

Bosnia & Herzegovina

Outlook

The economic trends are painting a picture of two economies – one in which export growth is booming and one in which domestic demand remains very weak. There is little doubt that the economy has turned the corner, however, the recovery appears to remain concentrated in a small number of industries. We have revised up our GDP forecast for the Bosnian economy to +0.5% in 2010 (from -1%). With lower external financing needs, FX reserves stable and the IMF agreement in place, macro risks are clearly moderating.

A tale of two economies

The economy has turned the corner, but the recovery appears to be concentrated in a few sectors

Industrial production is picking up. In many ways the economic data for Bosnia Herzegovina to date this year paint a picture of two economies – one in which export growth is booming due to activity in a handful of sectors and one in which domestic demand remains very weak. In both the Federation and in Republika Srpska (RS) industrial production data show a pick up. In the Federation manufacturing activity has rebounded even faster (by 4.7% yoy in Jan-April) as textile, chemicals, metals and furniture production has increased sharply; in RS mining activity and metals production have been the main drivers of a 7.3% yoy increase in industrial production over this period. This activity has been reflected in merchandise trade data which revealed a 29.5% yoy increase in exports over this period. Household demand is weaker, but improving: retail trade data is marginally positive in real terms in the Federation (up 0.4% yoy in Jan-April) and up 3% yoy in RS over the same period. Yet, with import growth flat, loans to the household sector in April down 5.6% yoy and up only 1% yoy to enterprises, domestic demand will remain weak. In addition, gross wages have fallen in real terms by over 1% yoy in 1Q10. In the absence of administered price rises at the start of the year, inflation would be close to zero for the second year in a row. Although there is little doubt that the economy has turned the corner, the recovery currently appears to be concentrated in just a handful of private sector employers in a small number of industries.

GDP forecast revised up to 0.5% in 2010

We have revised up our GDP forecast for the Bosnian economy and expect a lower current account deficit. On the back of an almost 30% yoy rise in merchandise exports and no change in imports in the first four months of the year, in conjunction with somewhat better industrial production data, we have revised our growth forecast to 0.5% from -1.0% for this year. The remainder of 2010 will undoubtedly see the continuation of a sharp recovery in merchandise exports, which is also the reason why we have revised our forecast of the current account deficit from 6.3% of GDP to 3.6% of GDP. In 2011 and 2012 we do not see exports growing as quickly: indeed, a large part of this year's recovery only reflects a pick up in external demand from 2009's extremely depressed levels. More importantly, we see the basic balance (the current account deficit minus FDI) in 2010-12 as slightly positive, even though we do not see FDI inflows returning to pre-crisis levels. This implies lower external financing needs going forward. The conclusion is that macroeconomic risks are moderating in Bosnia Herzegovina. This is one of the reasons we maintain our view that the currency board arrangement is solid.

Despite progress key structural reforms are yet to be locked in...

IMF delays approval of the EUR 38mn disbursement. In May the IMF mission concluded that, based on 1Q 2010 data, the authorities had met their quantitative targets. However, in terms of

structural benchmarks, the government is enjoying less success, especially in the Federation. As a result the IMF mission postponed a decision on whether to recommend the disbursement of the third EUR 38mn tranche to Bosnia Herzegovina. The measures the Federation government has to meet include #1 accelerating audits of eligibility for social welfare payments, #2 completing the reform of privileged pensions and #3 making sure that the agreed wage bill allocation for 2010 is not exceeded.

...as the general election on 3 October moves into focus

General elections in October are the main event of the year. Efforts to lock in reforms of the pension system and welfare eligibility will be challenging at the current point in the political cycle, as general elections will be held soon (on 3 October this year).

No change to sovereign rating expected

Sovereign rating expected to remain stable. With FX reserves stable, the country's external imbalances narrowing and the IMF agreement in place (despite unsurprising delays in implementation), we see no change to the credit rating in the next 12 months.

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