Country report **BOSNIA AND HERZEGOVINA**

Summary

After several years of relatively strong pre-crisis growth, Bosnia and Herzegovina's economy will likely head back into recession this year. Falling export demand and very weak domestic demand due to high unemployment, a poor business environment and needed austerity measures leave no room for growth. Meanwhile, following debt service delays last year, the central and regional governments will have to cut back on spending in order to meet the demands of a new IMF standby-agreement and thereby avoid a sovereign default. The formation of a central government this year, following the 2010 legislative elections, bodes well in this respect. However, the associated public sector wage cuts and possible job losses could exacerbate lingering ethnic tensions amid a climate of rising ethnically-based nationalism, which could lead to incidences of social unrest. Meanwhile, due to very weak domestic demand, Bosnia and Herzegovina's current account deficit is expected to decline to more sustainable levels, which should help keep foreign exchange reserves are at the currently acceptable level.

Things to watch:

- Economic recovery in former Yugoslavian countries and the euro area
- Implementation of austerity measures
- Rising nationalism and tensions between the various ethnic groups

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Bosnia and Herzegovina

National facts	
Type of government	Emerging federal republic
Capital	Sarajevo
Surface area (thousand sq km)	51
Population (millions)	3.8
Main languages	Bosnian (official)
	Croatian (official)
Main religions	Muslim (40%)
	Christian Orthodox (31%)
	Roman Catholic (15%)
Head of State (president)	Bakir Izetbegović (Bosniak)
	Željko Komšić (Croat)
	Nebojša Radmanović (Serb)
Head of Government (prime-minister)	Vjekoslav Bevanda
Monetary unit	Convertible Marka (BAM)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	18	0.03
Nominal GDP at PPP	33	0.04
Export value of goods and services	7	0.03
IMF quotum (in mln SDR)	169	0.08
Economic structure	*2011*	*5-year av.*
Real GDP growth	1.2	3.1
Agriculture (% of GDP)	8	9
Industry (% of GDP)	26	26
Services (% of GDP)	65	65
Standards of living	*USD*	*% world av.*
Nominal GDP per head	4877	45
Nominal GDP per head at PPP	8875	72
Real GDP per head	3371	41

Social and governance indicators	rank / total
Human Development Index (rank)	74 / 187
Ease of doing business (rank)	125 / 183
Economic freedom index (rank)	104 / 179
Corruption perceptions index (rank)	91 / 183
Press freedom index (rank)	58 / 178
Gini index (income distribution)	36.21
Population below $1.25 per day (PPP)	2.00%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Slovenia	18	Croatia	20
Croatia	15	Germany	13
Italy	15	Slovenia	13
Germany	14	Italy	10

Main export products (%)	
Base metals	22
Mineral products	17
Machinery & mechanical appliances	10
Woord & Wood products	6
Main import products (%)	
Mineral products	20
Machinery	13
Foodstuffs	11
Base metals	9
Openness of the economy	
Export value of G&S (% of GDP)	40
Import value of G&S (% of GDP)	63
Inward FDI (% of GDP)	3.0

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Twenty years after the start of its devastating civil war, Bosnia and Herzegovina (BiH) remains one of the poorest countries in Europe. Given a nominal GDP of USD 18bn and a population of 3.8m, nominal GDP per capita amounted to a mere USD 4,877 last year, or USD 8,875 in PPP terms. Following years of high reconstruction-driven growth in the 1990's, BiH's economic expansion has lost steam in recent years and the country fails to exploit its considerable economic potential in the fields of tourism, low-cost manufacturing, and natural resource extraction (e.g. bauxite or oil). Lacking reforms of BiH's poor business climate, political gridlock and lingering uncertainty about the future of the current administrative set-up explain part of this problem, as they undermine domestic and foreign investors' confidence. These problems are reflected in BiH's very weak performance on both the World Bank's Ease of Doing Business index (125/183) and the Economic Freedom index (104/179) of the Heritage Foundation.

Unfortunately, the outlook for major improvements is rather bleak. The intricate multi-layered ethnically-based administrative structures that have been introduced by the Dayton Peace Agreement obstruct efficient policymaking. Additionally, rising tensions and lacking willingness to compromise between the three ethnic groups – Bosnian Muslims (Bosniaks), Catholic Croats and Christian Orthodox Serbs – further reduce the chances for any meaningful improvement in the years to come. Consequently, business activity will continue to be hampered by widespread corruption, poorly defined property rights, unclear local and federal regulation, or even declining access to export markets as BiH fails to implement legislation required to guarantee minimum quality standards (for more on this latter topic please refer to the economic policy section).

Due to its difficult operating environment and the widespread presence of political patronage, the government has become a major employer in BiH, which is reflected in the large size of the services sector that generates about 2/3 of total output. The country's narrow industrial sector, which mainly produces base metals, mechanical appliances and intermediary industrial products, accounts for a quarter of total output. Agricultural production generates about 10% of GDP. BiH mainly exports base metals, mineral products and machinery to the former Yugoslav republics of Croatia and Slovenia, as well as Germany and Italy. Mineral products, particularly oil and fuels, machinery and foodstuff constitute its most important imports.

BiH's banking sector is dominated by four foreign-owned banks, which together hold about 70% of all bank assets. The sector also comprises various smaller local banks. With a Tier 1-ratio of 12% at the end of the third quarter of 2011, the banking sector appears to be adequately capitalized. However, the increase in the sector-wide non-performing loan ratio to 12.6% in late 2011, from 5.9% in 2009, and likely further asset quality deterioration amid a rather challenging economic outlook could gradually undermine bank capitalization level. As 95% of bank assets are held by foreign banks, mainly from Austria, Italy and Slovenia, withdrawals of funds from the BiH subsidiaries to support their parent banks cannot be ruled out completely, which particularly holds for the currently very weak Slovenian banks and to a minor degree also for Italian banks. Unless the signing of a new IMF standby-agreement enables BiH's government entities to tap into international capital markets, rising exposures to local government debt could also burden BiH's banking sector. Additional risks might also arise from currency mismatches on the banks' balance sheet, if the current peg of BiH's convertible mark were to break.

Figure 1: Economic growth

Source: EIU

Figure 2: Unemployment and inflation

Source: Central Bank of Bosnia and Herzegovina, EIU

Following a 3.1% contraction in 2009, BiH's economy embarked on a rather lackluster recovery in 2010 and 2011, posting growth rates of just 0.7% and 1.2%, respectively. Amid a very challenging external and domestic environment, BiH's economy is expected to relapse into recession this year, before growth is expected to recover to about 1% next year. While external demand suffers from the ongoing euro area sovereign debt crisis, very high unemployment levels, necessary austerity measures, and tight credit conditions depress domestic demand. Even though remittances inflows, mainly from Germany, should remain a stabilizing factor for domestic demand going forward, the risks to the growth outlook are tilted to the downside, given considerable uncertainty about the further development of the euro area debt crisis and the still lingering risk of outbursts of ethnic violence if the economic and employment situation were to worsen considerably.

Political and social situation

While being conceived as a temporary political solution to end BiH's civil war, the 1995 Dayton Peace Agreement's ethnically-based administrative and political structures still determine the country's political life. Consequently, BiH is divided between two ethnically-based entities, the Bosniak-Croat Federation of Bosnia and Herzegovina (Fed BiH) and the Bosnian-Serb Republika Srpska (RS), as well as the district of Brcko. The latter is administrated by the United Nations High Representative for Bosnia and Herzegovina. Reflecting its multi-ethnic composition, the Fed BiH is subdivided into various cantons with their own local governments. Overarching the two entities and one district is the central government. BiH's central government includes members of the three ethnic entities, while the presidency rotates every eight months among the members of the multi-ethnic presidential troika. The United Nations remain represented by the Office of the High Representative (OHR), which has the power to intervene in local politics if necessary. Even though the intricate ethnicity-based system helped pacify the civil war-torn country in the 1990's, its rigid structures and focus on ethnic representation turned into a major obstacle in recent years and cemented an ethnically-based political landscape.

Following a 15-month stalemate in the aftermath of the inconclusive October 2010 federal elections, BiH's current central government was formed in January 2012. The coalition government comprises six parties representing BiH's three ethnic entities and it is headed by the Bosnian-Croat Vjekoslav Bevanda. Central government stability is weak at best, however, and remains exposed to destabilization attempts by local politicians, particularly from the RS, that oppose the strengthening of federal institutions. The recent cancellation of all cabinet meetings following Bosnian-Serb protests against BiH's support for a UN resolution on Syria illustrates the central government's weakness vis-à-vis political interests of the two entities Fed BiH and RS. Consequently, the outlook for needed structural reforms to improve BiH's business climate and the overdue review of the country's constitution remain bleak, which contributes to the risk of a near-term break-up of BiH. Still, given international opposition to such a development, as well as a widespread apathy regarding political developments within both entities, the likelihood of an actual break-up is rather low.

Notwithstanding, tensions between the different ethnic groups are expected to increase in the coming year due to the renewed recession and possibly sizeable cost-cutting measures in the public sector. Also, various memorial events commemorating the 20th anniversary of the civil war could lead to further ethnic polarization, as the focus on the siege of Sarajevo and the Srebrenica massacre by Bosnian Serbs could further alienate the RS from the Fed BiH. The same also holds for Bosniaks and Croats, who also fought each other, but formed an alliance in a later stage of the civil war. Calls by Bosnian Croats (10% of BiH's population) for the separation of the Fed BiH into a Bosniak and a Croat entity bear witness to the lingering tensions between the former allies. The same holds for recent rumors indicating Croat opposition to increased control by the Fed BiH government (and thus also Bosniaks) over local police forces. Amid ongoing ethnic tensions, shifting control over armed and law enforcement forces to the multi-ethnic central government remains highly contentious. This illustrates that none of the ethnic groups seems to completely exclude the possibility of renewed violent conflict. While we do not expect the outbreak of hostilities in the near future, we caution that the worsened economic situation increases the risk of social unrest and could lead to local incidences of violence, particularly against refugees that have returned to areas that are now under the control of another ethnic group. General awareness among all ethnicities of a swift NATO/EU intervention in case of rising violence should also act as a deterrent, even though the presence of EU forces has been reduced in recent years and the United Nation's Office of the High Representative is expected to be closed next year.

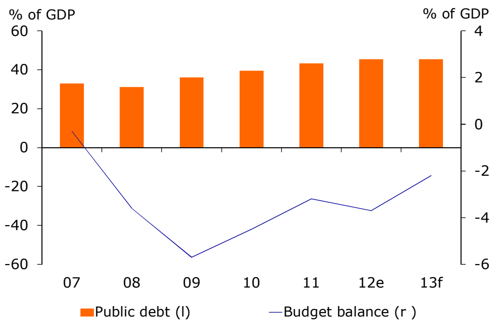
BiH's external relations mainly focus on the country's accession to the EU and NATO, while the two entities Fed BiH and, in particular, the RS also try to deepen their bilateral relations with other former Yugoslav republics. Although BiH has signed a Stabilization and Association Agreement (SAA) with the EU, progress towards eventual membership is slow, as BiH's fails to implement necessary (constitutional) reforms that ensure that the country meets minimum European standards. The prospects for NATO membership are slightly better, though recent reforms to strengthen BiH's federal army required considerable compromises with the RS, which is rather critical of NATO accession.

Economic policy

Unsurprisingly, BiH's economic policy suffers from the political stalemate at the federal level and the conduct of various uncoordinated policies in the different entities, which provides an explanation for the country's poor business climate. In spite of the common challenges posed by the current economic difficulties, co-operation between the entities is minimal. For example, Croatia, which is one of BiH's key trade partners, will join the EU next year and hence will adhere to EU standards in the area of food safety. As BiH's politicians cannot agree on whether the entities or the central government should be responsible for food safety, large parts of BiH's agricultural exports could be blocked, which could drive thousands of farmers into bankruptcy.

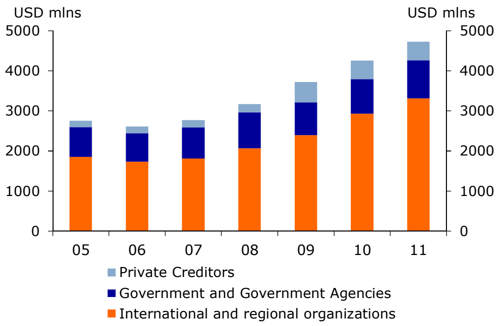
Also if it comes to the fiscal situation, the different parties hinder progress. Particularly since the outbreak of the global economic crisis, the weaknesses of BiH's taxation system continue to haunt the country with recurrent sizeable budget deficits. BiH therefore applied for a three-year IMF standby agreement (SBA) in 2009, but the program had to be interrupted in 2010 because of fiscal and political difficulties as BiH struggled to form a central government. Given BiH's challenging economic outlook, the country has again applied and received preliminary support for another two-year USD 500m IMF SBA this year. Also, faced with the prospect of sovereign default, the central and local governments embarked on fiscal austerity ahead of the IMF's decision. The ensuing public spending cuts, which will likely entail wage cuts, lay-offs and limited pension cuts (also for war veterans) are highly contentious and lack general support across all coalition partners at the federal level. Consequently, the adoption of the 2011 and 2012 budget had been postponed, which resulted in various foreign debt repayment delays in early 2011.

Figure 3: Public finances



Source: EIU

Figure 4: Creditors of foreign public debt



Source: Central Bank of Bosnia and Herzegovina

Following the adoption of the 2012 budget earlier this year, BiH's budget deficit is expected to come in at 3.7% of GDP this year, which represents a further deterioration with respect to the 2011 budget deficit of 3.2% of GDP. Provided BiH manages to implement the recently adopted austerity measures and sticks to the conditions imposed under the (likely) renewed IMF SBA, its budget deficit is expected to decline to 2% of GDP next year.

Due to recurrent large budget deficits and a weak economic performance, BiH's public debt burden is expected to have increased from 33% of GDP in 2007 to 46% of GDP in 2012. Given this year's repayment of the previous IMF SBA, the public debt ratio is expected to remain stable next year, in spite of the renewed large budget deficit. BiH's public debt is largely concessional and owed to international and regional organizations, like the EBRD and the IMF. Even though budgetary rules explicitly prioritize external debt service, access to international capital markets remains very limited, which recently forced the (local) governments to tap the shallow local capital markets. Given insufficient access to private external funding, continuous multilateral support is needed to avoid a sovereign default.

BiH's currency, the convertible marka (KM) (de-facto the former Deutsche Mark) is pegged to the euro at 1.995 KM, which forces the country to adopt the ECB's monetary policy stance. Earlier periods of relative euro strength vis-à-vis currencies of other former Yugoslav republics led to some concerns about BiH's competitiveness, but due to the current euro weakness, BiH's exports should actually benefit from the peg.

Balance of Payments

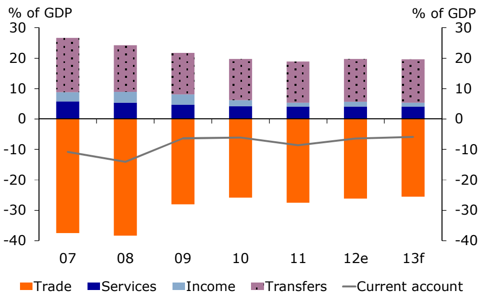
Due to a very large structural deficit on the trade balance, BiH tends to run recurrent sizeable current account deficits in recent years. The current account deficit increased from 6.1% of GDP in 2010 to 8.7% of GDP last year, as rising commodity prices for energy and foodstuffs drove imports, while exports suffered from the weak economic performance in the euro area and neighboring countries. Benefitting from the relatively positive economic development in Germany, home to a considerable number of Bosnian refugees, BiH's structural transfer balance surplus improved from 13.5% of GDP in 2010 to 14% of GDP in 2011, but this improvement could not compensate for weaker net exports of goods and services. Given very weak domestic demand and a rebound in exports on the back of rising prices for base metals, BiH's current account deficit is expected to decline to about 6-7% of GDP this year before falling to 6% of GDP next year.

While foreign direct investment inflows suffered from the economic turmoil in the euro area in recent years and merely covered about a-third of the current account deficit, they could cover the entire current account deficit in the coming years, particularly if Shell, which received exclusive oil and gas exploration rights in BiH, decides to develop the local energy sector.

External position

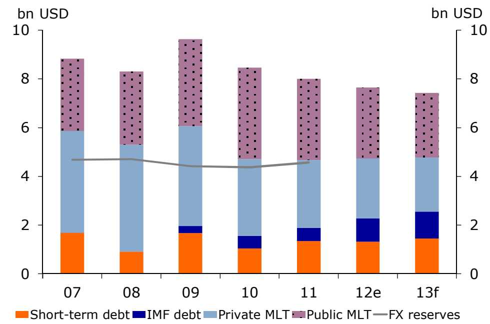
BiH's current external position is acceptable. Total external debt amounted to about 40% of GDP last year with short-term debt accounting for about one-sixth of the total foreign debt load. Public and private medium-to-long term debt both stood at about 17% of GDP last year, while IMF debt reached a level of about 3% of GDP last year. Owing to BiH's limited access to international capital markets and the likely renewal of the IMF SBA, private external debt is expected to fall to about 14% of GDP, while IMF debt will rise to about 6%. As most of the external debt is owed to multilateral organizations or individual countries, BiH's external debt position benefits from relatively generous debt repayment conditions and a certain degree of leniency.

Figure 5: Current account



Source: EIU

Figure 6: Foreign debt and FX reserves



Source: Central Bank of Bosnia and Herzegovina, EIU

In spite of recurrent large current account deficits, BiH's foreign exchange reserves remained relatively constant at about USD 4.5bn, which equals about 50% of total foreign debt or 350% of short-term debt. This level corresponds to an import cover of 4.9 months. The current level of reserves should guarantee the stability of the peg of the convertible marka to the euro in the coming years.

Bosnia and Herzegovina

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.1	5.7	-3.1	0.7	1.2	-0.2	0.8
Consumer prices (average % change pa)	1.6	7.4	-0.4	2.1	3.7	2.2	2.1
Current account balance (% of GDP)	-10.8	-14.1	-6.3	-6.1	-8.7	-6.4	-5.9
Net foreign exchange reserves (mln USD)	4685	4710	4415	4371	4568	n.a.	n.a.
Economic growth							
GDP (% real change pa)	6.1	5.7	-3.1	0.7	1.2	-0.2	0.8
Economic policy							
Budget balance (% of GDP)	-0.3	-3.6	-5.7	-4.5	-3.2	-3.7	-2.2
Public debt (% of GDP)	33	31	36	40	43	46	46
M2 growth (% change pa)	21	4	2	7	6	2	5
Consumer prices (average % change pa)	1.6	7.4	-0.4	2.1	3.7	2.2	2.1
Exchange rate LCU to USD (average)	1.4	1.3	1.4	1.5	1.4	1.5	1.5
Recorded unemployment (%)	29.0	23.4	24.1	27.2	27.6	n.a.	n.a.
Balance of payments (mln USD)							
Current account balance	-1648	-2605	-1075	-1009	-1583	-1110	-1030
Trade balance	-5704	-7097	-4754	-4293	-5034	-4500	-4450
Export value of goods	4243	5194	4080	4937	6030	5790	5960
Import value of goods	9947	12291	8834	9230	11064	10290	10410
Services balance	879	980	797	695	755	700	720
Income balance	460	672	579	331	227	270	210
Transfer balance	2718	2841	2303	2258	2469	2420	2490
Net direct investment flows	2042	968	230	222	540	390	790
Net debt flows	1392	-450	946	-996	661	620	710
Change in international reserves	1371	-562	49	-163	-217	300	150
External position (mln USD)							
Total foreign debt	8823	8303	9625	8457	7996	7640	7430
Short-term debt	1687	905	1677	1037	1348	1320	1450
Total debt service due, incl. short-term debt	1607	2133	1705	3036	1681	2000	2070
Total foreign exchange reserves	4685	4710	4415	4371	4568	n.a.	n.a.
International investment position	-5397	-8253	-10018	-9693	n.a.	n.a.	n.a.
Total assets	9189	8605	8793	7927	n.a.	n.a.	n.a.
Total liabilities	14586	16858	18811	17620	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-37.5	-38.4	-28.1	-25.8	-27.5	-26.1	-25.5
Current account balance (% of GDP)	-10.8	-14.1	-6.3	-6.1	-8.7	-6.4	-5.9
Inward FDI (% of GDP)	13.6	5.3	1.4	1.4	3.0	2.3	4.6
Foreign debt (% of GDP)	58	45	57	51	44	44	43
Foreign debt (% of XGSIT)	91	75	108	91	75	75	70
International investment position (% of GDP)	-35.4	-44.6	-59.1	-58.3	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	17	19	19	33	16	19	20
Interest service ratio incl. arrears (% of XGSIT)	3	3	3	2	2	2	2

Source: Central Bank of Bosnia and Herzegovina, EIU