

Bosnia and Herzegovina

Key developments and challenges

The major challenge in Bosnia and Herzegovina remains constitutional reform, without which further progress towards a more efficient state, implementation of a comprehensive reform and growth agenda and EU approximation will be difficult to achieve.

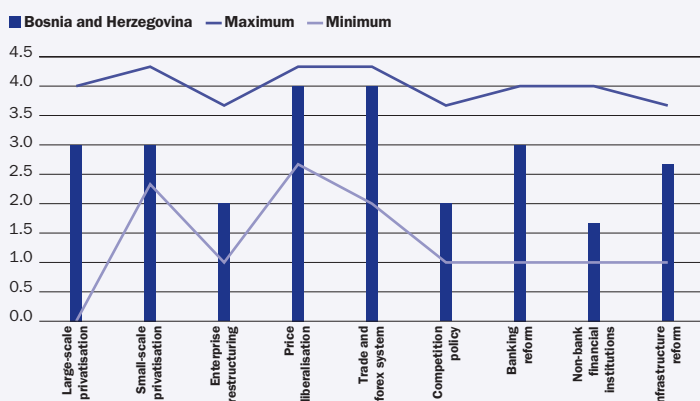
The privatisation process has virtually come to a stand-still in recent years, depriving the entities of much-needed privatisation revenues, in particular in the Federation of Bosnia and Herzegovina (FBH).¹ The sale of major companies in the aluminium, construction, telecommunications and trade sectors remains a priority.

The International Monetary Fund (IMF) stand-by arrangement (SBA) signed in July 2009 remains on track. The agreement includes a commitment by the authorities to public sector reform, in particular in the FBH, and continued implementation of politically difficult cuts to benefits and public sector wages.

Main macroeconomic indicators (%)

	2007	2008	2009 estimated	2010 projected
GDP growth	10.8	6.0	-2.8	0.8
Inflation (end year)	4.9	3.8	0.0	2.0
Government balance/GDP	-0.1	-4.2	-4.6	-5.0
Current account balance/GDP	-9.3	-13.3	-6.6	-5.5
Net FDI (in million US\$)	2040	1044	256	262
External debt/GDP	42.5	37.9	46.6	na
Gross reserves/GDP	26.2	16.7	16.7	na
Credit to private sector/GDP	48.4	51.8	51.4	na

Transition indicators 2010



Macroeconomic performance

Economic indicators over the past year reveal a mixed picture. Real GDP is estimated to have fallen by 2.8 per cent year-on-year in 2009, industrial production has been struggling and foreign direct investment (FDI) dropped significantly by more than 70 per cent to €177 million. However, both the trade and current account deficits declined substantially and annual inflation remains very low, rising slightly to 2.5 per cent as of June 2010.

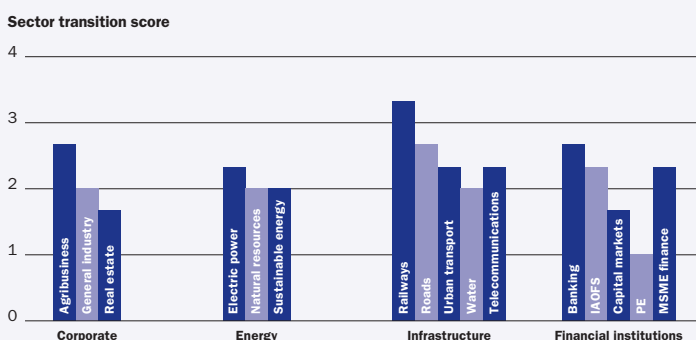
The authorities succeeded in limiting the impact of the financial crisis. Confidence in the banking sector was strengthened with a further increase in the deposit insurance limit in March 2010 to KM 35,000 (€18,000), following an initial increase in 2009. The SBA was temporarily put on hold at the start of 2010 when the parliament of the Federation failed to pass a law envisaging the reform of benefits to war veterans. The situation was, however, resolved when the law was finally adopted in February 2010. In March, the IMF Board approved the first review, and the second and third tranches amounting to €140 million were released.

Following the contraction in 2009, a bottoming out of GDP seems to be taking place, but growth is expected to be negligible this year and modest in 2011. Growth is likely to stem from a recovery in exports as demand for Bosnian goods picks up, especially for steel and aluminium, from the eurozone and neighbouring countries. The currency board will continue to anchor macroeconomic policy and governments at all levels will need to control spending and coordinate more effectively, with the support of the National Fiscal Council. The main risks to the outlook lie in the possibility of governments reversing or failing to implement the fiscal consolidation measures necessary to remain on track with the IMF programme.

Structural reform

Bosnia and Herzegovina's progress in transition has been effectively stalled for some years, and as a result the country lags behind all others in south-eastern Europe. The country's complicated political and constitutional structure is a major hindrance to reform and good governance. A significant privatisation agenda lies ahead but, in the FBH at least, there appears to be little appetite for bringing major enterprises slated for sale to the market. As a result of the reform paralysis, the country also lags behind other EU candidates or potential candidates in the region in terms of EU approximation.

2010 sector transition indicators



Note: Water – Water and wastewater; IAOFS – Insurance and other financial services; PE – Private equity

Recent developments

The implementation of the Stabilisation and Association Agreement (SAA) with the European Union is progressing adequately and the authorities are adhering to their trade commitments under the SAA and the regional Central European Free Trade Agreement (CEFTA). In September 2009 the Constitutional Court abolished a controversial customs law, which had reintroduced customs tariffs on meat and dairy products from Croatia and Serbia. The abolition has promoted regional trade liberalisation and expanded competition in the domestic market.

According to the EU Progress Report 2009, policy reform efforts have been negligible and structural rigidities continue to hamper the investment and business climate. There has been virtually no progress over the past year in privatisation, both due to the adverse market conditions and a lack of political will to sell-off economically sensitive enterprises. The FBH 2010 Privatisation Plan had foreseen the sale of nine major companies including, among other things, the aluminium maker Aluminij d.d. Mostar, the engineering company Energoinvest and the construction company Hidrogradnja. Most of these companies had been designated for sale under the previous privatisation plan.

The rehabilitation of the railway sector continued over the past year with the signing of several projects intended to upgrade and modernise the railway system. In November 2009 a consortium of the two Austrian construction companies, Alpine and Swietelsky, won the public tender to upgrade the railway tracks in both Entities to allow trains to travel at a higher speed. Furthermore, public service obligations (PSOs) have been signed earlier in 2010, increasing the accountability and transparency of services to railway passengers and aligning regulations to European standards.

In September 2009, the ongoing construction of four sections of the Corridor Vc was suspended because of political difficulties. The paralysis was finally resolved in March 2010 when the parliament amended the legal framework to allow the start of construction without the approval of the Ministry of Physical Planning. Work is expected to resume in the coming months.

In June 2010 the government of the RS cancelled an agreement signed last year with the Austrian construction company, Strabag, to establish a joint venture to construct a highway network in the RS. Strabag encountered difficulties in securing finance, as the deal had been signed without a public tender and therefore prevented international financial institutions (IFIs) such as the EBRD and the European Investment Bank (EIB) from providing loans.

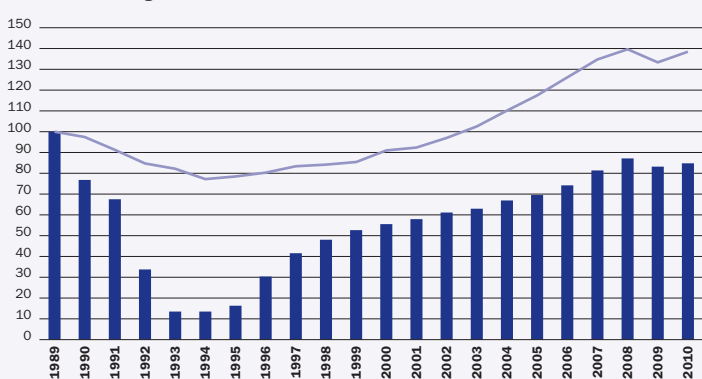
The banking system has remained sound, despite the global crisis and the significant outflow of deposits of around KM 800 million (about €410 million) in the fourth quarter of 2008. By early 2010, the total level of deposits had returned to pre-crisis levels, and the deposit insurance scheme was strengthened significantly in January 2010 with a €50 million EBRD loan. The Vienna Initiative agreement among the main banks has been successful in preventing outflows of funds back to the foreign parent banks. In order to counteract a rise in non-performing loans, regulations regarding debt restructuring were loosened in both Entities early in 2010, enabling debtors to restructure their obligations to commercial banks and extend their maturities to one year.

Structural reform priorities

- In the corporate sector, a key priority is to lessen the role of the state and proceed with important privatisations, particularly for profitable companies in the metals and telecommunications sectors. The authorities that come to power after general elections in October 2010 should take the necessary steps to bring these companies to sale. In addition many companies privatised by a voucher system have poor corporate governance and need to be either restructured or entered into bankruptcy.
- All infrastructure sectors are hampered by the extremely limited role for commercially oriented players and the resulting lack of cost-effectiveness. The regulators in the roads and railways sectors need to be strengthened and further unbundling is a priority in the power sector.
- In the financial sector banks are generally well capitalised and the sector is quite competitive, but the establishment of a unified system of banking supervision remains a key priority, while the development of non-bank financial markets, including equity markets, is still at a very low level.

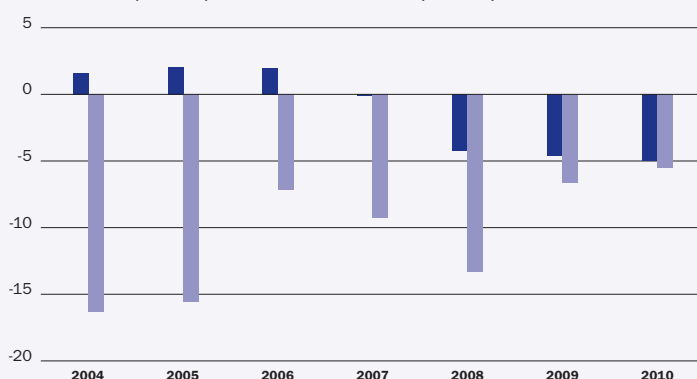
Real GDP (1989 = 100)

■ Bosnia and Herzegovina — EBRD-30



Fiscal balance and current account balance

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



¹The constitutional entities distinguished in this assessment include the State of Bosnia and Herzegovina (BH), the Federation of Bosnia and Herzegovina (FBH) and its Cantons, and the Republika Srpska (RS). The FBH and the RS are referred to as the "Entities".