BOSNIA AND HERZEGOVINA

Highlights

- **Economic recovery has started in 2021.** After a gross domestic product (GDP) contraction of 3.2 per cent in 2020, the first half of 2021 was marked by positive signs for the economy, including strong growth in manufacturing output, exports and tourist overnight stays.
- **Work on transitioning away from coal has started but concerns remain about environmental sustainability.** One of the three state-owned power utilities in the country has agreed with the miners' union on a restructuring plan, but the country is in breach of environmental standards of the Large Combustion Plant Directive (LCPD).
- **Loan repayment moratoria and other Covid-19 response measures were extended.** Due to the worsening epidemiological situation in early 2021, the loan repayment moratoria were prolonged until June 2021 and other special measures for banking sector clients up to the end of December 2021.

Key priorities for 2022

- **To support post-Covid-19 recovery, public capital expenditure should be boosted and strategic planning for large capital investments introduced.** The authorities currently lack a comprehensive investment strategy, and implementation of public investment projects is often slowed by weak internal capacity, lack of financing and political disagreements.
- **Reforms of state-owned enterprises (SOEs) should be stepped up.** The country still has a large and inefficient SOE sector. Establishing a clear ownership rationale, key performance indicators and an effective governance system should improve the performance of the sector, with positive spill-over effects to the private sector and whole economy.
- **Financial stability should be closely monitored and supervisory activities properly coordinated.** Although banking supervision agencies have worked together during the Covid-19 pandemic, there is no centralised macro-prudential framework in the country. In addition, some obstacles to an effective non-performing loan (NPL) resolution (for example, facilitation of out-of-court restructurings or tax treatment of NPL sales to specialised companies) remain.

Main macroeconomic indicators %

	2017	2018	2019	2020	2021 proj.
GDP growth	3.2	3.7	2.8	-3.2	4.5
Inflation (average)	1.2	1.4	0.6	-1.6	1.8
Government balance/GDP	1.8	1.7	1.4	-4.1	-3.3
Current account balance/GDP	-4.8	-3.3	-2.8	-3.8	-3.9
Net FDI/GDP [neg. sign = inflows]	-2.3	-2.9	-1.5	-1.7	-2.2
External debt/GDP	72.0	64.4	64.3	69.5	n.a.
Gross reserves/GDP	33.6	34.8	35.7	40.5	n.a.
Credit to private sector/GDP	58.3	57.5	58.0	58.9	n.a.

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Covid-19: macroeconomic implications

After a recession in 2020, economic activity has been recovering in 2021. The economy contracted by 3.2 per cent in 2020 on the back of falling exports, consumption and investment. The tourism sector was severely affected; foreign tourist arrivals decreased by 84 per cent in 2020. Trade, transport and accommodation and food services recorded a combined decline of more than 10 per cent. The crisis also hit the manufacturing sector, where production of base metals, motor vehicles and other transport equipment fell by around 25 per cent and the production of furniture, clothes and beverages by around 15 per cent. Because of the Covid-19 pandemic, remittances from the country's large diaspora also shrank by 16 per cent, negatively affecting consumption. The recovery started in the first quarter of 2021, with GDP growing by 1.5 per cent year-on-year on the back of growth in private consumption and exports. Growth accelerated in the second quarter as the economy expanded by 11.6 per cent year-on-year, with strong expansion across all expenditure categories. Manufacturing output started expanding from March, averaging nearly 9 per cent year-on-year until September, and goods exports increased sharply in the first nine months (33.1 per cent year-on-year in nominal terms). The tourism sector is also doing significantly better, with a 112 per cent increase in overnight stays of foreign tourists in the first eight months of 2021 versus a year earlier. Still, the number of overnight stays is around 55 per cent of that in the same period in 2019.

Bosnia and Herzegovina did not secure a programme with the International Monetary Fund (IMF). The talks between the country's authorities and the IMF on a three-year Extended Fund Facility worth €750 million ended in failure in December 2020, due to disagreement over which reforms should be included in the programme. Discussions about a new programme may restart later in 2021.

Public debt has increased moderately. As a result of the entity governments requiring more financing to respond to the Covid-19 crisis, public debt rose by around 4 percentage points over the past year, to 36.7 per cent of GDP at the end of 2020. In April 2021 Republika Srpska placed a five-year Eurobond worth €300 million on international financial markets (London Stock Exchange). The Republika Srpska government planned to use the proceeds to finance the budget and repay debts. Disbursement of the European Commission (EC)'s macro-financial assistance, approved in May 2020, has progressed very slowly. The disbursement of the first instalment (€125 million) is awaiting the country's ratification of the memorandum of understanding, which was signed in January 2021. IMF special drawing rights of approximately €300 million were allocated at the end of August 2021.

Moderate growth is expected in the short term. GDP is forecast to grow by 4.5 per cent in 2021 on the back of the ongoing recovery in exports and resumption of consumption, followed by 3.0 per cent growth in 2022. Downside risks include a potentially slower recovery in the main eurozone export markets, a possible prolonged impact of the Covid-19 pandemic on tourism and the persistent unwillingness of the authorities to undertake structural reforms and increase investor confidence.

Policy response to Covid-19

The accommodating fiscal policy is continuing in 2021. Fiscal measures related to the Covid-19 response in 2020 amounted to 2.5 per cent of GDP in 2020 and are projected at around 1.8 per cent of GDP in 2021. These primarily include support for firms but also households, as well as extra spending on the health sector. In 2020 the entity governments established guarantee funds to support on-lending by commercial banks. The Federation of Bosnia and Herzegovina fund (backed by government funding of around €50 million) has no expiration date. The Republika Srpska fund (backed by government funding of around €25 million) is set to expire by the end of December 2021, but may be extended.

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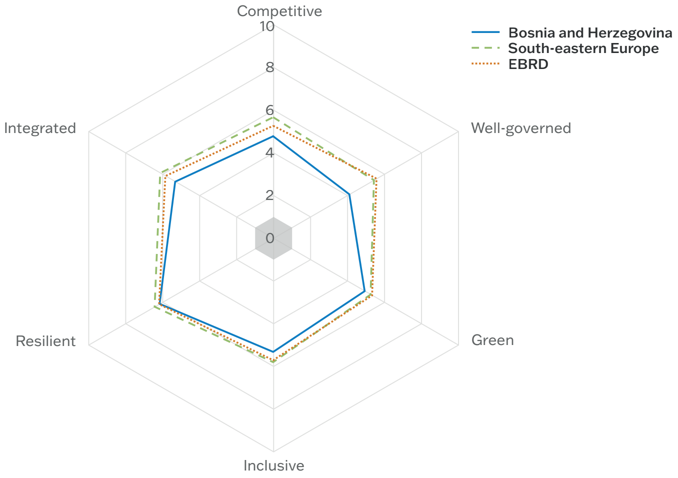
Loan repayment moratoria and other measures adopted at the onset of the Covid-19 pandemic have been extended. In March 2021 the application of the loan repayment moratoria, initially set to expire at the end of 2020, was extended by six months by the banking agencies of Republika Srpska and the Federation of Bosnia and Herzegovina, to June 2021. Other special measures, such as a grace period for repaying loan principal and a longer maturity for annuity loan repayments, were extended until the end of December 2021.

Assessment of transition qualities (1-10)



Structural reform developments

There has been limited progress in the European Union (EU) approximation process over the past year. The country submitted an EU membership application in February 2016. In May 2019 the European Commission issued its Opinion on the application, which was subsequently endorsed by the Council. The Opinion identified 14 key priorities for the country to fulfil in order to be recommended for the status of EU candidate country. In its most recent report of October 2020, the European Commission recognised that some steps have been taken to address the key priorities from the Opinion amid the Covid-19 pandemic. However, the report also states that the country is at an early stage in its level of preparedness and ability to take on the obligations of EU membership and needs to significantly step up the process to align with the EU *acquis* and implement and enforce related legislation.

Problems with energy efficiency and pollution have led to infringement procedures. Bosnia and Herzegovina is in breach of environmental standards of the LCPD. As a signatory of the Energy Community Treaty, the country is subject to the LCPD, which sets emission limits for sulphur dioxide, nitrogen oxides and dust (particulate matter) for plants with a rated thermal input equal to or above 50 MW. However, with the energy sector heavily dependent on coal, the country keeps exceeding agreed limits. Consequently, the Energy Community Secretariat launched an infringement case in March 2021. This comes on top of an existing infringement process regarding the planned Tuzla 7 thermal power plant (450 MW), the construction of which remains uncertain.

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A credible commitment to decarbonisation is still missing. While work on a National Energy and Climate Plan (NECP) is ongoing, both entities currently lack a credible and firm commitment to decarbonisation, in particular to the transition away from coal-fired power. All three state-owned electricity generators have strengthened their plans for new renewable energy sources, envisaging large investments in wind, solar and new hydropower plants. Other investments in gas interconnections for heating purposes are planned. However, some of these planned projects are already marked by controversy and it remains to be seen whether the SOEs have the financial capacity to implement these significant investments. And with the authorities' lack of firm commitment to a credible NECP and regulatory framework to enable bankable private sector investments, these renewable energy investments are placed in doubt.

Work on a transition away from coal has started in the FBiH entity. EPBiH, one of the three state-owned power utilities in the country, has initiated a reorganisation of the coal mines to make them economically sustainable. In May 2021 the government of the Federation of Bosnia and Herzegovina, EPBiH and the miners' union agreed on restructuring, which will see the number of employees in the mines fall by 2,000 to 5,200 by 2023. This plan also envisages new investments and efforts to reskill employees. Discussions on a Just Transition Roadmap have started at the state and entity levels. Renewable energy capacity has also expanded, with the wind farm Podvelezje (48 MW of installed capacity) starting operations in March 2021. In addition, in July 2021 the EPBiH announced plans to build solar power plants on former open-pit coal mines. It also launched a public call for municipalities, individuals and legal entities to express interest in selling or leasing out land for constructing photovoltaic power plants.

Banking sector NPLs are down but still relatively high. The capital adequacy ratio of the banking sector stood at 18.9 per cent at the end of March 2021, well above the regulatory minimum of 12.0 per cent. At the same time, the NPL ratio of the banking sector was at 6.0 per cent, down from 6.6 per cent a year ago but with the potential to increase once loan repayment moratoria and special measures have been lifted. During the Covid-19 pandemic, the two entity banking supervisory agencies have worked closely together to implement support measures such as debt moratoria.