BOSNIA AND HERZEGOVINA

Highlights

- **Growth continued in 2018 amid political uncertainty but has slowed in 2019.** In 2018, GDP increased by 3.6 per cent. However, it eased to 2.7 per cent year-on-year in the first half of 2019.
- **The delay in forming governments has blocked much-needed reforms.** The Federation entity- and state-level government are still not in place after the October 2018 elections, and the IMF programme continues to be stalled.
- **In May 2019, the European Commission adopted the Opinion on Bosnia and Herzegovina's EU membership application.** The Opinion identified 14 key priorities, in the areas of democracy/functionality, rule of law, fundamental rights and public administration reform, which the country needs to fulfil in order to progress with EU approximation.

Key priorities for 2020

- **The business climate needs to improve substantially.** The business environment remains one of the most convoluted in Europe, with different regulations in the two entities and the Brčko district. The private sector would benefit greatly from harmonised regulations and a reduction in "red tape" and para-fiscal charges.
- **Inefficient state-owned enterprises (SOEs) should be tackled.** SOEs impose a significant fiscal burden and have negative effects on other businesses. They should be depoliticised and restructured, followed in some cases by a renewed and credible push for privatisation.
- **Public administration reform should be pursued.** Bosnia and Herzegovina is known for an oversized and inefficient public sector, putting a significant burden on taxpayers and adversely affecting the business environment. The Republika Srpska should also adopt as soon as possible the strategic framework of public administration reform for 2018-22, and the country should embark on developing a professional, de-politicised and merit-based civil service.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.1	3.1	3.2	3.6	3.0
Inflation (average)	-1.0	-1.1	1.2	1.4	1.0
Government balance/GDP	0.7	1.2	2.6	2.3	1.0
Current account balance/GDP	-5.1	-4.7	-4.3	-3.7	-5.0
Net FDI/GDP [neg. sign = inflows]	-1.8	-1.8	-2.1	-2.6	-3.0
External debt/GDP	62.9	63.8	61.1	61.0	n.a.
Gross reserves/GDP	30.1	31.9	33.5	35.3	n.a.
Credit to private sector/GDP	55.0	54.3	55.6	55.2	n.a.

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Macroeconomic performance

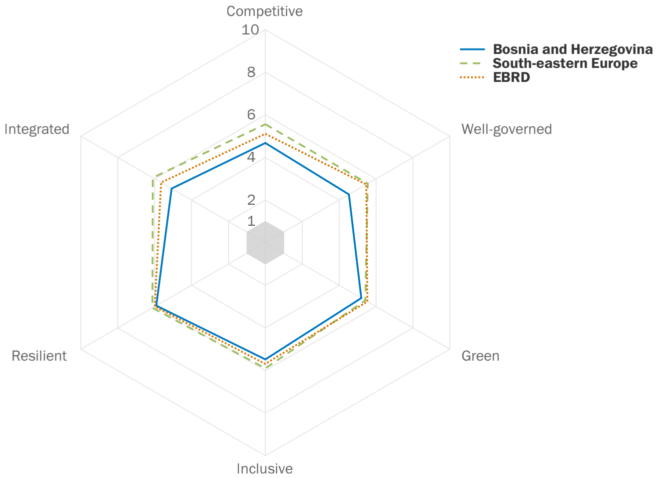
The economy has once again proved to be resilient to a slowdown of reforms and continued political uncertainty. GDP growth in 2018 surprised on the upside, reaching 3.6 per cent, 0.5 percentage points higher than the 2015-17 average. The value-added increased most in the agriculture sector and in electricity production. Unemployment dropped by two percentage points, but at above 18 per cent remains high, especially for young people (close to 40 per cent). In the first half of 2019 growth slowed to 2.7 per cent year-on-year, primarily due to a slowdown in exports and increase in the growth of imports.

Inflation has trended down. After increasing from 0.3 to 1.8 per cent year-on-year in the first half of 2018, on the back of rising fuel prices and excise duties on cigarettes, inflation stabilised around that level for the rest of the year. In 2019, it started to decline, falling back to 0.3 per cent year-on-year in September. The decline was primarily led by the slowdown of transport prices growth.

The consolidated budget stayed in surplus for the fourth year in a row, also due to the under-execution of capital expenditures. In 2018, government revenues were higher than expenditures by 2.2 per cent of GDP. Public debt also fell, reaching 33.6 per cent of GDP as of the end of June 2019. However, the quality of fiscal governance has remained low. The country lacks medium-term fiscal planning and focuses strongly on maintaining current spending patterns, often at the cost of delaying much-needed public investment. Also, accumulated public sector arrears pose significant fiscal challenges. In the Republika Srpska these mostly stem from the health sector, while the majority of arrears in the Federation of Bosnia and Herzegovina (FBIH) have been accumulated by SOEs. Documentation and monitoring of arrears are weak in both entities, too.

Further moderate growth is likely in the short term. GDP is expected to expand by 3.0 per cent annually in both 2019 and 2020. Risks to the projection are tilted to the downside and mainly relate to uncertainty about the reforms (that is, improvements in the business climate and standards of governance, as well as advancement of the country's EU approximation agenda) and slowdown in the main export market, the eurozone.

Assessment of transition qualities (1-10)



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Major structural reform developments

The European Commission has adopted the Opinion on Bosnia and Herzegovina's EU membership application. The country submitted an EU membership application in February 2016. In May 2019 the European Commission issued the Opinion on the application. The Opinion identifies 14 key priorities for the country to fulfil in order to be recommended for the status of EU candidate country. These priorities lie in the areas of democracy and functionality of institutions, rule of law, fundamental rights and public administration reform. The Commission encouraged the authorities to agree and implement socio-economic reform measures, in line with the Economic Reform Programme policy guidance, and to continue engaging in regional cooperation and strengthening bilateral relations with neighbouring countries.

Business environment has remained unchanged over the past year. Bosnia and Herzegovina keeps lagging behind its Western Balkans peers on global competitiveness lists. In 2019, the country was ranked 92nd among 141 economies in World Economic Forum's Global Competitiveness Index, one place lower than in 2018, with several areas with a rank above 100th (institutions, product and labour market, business dynamism and innovation capability). Similarly, Bosnia and Herzegovina ranked 90th among 190 countries in the *World Bank's Doing Business 2020* report, dropping one place from the year before as no major reforms took place. While it ranked relatively well on trading across borders and resolving insolvency (27th and 37th, respectively), the areas in need of major push are starting a business (184th), dealing with construction permits (173rd) and paying taxes (141st).

Public administration reform is stalled. A countrywide strategic framework on public administration reform for 2018-22, developed by inter-institutional working groups appointed by the Council of Ministers of Bosnia and Herzegovina and the entity and Brčko District governments in March 2018, is lacking as Republika Srpska has still not adopted it. The need for reform is urgent as the public administration in Bosnia and Herzegovina is complex and often has overlapping competences, duplications of functions and an unclear division of responsibilities across various levels of governments. The poor quality of the institutional set-up is reflected in the country's lowest ranking (111th) in Europe on institutions in the World Economic Forum's Global Competitiveness Index 2018.

There has been little progress in the past year with privatisation or restructuring of SOEs. The Republika Srpska authorities managed to sell (minority) stakes in three companies out of 14 in the 2018 privatisation plan. The plan also included three strategic enterprises, but one of these went into bankruptcy in February 2019 (a producer of special diesel engines and spare parts for engines Fabrika motora specijalne namjene), while the other two have not been privatised. The entity's railway company started a financial, workforce and organisational restructuring in 2018, planned for completion in 2021. The process is supported by a World Bank loan (€51.3 million) and technical assistance. The FBIH entity sold none of the four enterprises in the 2018 privatisation plan, although they have been planned for sale for a long time. The state footprint in Bosnia and Herzegovina is large, with around 550 SOEs employing 80,000 people, or about 10 per cent of the total workforce. These companies are usually characterised by weak transparency, accountability and performance, and suffer from political influence. Many of them are burdened by excess employment and debts, and are loss makers. As such, they pose risks to macroeconomic performance, fiscal sustainability and competitiveness. One of the recent examples is the indebted aluminium smelter Aluminij, which required government intervention in September 2018. In mid-July 2019, the company was disconnected from the power grid, after strategic partnership talks between the Federation entity's government and a consortium failed. The entity's government gave the company a deadline of the end of 2019 to restructure. Failure to do so could potentially lead to bankruptcy and loss of employment of 900 workers in Aluminij and about 10,000 workers in the supply chain.

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The road network is being improved slowly. The improvements focus mostly on the Corridor Vc motorway, connecting the Port of Ploče in Croatia with Budapest in Hungary. The motorway will represent an important trade route to European markets. In the past year, contracts for few motorway sections in FBIH have been signed, while works on the first section of the corridor in Republika Srpska started in June 2019. In general, the project is lagging behind (it was initially expected to be finished in 2012) and by September 2019 around one-third of the highway (or around 100 kilometres) had been completed. The EBRD supported the project in 2019 with a loan of up to €210 million for a new motorway section that will include a bypass for the town of Doboj. The project is expected to be completed by 2030 and will cost around €4 billion. In addition, the Republika Srpska and China's SDHS-CSI BH signed in December 2018 a 33-year concession agreement on the construction of the 42 kilometre Banja Luka-Prijedor highway.

The banking sector is well-capitalised, but non-performing loans (NPLs) remain elevated. The capital adequacy ratio of the banking sector stood at 17.9 per cent at the end of June 2019, well above the regulatory minimum of 12.0 per cent. Still, some (primarily local) banks have insufficient capital endowments and unfavourable credit portfolios. The NPL ratio of the banking sector stood at 8.0 per cent at the end of June 2019 (down from 9.3 per cent a year ago). The NPLs are concentrated in domestically owned banks and are largely a legacy issue. The new banking laws adopted in 2017 should support the soundness of the banking sector, but banking sector supervision is hampered by fragmented competences. In addition, the country has not yet adopted a law on deposit insurance that would complete the bank resolution framework in line with EU directives.

A controversial coal-fired power station may breach EU commitments and conserve polluting generation capacities. In March 2019, the Energy Community opened an infringement procedure against Bosnia and Herzegovina over state aid to the Tuzla 7 coal power plant. The 450 MW extension of Tuzla thermal power plant is planned to be financed through a loan of €614 million from the Chinese Exim Bank, which received a guarantee by the Federation entity in spring 2019. The new facility (with other planned units) would further increase Bosnia and Herzegovina's reliance on highly polluting lignite-based power generation and would result in expensive stranded assets at a later date.

The entity governments have endorsed a joint package of socio-economic reforms (2019-22). Under this package, which was endorsed in October 2019, the governments will be aiming at improving the business environment and stimulating growth and competitiveness, as well as at depoliticising SOEs, reforming the healthcare system and providing better opportunities for young people, women and other vulnerable groups.