Bosnia and Herzegovina

Highlights

- **The country is enjoying a better-than-expected post-pandemic recovery.** Following robust GDP growth of 7.5 per cent in 2021, the country continued to post strong growth rates in demand-driven service sectors and manufacturing in the first half of 2022.
- **The long-awaited public enterprise (PE) reform is slowly advancing.** The authorities have taken steps towards establishing PE oversight units in the two General Secretariats. Once active, the units will oversee the companies' financial performance.
- **The legislative framework to stimulate investment in renewables is gradually advancing, although the decarbonisation vision remains undeveloped.** The new legislation will replace state-determined feed-in tariffs with competitive bidding procedures for investments in clean energy.

Key priorities for 2023

- **The authorities should speed up initiatives to support the private sector and protect vulnerable groups.** Key short-term priorities in the current difficult global environment include targeted social support measures for vulnerable households, adopting a country-wide framework for e-signatures, and accelerating the digitalisation of public services.
- **A plan for green transition needs to be formed.** Setting up a vision for a decarbonisation pathway is crucial for Bosnia and Herzegovina, particularly given the large projected impact of the European Union (EU)'s forthcoming carbon border adjustment mechanism on the country's exports. The legislative package governing renewables should be finalised as soon as possible to leverage investor interest.
- **Reform of state-owned enterprises (SOEs) should progress.** Key steps required include operationalisation of SOE oversight units, implementation of systemic monitoring of fiscal risk stemming from state guarantees, and the creation of a country-wide SOE registry. The rationale for state ownership should be outlined in a State Ownership Policy document.

TABLE Main macroeconomic indicators %

	2018	2019	2020	2021	2022 proj.
GDP growth	3.7	2.8	-3.1	7.5	3.0
Inflation (average)	1.4	0.6	-1.1	2.0	10.5
Government balance/GDP	1.7	1.4	-4.7	0.7	0.5
Current account balance/GDP	-3.3	-2.6	-3.3	-2.4	-4.3
Net FDI/GDP [neg. sign = inflows]	-2.9	-2.1	-1.8	-2.3	-1.6
External debt/GDP	64.4	64.3	69.5	58.9	n.a.
Gross reserves/GDP	34.8	35.7	40.5	42.3	n.a.
Credit to private sector/GDP	57.5	58.0	58.5	54.0	n.a.

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Macroeconomic developments and policy response

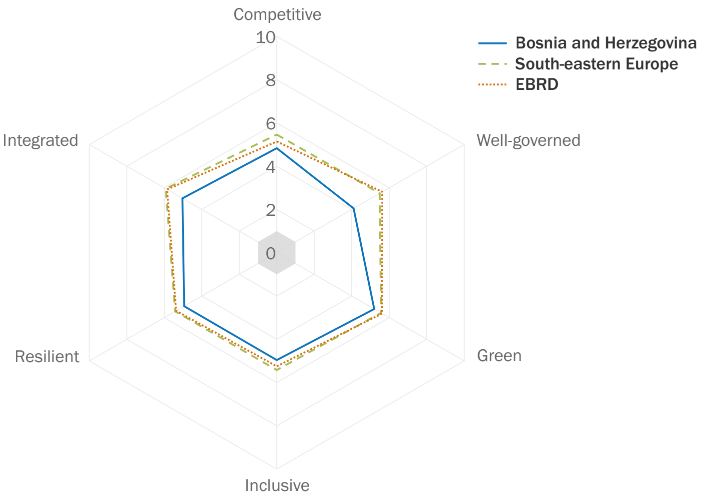
Robust economic growth continued into the first quarter of 2022. The economy expanded by 7.5 per cent in 2021, driven by very strong external demand and recovering domestic consumption, although investment remained weak. The first half of 2022 was marked by a continued expansion of GDP by 5.9 per cent year on year. Growth was led by investment, which rose by 24 per cent year on year, albeit partly driven by the base effect and a likely increase in inventories, and private consumption which grew by 3.5 per cent in real terms. Services led the expansion on the production side, as the fastest-growing sectors were trade, transport and hospitality, as well as information and communication services, followed closely by manufacturing. Exports continued to post strong growth rates in annual terms (30 per cent in the first half of the year), although their contribution was outstripped by imports rising to meet both producer and consumer demand. In line with the increased trade deficit in goods and elevated energy prices, the current account deficit doubled on an annual basis.

Inflation surged to unprecedented levels. The annual inflation rate has been rising since mid-2021 and reached a record-breaking 16.8 per cent in August 2022. While nearly all divisions of the consumer basket have registered price increases, the highest were food and transport, in line with globally rising food commodity and oil prices and the high proportion of household consumption going towards food. Unlike most countries in Europe, electricity has not been as significant a cause of inflationary pressures in Bosnia and Herzegovina as it continues to come from domestic coal-based production at below-market prices.

The authorities have implemented fiscal policy measures in an effort to shield the economy from rising prices. One-off increases in state aid for different categories were implemented and higher-than-planned pension hikes approved in the second quarter of 2022. While the Republika Srpska (RS) entity hiked electricity prices for firms at the beginning of 2022 but kept them well below market levels, the Federation of Bosnia and Herzegovina (FBiH) adopted in December 2021 an amendment to the Law on Electricity to enable a 20 per cent limit on electricity price increases for firms. Both entities have kept prices for households capped. A country-wide 90-day ban on log, firewood and pellet exports used for heating was adopted in June 2022 to curb price increases.

Growth is expected to moderate. GDP growth is forecast at 3.0 per cent in 2022 and 2.3 per cent in 2023 as risks tilt towards the downside. The economic impact of the war on Ukraine is expected to be reflected in a further rise in prices, thus eroding disposable income, a slowdown in the eurozone, Bosnia and Herzegovina's main export market, and increased geopolitical uncertainty. While political challenges associated with the elections in October 2022 complicate the short-term outlook, the economy's resilience demonstrated in recent years and a robust growth performance in the first half of the year bode well for short-term prospects.

CHART Assessment of transition qualities (1-10)



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Structural reform developments

The European Commission has issued a conditional recommendation for EU candidate status. In 2019 the European Commission issued the Opinion on Bosnia and Herzegovina's application for EU membership, identifying 14 key priorities for the country to implement to become an EU candidate country. These priorities – a roadmap for a comprehensive EU reform agenda – lie in the areas of democracy and functionality of institutions, rule of law, fundamental rights and public administration reform. Although progress in implementation has been slow thus far, in June 2022 the European Council expressed its readiness to grant the status of candidate country pending the European Commission's assessment of the progress in implementation of the 14 key priorities. In October 2022 the European Commission recommended that Bosnia and Herzegovina be granted candidate status by the European Council, on the understanding that steps were taken in eight concrete areas of reform.

Incremental progress has been made on PE reform. The PE sector is large and poorly documented in Bosnia and Herzegovina, with around 550 PEs that account for upwards of 10 per cent of all employment, many of which are low productivity loss-makers. While PE reform is a long-standing issue, the authorities in both entities have recently affirmed a commitment to reform. Both entities took steps towards establishing central oversight units for PEs in 2022, although full regulatory frameworks have not yet been adopted. A reform plan for SOEs has been in place in the RS since mid-2021, while the FBiH is continually updating a registry of SOEs, albeit with incomplete financial reporting.

Supervisory and regulatory banking sector standards have received equivalence status to the EU. The prudence of Bosnia and Herzegovina's supervisory and regulatory requirements was affirmed by a European Banking Authority assessment of equivalence to those of the EU, published in November 2021. Nonetheless, the financial safety net is incomplete due to the weak bank resolution framework in the absence of an effective country-wide financial stability fund which could provide liquidity on an exceptional basis when required to ensure stability. The need for an effective lender of last resort was illustrated when, in February 2022 following Russia's invasion of Ukraine, the EU imposed sanctions on Russian-owned Sberbank, which resulted in significant deposit withdrawals. A prompt sale of the bank in both entities helped to ensure stability of the sector.

The lifetime of two highly polluting coal-powered thermal power plants was extended. The country's three oldest power generation units (Tuzla 3, Tuzla 4 and Kakanj 5) "opted out" of the EU's Large Combustion Plant Directive (LCPD) in 2016, meaning that they are allowed to operate for a total of 20,000 hours between 2018 and 2023, after which they need to either close or comply with limits under the new Industrial Emissions Directive. Against the backdrop of a global energy price increase, in March 2022 the parliament of FBiH cancelled the opt-out regime for Tuzla 4 and Kakanj 5, and decided to extend their operations to 2028. The Energy Community Secretariat, which opened a case against the country in February 2022 for failing to meet the emissions ceiling set in its National Emission Reduction Plan (NERP), has stated that this was a clear breach of the country's obligations. Financing for a new Tuzla 7 power plant came into question in July, when the State Aid Council ruled that the guarantee from FBiH constitutes as illegal state aid, aligning its decision with European state aid enforcement standards.

The legislative groundwork for renewable energy development is slowly advancing. The new Law on Renewable Energy Sources entered into force in the RS in March 2022, setting out competitive bidding procedures as determinants of incentives for larger renewable capacities. The law introduces two new concepts: prosumer – a customer that builds and connects to a renewable-source power plant for self-consumption; and Renewable Energy Community – a legal entity entitled to produce, consume, store and trade electricity from renewable sources between members of the Community and access all energy markets. A similar piece of legislation, the draft Law on the Use of Renewable Energy Sources and Efficient Cogeneration, was adopted by the government of FBiH and is set to go through the entity's parliament. The draft law similarly adopts the two concepts, but establishes that both feed-in tariffs for small plants and feed-in premiums for large plants are to be determined through auctions.

The Law on Public Procurement was amended. The adoption of the amendment in August 2022, following years of parliamentary procedure, aligns public procurement legislation further with the EU's and is an important step in fighting corruption and organised crime.