



European Bank
for Reconstruction and Development

Bosnia and Herzegovina mini-diagnostic paper: Assessing progress and challenges in developing a sustainable market economy (2017)¹

Executive summary

Bosnia and Herzegovina stands at a crossroads. The country has managed to weather the worst of recent crises and setbacks relatively well, and the economy is now growing at a respectable rate. The Reform Agenda adopted in 2015 is progressing, a new 3-year IMF programme was signed in September 2016, and the country has formally applied to join the European Union, giving a clear signal of its long-term ambitions to be part of the European club. At the same time, fundamental problems that have dogged the country for many years threaten to slow down the reform process. It is imperative, therefore, that Bosnia and Herzegovina (BiH) continues to make progress towards a well-functioning and sustainable market economy.

This paper consists of a brief overview of the political economy, reform agenda, macroeconomic outlook and quality-by-quality description of main transition gaps according to the new EBRD methodology for measuring transition.² This methodology assesses each country six desirable qualities of a sustainable market economy: competitive, well-governed, resilient, integrated, green, and inclusive. Each quality can be measured to give an average transition quality (ATQ) score. The methodology is currently being developed and refined, and scores for all EBRD countries, including Bosnia and Herzegovina, will be published later in 2017.

Bosnia and Herzegovina is lagging behind peers in terms of the six qualities of a sustainable market economy. The analysis of the qualities highlights the major challenges in all six areas. The country's preliminary scores are particularly low for competitiveness and governance. The highest score is for integrated, but all countries in the EBRD region tend to score relatively well on that dimension, so major challenges also remain for BiH in this area.

¹ This mini-diagnostic paper, prepared by the Economics, Policy and Governance Department at the EBRD, draws on a number of EBRD background papers and notes on regional issues in the Western Balkans. A synthesis of this work – the Western Balkan regional diagnostic paper – is in preparation and will be published later in 2017

² For more information on the EBRD's new transition concept, see: <http://www.ebrd.com/news/2016/ebrd-updates-transition-concept-.html>.

Political economy

The unique constitutional set up of BiH has a major impact on the country's political economy. Bosnia and Herzegovina is a former republic of ex-Yugoslavia, which obtained its current shape as a result of the Dayton Peace Accords that ended the devastating war of 1992-1995. The country's challenges to a great extent stem from the legacy of this war and of the Dayton agreement. The latter paved the way to peace and stability in BiH and has supported it ever since. At the same time, it created a uniquely complex institutional structure, which has generated fragmented policy making. At the central level, the decision-making process is based on a daunting system of checks and balances, which were designed to protect the interests of the three "constituent" peoples, but which often encourage their representatives in the central state bodies to demonstrate their commitment to their respective Entities (the country comprises two Entities whose governments have more powers than the state level Council of Ministers), and to their respective ethnic communities rather than to the State. This is additionally complicated by the fact that ethnic-based political parties continue to dominate the political scene in the country.

The complicated system of checks and balances hampers efficient functioning of the state, even though some businesses have over the years adapted to circumvent the barriers. Despite initial convergence and economic integration, driven by the need of the post-war reconstruction and economic development, further integration within the country has been limited due to political obstacles. The specifics of BiH's constitutional set up mean that many of the weaknesses common to other Western Balkans countries, such as low capacity of public administration, excessive politicisation (in BiH's case – also 'ethnicisation') and lack of meritocracy in civil service, weak judiciary, corruption and red tape have been multiplied in BiH. This is one of the main reasons the country lags behind its regional neighbours in various tables related to the ease of doing business.

Without a comprehensive reform of the constitutional set-up, meaningful progress towards a more efficient and democratic state may be difficult to achieve. Several attempts were made over the years to reach an agreement on the constitutional reform, but so far without success. Local leaders fundamentally disagree regarding the optimal internal organisation of the country and consequently regarding the deeper reforms required to overcome the country's dysfunctions.

Not all obstacles can be blamed on Dayton. In particular, nothing in the Dayton Accords prevents privatisation, which has been stalled in some parts of BiH for many years. Unlike in some other countries of south-eastern Europe, where the process of privatisation has advanced over the years of transition, in BiH, and particularly in FBiH, the main economic power and assets are still in the hands of the state. More precisely, given the above-mentioned specifics of BiH's set up, it is in the hands of the leadership of its ethnic political parties. The system of trading the seats on key state-owned companies between political parties winning the elections is one of the cornerstones of the existing system of governance in FBiH. This practice is to a great extent a legacy of ex-Yugoslavia, but it is additionally complicated in BiH by the application of an "ethnic key".

Reform Agenda

In 2015, BiH embarked on a wide range of reforms enshrined in a formal Reform Agenda. The new EU approach is based on gradual progress and proportional incentives, while leaving for more distant future tackling some of the more difficult issues related to the constitutional reform. For EBRD, there is an opportunity to contribute, alongside other IFIs, to shaping the reform programme of the governments of BiH at all levels and help get unstuck transition in a country of operations, which has been for years one of the Bank's major recipients in the Western Balkans.

The Reform Agenda represents a formal commitment by all levels of governments and all main political forces in BiH. The planned reforms, with a horizon of 2015-2018, are grouped in six areas: public finance; business climate; labour market; pension reform; rule of law; and public administration.

Reforms in the area of public finance, taxation and fiscal sustainability are part and parcel of the arrangement with the IMF. They include measures for lowering public debt and reducing public spending (including through public administration reform), increase in revenues through the expansion of the tax base and reducing tax exemptions.

Reforms in the area of business environment aim at eliminating the well-documented barriers and deficiencies in this area. The planned reform measures include new laws on companies and business registration, expediting procedures for various permits, better investor protection laws, more efficient insolvency frameworks, including amended legislation on bankruptcy, and introducing commercial courts in F BiH. Included in the chapter of “business environment” is the critical, even if short, section related to the privatisation agenda. This is one of the potentially most important areas, but is also one of the most sensitive ones, for the reason of vested interests explained in the previous section.

Labour market reforms largely centre on the adoption and implementation of the new Labour Laws, designed to increase flexibility in working conditions and allow differentiated wage setting based on skills and performance, and are closely related to the objective of combatting significant grey economy.

Pension reform and social welfare are due to be accomplished with the help of WB and IMF. In F BiH, in particular, the insurance-based system must be put on a firm financial footing, including containing costs of privileged pensions and reducing early retirement options. Both Entities work on developing voluntary-pensions scheme proposals.

Reforms in the area of the rule of law envisage a number of commendable objectives. These include: adoption of anti-corruption strategies, a new counter-terrorism strategy, enhancing professionalism and integrity of the members of the judiciary by applying objective criteria for appointments and strengthening their accountability through new rules of disciplinary procedure etc.

The same refers to the prospects for the implementation of the public administration reforms, which proclaims the objective of creating “modern, transparent, effective, cost-efficient and accountable public administration”. The lack of it is one of the key weaknesses of BiH, but this state of affairs is to a great extent part and parcel of the Dayton set up. It remains to be seen how the Entities manage to adopt and – more importantly – implement the required new laws on civil servants with their focus on “objective criteria” for employment.

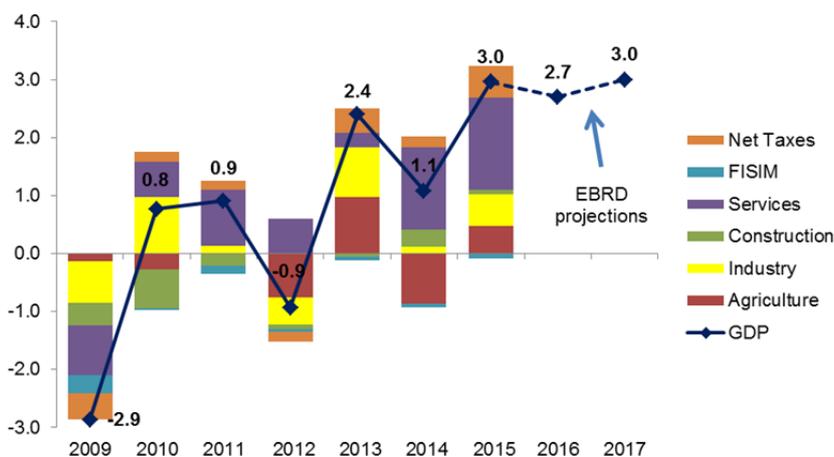
Macroeconomic outlook

The economy has been relatively resilient over the past 15 years, but has grown at a rate below the regional average. Average economic growth in Bosnia and Herzegovina in the period of 2001 – 2016 was 3.0 per cent. In comparison, average growth in the EU during the same period was 1.4 per cent, suggesting that BiH has been catching up gradually towards EU standards of living. Compared to its Western Balkan peers, however, the growth performance was lower than in other countries except FYR Macedonia, despite the fact that, at the start of this century, BiH had one of the lowest starting points in the region (higher only than Albania and Kosovo). As of 2016, the GDP per capita of BiH stands at only 30 per cent of the EU average. Therefore, the country's potential for catching up remains strong.

The economy is fairly diversified, with two-thirds devoted to trade, industry and public administration. Three sectors predominate: industry, domestic trade and public administration (including education, health care and social care). Domestic trade, including transport and storage as well as accommodation and food services, is among the largest sectors in the economy, as in other Western Balkan countries. Relative to others, however, BiH has a high share of value added in industry (only Serbia in the region is higher), with important sectors such as metal production, power production, wood processing and car components production. The share of public administration in the economy is higher than in all other WB countries, reflecting the multiple layers of public government, including the central government, governments of two entities and the Brcko district, cantonal governments in the Federation of BiH, as well as local administration across the country. Agriculture is the fourth largest sector in the country, with a 7 per cent share of economic activity.

The economy has shown some volatility in recent years. GDP grew by 3 per cent in 2015, the strongest level of growth since 2008, helped by a strong performance in wholesale and retail trade, manufacturing and a recovery in agriculture (Chart 2). 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). GDP growth was projected at around 2.7 per cent in 2016. Further growth of about 3 per cent is expected in the short term, in line with the average growth of the past 15 years.

Chart 2: GDP growth in BiH, by sector



Source: Agency of Statistics of BiH, EBRD Regional Economic Prospects (November 2016), and authors' calculations.

Competitive

Bosnia and Herzegovina's economy is considered less competitive than most regional peers. The country benefits from its historical role as a regional manufacturing hub with a diversified manufacturing base and a high level of trade integration. However, the economy is constrained by obstacles in the business environment and the lack of adequate skills and essential infrastructure. The European Commission (EC) considers BiH to be at an early stage in developing a functioning market economy and achieving the capacity to cope with competitive pressure and market forces within the EU.

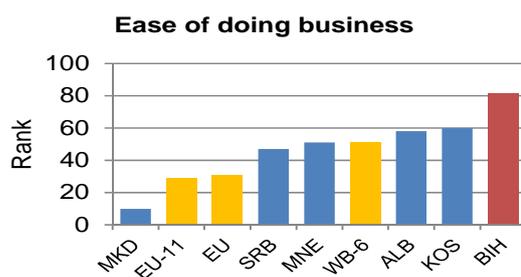
- The biggest problem for competitiveness is BiH's **complex constitutional structure**, which is a fundamental constraint on reforms and private sector activity. The 1995 Dayton Peace Agreement created a uniquely complex state structure with checks and balances that gives ample opportunity to politicians to block much-needed reforms and stifle competition.
- Institutional constraints are also reflected in a poor **business environment**, which holds back existing companies and limits the entry of new firms.
- **Privatisation** has lagged behind, especially in the Federation. Key Federation assets in the telecoms and metals sector remain in state hands, and the energy sector in both entities is still mainly state-owned.
- **Productivity** across the economy is above the average level of Western Balkan countries, but below levels in EU-11 countries. The country has a diversified manufacturing base and exports a range of products competitively, with a strong comparative advantage in sectors such as furniture and wood, paper and paper production.
- Despite some constraints in access to finance, a significant number of firms including SMEs engage in the **adoption of new products and processes**, according to BEEPS V, but the private sector is far from the innovation frontier.
- Although some competitive pressure is ensured through the country's trade openness, the domestic enforcement of **competition policy** is limited and falls well behind EU standards. The competition council is appointed on the basis of political and ethnic affiliation and frequently makes decisions on the basis of vested interests rather than competition principles.
- Competitiveness is also adversely affected by constraints regarding important inputs for the private sector, **notably inadequate (transport) infrastructure**, and a low quality of the education system, limiting access to **skilled labour**.

81st in ease of doing business 2017 among 190 countries (World Bank)

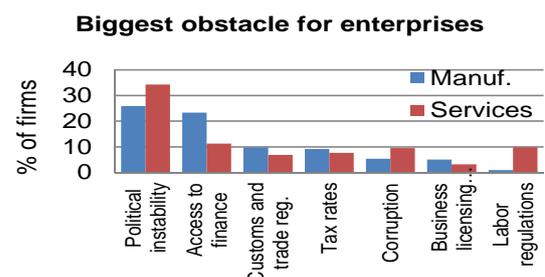
107th in the 2016 Global Competitiveness Index among 138 countries.

37th in economic complexity out of 124 economies (Harvard CID, 2014)

Ranked in the lower 40th percentile among EBRD CoOs on overall competitiveness (13 indicators).



Source: World Bank's Doing Business 2017 Report.



Source: BEEPS.

Quality of a sustainable market economy

Well-governed

Bosnia and Herzegovina performs poorly on most aspects of public governance. Governance is hindered by veto mechanisms that are built into the political system and hinder major country-wide reforms. The practices of ethno-political patronage have created a bureaucracy that over the years has become oversized, producing poor coordination among numerous levels of government and delivering to citizens and businesses a fragmented and weak institutional, policy, administrative, and legal environment.

- With regard to **rule of law**, the country is judged by the EC to be at “some level of preparation” (the second lowest on a five-point scale) with regard to functioning of the judiciary, fight against corruption and fight against organised crime.
- **Corruption** is seen as a major obstacle by the private sector. In BEEPS V, more than 25% of firms deem it a major or very severe obstacle.
- **Political connections** are seen by many people as key to success in life, according to the Life in Transition Survey (LiTS III), with 43 per cent rating this factor as more important than either effort and hard work, or intelligence and skills.
- The authorities give significant, market-distorting **state subsidies and guarantees** to businesses. Many state-owned companies have built up substantial arrears in social security contributions.
- **The legal environment for private sector activities is complex.** The institutional framework governing public-private partnerships (PPPs) lacks clarity. Taking and enforcing security can be challenging. Enforcement of contracts remains cumbersome.³
- The **corporate governance framework** suffers from a number of weaknesses. The EBRD’s assessment of corporate governance legislation and practices in BiH points to particular problems with stakeholders and institutions, structure and functioning of the board, and internal control, all of which score 2 on a scale of 1 (worst) to 5 (best).⁴ In addition, environmental, health and safety, and social issues need to be integrated into corporate governance practices to align with good international practice.

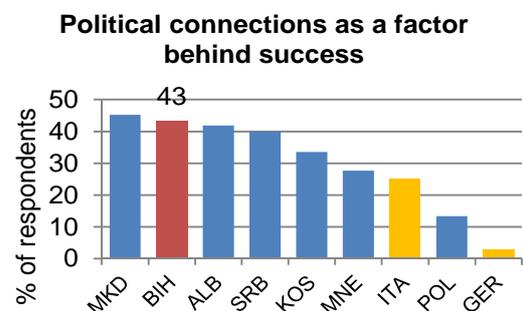
76th out of 167 countries on Transparency International’s Corruption Perceptions Index.

Less than 40 per cent of BiH respondents think there are free elections, stability and law and order. (LiTS)

Less than 30 per cent of BiH respondents think there is a fair justice system or an independent press. (LiTS)



Source: The World Bank’s Worldwide Governance Indicators database.



Source: EBRD/World Bank Life in Transition Survey III.

³ See “Practical legal guide – Bosnia and Herzegovina”, paper prepared by OGC Country Lawyer – Amine Bennis, March 2016.

⁴ See “Corporate governance in transition economies: Bosnia and Herzegovina country report”, prepared by Gian Piero Cigna, Pavle Djuric and Alina Sigheartau, EBRD, August 2016.

Quality of a sustainable market economy

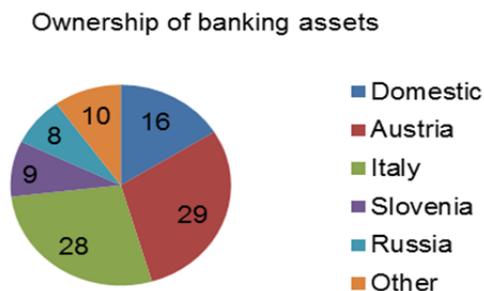
Resilient

BH's economy has proven relatively resilient over the years to various shocks, both internal and external. Macroeconomic policy is anchored by the strict currency board arrangement, in place since 1997, under which the currency (KM) is pegged to the euro and supported by a strong level of foreign exchange reserves. The economy is increasingly open to trade and relatively diversified. Agriculture is an important sector. Although reliance on food imports is high, food security is not an issue. BiH is the second largest electricity exporter in the Western Balkan region and has good security of electricity supply through its regional interconnections. Financial stability has been preserved throughout the crisis although the level of financial development has room for expansion. BiH is vulnerable to climate change shocks as witnessed by the major floods and their economic damage in 2014.

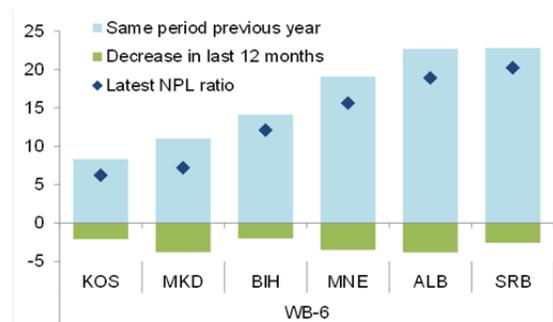
- A new **3-year arrangement with the IMF**, signed in September 2016, will help ensure that the central bank remains independent and that reserves of the central bank (at almost 30 per cent of GDP) will not be used for any budgetary or public investment purposes.
- The **banking sector** is highly liquid. However, the capital adequacy ratio is below 15 per cent, which is low by regional standards, and non-performing loans, although declining, remain significant at 12 per cent. Banking supervision is at the entity level, hindering the development of a single market in banking services throughout the whole country.
- Private sector credit stands at 56 per cent of GDP, implying **moderate banking penetration**. The private sector loan portfolio is almost equally divided between loans to households and loans to enterprises. The development of **non-banking financial services** such as leasing, factoring and insurance is at an early stage. **Capital markets** are also fragmented, with a separate stock market in each entity, and there is no local institutional base for private equity transactions.
- **Flood damage** has become a serious risk to economic growth. In 2014, severe flooding caused an estimated €2 billion in damages (15 per cent of GDP). Further floods have occurred in 2015 and 2016 both in BiH and in other Western Balkan countries.
- BiH is a **net exporter of power**, with significant resources still unexploited. However, energy sector reforms have lagged behind, and further improvements towards energy efficiency and the development of renewables are needed. The country is dependent on Russian gas, with limited alternatives at present.

The capital adequacy ratio is **14.86 per cent**, which places BiH at 27th among EBRD CoOs.

Oil and gas imports account for **16 per cent** of overall imports.



Source: Bankscope.



Source: National authorities.

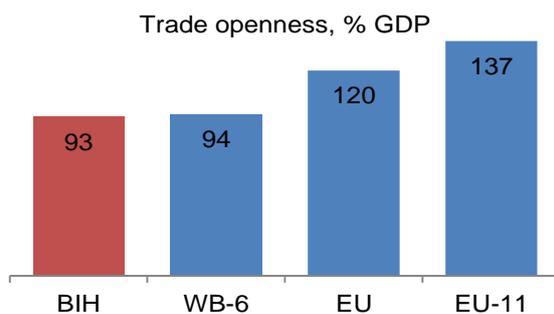
Integrated

The promotion of cross-border integration is at the heart of long-term economic development in Bosnia and Herzegovina and the rest of the Western Balkans. Although BiH has a Stabilisation and Association Agreement (SAA) with the EU (in force since June 2015), the degree of trade openness is well below typical EU levels. BiH is not yet a member of the WTO. The quality of transport infrastructure is inadequate and the difficult terrain in the region has made transport projects complicated and expensive.

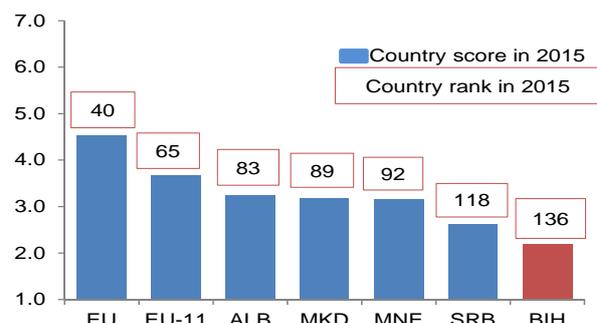
- BiH's measure of **trade openness** ((exports + imports)/GDP) is 93 per cent, well below the EU average (120 per cent). The country has tariff-free access to the EU for most goods, as well as to neighbouring non-EU members under the CEFTA. Further progress is needed, however, in reducing **non-tariff barriers**.
- BiH and other WB countries are not well integrated into **western European supply chains**. More than 60 per cent of BH's goods exports are in manufacturing, but mostly in low- and medium-skill, labour- and resource-intensive goods.
- **Foreign direct investment** levels are low by regional standards: the FDI stock per capita is just €1,500, compared with an €2,600 in the Western Balkans, reflecting the weak business environment and complex institutional structure.
- The quality of **transport infrastructure** is ranked in the WEF's GCI as lower in BiH than in other Western Balkan countries (excluding Kosovo), with poor scores in all four categories: rail, road, water and air. Improvements to road traffic safety are needed to reduce accidents and fatalities. The difficult terrain makes transport projects costly and time-consuming. Fiscal space is limited. There has been little private sector involvement to date in transport projects, and no PPP has yet been successfully implemented in the transport sector in BiH.
- **Cross-border energy integration** has progressed over the years, with cross-border trading enabled by the establishment in 2014 of the Coordinated Auction Office (in Montenegro) for SEE. BiH is the Western Balkan's second-largest electricity producer (behind Serbia), with an installed capacity of 4,000 MW, equally divided between hydro and coal-run power plants. However, major investments are needed to strengthen further intra- and inter-regional energy linkages.

Bosnia and Herzegovina has formally applied to join the **European Union** in February 2016. 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).



Source: IMF's World Economic Outlook; Authors' calculations.



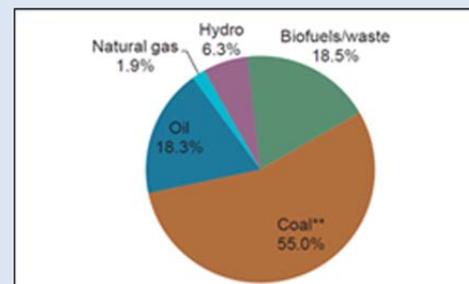
Source: World Economic Forum's Global Competitiveness Index.

Green

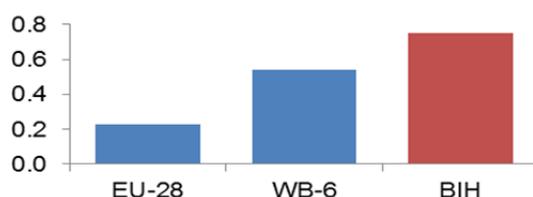
Bosnia and Herzegovina is more carbon and energy intensive than the Western Balkan average, and far above the EU average. Primary energy production is still dominated by fossil fuels (including coal), which account for about ¾ of total primary energy supply. Also, there are sizeable losses and inefficiencies in energy generation and transmission, infrastructure and final consumption, whereby technologies are outdated, buildings are poorly insulated and the use of equipment is inefficient. The country has shown commitment to climate change by signing the Paris Agreement, although it has yet to ratify it.

- **Demand-side energy efficiency needs to be improved across different economic sectors.** The highest levels of energy consumption and carbon emissions are generated from heating in buildings and transportation. Although there are some laws on energy performances in place, implementation of the Energy Performance in Buildings Directive (EPBD) and Energy Efficiency Directive (EED) has been slow and need to be expedited, while adoption of draft energy efficiency laws remain incomplete.
- **Greening energy supply** can be a key driver of private sector growth. Hydropower potential is estimated at 6,000 MW, against the currently installed capacity of 2,054 MW. There are currently no wind farms in BiH, but wind energy potential is estimated at 2,000 MW.
- The **current pipeline of new thermo-power plants**, with an already installed capacity of 2,000 MW, poses significant climate change risks, while existing plants remain inefficient.
- BiH's economy including housing, energy, transport and water and sewage supply stock, **is particularly vulnerable to the adverse impacts of climate change, such as flooding**, which in 2014 led to an estimated economic loss of 15 per cent of GDP.
- Other environmental issues in BiH are the **high levels of outdoor air pollution**, caused mostly by thermal power plants, leading to the fifth highest rate of pollution related mortality (92 deaths per 100,000) in the world, and **waste management**. On the former, emissions from the new thermo-power plants and transport-related emissions are expected to increase in line with the growing economy and expansion of the road network, which could make the situation worse. On the latter, there are insufficient waste disposal system capacities, which lead to considerable quantities of waste being dumped illegally, posing threats to public health and the environment. Also, **biodiversity and nature protection concerns** exist with regards to renewable energy and infrastructure development, and these issues require careful management.

BH share of total primary energy supply



Carbon intensity
(CO2 emissions per unit of GDP)



Source: International Energy Agency, Authors' calculations.

Ambient air pollution
(Concentrations of PM2.5)



Source: WHO.

Inclusive

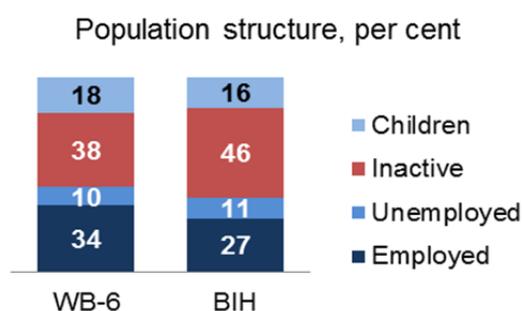
Bosnia and Herzegovina faces major inclusion challenges across a number of dimensions. The country has suffered for many years from high unemployment, especially among younger people, which contributes to a significant emigration of talented people each year. Partly as a consequence, skills mis-matches are an important constraint for businesses. Groups such as Internally Displaced persons (IDPs) and Roma continue to experience different forms of discrimination. Regional inclusion gaps are also significant in BiH.

- **The share of the population in formal employment is very low.** Those employed account for only 27 per cent of the total population, while nearly half the population is economically inactive, including pensioners, people in school (secondary or university), people with health disabilities, and those who are discouraged from looking for a job.
- The current **unemployment rate** in BiH is 25 per cent (23 per cent male and 30 per cent female) and, of these, more than 90 per cent are long-term (more than one year) unemployed.
- **Youth unemployment** is 56.9 per cent (male) and 58.5 per cent (female). Youth inclusion gaps for education (both quality and quantity) and financial inclusion are rated as medium.
- **Educational levels** in BiH are below EU standards, as indicated by the standardised PISA scores for maths, reading and science. In BEEPS V, more than 7 per cent of firms cited an inadequately educated workforce as a major or very severe constraint, and 14 per cent said they would expect annual sales to increase if an adequate workforce were available.
- **Gender inclusion gaps** in BiH are mostly medium, including access to finance. They are however large with regard to employment and business, with women's labour force participation standing at only 34.4 per cent, compared to 58 per cent for men. Legal restrictions still exist for women to access certain jobs, and women's participation in corporate decision making remains low at 8 per cent. According to BEEPS V, 27 per cent of firms report female participation in ownership.
- **Regional inclusion gaps** are large with respect to the quality of institutions. They are medium for access to services and labour markets.
- **Roma** are highly vulnerable. Roma women experience double discrimination as members of a minority and as women. Almost 80 per cent of Roma women do not complete primary education and 90 per cent of them have no access to employment.

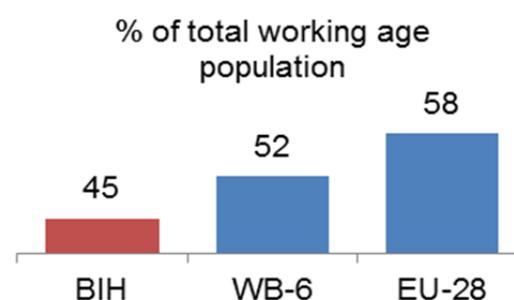
Male and female labour force participation (15+, 2015, ILO estimates) stand at 58.0 and 34.4 per cent, the lowest in Western Balkans.

Less than 10 per cent of 15+ population has access to training to start or grow a business (2013, Gallup).

Less than 35 per cent of young adults (age 15-24) have an account at a financial institution (2014, Global Financial Inclusion Database).



Source: World Development Indicators; Authors' calculations.



Source: World Development Indicators.

