



BOSNIA AND HERZEGOVINA

Highlights

- **The economy showed resilience in 2014 despite suffering extensive damage due to flooding.** Exports and retail sales held up well, keeping overall growth in 2014 in positive territory. Preliminary growth figures for the first half of 2015 are also looking healthy.
- **A new commitment to EU-oriented reforms has been made.** In July 2015, after lengthy discussions, governments at all levels in Bosnia and Herzegovina adopted a new Reform Agenda. In April 2015 the Council of the European Union decided to unfreeze the Stabilisation and Association Agreement (SAA), signed in 2008, which entered into force in June 2015. Important labour market reforms are also advancing.
- **A proposed public-private partnership (PPP) in the roads sector has been cancelled.** The failure of the tender for a major motorway project is a disappointment as the project could have served as a flagship for other PPPs in the Western Balkans region.

Key priorities for 2016

- **Implementation of the new Reform Agenda is key to sustainable economic development.** Authorities at all levels need to build on the positive momentum generated by the agenda in order to convince investors that reforms envisaged in the plan will be carried out, and to move forward in the EU approximation process.
- **Progress in privatisation is needed.** The process has been stalled for many years in the Federation. A few flagship sales could bring in much-needed investment and revitalise important sectors such as energy and telecommunications.
- **Adoption of a new banking law would strengthen the financial sector.** The lack of an effective resolution framework for troubled banks leaves authorities with few useful tools to deal with these banks. A new banking law with an adequate resolution framework, including a resolution fund, would strengthen the resilience of the banking sector.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	1.0	-1.2	2.5	1.0	2.8
Inflation (average)	3.7	2.0	-0.1	-0.9	-0.5
Government balance/GDP	-2.8	-2.7	-1.9	-3.0	-1.6
Current account balance/GDP	-9.6	-8.9	-5.8	-7.7	-7.7
Net FDI/GDP [neg. sign = inflows]	-2.6	-2.0	-1.7	-3.1	-2.6
External debt/GDP	48.9	52.2	52.2	51.9	n.a.
Gross reserves/GDP	24.5	24.8	26.4	28.7	n.a.
Credit to private sector/GDP	57.1	58.8	59.0	59.7	n.a.

Macroeconomic performance

The economy has remained resilient despite serious flood damage. The year 2014 started strongly for the economy, with growth in the first quarter of 2.7 per cent year-on-year. However, the severe floods in mid-2014, which affected a quarter of Bosnia and Herzegovina's population and caused an estimated €2 billion (15 per cent of GDP) in damage, constituted a significant setback for the country. The impact has been compensated by a strong export performance. Industrial production has also picked up. Overall, growth in 2014 is estimated at 1 per cent. Preliminary growth figures for the first half of 2015 are also positive. In the first quarter, GDP grew strongly at 2.1 per cent year-on-year, with particularly robust growth in wholesale and retail trade, public administration and construction, while growth in the second quarter accelerated to 4.4 per cent year-on-year.

The IMF Stand-By Arrangement (SBA) is over, but a new programme is under discussion. The arrangement with the IMF, approved in September 2012, and further extended in January 2014, was an important anchor for reforms. It was also augmented in 2014 to help the authorities cope with flood damage. However, delays to disbursements had occurred along the way because of lack of progress on structural reforms, and the eighth review was not completed. Discussions have begun on a new three-year programme, which would be directed towards budget support but which would also have a strong structural reform agenda.

A modest reconstruction-related rebound is under way in 2015. In addition, economic growth is being boosted by several major projects in the transport and energy sectors and solid export performance. Economic growth is projected at around 2.8 per cent in 2015, rising to 3.0 per cent in 2016. In the medium term, growth prospects could be enhanced if governments at all levels implement the ambitious reform agenda adopted in July 2015 (see below) and if the EU approximation process advances. However, the economy remains vulnerable on many fronts, not only as the whole region struggles, but also because of the poor investment climate in Bosnia and Herzegovina, which is a major deterrent to investment. While the country's potential for catching-up remains strong, as the GDP per capita (adjusted for purchasing power standards) stands at only 29 per cent of the EU average, the dysfunctional and complex constitutional structure continues to impede the implementation of comprehensive reforms and improvements to the business climate, thus hindering economic development.

Major structural reform developments

Bosnia and Herzegovina has committed to ambitious reforms. In July 2015, after lengthy discussions, governments at state and entity levels adopted a new Reform Agenda. This agenda includes six priority areas: public finances, taxes and tax sustainability; business climate and competitiveness; labour market; social protection and pensions; the rule of law and good governance; and public authorities. The Agenda is aligned with the EU's new emphasis on economic governance in Bosnia and Herzegovina and other Western Balkans countries. In April 2015, the Council of the European Union decided to unfreeze the Stabilisation and Association Agreement (SAA), signed in 2008, which entered into force in June 2015.

Bosnia and Herzegovina is in the final stages of accession to the World Trade Organization (WTO). The country currently has "observer" status in the WTO. It applied for membership in 1999 and presented its memorandum covering all aspects of its trade and legal regime in 2002. So far, 12 meetings of the Working Party for Bosnia and Herzegovina have taken place while the country has concluded bilateral negotiations with all but two member states.

Doing business remains difficult. Bosnia and Herzegovina continues to perform poorly on various international rankings of competitiveness and the quality of the business environment. In the World Bank *Doing Business 2016* report, Bosnia and Herzegovina was ranked 79th, three places up from the previous year, mainly on the basis of reforms regarding getting electricity. The country is ranked worst in the areas of starting a business, dealing with construction permits, getting electricity and paying taxes.

Little progress has been made in the past year on privatisation. In the Federation, the government still has significant stakes in a number of large companies, some of which have accumulated large arrears. In February 2015 the Federation government announced that it would try to sell its remaining shares in 14 large companies, including the pharmaceutical company, Bosnalijek; the aluminium producer, Aluminij; and the engineering company, Energoinvest. To date, however, there has been little or no concrete progress in these privatisations. In the new Reform Agenda signed in July 2015, the governments of both entities have committed to classifying and publishing a list of public enterprises that are viable and those that are not. The agenda also commits the Federation government to prepare early plans for the partial privatisation of BH Telekom.

The proposed PPP in the roads sector has not advanced. A tender was launched in August 2012 for the construction of the part of the Trans-European Corridor Vc that sits between the Croatian border and Doboj, and a detailed bid was submitted in April 2014 by a consortium led by Austria's Strabag in consortium with the French firm Bouygues. However, the Republika Srpska government has cancelled the process due to the high price of the single submitted bid. Other sections of Corridor Vc are advancing, financed through international financial institution (IFI) sovereign debt, and investment in flood damage repairs and road modernisation is also progressing.

Financial institutions have remained resilient, but non-performing loans (NPLs) remain problematic. As of mid-2015, capital adequacy stands at 15 per cent (Tier 1 capital to risk-weighted assets), although vulnerabilities exist within some domestically owned banks, a number of which are struggling to meet capital requirements while some rely on public support. NPLs remain a significant issue for the sector although they had stabilised at around 14 per cent by mid-2015 versus 15.1 per cent at the end of 2013. These reflect the legacy of the crisis (double dip recession) and a still-weak economy, and they constitute a significant drag on bank lending, especially in some domestic banks where the NPL levels are particularly high. Bank governance problems, weak supervision powers, and inadequate corporate resolution and insolvency frameworks are obstacles to addressing asset quality problems. The recent IMF Financial Sector Assessment Program (FSAP), published in August 2015, praised the improvement of the financial sector oversight since the 2006 FSAP, but it also noted that the supervisors' corrective and enforcement powers are weak and fragmented and there is no effective resolution framework/tools for troubled banks.

A new labour law was adopted in the Federation. The new law, adopted in July 2015, is an important part of the new Reform Agenda and is seen as a necessary step towards a new arrangement with the IMF. The law introduces more flexible working practices and is in line with similar recent laws in neighbouring countries. The aim is to promote job creation and improve the flexibility of the labour market, which is seen as essential given the persistently high unemployment rate, especially among the youth. The adoption of a new labour law in the Republika Srpska is still pending.