

Bosnia and Herzegovina¹

Key challenges

- Constitutional reform to make the state more efficient and effective is the main challenge facing the country and is essential for ensuring long-term economic viability.
- To invigorate the pace of privatisation, especially in the Federation, urgent changes are needed. These include faster tender procedures and enhanced efforts to prepare companies for sale and attract the interest of investors.
- The volume of total government spending should be reduced significantly to give the private sector the opportunity to grow further, thus helping to ensure the economy's long-term sustainability.

Business environment and competition

The business environment in Bosnia and Herzegovina has improved recently. According to a survey of 460 companies, carried out in April and May 2007 and sponsored by the World Bank, the burden of inspections has been greatly reduced in both Entities relative to a few years ago. However, the process of business registration remains lengthy by regional standards. A single business registration system has been in place since June 2007. The competition authority has become increasingly active over the past year. By July 2007 it had issued 33 decisions, including some high-profile cases in the oil and telecoms sectors.

Infrastructure

Important advances have been made in recent years in the commercialisation of the roads sector. Major construction projects, especially those associated with Corridor Vc, are in preparation. The contracts for the construction and maintenance works are fully open tendered and foreign companies can participate in the process. The financing of road sector maintenance is sound and charges for heavy vehicles have been introduced. In the railway sector, however, the key reforms envisaged when the new Railway Law was adopted in 2005, including the establishment of an independent railway regulatory body, have been delayed until 2008.

In February 2007 the RS energy company Elektroprivreda RS signed a major agreement with the Czech power utility, CEZ, for the upgrading of the existing power plant and development of a new coal-fired power plant in Gacko. The project will be spread over a number of years and is expected to cost around €1.5 billion.

The main development in the telecoms sector over the past year was the sale in early 2007 of 65 per cent of Telekom Srpske in the RS to Telekom Srbija in Serbia for €646 million. The price paid by the winning bidder was considered to be above fair market value by some industry analysts and substantially more than that offered by the second-placed bidder, raising concerns about a political motive behind the deal. However, Telekom Srbija has pledged substantial investment over the coming years to upgrade services in Telekom Srpske. In the Federation, there has been little discernible progress in restructuring or selling the two main operators, BH Telekom and HT Mostar, although the Federation government has hired Deloitte as an investment adviser for the sector.

Financial sector

The country has made strong and visible progress in developing the financial sector. Although there are still a relatively large number of banks – 32 at the end of 2006 – the sector is dominated by private, foreign-owned banks. Total banking assets continue to grow and now exceed €7.5 billion. Competition is quite intense and has led to a decrease in interest rates for borrowers (to about 7–8 per cent for corporates and 9–10 per cent for households as of April 2007), as well as a decline in margins for banks. However, banking supervision is still at the Entity level (although some banks operate in both Entities), despite repeated urging from the international community to unify the two supervisory agencies, either within the central bank or in a separate agency. A number of microfinance institutions and leasing companies are also expanding their activities rapidly.

Country data

Population (in millions)	3.8
Area ('000 sq km)	51.0
GDP (in billion US\$, 2006)	11.4
GDP per capita in 2006 at current international US\$ (PPP)	8,543
National currency	Convertible mark

Progress in structural reform

Liberalisation and privatisation

Bosnia and Herzegovina's progress towards a Stabilisation and Association Agreement (SAA) with the European Union (EU) has stalled. Although agreement has been reached in principle on most points, the failure by the authorities to agree on several key reforms, notably police reform, is preventing movement towards initialling and signing an SAA. As of late September 2007, the new Central European Free Trade Agreement had not yet been ratified.

Major sales of state assets have taken place in Republika Srpska (RS) over the past year. In addition to the sale of Telekom Srpske, the RS government agreed in February 2007 to sell majority stakes in the Bosanski Brod and Modrica oil refineries, as well as the fuel retailer Petrol, to Russian company Neftegazinkor for €121 million. In the Federation, however, the privatisation process has proceeded extremely slowly for several years. Privatisation receipts in the Federation in 2006 were a mere €5.6 million. The government has opened a tender for the privatisation of 88 per cent of the country's largest aluminium smelter, Aluminij Mostar, which accounted for 15 per cent of the country's total exports in 2006. The process is scheduled to be completed by the end of October 2007. In August, the government announced a tender for expressions of interest in a strategic partnership with the state-owned airline, BH Airlines.

¹ The territorial constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH), the Republika Srpska (RS) and the cantons of the Federation. The FBH and the RS are referred to as the "Entities". The District of Brčko enjoys a special status based on an Arbitration Award in accordance with the Dayton Peace Agreement.

Macroeconomic performance

Real GDP growth in 2006 was around 6 per cent, according to the most recent estimates – the highest growth rate since 1999. Strong growth continued into the first half of 2007, with retail sales increasing rapidly. Industrial production rose sharply last year – especially in the RS (up 19 per cent) – and important investments in recent years, such as those in the steel and aluminium sectors, are now bearing fruit. Exports of these goods have benefited from high world prices and overall exports of goods and services rose by 25 per cent in 2006. Preliminary figures for the first half of 2007 show a strong recovery of industrial production in the Federation.

Inflation remains very low (after a transitory upward blip in 2006 reflecting the introduction of VAT) and the currency board continues to function smoothly. Consolidated public spending as a percentage of GDP has been relatively steady in recent years at around 50 per cent, which is among the highest across all transition countries. Revenue collection is also strong (boosted by VAT) and the consolidated government budget has been in surplus for the past two years. However, significant wage and pension increases were promised for 2007 during the election campaign in October 2006. Unless governments at different levels take tough steps to control spending, then a general government deficit may be recorded in 2007.

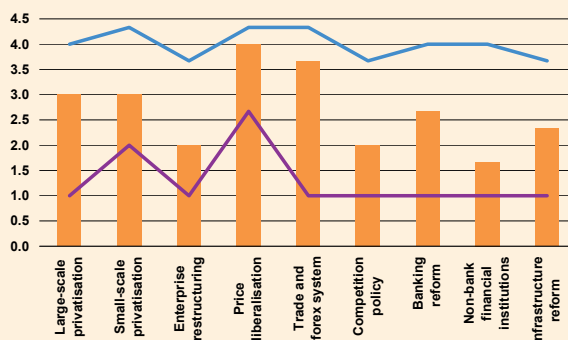
A strong increase in exports has helped to lower the very high trade and current account deficits in 2006, with the latter estimated at around 11–12 per cent of GDP, although there is a wide margin of error around this figure. There are steady inflows of capital, mainly as a result of a new momentum for privatisation in the RS as well as reinvestments by large companies already in the country, such as Mittal Steel. There have been several further large investments in 2007 to date, and FDI is on course for record levels of well over €1 billion. Foreign reserves have risen steadily and stood close to €3 billion by mid-2007.

Outlook and risks

On current trends, growth is likely to remain at around 5–6 per cent over the next two years. This growth is being driven by strong private sector activity and entrepreneurship, demonstrating how resilient private enterprises are to the significant obstacles to doing business in the country. The main risks to this relatively favourable scenario lie in the political sphere. Bosnia and Herzegovina is entering perhaps the most sensitive phase of transition since the end of the war in 1995. Continued economic progress is not assured and depends crucially on the authorities introducing and implementing key political and constitutional reforms that are designed to make the state less dysfunctional. At present, there is no consensus in the country on the way forward regarding these matters. There are also important risks on the fiscal side, given that coordination on spending decisions by different levels of government is currently limited and because the borrowing powers of the state and Entity governments were recently expanded. To mitigate this, new laws on government borrowing will impose debt ceilings.

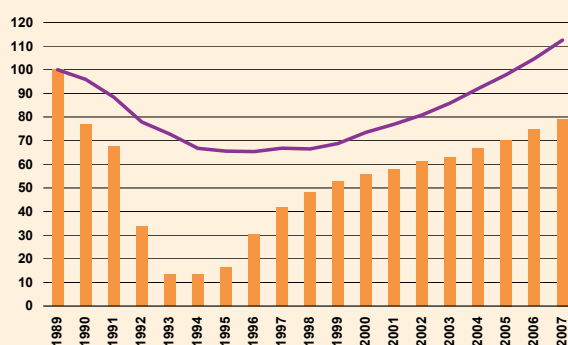
Transition indicators, 2007

■ Bosnia and Herzegovina ■ Maximum, transition countries ■ Minimum, transition countries



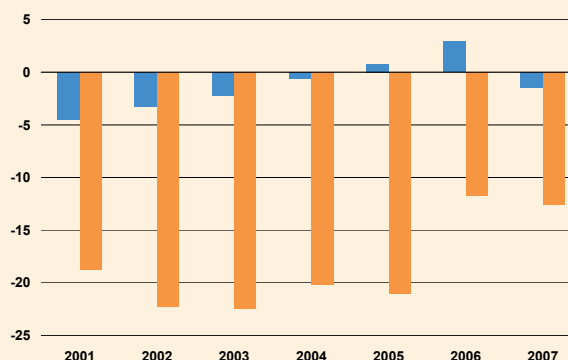
Real GDP (1989=100)

■ Bosnia and Herzegovina ■ Average, transition countries



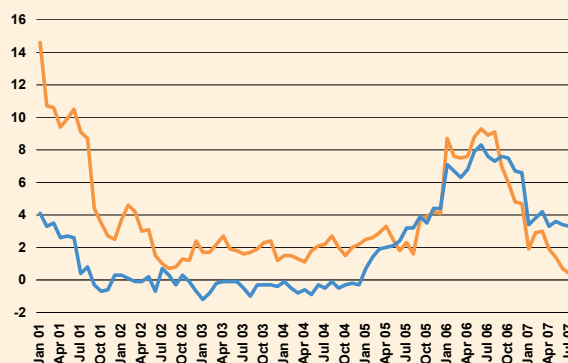
Fiscal balance and current account balance

■ Fiscal balance (% of GDP) ■ Current account balance (% of GDP)



Interest rates and inflation

■ RPI Republika Srpska (% year-on-year) ■ RPI Federation (% year-on-year)



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility – full	Competition office – yes	Independent telecoms regulator – fully	Capital adequacy ratio – 12 per cent	Share of population living in poverty – na
Controls on inward direct investment – yes ¹	Quality of insolvency law – high	Independent electricity regulator – partially	Deposit insurance system – yes	Government expenditure on health – 10.0 per cent of GDP
Interest rate liberalisation – full	Secured transactions law – some defects	Separation of railway infrastructure from operations – partially	Quality of securities market laws – high	Government expenditure on education – na
Exchange rate regime – currency board pegged to euro	Quality of corporate governance law – low	Independence of the road directorate – fully	Private pension funds – no	Household expenditure on power and water – 4.9 per cent
Wage regulation – no		Quality of concession laws – medium		
Tradeability of land – limited de jure				

	2001	2002	2003	2004	2005	2006	2007
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.5	2.6	2.6	2.6	na	na	na
Private sector share in GDP (in per cent)	40.0	45.0	50.0	50.0	55.0	55.0	60.0
Private sector share in employment (in per cent)	na	na	na	na	na	na	na
Budgetary subsidies and current transfers (in per cent of GDP)	na	na	6.3	5.8	5.8	6.0	na
Share of industry in total employment (in per cent)	na	na	na	na	na	na	na
Change in labour productivity in industry (in per cent)	na	na	na	na	na	na	na
Investment/GDP (in per cent)	18.9	20.4	19.9	20.3	na	na	na
EBRD index of small-scale privatisation	2.7	3.0	3.0	3.0	3.0	3.0	3.0
EBRD index of large-scale privatisation	2.3	2.3	2.3	2.3	2.7	2.7	3.0
EBRD index of enterprise reform	1.7	1.7	2.0	2.0	2.0	2.0	2.0
Markets and trade							
Share of administered prices in CPI (in per cent)	na	na	na	na	na	na	na
Number of goods with administered prices in EBRD-15 basket ²	5.0	5.0	5.0	5.0	5.0	4.0	na
Share of trade with non-transition countries (in per cent) ³	52.8	50.8	49.6	na	47.4	45.5	na
Share of trade in GDP (in per cent)	68.1	89.7	91.1	93.8	99.8	96.6	na
Tariff revenues (in per cent of imports)	13.1	7.2	6.4	5.1	na	na	na
EBRD index of price liberalisation	4.0	4.0	4.0	4.0	4.0	4.0	4.0
EBRD index of forex and trade liberalisation	3.0	3.0	3.7	3.7	3.7	3.7	3.7
EBRD index of competition policy	1.0	1.0	1.0	1.0	1.0	1.7	2.0
Financial sector							
Number of banks (foreign-owned)	49 (20)	40 (21)	37 (19)	33 (17)	33 (20)	32 (22)	na
Asset share of state-owned banks (in per cent)	17.3	6.2	5.3	4.0	3.6	3.2	na
Asset share of foreign-owned banks (in per cent)	65.3	76.7	79.7	80.9	90.9	94.0	na
Non-performing loans (in per cent of total loans)	20.7	11.5	8.4	6.1	5.4	4.1	na
Domestic credit to private sector (in per cent of GDP)	5.8	11.8	15.1	18.4	22.4	25.2	na
Domestic credit to households (in per cent of GDP)	5.2	10.0	12.9	15.2	17.6	19.6	na
Of which mortgage lending (in per cent of GDP)	na	na	na	na	na	na	na
Stock market capitalisation (in per cent of GDP)	na	na	na	na	na	na	na
Stock trading volume (in per cent of market capitalisation)	na	na	na	na	na	na	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	na	na	na
EBRD index of banking sector reform	2.3	2.3	2.3	2.7	2.7	2.7	2.7
EBRD index of reform of non-bank financial institutions	1.0	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	22.3 (11.7)	23.7 (19.6)	24.5 (28.1)	24.6 (36.4)	24.8 (40.8)	25.3 (48.3)	na
Internet users (per 100 inhabitants)	1.2	2.6	3.9	15.1	20.6	24.3	na
Railway labour productivity (1996=100)	131.2	134.5	136.3	256.0	480.7	481.4	na
Residential electricity tariffs (USc kWh)	5.7	6.0	7.1	6.7	6.9	6.2	na
Average collection rate, electricity (in per cent)	95	86	na	na	96	98	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.9	5.5	5.3	5.4	na	na	na
EBRD index of infrastructure reform	2.0	2.3	2.3	2.3	2.3	2.3	2.3
Electric power	2.3	3.0	3.0	3.0	3.0	3.0	3.0
Railways	2.3	3.0	3.0	3.0	3.0	3.0	3.0
Roads	2.0	2.0	2.0	2.0	2.3	2.3	2.7
Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Water and waste water	2.0	2.0	2.0	2.0	2.0	2.0	2.0

¹ There are restrictions on the production and sale of arms, ammunition, military equipment and public information.

² Administered prices in either the Federation or Republika Srpska or both Entities.

³ For some years data were unavailable for important trading partners such as Croatia, FYR Macedonia, Montenegro and Serbia. As a result, the share of trade with non-transition countries for these years has been over-estimated.

	2001	2002	2003	2004	2005	2006 Estimate	2007 Projection
Output and expenditure <i>(Percentage change in real terms)</i>							
GDP	4.3	5.3	3.0	6.0	5.5	6.2	6.0
Total consumption	na	na	na	na	na	na	na
Gross fixed capital formation	na	na	na	na	na	na	na
Industrial gross output	-2.0	11.5	3.8	12.0	9.8	18.0	na
Agricultural gross output	na	na	na	na	na	na	na
Employment <i>(Percentage change)</i>							
Labour force (end-year)	-1.4	-0.7	0.8	1.6	0.5	0.3	na
Employment (end-year)	-3.4	-2.0	-1.0	0.2	2.1	2.1	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year) ¹	40.2	41.0	42.1	42.9	42.0	41.0	na
Prices and wages <i>(Percentage change)</i>							
Consumer prices (annual average)							
Federation (KM based)	1.9	-0.2	0.2	-0.3	2.1	7.5	na
Republika Srpska (KM based)	7.0	1.7	1.8	2.2	2.7	7.0	na
Consumer prices (end-year)							
Federation (KM based)	0.3	-0.7	0.3	-0.3	4.4	6.6	na
Republika Srpska (KM based)	2.2	2.4	1.3	2.2	3.7	4.7	na
Gross average monthly earnings in economy (annual average)							
Federation	7.6	9.2	8.3	1.8	4.6	8.0	na
Republika Srpska	14.7	18.7	9.3	11.6	10.0	12.2	na
Government sector <i>(In per cent of GDP)</i>							
General government balance	-4.5	-3.3	-2.2	-0.6	0.8	2.9	-1.4
General government expenditure	53.2	48.0	52.9	50.4	49.4	47.9	na
Monetary sector <i>(Percentage change)</i>							
Broad money (M2, end-year)	89.3	8.6	8.4	24.3	18.2	24.7	na
Domestic credit (end-year)	5.2	28.2	19.8	18.0	27.6	20.6	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	38.5	39.6	40.7	46.5	51.1	56.8	na
Exchange rates <i>(KM per euro)</i>							
Exchange rate (annual average)	2.0	2.0	2.0	2.0	2.0	2.0	na
External sector <i>(In millions of US dollars)</i>							
Current account	-1,042.5	-1,375.5	-1,750.0	-1,884.0	-2,150.0	-1,338.0	-1,713.0
Trade balance	-2,073.0	-3,327.0	-4,152.0	-4,572.0	-4,990.0	-4,293.0	-4,843.0
Merchandise exports	854.0	1,104.0	1,473.0	2,085.0	2,600.0	3,358.0	4,191.0
Merchandise imports	2,927.0	4,431.0	5,625.0	6,657.0	7,590.0	7,651.0	9,034.0
Foreign direct investment, net	119.0	266.0	381.6	607.5	550.0	420.0	1,500.0
Gross reserves, excluding gold (end-year)	1,221.0	1,295.0	1,765.0	2,389.0	2,720.0	3,160.0	na
External debt stock	2,817.7	3,636.6	4,518.1	5,106.1	5,658.7	6,136.8	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	4.6	3.3	3.5	4.0	4.1	4.7	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	6.2	8.7	6.8	4.8	4.1	4.1	na
Memorandum items <i>(Denominations as indicated)</i>							
Population (end-year, million) ²	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in millions of markas)	12,137.0	12,806.0	13,492.0	14,678.0	15,791.0	17,750.0	19,792.0
GDP per capita (in US dollars)	1,461.6	1,623.0	2,049.4	2,453.0	2,687.4	2,999.8	na
Share of industry in GDP (in per cent)	na	na	na	25.0	25.3	25.2	na
Share of agriculture in GDP (in per cent)	na	na	na	10.6	10.9	10.5	na
Current account/GDP (in per cent)	-18.8	-22.3	-22.5	-20.2	-21.1	-11.7	-12.5
External debt - reserves (in US\$ million)	1,596.7	2,341.6	2,753.1	2,717.1	2,938.7	2,976.8	na
External debt/GDP (in per cent)	50.7	59.0	58.0	54.8	55.4	53.8	na
External debt/exports of goods and services (in per cent)	216.3	254.6	206.0	170.7	156.3	137.4	na

¹ Registered unemployment. A labour force survey in March 2006, based on ILO definitions, puts the unemployment rate at 31.1 per cent.

² Excludes refugees abroad.