BOSNIA AND HERZEGOVINA

Highlights

- **A recession is expected in 2020 due to the Covid-19 pandemic.** Manufacturing sector output fell by 12 per cent year-on-year in the first seven months of the year. Tourism has also been hit hard, with a significant decrease in the number of foreign tourist arrivals.
- **Credit guarantee programmes have been introduced in the two entities.** The programmes help small and medium-sized enterprises (SMEs) access finance during the pandemic.
- **A controversial new coal-fired power plant is under European Union (EU) scrutiny, but energy diversification is slowly advancing.** The state aid case of the Tuzla 7 project has been referred to the highest decision-making body of the Energy Community: the Ministerial Council. A number of small solar and wind projects are under construction or planned, as well as the diversification of gas supply routes.

Key priorities for 2021

- **Reform of state-owned enterprises (SOEs) should be high on the agenda.** The large number of SOEs impose a significant fiscal burden and have negative effects on other businesses and competition. They should be depoliticised and restructured, followed in some cases by a renewed and credible push for privatisation.
- **Further movement towards a single economic area within Bosnia and Herzegovina would help improve the quality of the business environment.** Significant differences in business conditions and procedures in the two entities continue to hinder private sector development. Also, simplifying business registration, licensing and permitting, introducing e-signatures and improving bankruptcy laws would support the post-Covid-19 economic recovery.
- **The authorities should step up their efforts to conduct structural reforms.** The pandemic has exacerbated the structural weaknesses of the economy. In order to improve growth prospects, institutional and socio-economic reforms are needed.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.1	3.2	3.7	2.7	-5.0
Inflation (average)	-1.1	1.2	1.4	0.6	-0.8
Government balance/GDP	1.2	2.6	2.2	1.9	-5.5
Current account balance/GDP	-4.7	-4.3	-3.7	-3.5	-4.5
Net FDI/GDP [neg. sign = inflows]	-1.8	-2.1	-2.5	-2.7	-1.5
External debt/GDP	63.8	72.0	64.5	65.4	n.a.
Gross reserves/GDP	31.9	33.6	34.8	35.7	n.a.
Credit to private sector/GDP	54.3	55.6	55.1	55.8	n.a.

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Covid-19: macroeconomic implications

The economy has slowed further due to the pandemic-related lockdown measures. Before the outbreak of Covid-19, economic growth had been falling. A decline of industrial output and a slowdown in the main trading partners resulted in Bosnian GDP growth dropping to 2.7 per cent in 2019 (from 3.7 per cent in 2018). Growth fell further in the first half of 2020 to 3.8 per cent year-on-year, on the back of falling exports, investment and consumption. The crisis has seriously hit the manufacturing sector, with output in this sector falling by 12.3 per cent year-on-year in the first seven months of the year. Certain industries, such as base metals and furniture production, decreased their output by more than 30 per cent year-on-year during the same period. The tourism sector has also been severely affected. In July 2020, foreign tourist arrivals in both entities were more than 80 per cent lower than in July 2019. Because of the pandemic, remittances from the country's large diaspora are also being negatively affected. Available data show that in the first half of 2020 remittances were down by 16.9 per cent year-on-year.

Inflation dropped below zero. After falling to 0.6 per cent in 2019 (from 1.4 per cent in 2018), the inflation rate continued to trend downwards in 2020 and became negative in April, averaging -0.7 per cent year-on-year in the first seven months of the year. The deflationary pressures came from several factors: a fall in transport prices (related to the decline of oil prices globally); the continuing decline of clothing and footwear prices; and the entity governments' decisions to restrict margins on oil products and prices of basic food, hygiene products, medicines and protective equipment during the pandemic emergency.

Public debt is at a moderate level but is expected to increase. As a response to the crisis, the entity governments have adopted a set of measures to mitigate the economic consequences of the pandemic (see below). Public debt was 33.0 per cent of GDP as of the first quarter of 2020, but is on a rising path as a result of falling GDP, new loan arrangements with international institutions (including €333 million under the International Monetary Fund's Rapid Finance Instrument and €250 million under the European Commission's (EC's) Macro-Financial Assistance, which is currently under discussion), and increased borrowing by governments in the domestic financial market.

After the recession in 2020, a recovery is expected in 2021. GDP is forecast to fall by 5.0 per cent in 2020 and grow by 3.0 per cent in 2021. Risks to the projection are on the downside, related to the potential return of the pandemic, slow recovery in the main eurozone export markets and uncertainty about progress in the country's reform agenda.

Policy response to Covid-19

Support measures mitigating the effects of the crisis were introduced in both entities. In the Federation of Bosnia and Herzegovina (FBIH), a Stabilisation Fund helps cover minimum wages and social contributions in affected companies, while the FBIH Development Bank set up a guarantee fund to maintain and improve the liquidity of companies. Other measures include extra funds for cantons and municipalities in the Federation, exemptions from para-fiscal fees for affected businesses, and the cancellation of advance corporate income tax payments. In the Republika Srpska (RS), a Solidarity Fund was established to support businesses, corporate income tax payments were deferred, and a fixed pricing margin for certain staple products was temporarily introduced. In addition, the RS government covered gross minimum wages for April, along with income taxes and contributions for March wages for affected businesses, and the RS Investment Development Bank deferred overdue payments. Credit guarantee programmes for SMEs have also been introduced in both entities. In August 2020 the FBIH Banking Agency and RS Banking Agency extended the moratorium on loan repayment by a further six months. Both agencies introduced the moratorium initially in March 2020 and then prolonged it by two more months. In August 2020 the RS Banking Agency also banned banks in the entity from paying dividends from 2019 profits.

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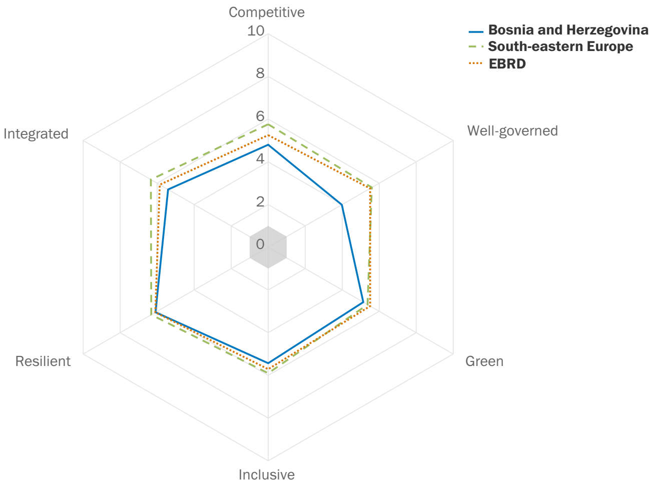
Assessment of transition qualities (1-10)



Structural reform developments

The authorities are discussing a new arrangement with the International Monetary Fund (IMF). The previous Extended Fund Facility arrangement with the IMF (€553.3 million) officially expired in September 2020 but, because of the lack of economic reforms, only two tranches were disbursed. It is expected that talks between the country's authorities and the IMF on a new arrangement will start in November 2020. The new arrangement, if agreed, is likely to focus on reforms to the health sector and response to the Covid-19 crisis, and SOEs.

There has been little progress in EU accession negotiations over the past year. The country submitted an EU membership application in February 2016. In May 2019 the EC issued the Opinion on the application, which was subsequently endorsed by the Council in December 2019. 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.

The state footprint in Bosnia and Herzegovina remains large. Around 550 SOEs in Bosnia and Herzegovina employ 80,000 people or about 10 per cent of the total workforce. Many of them are loss-makers, characterised by weak transparency, accountability and performance, and suffer from political influence. Over the past year, there has been little progress in reforming these companies.

Construction of a controversial new coal-fired power plant is advancing. Initially, the project was planned to begin in March 2020, but was delayed by the pandemic. The new 450 MW unit (Tuzla 7) at the country's largest power plant is expected to produce around 2,750 GWh of electricity annually. The project, worth around €720 million, is to be implemented by a Chinese consortium and financed mainly by a loan from China's Exim Bank. Besides posing environmental concerns, the project is also controversial because of a potential breach of EU state aid rules, related to the loan guarantee for Tuzla 7 approved by the Federation government. After terminating negotiations related to the construction of the unit with FBIH representatives without having reached an agreement in late 2019, the Energy Community Secretariat referred the Tuzla 7 state aid case to the highest decision-making body of the Energy Community, the Ministerial Council, in June 2020.

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Steps have been taken to diversify the energy portfolio towards more renewables. One of the three state-controlled power producers Elektroprivreda BiH has started the construction of a 48 MW wind park Podveležje, worth €83 million and with an expected annual output of 130 GWh. The RS power utility (ERS) has submitted to the government of RS an offer to build a solar power plant Trebinje 1, a project worth around €50 million, but with somewhat lower installed capacity (73 MW) and power output (101.5 GWh annually) than initially planned. The company is also developing a project for a 48 MW wind farm Hrgud in eastern Herzegovina, whose construction should start by the end of the year. Other projects are in the process of receiving energy permits for their construction. In June 2020 the Federation parliament adopted conclusions calling for a prohibition of the construction of small hydropower plants on the territory of the Federation of Bosnia and Herzegovina.

Banking sector non-performing loans (NPLs) are down and regulatory reforms in the sector have progressed. The capital adequacy ratio of the banking sector stood at 18.4 per cent at the end of June 2020, well above the regulatory minimum of 12.0 per cent. Still, some (primarily local) banks have insufficient capital endowments and unfavourable credit portfolios. At the same time, the NPL ratio of the banking sector stood at 6.7 per cent (down from 8.0 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 June 2020 the new Law on Deposit Insurance in Banks was adopted. The law envisages mandatory membership of banks in the deposit insurance programme, a shorter deadline for payout to depositors (20 days from the day the bank's licence is revoked, rather than the earlier 90 days) and use of funds of the Deposit Insurance Fund for bank resolution.