

Bosnia and Herzegovina

Key developments and challenges

The past year has, once again, seen little progress in privatisation, especially in the FBH.¹ Although the global environment is more challenging, it is important to restore momentum to the process so that stakes can be offered when conditions improve.

Prudent regulation by the central bank and strong coordination among the domestic authorities, foreign-owned commercial banks and international financial institutions enabled the banking sector to weather the financial crisis. Further efforts are needed to maintain confidence, including through an expansion of deposit insurance coverage towards EU levels.

Bosnia and Herzegovina has embarked on a three-year programme with the International Monetary Fund (IMF) that will support the authorities' efforts to safeguard the currency board. In this context, the authorities need to adhere to commitments to reduce public sector spending, including in the area of social transfers.

Country data

Population (in millions)	3.8
Area ('000 sq km)	51.0
GDP (in billion US\$, 2008)	18.5
Average transition score (scale: 1 to 4.33)	2.78

Progress in structural reform

Liberalisation and privatisation

Since the Stabilisation and Association Agreement was signed and the Interim Trade Agreement with the European Union came into force in the summer of 2008, there has been little further progress in EU integration. Bosnia and Herzegovina was (like Albania) excluded from a European Commission recommendation in July 2009 to the Council of the European Union to extend visa-free access to the Schengen area for citizens of the Western Balkans.

Regional trade liberalisation suffered a set-back when parliament passed a law in June 2009, contrary to the regional Central European Free Trade Agreement (CEFTA), to reintroduce customs tariffs on meat and dairy products from Croatia and Serbia. However, the Constitutional Court suspended the law in July 2009.

Slow progress in privatisation in the FBH in recent years has meant that proceeds from sales have been negligible. In February 2009 the FBH government adopted a new privatisation programme, with the aim of raising KM 1 billion (around €515 million) over the following 15 months. Under the plan, 11 companies would be sold through direct tender, including some of the Entity's biggest companies in aluminium, construction and telecommunications. However, given previous failures, there are doubts that the plan's targets will be met.

For example, the privatisation of the Mostar-based aluminium smelter, the largest exporter in the country, failed even though it had received the interest of strategic sponsors. The proposed privatisation of the two telecommunications companies in the FBH – BH Telekom and HT Mostar – remains on hold, as global conditions have made the prospects less attractive to potential investors. One important deal over the past year was the partial privatisation in December 2008, through the sale of 49 per cent, of BH Airlines to Turkish Airlines; the government retains a majority stake.

Business environment and competition

The quality of the business environment in Bosnia and Herzegovina continues to lag behind other countries in south-eastern Europe, according to the World Bank's *Doing Business 2010* survey scores. In the 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV), more than one-quarter of the enterprises surveyed identified political instability as the main problem affecting their operations. Tax rates were also considered a serious obstacle by many respondents. The Foreign Investor Council White Paper, published in December 2008, highlights business registration as a particular problem for foreign investors. The introduction of a new Companies Law in the RS, effective from July 2009, aims to simplify the registration of new companies and bring companies law closer to EU standards.

Infrastructure

In the roads sector, several projects have been signed in the past year with international financial institutions for building parts of the 330 km Corridor Vc (a branch of the fifth pan-European corridor), as well as strengthening the institutional development of the Motorway Directorate in both Entities. In May 2009 the RS government and Austrian construction company, Strabag, signed a contract to establish a joint venture company to construct highways in the RS. Strabag will build, operate and maintain major roads in the Entity. The first project will be the proposed highway from Banja Luka to Dobo, for which Strabag will have a 30-year concession. However, raising financing is likely to be difficult, as this was a directly negotiated concession. In the railways sector, various projects to upgrade and modernise services are ongoing, with the support of bilateral donors and international institutions.

Financial institutions

The banking system has remained sound, despite the global crisis. There was a significant outflow of deposits of around KM 800 million (about €410 million) in the fourth quarter of 2008, but the central bank reacted promptly and effectively to stem the outflow and restore confidence. Bank reserve requirements were lowered, credit lines from abroad were excluded from the base used in calculating mandatory reserve requirements, and deposit insurance was raised from KM 7,500 to KM 20,000. A further increase in the level of deposit insurance is being prepared, depending on the swift adoption of amendments to the state law on debt, debt issuance and guarantees. In addition, within the context of the new IMF programme, the main foreign-owned banks have made a commitment to maintain their exposure to the country at the same level as, or higher than, that prevailing at the end of 2008.

Macroeconomic performance

After several years of strong growth, the economy began to suffer in late 2008, with GDP growth estimated at 5.4 per cent for the year as a whole. However, the full effects of the global financial crisis were not felt until the first half of 2009 when various factors contributed to a dramatic slow-down, including the drying-up of bank credit, a severe contraction in foreign direct investment (FDI), lower demand from the European Union for exports and a fall in remittances from workers abroad. Construction activity in particular has suffered and unemployment is rising.

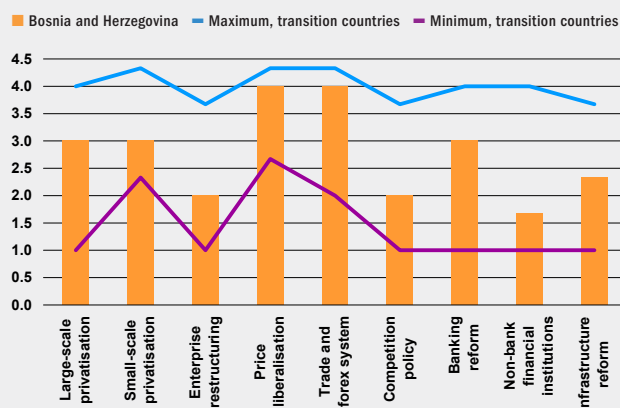
The authorities' problems have been compounded by major fiscal pressures. The signing of the SAA in June 2008 meant that VAT refunds accelerated and custom duties on EU imports decreased, contributing to lower revenues, while the failure of the authorities to adjust their spending behaviour accordingly, as witnessed by increases in wages and social benefits, put upward pressure on expenditures. As a result, the general government balance deteriorated from approximately zero in 2007 to a deficit of 4 per cent of GDP in 2008. The authorities responded by curbing non-mandatory expenditures in the first quarter of 2009. In addition, the Fiscal Council has begun to contribute to better coordination of fiscal policies among the state, entities and cantons. The currency board remains the key anchor for monetary policy, and by August 2009 inflation had fallen to below zero, reflecting not only currency stability but also weak domestic demand. The decline in domestic demand has contributed to a significant drop in the current account deficit, which is expected to fall from nearly 15 per cent of GDP in 2008 to less than 10 per cent in 2009. In July 2009 following important fiscal measures at state and entity level, the IMF approved a 36-month stand-by arrangement of US\$ 1.57 billion.

Outlook and risks

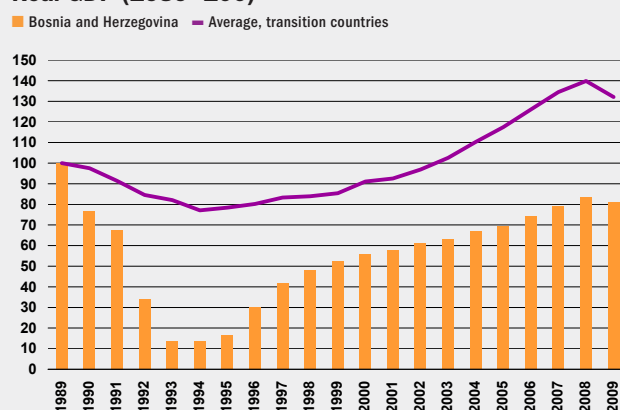
In the short term, the economy will remain weak. GDP is expected to decline by around 3 per cent in 2009, with the likelihood of at best a very modest recovery in 2010. The authorities have very little room for manoeuvre to alleviate the effects of the crisis, especially in the FBH where (unlike in the RS) there are virtually no funds from past privatisation receipts. However, the economy is likely to remain stable, aided by low inflation, continued strong support from parent banks abroad and IMF support under the new programme. Over the medium term, there is no reason why growth should not improve, aided by the resumption of strong inflows of FDI, provided that the authorities implement reform-oriented policies and that the country remains on the path to EU integration. The main risks to this scenario are political and economic; the issues of constitutional reform, the creation of a genuine single economic space and the need to reduce the size of the public sector remain the key challenges to achieving long-term prosperity.

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.

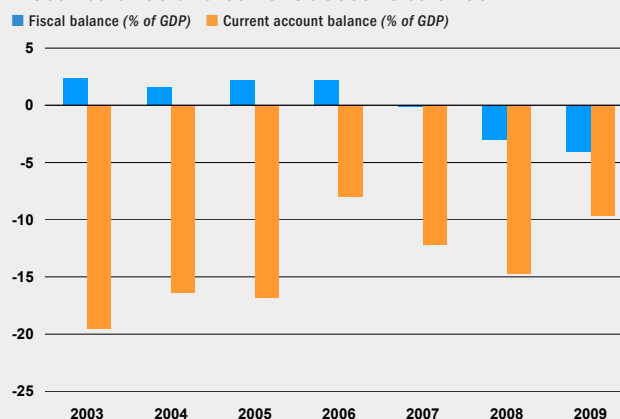
Transition indicators 2009



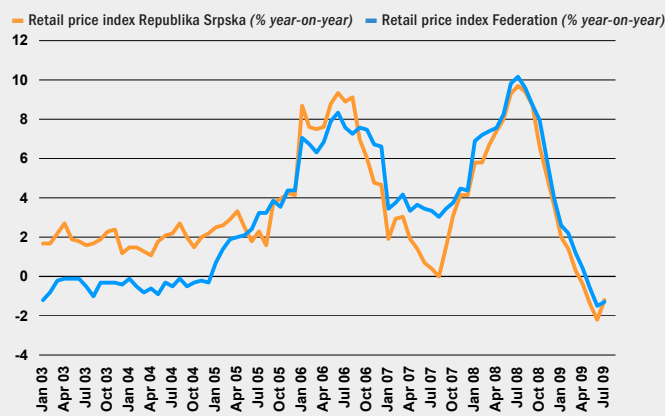
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



Liberalisation and privatisation	Business environment and competition	Infrastructure	Financial sector	Social reform
Current account convertibility - full	Competition office - yes	Telecoms regulatory assessment compliance - high	Capital adequacy ratio - 12 per cent	Share of population living in poverty - < 2 per cent (2004)
Controls on inward direct investment - yes ¹	Quality of insolvency law - high	Independence of the electricity regulator - partial	Deposit insurance system - yes	Government expenditure on health - 9.5 per cent of GDP (2006)
Interest rate liberalisation - full	Secured transactions law - modern/some defects	Separation of railway infrastructure from operations - partial	Private pension funds - no	Government expenditure on education - na
Exchange rate regime - currency board pegged to euro		Independence of the road directorate - full		Household expenditure on power and water - 4.9 per cent
Wage regulation - no				
Tradeability of land - limited de jure				

Structural and institutional change indicators

	2003	2004	2005	2006	2007	2008	2009
Enterprises							
Privatisation revenues (cumulative, in per cent of GDP)	2.6	2.6	na	na	na	na	na
Private sector share in GDP (in per cent)	50.0	50.0	55.0	55.0	60.0	60.0	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)	5.9	5.4	5.4	5.5	5.1	4.6	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)	19.9	27.1	27.0	21.6	28.1	21.3	na
<i>EBRD index of small-scale privatisation</i>	3.0	3.0	3.0	3.0	3.0	3.0	3.0
<i>EBRD index of large-scale privatisation</i>	2.3	2.3	2.7	2.7	3.0	3.0	3.0
<i>EBRD index of enterprise reform</i>	2.0	2.0	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	4.0	6.0	na	na
Share of trade with non-transition countries (in per cent) ³	48.5	47.9	45.4	43.7	42.8	42.4	na
Share of trade in GDP (in per cent)	85.0	87.2	91.4	90.2	95.3	93.1	na
Tariff revenues (in per cent of imports)	6.4	5.1	na	na	na	na	na
<i>EBRD index of price liberalisation</i>	4.0	4.0	4.0	4.0	4.0	4.0	4.0
<i>EBRD index of forex and trade liberalisation</i>	3.7	3.7	3.7	3.7	3.7	4.0	4.0
<i>EBRD index of competition policy</i>	1.0	1.0	1.0	1.7	2.0	2.0	2.0
Financial sector							
Number of banks (foreign-owned)	37 (19)	33 (17)	33 (20)	32 (22)	32 (21)	30 (21)	na
Asset share of state-owned banks (in per cent)	5.3	4.0	3.6	3.2	1.9	0.9	na
Asset share of foreign-owned banks (in per cent)	79.7	80.9	90.9	94.0	93.8	95.0	na
Non-performing loans (in per cent of total loans)	8.4	6.1	5.4	4.1	3.0	3.1	na
Domestic credit to private sector (in per cent of GDP)	31.0	32.3	39.6	44.2	50.6	53.5	na
Domestic credit to households (in per cent of GDP)	11.6	13.6	17.6	19.6	26.2	27.2	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	23.7	36.2	59.8	71.8	31.3	na
Stock trading volume (in per cent of market capitalisation)	na	5.0	10.7	7.4	9.2	3.2	na
Eurobond issuance (in per cent of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	na
<i>EBRD index of banking sector reform</i>	2.3	2.7	2.7	2.7	2.7	3.0	3.0
<i>EBRD index of reform of non-bank financial institutions</i>	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Infrastructure							
Fixed-line (mobile) penetration rate (per 100 inhabitants)	24.8 (28.4)	25.2 (37.2)	25.6 (42.2)	26.2 (49.9)	28.2 (64.9)	27.3 (84.3)	na
Internet users (per 100 inhabitants)	4.0	15.5	21.3	25.1	27.9	34.7	na
Railway labour productivity (2000=100)	136.3	256.0	480.7	481.4	447.3	448.0	na
Residential electricity tariffs (USc kWh)	7.1	7.3	6.4	7.4	8.6	9.1	na
Average collection rate, electricity (in per cent)	90	93	96	98	98	98	na
GDP per unit of energy use (PPP in US dollars per kgoe)	4.5	4.7	4.7	na	na	na	na
<i>EBRD index of infrastructure reform</i>	2.3	2.3	2.3	2.3	2.3	2.3	2.3
- Electric power	3.0	3.0	3.0	3.0	3.0	3.0	3.0
- Railways	3.0	3.0	3.0	3.0	3.0	3.0	3.0
- Roads	2.0	2.0	2.3	2.3	2.7	2.7	2.7
- Telecommunications	2.3	2.3	2.3	2.3	2.3	2.3	2.3
- Water and wastewater	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 and Serbia and Montenegro. As a result, the share of trade with non-transition countries for these years has been over-estimated.

Macroeconomic indicators

	2003	2004	2005	2006	2007	2008 Estimate	2009 Projection
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	3.0	6.3	3.9	6.7	6.8	5.4	-3.1
Industrial gross output	3.8	7.2	6.4	5.5	8.2	8.0	na
Agricultural gross output	na	13.3	5.8	6.1	-0.3	3.0	na
Employment	<i>(Percentage change)</i>						
Labour force (end-year)	0.8	1.6	0.5	9.6	1.6	-0.6	na
Employment (end-year)	-1.0	0.2	2.1	4.3	4.5	4.0	na
	<i>(In per cent of labour force)</i>						
Unemployment (end-year)	42.1	42.9	42.0	44.8	43.2	40.6	na
Prices and wages	<i>(Percentage change)</i>						
Consumer prices (annual average)							
– Federation (KM based)	0.1	-0.3	3.0	6.0	1.9	7.7	3.6
– Republika Srpska (KM based)	1.8	1.9	5.2	6.4	1.1	6.9	2.5
Consumer prices (end-year)							
– Federation (KM based)	0.3	-0.3	4.4	4.5	5.5	4.0	1.5
– Republika Srpska (KM based)	1.3	2.2	3.7	4.6	4.3	3.6	0.7
Gross average monthly earnings in economy (annual average)							
– Federation	8.6	1.9	4.6	8.0	9.8	13.4	na
– Republika Srpska	9.3	11.6	10.0	12.2	10.3	29.4	na
Government sector	<i>(In per cent of GDP)</i>						
General government balance	2.3	1.6	2.2	2.2	-0.1	-3.0	-4.0
General government expenditure	39.2	38.8	39.9	45.2	47.6	50.9	na
Monetary sector	<i>(Percentage change)</i>						
Broad money (M2, end-year)	8.4	24.3	18.2	24.7	21.6	4.3	na
Domestic credit (end-year)	20.7	16.3	27.6	22.3	29.5	22.3	na
	<i>(In per cent of GDP)</i>						
Broad money (M2, end-year)	37.9	43.3	47.7	52.7	56.6	50.9	na
Exchange rates	<i>(KM per US dollar)</i>						
Exchange rate (end-year)	1.5	1.4	1.6	1.5	1.3	1.4	na
Exchange rate (annual average)	1.7	1.6	1.5	1.6	1.4	1.3	na
External sector	<i>(In millions of US dollars)</i>						
Current account	-1,631.0	-1,639.3	-1,844.5	-981.0	-1,848.5	-2,764.4	-1,630.0
Trade balance	-4,159.3	-4,569.7	-4,898.9	-4,298.1	-5,956.7	-7,092.4	-5,900.0
– Merchandise exports	1,477.5	2,086.7	2,555.3	3,381.4	4,243.3	5,194.0	4,600.0
– Merchandise imports	5,636.8	6,656.4	7,454.2	7,679.5	10,200.0	12,286.4	10,500.0
Foreign direct investment, net	381.8	708.3	607.8	718.4	2,087.5	1,002.8	600.0
Gross reserves, excluding gold (end-year)	1,611.0	2,208.0	2,530.0	3,371.0	4,524.0	3,515.0	na
External debt stock	4,475.9	5,139.2	5,400.2	6,025.6	7,342.5	7,981.3	na
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.2	3.7	3.8	5.0	5.0	4.2	na
	<i>(In per cent of exports of goods and services)</i>						
Debt service	4.0	3.1	4.2	4.0	3.2	2.8	na
Memorandum items	<i>(Denominations as indicated)</i>						
Population (end-year, million) ¹	3.8	3.8	3.8	3.8	3.8	3.8	na
GDP (in millions of markas)	14,505.0	15,786.0	16,928.0	19,121.0	21,647.0	25,100.0	24,298.0
GDP per capita (in US dollars)	2,203.2	2,638.1	2,880.9	3,227.0	3,986.4	4,942.8	na
Share of industry in GDP (in per cent)	16.1	16.4	16.3	16.0	21.0	20.0	na
Share of agriculture in GDP (in per cent)	8.1	8.9	8.7	8.5	7.9	8.0	na
Current account/GDP (in per cent)	-19.5	-16.4	-16.8	-8.0	-12.2	-14.7	-9.6
External debt - reserves (in US\$ million)	2,864.9	2,931.2	2,870.2	2,654.6	0.0	3,457.3	na
External debt/GDP (in per cent)	53.5	51.3	49.3	49.1	48.5	42.5	na
External debt/exports of goods and services (in per cent)	183.0	136.9	122.6	90.2	69.6	61.2	na

¹ Excludes refugees abroad.