tax receipts enabling the government to run a budget surplus. With the global financial crisis, there was a contraction of the credit supply and thus of spending on goods and services. BiH entered a double-dip recession (2009, 2012) interspersed by years of stagnant growth. When foreign credit collapsed government revenues also nose-dived and public debt exploded from a previously low level; as of end of 2016 it hovered around 40% of GDP. Since the crisis, Bosnia has signed three standby agreements with the IMF (2009, 2012, 2016) in order to borrow the money to cover the growing budget deficit (6% of GDP in 2009) and trade deficits (still an astonishing estimated 25% of GDP in 2015).

Nevertheless public sector expenditure ranks second in the region owing to a complex and highly decentralized governance structure, comprising a central level of government, the BiH Institutions, Brčko District (DB), and two Entities—the Federation of Bosnia and Herzegovina (FBiH) and the Serbian Republic (RS) – each of which has its own government, extra-budgetary funds (EBFs), and local self-governance units. FBiH has 10 cantons representing a level of government between the government of FBiH and local self-governance units, and each canton has its own government and some EBFs. A Fiscal Council was set up in 2008 to coordinate fiscal policies by setting medium-term fiscal



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targets each year with the aim of reducing the primary deficit and total public consumption and setting the annual ceilings for indebtedness of the budgets of BiH, FBiH, RS, and DB. While there has been some success in consolidating primary balances, the problem of co-ordinating debt ceilings remains. Indeed the share of lower levels of government (cantons, municipalities, cities and public enterprises) in the total external debt of FBiH is constantly rising (from 1,046.76 million KM in 2010 to 2,447.62 million KM in 2015).

The privatisation of loss-making public sector firms forms a key plank of the SBAs and is seen as significantly reducing public sector debt. In 2015 public enterprises accounted for 1,769.22 million KM of the debt of the Federation of Bosnia and Herzegovina (FBiH), doubling from 825 million KM in 2010. But is privatisation necessarily a panacea? The privatization process in Republika Sprska (RS) in 2006–07 led to significant windfall receipts, which in the form of higher public sector wages and higher spending on goods and services were merely recycled in the credit bubble. Thus while efforts are needed to check the increase in uncovered liabilities by lower levels of government and loss-making state-owned enterprises, the danger is that public budgets continue to be geared to milking one-off income from privatisation and reducing welfare spending in order to borrow and repay debt. The problem in considering sustainable public finance is rather one of creating an alternative model of economic growth which recognises the economic significance and potential of the public sector – in terms of the economic multiplier – and thus promotes sustainable public finance.



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# 1. LEGAL FRAMEWORK ON PUBLIC DEBT

## 1.1. Institutional Framework and Regulation of the Public Debt

The country has a highly decentralized governance structure, with two Entities (the Federation of BiH (FBiH) and the Republika Srpska (RS)) having their own constitutional right to borrow externally and domestically. Hence, under the Law on Borrowing, Debt and Guarantees of BiH the BiH Institutions (the national level) have a major legal role in contracting of foreign debt of all levels in BiH, including the Entities and DB. After the Entity foreign loans have gone through all of the procedures at the Entity government level, the BiH Parliament must ratify all loans as the BiH Institutions are the ultimate guarantor of debt to international financial institutions (IFIs), and the BiH Ministry of Finance and Treasury (MFT) administers all foreign debt servicing for all levels in BiH. Thus, virtually all of the countrywide foreign debt servicing (except some very small Entity direct foreign debt—around 145.03 million KM in 2016) is a special part of the BiH Institutions budget (both in planned budget and in execution reports).

The external debt of the entities is serviced from the indirect tax revenues of the entities from the sub-account of the entity opened with the Central Bank (CBBiH). It is only once their share of the external debt has been deducted do the entities receive the remainder of their indirect tax revenues. The direct external debt of the entities is serviced from their direct tax revenues out of the Single Treasury Account, which is opened with the commercial banks. In the latter case, entities pay their liabilities directly to the creditor.



Total public debt is reviewed annually by the MFT, CBBiH, and the Fiscal Council through the regular Article IV consultations with the IMF, and this scrutiny is currently intensified under the monitoring required by the Standby Agreement (SBA). The BiH MFT regularly monitors all of the foreign debt servicing for the entire country, exchanging information with the Entities and DB. BiH’s high level of fiscal decentralization, with no official harmonized methodology for fiscal reporting, and an irregular flow of information between the entities and the BiH, presents a significant barrier to planning and monitoring fiscal policy in the country. The BiH MFT also monitors the implementation of such loans, including by reviewing annual project audit reports and approving any withdrawal applications. It reports monthly on debt monitoring and prepares a report on public debt in BiH (including both external and internal public debt stock and repayment projections) for the BiH Institutions’ medium-term expenditure frameworks. In addition, it annually prepares a separate review of the country’s total public debt, which it submits to BiH Parliament.

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However, the situation was clearly not satisfactory since in May 2016 the House of Representatives of BiH adopted a resolution asking the BiH Ministry of Finance and Treasury to provide information on the state of public indebtedness of Bosnia and Herzegovina every 6 months. Thus it must be noted that these monitoring activities are not carried out particularly transparently: for example the website of MFT at the moment carries no execution reports, monitoring reports exist only for three years, and the last debt servicing report is from 2009!

Before 2016, due to the decentralized administrative structure, the MFT, and thus the BiH Institutions, do not carry out debt sustainability analysis (DSA). The only relevant work in this area was undertaken by the IMF for their Article IV Country Reports or periodically in some of the review reports under the SBA. Indeed, the IMF debt sustainability analyses were performed without the active participation of the BiH institutions (other than data provision). Nor did the BiH Institutions use this analysis in their strategic planning process in terms of future borrowing policies and needs at any government level.

A Fiscal Council was created in 2008 to coordinate fiscal policies between the BiH Institutions and the Entities. The Council prepares the Global Framework of the Fiscal Balance and Policy (GFFBP), determines revenues from indirect taxation and the budget of BiH Institutions, thereby creating preconditions for budget planning at lower level of governments, which are responsible for over 90% of public expenditures. The GFFBP should set medium-term fiscal targets each year; however, the only fiscal goal is the reduction of the primary deficit and total public consumption; concerning debt it sets the annual ceilings for indebtedness of the budgets of the BiH Institutions and the Entities in compliance with legal limits. While there has been some success in consolidating primary balances, the problem of co-ordinating debt ceilings remains. Indeed, the share of lower levels of government (cantons, municipalities, cities and public enterprises) in the total external debt of FBiH is constantly rising (from 1,046.76 million KM in 2010 to 2,447.62 million KM in 2015).



The Law on Borrowing, Debt and Guarantees of BiH stipulates that an Advisory Committee for Debt (comprising of two representatives from Council of Ministers, one of which is the Finance Minister, one representative from the CBBiH, two representatives from the Entity Governments including Finance Ministers, and the Finance Directorate director from the Brčko District), is supposed to be in charge of preparing state debt management strategy. However, in practice, this has not been implemented.

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## 1.2. Debt Legislation

Law on Borrowing, Debt and Guarantees in BiH; Law on Settlement of Liabilities from Foreign Currency Deposit Savings; Law on Debt, Borrowing and Guarantees in FBiH; Law on Borrowing, Debt and Guarantees in RS; and Law on Internal Debt of DB.

Both Entities have introduced legal fiscal rules that satisfy the usual definition of fiscal rules (being numerical, serving as a permanent constraint on fiscal policy, and relating to expenditure or debt levels). The contracting of loans and issuance of guarantees are made within limits for total debt and total guarantees, and always approved by a single responsible level of governance. However, there are no fiscal rules for BiH Institutions.

In RS, the fiscal rule was introduced in 2012, by the Law on Borrowing, Debt and Guarantees, which prescribes that the total debt of RS, which covers the public debt of RS, the debt of public enterprises, the debt of the RS Investment Development Bank, and the debt of other public sector institutions, cannot exceed the level of 60% of GDP, while the public debt of RS (which covers the debt of Republika Srpska, debt of units of local self-governance, and the debt of the EBFs for social insurance) cannot exceed 55% of GDP. The Law on Borrowing, Debt and Guarantees of RS also stipulates that units of local government may borrow in long term only if in the course of the period of the onset of debt the total amount that accrues for repayment, on the basis of the proposed debt and the total of accrued, outstanding existing debt, in any of the subsequent 32 years, does not exceed 18% of the amount of its regular revenues executed in the preceding fiscal year.



The Law on Budgets in FBiH stipulates a fiscal rule that the planned current budget must be balanced and, if a current deficit is executed, the government must plan for a current surplus in the next three years. The Law on Borrowing, Debt and Guarantees of FBiH stipulates that future servicing of FBiH public debt cannot exceed 18% of current revenues, while future servicing of cantonal and local self-governance units' public debt in FBiH cannot exceed 10% of current revenues.

The debt of the entities, including for budget support loans for Entity government budgets, has increased almost threefold since 2005/2006, but it remains within the range of the relevant legal constraints.
All borrowing of the government and units of local self-governance is under the control of the RS Ministry of Finance, which also controls the issuance of guarantees for the borrowing of public companies. Monthly reports are made to the RS MF, which consolidates them with central government debt, with a purpose of preparing timely records for total RS debt. MF RS submits quarterly reports on the balance of debt and guarantees of the local self-governance units to the MFT of the BiH Institutions.

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Annual reports are submitted to RS National Assembly, and a review of debt is provided within the RS Medium Term Expenditure Framework. In addition, the quarterly report on outstanding external and internal debt is also required as a part of monitoring within the framework of IMF SBA. According to the RS MF, a debt sustainability analysis (DSA) for external and domestic debt has been undertaken annually, but the analysis was not publicly available until 2015, raising legitimate questions as to the credibility of previous exercises (World Bank 2014). The FBiH MF maintains an electronic database of external and internal debt, including that of cantons and local self-governance units. The MF regularly reviews external and internal debt, including as part of the regular review also submits data to the BiH MFT Debt Management Unit, which maintains an access database of all internal and external debt of all governments of BiH. While data on debt status was collected regularly (with some delays at the local self-governance level) and reports on debt stock and servicing projections are provided, full debt sustainability analyses (DSAs) were not performed until 2015, except for the regular DSAs prepared by the IMF.

The authorities undertook, by the end of 2016, to submit amendments to the Law on Debt, Borrowing and Guarantees and a new Law on Public Revenue Allocation to the Parliament in order to strengthen controls over lower level governments.



Thus far, in accordance with its Letter of Intent to the IMF, only the Government of FBiH has adopted a Draft Law on Debt, Borrowing and Guarantees, on 10 October 2017, subject to ratification by the FBiH parliament. With this law, FBIH aims to implement EU fiscal rules on debt, borrowing and guarantees and the EU statistical methodology for the measurement of public debt. The Maastricht criteria fixing levels of public debt in relation to the gross domestic product will be integrated into BiH law. The law creates preconditions, in accordance with the principles of good practice, for stronger control over borrowing and determines the objectives of borrowing.

The Law on Budgets in FBiH, adopted in December 2013, prescribed the integration of debt sustainability analysis into the budget documentation. The Draft Law prescribes the obligation of the Government of FBiH to adopt a debt management strategy that is based on the goals set by the law as well as an annual debt plan. The Federal Parliament is given the final say on the amount of federal debt and guarantees, upon a proposal from the Government. The law establishes new debt servicing limits for cantons, cities and municipalities in relation to budget revenues and defines debt thresholds in relation to GDP. Thus Clause 11 states that short-term debt to finance the budget deficits must be repaid in the fiscal year in which the debt was incurred, and must not exceed 15% of regular budget revenues realized in the previous fiscal year.

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An annual limitation of new borrowing is introduced for legally prescribed institutions and legal entities, limits new indebtedness and the issuing of guarantees without prior approval of the Federal Ministry of Finance (Article 17), and secondarily the approval of Canton Ministers of Finance and cities and councils (Articles 18 and 19). Public health institutions are explicitly prohibited from new borrowing (Article 16).

The law strengthens the rights of creditors who may demand further debt insurance on the part of legally defined debtors in the form of: bills of exchange, a dedicated cash deposit to the amount of the annual annuity, total or part of revenue expected from capital investment, revenues from indirect taxes belonging to the canton, city and municipality, the guarantee of a bank or financial insurance company or of Bosnia and Herzegovina. Equally the federal government, which is obliged to cover indirect debt in the event of default, has sought to increase its rights against end-users who are late in settling their obligations. Under Article 34, it may temporarily suspend transfers from the federal budget to cantons, cities and municipalities; seize income from the Special Account for the distribution of indirect taxes to cantons, cities and municipalities; activate debt insurance instruments. More generally until the debt is settled the Federal Ministry of Finance cannot issue a guarantee or create new debt on behalf of the end-user.

The law stipulates the obligation to establish, finance and manage a Guarantee Fund at the level of FBiH, the canton, the city and the municipality (Section E, Draft Law). The Guarantee Fund is intended exclusively for payment under activated guarantees. The funds of the Guarantee Fund are set to the amount of total contingent liabilities due in a given year and budget planning to provide for the latter is made mandatory. The Federal Ministry of Finance is authorized to charge an administrative fee for processing guarantee requests, refundable in the event of a successful application, and calculate and charge the commission and risk premium for each issued warranty. For the purpose of increasing funds, the money available to the Guarantee Fund can be invested in open market operations. In the event of non-payment, the Federal Ministry of Finance is authorized to activate the debtor's insurance instruments, seize public funds and charge default interest on all amounts paid to the creditor on the basis of the issued guarantees.



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# 2. PUBLIC DEBT

## 2.1. Indicators of the Public Debt and Debt Burden

In 2016, total public debt, including external and internal indebtedness, increased by 1.18 percent compared to the previous year, from 11.949 billion KM to 12.089 billion KM, but fell in GDP terms for the first time since 2008, from 40,75% of GDP to 39.78%% (see Table 1 below). Public debt is not particularly high by international standards, indeed it is well within the framework of Maastricht criteria (60% of GDP), but it has increased threefold since 2006, in large part because of budget support loans, due to a structural budget deficit. As far as indicators of debt burden – and thus public finance sustainability - are concerned, the overall trend is far from certain and legitimate concerns remain. It is true that public debt/GDP and foreign debt/export of goods and services indicators marginally improved in 2016 as the result of higher GDP growth rate in comparison with public debt growth and higher growth rate of export of goods and services in comparison with foreign debt growth. However, foreign debt servicing increased in 2016 as a proportion of a range of indicators – of net revenues, of export of goods and services and of GDP -representing a rising debt burden (see Table 1).

***Table 1 Basic indicators of public debt for 2015 and 2016 (BHMFT 2017)***

| **Description** | **2015.** | **2016.** |
|---|---|---|
| Outstanding public debt (million KM) | 11,949.10 | 12,089.65 |
| Outstanding foreign debt (million KM) | 8,411.07 | 8,539.03 |
| Outstanding domestic debt (million KM) | 3,538.03 | 3,550.62 |
| Outstanding foreign debt (million KM) | 592.89 | 735.40 |
| GDP (million KM) | 29,462.00 | 30,389.00 |
| Net revenues from indirect taxes (million KM) | 5,131.10 | 5,387.20 |
| Export of goods and services (million KM)35 | 9,863.00 | 10,139.00 |
| Outstanding public debt/GDP | 40.56% | 39.78% |
| Outstanding foreign debt/GDP | 28.55% | 28.10% |
| Outstanding domestic debt/GDP | 12.01% | 11.68% |



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| | | |
|---|---|---|
| Foreign debt servicing/GDP | 2.01% | 2.42% |
| Foreign debt servicing/Net revenues from indirect taxes | 11.33% | 13.42% |
| Outstanding foreign debt/Export of goods and services | 85.28% | 84.22% |
| Foreign debt servicing/Export of goods and services | 6.01% | 7.25% |

Public debt is divided into internal and external debt. External debt increased by KM 127.96 million or 1.52%, while the internal debt increased by KM 12.59 million or 0.35%. The share of external debt in the structure of total public debt in 2016 was 70,63%, while in 2015 it was 70.38%; that of internal debt was 29,37% in 2016, while in 2015 it was 29.62%. Thus, while both increased in absolute terms, the share of external debt compared to internal debt rose as a proportion of total public debt. The share of external debt in the servicing of the total public debt is 43.31%, while that of the internal debt is 56.69%. The shares of the total public debt in 2016 were: FBiH 54.28%, RS 45.04%, BD 0.24% and the BiH institutions 0.44%. FBiH was responsible for 55.06% of this debt in 2015, RS for 44.22% in 2015. Hence FBiH's share of total public debt rose in comparison with that of RS. FBiH's share of total public debt servicing costs was 52.55%, RS 46.34%, while the BiH Institutions amounted to 0.24%.



## 2.2. External Debt

As of end of 2016, the external debt of BiH had risen to 8,539.03 million KM from 8,401.49 million KM in 2015, an increase of 1.52%. As a proportion of GDP external debt fell from 28,68% in 2015 to 28,01%. The external debt service in 2016 amounted to KM 735.40 million, of which KM 611.69 million or 83.18% relates to the principal, with KM 123.71 million or 16.82% interest. In 2015 external sovereign obligations totaled 581.33 million KM, of which the repayment of the principal concerned 477.99 million KM or 82.22% and interest payments, service and other costs 103.34 million or 17.78%. Thus while external debt fell in GDP terms, the burden of debt servicing rose from 2.01% of GDP in 2015 to 2.42% in 2016. This is even clearer if we look at external debt servicing in relation to indirect revenues, from which debt is serviced by the BiH Institutions: it rose from 11.33% in 2015, an already significant annual drain on the budget, to 13.42% in 2016.

At end of 2016, 61.9% of this debt belonged to FBiH, while RS was responsible for 37.14%. The equivalent figures for 2015 were 63.19% for FBiH, while RS was responsible for 35.9%. Hence in 2016, the FBiH share fell by -1,29% while the RS share increased by 1,24%. In the total serviced external debt

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obligations, the Federation of B&H participated with 464.41 million KM (64.22%), Republika Srpska with 251.52 million KM (34.78%), Brčko District with 2.57 million KM (0.36%) and the Institutions of B&H with 4.63 million KM (0.64%). In 2015, the shares were the following: the Federation of B&H participated with 381.6 million KM (64.36%), Republika Srpska with 204.3 million KM (34.45%), Brčko District with 2.9 million KM (0.48%) and the Institutions of B&H with 4.1 million KM (0.69%). Thus, the change in the shares of servicing costs broadly followed the movement in the shares of the overall external debt.

While a large part of the debt stock has been contracted on concessional terms over with a favourable maturity structure, according to the IMF, external debt servicing obligations are projected to increase again in the coming years. According to official projections, the ratio of foreign debt servicing to revenues from indirect taxes, will increase from 13.42% in 2016 to 18.1% in 2017, and will only fall slightly, to 15.2%, by 2019 (ERP 2017).

The external debt portfolio shows that concessional loans (with grant element larger than 35%) account for largest share of total external debt, while the main sources of such financing (over 73%) are multilateral institutions. External financing available for BH over 2016-2018 period is estimated at KM 3 billion, of which 49% would come from concessional borrowing. Taking into account costs and risks of contracting such loans, BiH would continue the policy of borrowing from multilateral institutions, and estimates indicate that 65% of needs could be met by financing from such sources. However, since BiH has no more access to International Development Agency Resources, external financing portfolio would shift in the medium tern towards less concessional financing (Debt Management Strategy, 2015). The difficulty is that BiH has little or no access to international capital markets, and is also constrained by the high level of external private sector debt not matched by external assets, which corresponds to a further 24% of GDP. It has been argued that the slower growth of debt in 2016 is due to problems accessing international capital markets (European Commission 2016). In the short term, the risk is of dependence on multilateral institutions. Thus, according to the European Commission, the increase in the burden of external debt service in 2015 was due to intensified issuing of short-term government securities to make up for the nondisbursement of tranches under the IMF Stand-by Arrangement (European Commission 2016). The failure of the FBiH government to meet IMF conditionality has resulted once again in the freezing of the SBA in 2017.

The majority share in the total amount serviced in 2016 was made up of payments to the following three IFI creditors: the International Monetary Fund was paid 179.49 million KM, the World Bank 104.56 million KM, and the European Bank for Reconstruction and Development 112.89 million KM. In 2016,



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the share of such multilateral creditors of the total external debt amounted to 78,44%, while that of bilateral creditors (including both private international banks and governments) accounted for 21,56%. The external debt can be divided into "old" and "new" debt. The "old" debt is inherited from commercial debts on the part of the Socialist Federal Republic of Yugoslavia to the Paris Club and London Club creditors, and IBRD loans. As of the end of 2016, the share of the "old" debt in external indebtedness was 16.16% and showed a constant tendency to decrease, its share falling from 21.75% in 2013 to 19.65% in 2014% and 17,89% in 2015. In the period between 1 January and 30 September 2016, the largest amount was paid to the London Club of creditors in the amount of KM 37.74 million, to the World Bank-IBRD KM 35.96 million and to the Paris Club of creditors KM 20.78 million, representing in total KM 94.48 million.

The lion's share of the "new debt", which makes up 83.84% of total external debt, is represented by debts to international financial institutions (World Bank, IDA and IBRD, EIB, IMF, EBRD, European Commission). The new debt in the period 2015-2016 increased from 6.906,14 million KM to 7.158,81 million KM. The new debt in the period 2006-2016 increased three-fold as a result of IFI loans to finance infrastructure projects and to support budgets.



We will consider the implication for public finance of the shift to foreign borrowing to meet revenue shortfalls when we come to examine internal debt. As far as infrastructure is concerned, BiH has significant infrastructure needs, mainly road construction and energy generation, which are vital to its economic growth potential. However, the share of public capital spending has been decreasing over time, from around 8% of average in the pre-crisis period to less than 7% thereafter, and its financing has gradually shifted from revenues to debt generating foreign financing.

Thus, of "new" external debt, 52.78% relates to infrastructure projects, 34,43% to the public sector (including budgets), and 12.79% to promotion of economic activities. Of total withdrawn funds in 2016, 68.68% pertain to infrastructural projects, 27.65% to the public sector, and 3.67 % to economic activities. 668.71 million KM of approved credit funds was engaged in 2016. Of the total amount, 39.45% relates to the EIB, 22.41% to the IMF, 13.02% to IDA credits and 6.32 % to OPEC, while other creditors participate with 18.8%.

As of 31 December 2016, the total value of projects planned for foreign credit financing amounts to 1,938.36 million KM, of which the FBiH has a 87.03% share, while that of RS is 11.96%. These projects are mainly funded from multilateral sources (80.60%), of which EBRD and EIB are the largest, while 19.40% of them are financed from bilateral sources. Infrastructure projects represent 82.32% of the total

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value of planned projects, public sector projects 10.74 %, and projects relating to entrepreurial activities 6.94 %. The currency structure of their financing is almost entirely in Euros (95%), and when it comes to the interest structure, loans with a variable interest rate are 80% of the total.

### 2.3. Internal Debt

The internal debt of Bosnia and Herzegovina amounted to 3,550.62 mil KM as of 30.06.2016, an increase of 0.35% over 2015, which in GDP terms represented a fall from 12,07% in 2015 to 11,79%. This represented a sharp slowdown in the growth of internal debt: which in 2015 was 7.20% higher than in 2014, while in 2014 it was higher by 9.26% compared to 2013.

Between January and June 2016, the governments of the Entities and BD serviced internal debt obligations of 443.53 million KM, of which 405.23 million KM went on the principal and 38.30 million KM on interest. FBiH paid out 179.47 million KM principal and 16.06 million KM interest, RS 220.34 million KM principal and 22.08 interest and other expenses, and BD 5.42 million KM on principal and 0.16 KM million interest.

In an exact inversion of the proportions of shares in external debt, here FBiH was responsible for 35,88% of internal debt, while RS claimed 64%, the share of FBiH increasingly marginally since end of 2015, representing a rise in its total debt of 4,48% and a fall in RS debt of -0,88%. BiH has limited formal public debt as it did not issue bonds and treasury bills until 2007. These non-market, fixed interest rate instruments were issued to address the substantial domestic liabilities from the pre-war period and fiscal claims resulting from the 1992-95 war. In 2004 both FBiH and RS enacted laws dividing the claims into three groups: general liabilities, liabilities on the basis of savings in foreign currency inherited after the breakup of former Yugoslavia and liabilities on the basis of war damages. Between January and June 2016, the debt from the old foreign currency savings was reduced by 111.74 million KM, and from war claims by 13.71 million KM.



An increasing segment of the internal debt represents *long-term* borrowing to cover budget deficits in the wake of the financial crisis. Since 2011, these are financed by auctioning treasury bonds and notes on the stock market. In FBiH, coverage of offer on treasury bonds issued in 2016 was 2.5, and on treasury notes 2.24 to 4.22, depending on their maturity. The main investors in these securities were the foreign-owned banks, but other investors also appeared, principally insurance companies. In 2016 FBIH issued bonds to the nominal amount of 140.00 million KM, with a maturity period of 3 and 5 years at interest

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rates between 1.85% and 3.40%, following the issue of 310 million KM of bonds in 2015 with a maturity of 3-7 years at interest rates from 2.21% to 3.9%. The stock of debt on this basis is 620 million KM.

In 2016 RS issued bonds to the nominal amount of 281.71 million KM, with a maturity period of between 3 and 5 years at interest rates between 3.5% and 5%, following the issue of 241.26 million KM of bonds in 2015, with a maturity of 4-5 years at interest rates from 3.5% to 4.75%. This debt stock amounts to 728.02 million KM. To cover budget *shortfalls* and develop the financial market, RS issued six-month treasury bills to the total amount of 185.13 million KM at interest rates from 0. 1 to 2.71%. Debt outstanding on this basis amounted to 88 million KM. Funds raised by issuing securities are mainly used to settle the current liabilities of the entity governments.

Public budgets are being financialised not only in order to borrow and repay debt, but also to finance current expenditure. Public institutions are also turning to the foreign commerical banks to finance capital investment, public sector debt and infrastructure projects. Thus the indebtedness of RS to private banks in BiH as of end of 2016 was 122.74 million KM, of which 87.39 million KM pertained to obligations of the Pension and Disability Insurance Fund assumed by the treasury on 1 January 2016. Public sector debt with commercial banks was 1,028 billion KM in 2015. In 2016 the internal debt of municipalities, cities and cantons relating to the debt arising from borrowing at commercial banks and from bonds amounted to 539.22 million KM, of which the debt based on bonds amounts to 44.69 million KM and debt based on credit borrowing 494.53 million KM. From the point of view of public finance sustainability the increasing dependence on more expensive commercial credit represents a new stage of dependency on the failed credit-based model of growth.



### 2.4. Debt Guarantees

Guarantees issued by the state and the entities for foreign and domestic debt are not included in the total public debt, since they do not represent the debt of Bosnia and Herzegovina or the entities, but a potential debt to be paid in case the obligations are not met by the end user. State guarantees of Bosnia and Herzegovina amount to KM 345,173,226 KM and pertain mainly to infrastructure projects. Previous matured obligations for issued foreign State guarantees were serviced by end users in a timely manner. However, Republika Srpska assumed the obligation of repaying the credit of Nikola Tesla Ltd in the amount of 5 million KM, with the maturity period of 10 years, grace period of 1 year and interest at the rate of 4.60 per cent. The amount of this debt is 4.18 million KM.

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### 2.5. Debt structure and risk

Despite relatively low debt, and a stable banking system led by an independent central bank that keeps inflation in check, BiH is not well rated by credit rating agencies. Moody's B3 credit rating with a stable outlook reflects concerns related to government effectiveness in undertaking reforms, wide external deficits and a lack of access to private external capital making the economy heavily dependent on concessional inflows from IFI lenders to repay the same lenders.

External debt is subject to currency, interest rate and refinancing risk. The average interest rate on external debt is relatively low, reflecting concessional borrowing and low benchmark interest rates. The average interest rate on external debt fell from 1.5 % in 2015 to 1.42% in 2016, reflecting a trend. Approximately half of the BiH external debt is exposed to interest rate risk as the share of loans with variable interest rates in the structure of external debt is 47.3%, down from 49.8% in 2015. This means that about half of the foreign debt portfolio is exposed to changes in referent market interest rates, while these changes can affect the costs of debt servicing. On average, interest rate re-financing, i.e. changes in foreign debt interest rates takes 4 to 5 years, while the debt to be refixed in Year 1 is 49.9 per cent, i.e. 49.9 per cent of total foreign debt in 2016 is susceptible to changes in foreign exchange rates. Compared to the previous year, interest rate risk has decreased slightly, but in order to further reduce exposure borrowing at fixed interest rates is desireable while taking into account that the current cost of variable interest rates is lower than that of fixed interest rates.



The average external debt maturity in 2016 remained unchanged at 7.2 years. The average contracted grace period in 2015 was 8.2 years, which, in comparison with the average grace period of 6.5 years in 2015, means that  the share of credits with a grace period, which became effective in 2016 is smaller. Indicators of risk of refinancing continued to deteriorate in 2016, suggesting that maturities should be extended to mitigate risk. 92.8% of the external debt is denominated in 3 foreign currencies, the Euro, IMF special drawing rights (SDR) and US dollars. The majority of outstanding liabilities or 77.54% were paid in EUR, 18.61% in USD, while 3.85% were realized in other currencies. Approximately a quarter of the disbursed liabilities in EUR (25.59%) were to the IMF. However, IFI risk assessments emphasize that only 48.8% of foreign debt is subject to changes in exchange rates, or exposed to currency risk due to the existing monetary policy based on fixed exchage rates. However, it is a fact that the increase in the value of the external debt in 2015 was wholly due to currency appreciation (primarily the US Dollar).  It is argued that a reduction in currency risk is possible through an increase in external borrowing in euros in relation to other foreign currencies.

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So how should we assess risk, that is public finance sustainability? IFI assessments tend to agree that the level of public debt is not excessive – for example it is well below the Maastricht limit of 60% of GDP – and is sustainable in relation to foreign currency reserves and share of exports. Similarly at first glance it seems that the level of the consolidated deficit is low (2% of GDP). However, given the structural trade deficit, and the consequently high current account deficit (7.9% in 2015), the economy remains extremely dependent on borrowing to finance current consumption and expenditure as well as existing debt. It is thus extremely vulnerable to external risks (Eurozone rates of economic activity, foreign bank lending). Furthermore, as BiH is unable to borrow on the international capital markets by issuing government bonds the only possible sources of funding remain the IFIs and the domestic capital market. IFI conditionality may in fact threaten public finance sustainability: the downsizing of the public sector reduces government spending, without necessarily replacing it with public or private investment, and thus short term debt is repaid without checking longer-term rising public debt.



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## 3. INDEPENDENT REGULATORY AND OVERSIGHT BODIES/ ACCOUNTABILITY

Relation not just to transparency but efficacy and sustainability: Legal framework if any, and efficacy of regulation, incl. Funding, incl obligation of executive to follow/implement/sanction
All four main government levels have their own SAIs (supreme audit institution), each with its own laws and regulations in this area. However, the BiH Constitution does not include a clear declaration of the SAI role. The same applies to the constitution of the entities and the role of their respective SAIs. Legislation includes the Law on Auditing Institutions of Bosnia and Herzegovina, Law on the Auditing Institutions of FBiH, Law on Audit of Public Sector of RS, and Law on Audit of Public Administration and Institutions of DB.

SAIs are independent of the legislature and the executive. Coverage is uneven across the two Entities, since in FBiH not all units of the general government sector are regularly audited. The SAIs also cooperate with the internal audit function. All four SAIs have formally adopted the standards of the International Organization of SAIs (INTOSAI). Following the establishment of Committees for Audit in all three parliaments, which are specifically dedicated to the examination and follow-up of SAI audit reports, there has been an improvement in the use of audit reports and in Parliament's recognition of the roles of SAIs.



Annual budgets are published and annual reports on budget implementation are produced by the Ministry of Finance and Treasury and audited by the Supreme Audit Institution. Similar provisions also apply in the entities and in the Brčko District. Notwithstanding regular independent auditing, in the view of the European Commission, Bosnia has not yet achieved sufficient budget transparency. In the context of budget scrutiny, follow-up on external audit findings and recommendations needs improvement.

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# 4. PUBLIC DEBT MANAGEMENT

## 4.1. Mid-Term Debt Management Strategy

A BiH mid-term debt management strategy (MTDMS) document was finally published in March 2016, based on strategic documents produced by the entities in December 2015 for the period 2016-2018. Reflecting the highly decentralized governance structure, the BiH Law on Borrowing, Debt and Guarantees does not define debt management objectives. Hence, a bottom up approach was adopted with the determination of the borrowing strategies at the Entity level dictating the strategy at the national level. In the opinion of the IMF, the exercise was a success in ensuring improvements not only in the borrowing stance but also in overall debt management practices at the Entity level. In 2015, all Entities published their DMS. By late 2016, RS presented its auction calendar for the upcoming year 2017 to investors, after FBiH already had adopted this practice.

The MTDMS identifies the medium-term debt management objectives. These are providing funding for the financing needs of the state, entities and BD at an acceptable level of financing costs and risks. Given both dependence of multilateral lenders and exclusion from international capital markets, an additional objective is the development of the domestic securities market, as a basic prerequisite for effective debt management, i.e. to enable the effective management of borrowing and liquidity costs, and the diversification of the debt portfolio. The MTDMS operationalizes these goals and presents a plan that is intended to be implemented in the medium term in order to achieve the desired structure of the debt portfolio, reflecting the government's preference in terms of the balance between cost and risk. The MTDMS is prepared with technical assistance from the World Bank and follows the methodology of the World Bank and the International Monetary Fund.



Following the "bottom-up" approach the entities develop their own debt management strategy. Entities identify the best strategy, and a strategy that could be considered as the status quo (continuation of existing policy), on the basis of its gross financing needs and sources of funding and macroeconomic indicators, where the same common initial projections and shock scenarios in terms of interest rates on foreign debt and the currency exchange rate are employed, while different projections for interest rate movements on internal entity debt are used.

FBiH has chosen a DMS that aims to reduce currency risk, interest rate and refinancing risk and to develop the domestic securities market. According to this preferred strategy external borrowing should be made in euros at a fixed interest rate, where possible, and internal borrowing through treasury bills

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and bond maturities of 3, 5 and 7 years. Budgetary support will be financed from current receipts, from the IMF from the beginning of 2016, through better conditions - higher grace period and a greater maturity of the principal - and by issuing treasury bills with a maturity 3, 5 and 7 years. In the period from 2016 to 2018, the government of FBiH is not planning to enter the international capital market by issuing bonds.

RS has chosen a DMS whose main objective is the financing of approved investment projects, refinancing debt and fulfilling budget commitments, at minimum cost and risk, bearing in mind the level of development of the economy and the internal securities market. RS aims to develop the internal financial market by introducing, in 2016, bills of 3, 5, 7 and 10 years maturity with "bullet" repayment. Treasury bills and bonds of 3 and 5 years maturity will be issued to a lesser degree, while 7 and 10 year bonds will be gradually increased over the period 2016-2018. External borrowing will be from multilateral creditors in EUR and USD currencies (at fixed and variable interest rates), with a planned entry onto the international capital market, issuing bonds in 2018, preferably in cooperation with FBiH. FBiH and RS have common goals; the development of the domestic securities market, especially through the introduction of longer term bonds; the reduction of interest rate, re-financing and currency risk; and preferred borrowing at a fixed interest rate in EUR. RS has a greater preference for variable interest rate borrowing in EUR and USD currencies due to lower costs of variable in relation to fixed interest rates. BD does not plan to issue bonds. However, these strategies are not entirely consistent and moreover represent the composition of separate strategies. Furthermore, the lack of financial integration between the entities, for example in the existence of two separate stock markets, means less liquid domestic financial markets and thus more expensive and more limited sources of domestic lending.
The 'status quo' strategy enables the benefits of the preferred strategy to be assessed in relation to the situation without any change. Bearing in mind that Bosnia and Herzegovina has access to concessional IDA funding sources, the nominal amount of debt and the cost of debt are higher in the preferred strategy than the strategy that is the continuation of the current borrowing policies, while the risk of refinancing and the interest rate risk is lower. The analysis shows that the ratio of debt to GDP is expected to decrease compared to the current situation, while it will slightly increase in relation to the status quo. The average interest rate will increase due to reduced availability of favourable loans and expected increases in variable interest rates. According to the preferred strategy, the cost of funding will rise to 2.3%, which is slightly above the 2.2% of the status quo. The average time to maturity and the average time to re-fix according to the preferred strategy will be extended via greater external borrowing at fixed interest rates and the development of long term domestic bonds. The debt share with fixed interest rate increases to 61.5% according to the preferred strategy.



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Under the preferred strategy the share of external debt in total debt slightly increases in relation to the status quo. This is due to domestic market constraints, meaning that external borrowing will need to increase to service the existing debt due and finance investment and development projects in Entities and BD. The share of short-term foreign debt shows an improvement. The projection of debt shows a heightened burden of repayment until 2019, as a result of maturing obligations to the IMF based on the stand-by arrangement (SBA IV), and domestic bond maturities of 5-7 years.

In order to improve debt management in BiH needs to conduct an annual review and update of its MTDMS. At present, the MTDMS does not include the entire public debt. It covered 90.1% of the public debt of Bosnia and Herzegovina in 2014. It does not include: external state guarantees issued in Bosnia and Herzegovina; the internal guarantees of entities; internal debt incurred by the direct borrowing of municipalities, cities, cantons, public companies and social security funds. This remaining part of the public debt is not serviced by the budget of BiH institutions, the entities and BD, which is why it is not included in the MTDMS. But the internal debt due to direct borrowing is an increasing share of the debt and has been identified as a growing burden on public budgets.

### 4.1. Recommendations of the European Commission and the Reform Agenda



The 2016 European Commission Progress Report highlights the chronic weaknesses of public finance management in Bosnia and Herzegovina (European Commission 2016).

Given the decentralized administrative structure, public finances continue to be managed on a sub-system basis by adopting separate debt management or internal financial control strategies in the absence of an all-encompassing public financial management reform programme (PFM), although commitments to this end have been recently been made by both the BiH institutions and the entities. A budget preparation and management information system is used in the different levels of the administration for budget planning and for the medium-term budget framework, while the public investment management information system is still being brought up to its full capacity. Budget preparation and adoption timelines improved in 2016, except in the Brčko District where the 2016 budget was adopted after the legal deadline.

The institutions at all levels have considerable weaknesses in internal control and public procurement, making them vulnerable to inefficiency and waste. Social contributions and pension entitlements, which account for a significant portion of public funds, are managed by extra-budgetary funds that are neither

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integrated into the budget process nor into budget documentation such as the medium-term or annual budgetary outlooks. The inclusion of the pension fund in RS's treasury system as of January 2016 in order to stabilise its liquidity has yet to produce the expected results.

Bosnia has not yet achieved sufficient budget transparency. Annual budgets are published and annual reports on budget implementation are produced by the Ministry of Finance and Treasury and audited by the Supreme Audit Institution. Similar provisions also apply in the entities and in the Brčko District. The lack of harmonization at state level and in the entities hampers access to consolidated data. In the context of budget scrutiny, follow-up on external audit findings and recommendations needs improvement. In-year reporting is insufficient, as is citizens' participation in the budget process. There has been no attempt to prepare a citizens' budget at any of the government levels.

In response to EC recommendations, both entities have agreed to put in place a Finance Management Strategy for the 2016-2020. The BiH Council of Ministers also adopted the Public Finance Management Strategy of the Institutions of BiH for the 2017-2020 period. The Strategy aims at improving the public finance system in order to insure higher functionality, transparency, accountability and efficiency in managing public funds, thus contributing to improving of macroeconomic stability in BiH. It represents one of the key pillars of public administration reform and will be integrated in the new public administration reform strategy in BiH.



The Commission supports the authorities' efforts at fiscal consolidation in the context of the Reform Agenda, arguing for a balance between gradually reducing public debt and supporting growth friendly structural reforms and development projects. The aim is to reduce current spending by 3 percent of GDP by 2019. The public debt ratio should fall by 4 percentage points to reach about 37.6% in 2019. Given BiH's high external debt service obligations and limited access to financing, combined with the need for fiscal policy to support growth, there is a balance of payments gap estimated at about 5½ percent of GDP through 2019.

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## CONCLUSIONS AND RECOMMENDATIONS

As the problem of public debt is not excessive public spending as such we question whether the SBAs and Reform Agendas – privatisation of the public sector, consolidation of public spending, combined with business-friendly labour market, taxation and administrative reform – can do anything more than consolidate the current spending of the government sector.

Therefore, we do not share the risk assessment of the IFIs with regard to external and sovereign debt. Given the structural trade deficit, the economy remains dependent on foreign borrowing to finance current consumption and expenditure as well as existing debt. It is thus extremely vulnerable to external downside risks. IFI conditionality may actually increase risk: the downsizing of the public sector reduces spending and in turn government revenues, without necessarily replacing them with public or private investment, and thus short term debt is repaid without checking longer-term rising public debt. Long term public finance sustainability depends on the creation of an alternative model of economic growth which recognises the economic significance and potential of the public sector – in terms of the economic multiplier – and thus promotes sustainable public finance.



With the failure to replace foreign credit with an alternative model of growth, public institutions continue to be addicted to foreign borrowing, whether from the IFIs or commercial banks, to meet revenue shortfalls or finance capital investment, public sector debt and infrastructure projects. From the point of view of public finance sustainability this structural dependence on more expensive commercial credit increases sovereign debt risks. The trend towards borrowing from domestic capital markets does not present a break with this pattern since the foreign-owned banking sector continues to be the main creditor. It is not in itself a solution to the problem of structural barriers to public finance sustainability: like the trade deficit, the regressive tax system and lack of public sector investment.

Finally we recognise that the governance structure represents a specific problem, in terms of lack unnecessary administrative costs, spending to achieve political party ends, as well as a complete lack of transparency, accountability and even minimal regulatory competence. We conclude that that public finance sustainability is inconceivable without a wider reform of governance, and in particular with an increased capacity on the part of CSOs to advocate for sustainable public finance.

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