



BOSNIA AND HERZEGOVINA

Highlights

- **Bosnia and Herzegovina has formally applied to join the European Union.** The application was submitted in February 2016 and subsequently accepted by the European Council, and follows the entry into force of the country's Stabilisation and Association Agreement (SAA) on 1 June 2015.
- **Progress has occurred under the country's reform agenda, adopted in July 2015.** Areas of progress to date include the introduction of new labour laws in both entities, steps to improve the business environment, and fiscal consolidation measures.
- **A new IMF programme is in place.** The new programme – a three-year Extended Fund Facility – is targeting business environment improvements, improved quality and composition of public spending, and reforms in the banking sector.

Key priorities for 2017

- **The pace of progress under the reform agenda should be stepped up.** In particular, further efforts are needed to harmonise business regulations and legal structures across the multiple layers of government (especially between the two entities), and ease the administrative burden on firms resulting from onerous social and other quasi-fiscal obligations.
- **More progress needs to be made on the privatisation and resolution of state-owned companies.** The aluminium producer Aluminij and the Federation of Bosnia and Herzegovina's (the Federation's) telecommunications company, BH Telecom, should be privatised. A successful privatisation of BH Telecom would be a major positive signal to investors of Bosnia and Herzegovina's accelerated reform orientation and would help to improve the image of privatisation within the country.
- **Further energy sector reforms are needed.** In light of the country's recent progress on EU approximation, the authorities should take steps to ensure an EU-compliant legal framework in the energy sector that would remove the legal and contractual obstacles to establishing organised gas and electricity markets and market coupling. In addition, further efforts are needed to ensure competition on the local power market and the removal of power price regulation for end-users.

Main macroeconomic indicators %

| | 2012 | 2013 | 2014 | 2015 | 2016 proj. |
|-----------------------------------|------|------|------|------|---------------|
| GDP growth | -0.9 | 2.4 | 1.1 | 3.0 | 2.7 |
| Inflation (average) | 2.0 | -0.1 | -0.9 | -1.0 | -0.7 |
| Government balance/GDP | -2.7 | -1.9 | -2.9 | -0.2 | -0.8 |
| Current account balance/GDP | -8.7 | -5.3 | -7.5 | -5.6 | -5.1 |
| Net FDI/GDP [neg. sign = inflows] | -1.9 | -1.4 | -2.6 | -1.4 | -2.2 |
| External debt/GDP | 62.7 | 61.7 | 63.7 | 63.7 | n.a. |
| Gross reserves/GDP | 25.6 | 27.6 | 26.3 | 30.0 | n.a. |
| Credit to private sector/GDP | 56.3 | 56.6 | 56.4 | 55.8 | n.a. |

Macroeconomic performance

A reconstruction-related rebound took place in 2015. The economy has continued to show considerable resilience with the strongest level of growth, estimated at 3 per cent, since 2008, helped by a strong performance in wholesale and retail trade and manufacturing and a recovery in agriculture after flood damage in May 2014 which affected a quarter of Bosnia and Herzegovina's population and caused an estimated €2 billion (15 per cent of GDP) in damage. Growth in the first half of 2016 slowed down somewhat to 1.7 per cent year-on-year, although the industry sector continued to grow at a robust rate and the economy is being boosted by several major projects in the transport and energy sectors (in particular the Corridor Vc motorway project).

The International Monetary Fund (IMF) and the Bosnian authorities have signed a three-year €553 million Extended Fund Facility (EFF). The new programme, approved by the IMF Executive Board in September 2016, will help the governments of the two entities to fill their financing gaps. It should also play a catalytic role in mobilising other international financial assistance from the European Union and the World Bank. IMF financing is combined with an economic programme aiming to improve the business environment, create private sector jobs, strengthen the common economic space and raise the economy's growth potential. The envisaged measures include: (i) improving the functioning of the labour market, restarting the privatisation process and restructuring of state-owned firms, particularly in the Federation, and lowering the labour tax wedge; (ii) steps to ease public indebtedness through an improved composition and quality of public spending; and (iii) reforms in the banking sector which prioritise the adoption of new entity banking laws that will strengthen banking supervision by harmonising entity regulation, enhancing information sharing between banking agencies, and introducing a bank resolution mechanism.

Further growth is expected in the short term. The continuation of major infrastructure projects and the financial stability provided by the new IMF programme should both be supportive of growth, which is forecast at 2.7 per cent in 2016 and 3.0 per cent in 2017. In the medium term, growth prospects could be enhanced if governments at all levels implement the ambitious reform agenda and if the EU approximation process advances further. However, the economy remains vulnerable, partly 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 GDP per capita (adjusted for purchasing power parity) stands at only 30 per cent of the EU average, the country's complex institutional structure continues to impede the implementation of reforms, thus hindering economic development.

Major structural reform developments

Bosnia and Herzegovina has formally applied to join the European Union. The application was submitted in February 2016, and follows the entry into force of the country's Stabilisation and Association Agreement (SAA) on 1 June 2015. The European Council accepted the application in September 2016 and invited the European Commission to submit its opinion. Bosnia and Herzegovina is currently in the final stages of joining the World Trade Organization (WTO). The remaining matters to be resolved include the adoption of a new law on trade in the Federation, as well as the conclusion of bilateral negotiations with three member states (Brazil, Russia and Ukraine). The authorities are hoping to obtain membership status in the near future.

The new reform agenda, adopted in July 2015, is advancing gradually. The agenda includes six areas: public finances, taxes and tax sustainability; competitiveness; labour market; reforms of social protection and pensions; the rule of law and good governance; and reforms of public authorities. As of mid-2016, some initial progress had occurred: new labour laws which introduce more labour market flexibility have been adopted in both entities (see below), and prudent budgets have been agreed at all levels for 2016. Other business environment reforms enacted recently include the adoption of a new bankruptcy law in the Republika Srpska (RS) and new foreign direct investment (FDI) and company laws in the Federation. However, much more remains to be done, particularly in the areas of starting a business and dealing with construction permits, as evidenced by the country's latest ranking in the World Bank *Doing Business 2017* report, which places the country at 81st position out of 190 countries.

The Federation has pledged to restart the privatisation of state-owned companies and has achieved some successes recently. According to the 2016 privatisation plan, the Federation government plans to sell its stakes in some of the biggest companies in the country: blue-chip drug producer Bosnalijek and the aluminium smelter Aluminij. Other companies slated for privatisation this year include petrol firm Energopetrol, engineering firm Energoinvest, and insurer Sarajevo Osiguranje. In October 2016 the Federation managed to sell its 19.3 per cent stake in Bosnalijek. This followed a successful sale of a 39.9 per cent stake in tobacco factory Fabrika Duhana Sarajevo.

Energy sector reforms are advancing slowly. According to the Energy Community's latest report from February 2016, Bosnia and Herzegovina has renewed its commitment to reform and liberalisation in the sector. In particular, the country is advancing with compliant electricity and gas market laws which would transpose the Third Energy Package requirements in Bosnia and Herzegovina. However, the report also noted that the country lacks a compliant legal framework that would remove the legal and contractual obstacles to establishing organised electricity markets and market coupling. In addition, further efforts are needed to ensure competition on the local power market and the removal of regulation of power prices for end-users.

Upgrades to the country's road transport network have continued. The government's intention is to intensify the pace of construction of the major infrastructure project, Corridor Vc, the largest transport infrastructure investment project currently being developed in the country and the key piece of road infrastructure needed to connect Bosnia and Herzegovina to EU markets. So far, the construction has been financed by sovereign loans from the EIB and EBRD, repaid through a hypothecated fuel levy and through tolls (with around 80 per cent of the motorway companies' revenues coming from the fuel levy). This fuel levy is paid on fuel imports into Bosnia and Herzegovina. It is currently proposed that the fuel levy be increased by 15 pfenigs per litre of fuel, of which 10 pfenigs will be for motorways and 5 pfenigs for trunk roads. This will give an increased borrowing service capacity to the country's two motorway companies and should speed up the pace of construction of Corridor Vc.

New loans denominated in non-euro foreign currency have been banned. In November 2015 the national parliament adopted amendments to a consumer protection law, banning loans in any foreign currency other than the euro. The change has been initiated following the losses that many consumers suffered due to the higher costs of Swiss franc-denominated loans. Overall, the banking sector remains reasonably capitalised and liquid, but the level of non-performing loans, although declining, is still above 12 per cent and is a source of vulnerability. The banking agency of Republika Srpska has initiated a procedure for the liquidation of the state-owned Banka Srpske, and police are also looking into events at two other banks. However, the banks under investigation are small, and this is not expected to have a wider impact on the stability of the banking sector, which is dominated by international banking groups.

New labour laws are in place in both entities. The labour law in the Federation is in force as of April 2016, while the new labour law in the Republika Srpska was passed by the parliament in December 2015, despite strong opposition by the labour movements. These reforms include certain key features such as differentiated wage-setting based on skills, qualifications, experience and performance; reducing hiring disincentives; stepping up inspections and penalties for law violations; and protecting workers' rights. The aim is to make the labour market more flexible, with a view to reducing the country's high rate of unemployment. According to the latest labour force survey, published in July 2016, the unemployment rate was 25.4 per cent, two percentage points lower than in 2015. The unemployment rate among youth (aged 15 to 24 years) was 54.3 per cent.