

Country report

Bosnia and Herzegovina



Summary

After the devastating war in the early '90s, Bosnia and Herzegovina (BH) has managed to get itself back on track economically, although many problems remain. Structural unemployment, a big current account deficit, a lack of well-enforced property rights and an bureaucratic and complex fiscal system are just a few of the problems that need solving. BH was approved for an IMF-loan in 2009, which relieved financial pressures. However, elaborate reforms in the country's politics and economy are necessary if it wishes to continue on a sustainable growth path. The political impasse that has followed elections in late 2010 poses a major threat to BH's economic future. If current reforms are not expanded on the short term, BH will face an economic downturn and an increasingly strained relationship with the international (financial) community.

Things to watch:

- Continuing political stalemate.
- Further delay of reforms.

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Bosnia and Herzegovina

National facts			Social and governance indicators		rank / total	
Type of government	Emerging federal democratic republic		Human Development Index (rank)	68 / 169		
Capital	Sarajevo		Ease of doing business (rank)	110 / 183		
Surface area (thousand sq km)	51,197		Economic freedom index (rank)	104 / 179		
Population (millions)	3.8		Corruption perceptions index (rank)	91 / 178		
Main languages	Bosnian (official; 48%) Croatian (official; 14.3%) Serbian (37.1%)		Press freedom index (rank)	47 / 178		
Main religions	Muslim (40%) Orthodox (31%) Roman Catholic (15%)		Gini index (income distribution)	36.2		
Head of State (president)	Bakir Izetbegovic (Bosniak) Zeljko Komsic (Croat) Nebojsa Radmanovic (Serb)		Population below \$1.25 per day (PPP)	2.00%		
Head of Government (prime-minister)	Nikola Spiric		Foreign trade 2010			
Monetary unit	Marka (KM)		Main export partners (%)		Main import partners (%)	
Economy 2010			Croatia	15	Croatia	15
Economic size			Germany	15	Germany	10
	<i>bn USD</i>	<i>% world total</i>	Serbia	13	Serbia	10
Nominal GDP	17	0.03	Italy	12	Italy	9
Nominal GDP at PPP	32	0.04	Main export products (%)			
Export value of goods and services	6	0.03	Base metals	22		
IMF quatum (in mln SDR)	169	0.08	Mineral products	17		
Economic structure			Machinery & mechanical appliances	10		
	2010	5-year av.	Wood & wood products	6		
Real GDP growth	0.8	3.7	Main import products (%)			
Services (% of GDP)	64	65	Mineral products	20		
Industry (% of GDP)	26	26	Machinery	13		
Agriculture (% of GDP)	10	10	Base metals	10		
Standards of living			Foodstuffs	10		
	<i>USD</i>	<i>% world av.</i>	Openness of the economy			
Nominal GDP per head	4422	45	Export value of G&S (% of GDP)	37		
Nominal GDP per head at PPP	8551	73	Import value of G&S (% of GDP)	59		
Real GDP per head	3327	42	Inward FDI (% of GDP)	0.3		

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

Economic structure and growth

The war that ravaged Bosnia and Herzegovina (BH) during the early 1990s wreaked havoc on the country's economy, almost entirely shutting down national production and causing unemployment to skyrocket. Although BH did manage to achieve rapid economic growth in the first couple of years after the end of the war in 1995, output growth slowed again in the late 1990s. As a result, BH is one of the poorest countries in the Balkan, with real GDP at 3,327 USD, just 42% of the global average GDP. The global financial crisis caused a negative GDP growth of some 3% in 2009, but the economy grew again at +0.8% over 2010. Growth was driven by a strong surge in manufacturing and utilities, while construction and agriculture impacted GDP negatively over 2010. GDP-growth has continued during the first quarters of 2011. Assuming that BH's government will approve some elaborate financial and fiscal reforms, growth is expected to pick up again to about 3% over the next couple of years, boosted mainly by an increase in private consumption, FDI and exports.

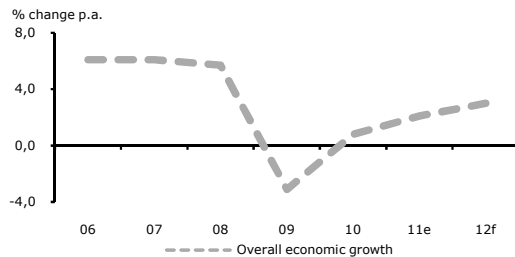
The services sector is the most important in BH's economy, accounting for 64% of total GDP. Industry accounts for a further 26%, agriculture accounts for 10%. BH's major export commodities are metals, clothing and wood products. Exports are quite undiversified and rely heavily on a number of key manufacturing sectors, making the country more vulnerable to changes in commodity prices. Export diversification is thus an area of focus for the government, as there is still a lot to gain as a source of economic growth. Most of the country's imports consist of fuels, machinery and foods. BH's main trading partners are Slovenia, Croatia, Italy, Germany and Austria.

BH has a couple of structural problems, the first being unemployment. At the end of the war, the unemployment rate was extremely high, spurring on the creation of a large informal sector in BH. This large informal sector still creates market distortions today. Although unemployment has fallen significantly over the last couple of years, BH's unemployment rate remains one of the highest of the region. Over the course of 2009, unemployment rose to 27.2%, after falling steadily for a good number of years. The unemployment rate is expected to remain around the 27% figure during the next couple of years.

Two other structural concerns in BH are corruption and the lack of property rights. Although some improvements have been made, the numbers remain grim. Corruption is widespread in BH. The country ranks 91st out of 178 countries on the Corruption Perceptions Index, the worst rank in the region. There also is a lack of well enforced property rights in BH, which makes contracts hard to enforce and seriously impedes BH's social and economic development.

BH's banking sector is small and underdeveloped. Still, the sector is relatively stable and is responsible for a big part of the country's FDI. A big part of the banks is in foreign hands, with Austrian banks being the most prevalent in BH.

Graph 1: Economic growth



Source: EIU

Political and social situation

Although some improvements are being made, political instability is expected to endure until the next elections in 2014, unless all parties in BH agree to compromise.

BH is a relatively young state, gaining independence in 1992. The country is split into two separate entities, the Bosnian Muslim (Bosniak)-Croat Federation of Bosnia I Herzegovina (FBiH) and the Bosnian-Serb Republika Srpska (RS). It also includes a self-governing district, Brcko, under the sovereignty of the central state government. BH's population is ethnically divided, being split into three ethnicities (Bosniak, Serb, and Croat). This ethnic divide is also represented in Bosnia's politics; the country is headed by three presidents, each representing one of the three main ethnicities, who rotate through the presidency every eight months. Elections are held in the separate entities, and the elected parties from the FBiH and RS are represented in the national government.

The most recent elections, held in October 2010, were dominated by ethnic nationalism, which has caused some major problems in BH. Although the Bosniak and Croat politicians have had a more moderate tone after the elections, advocating the importance of national unity, the elected Serb politicians are more radical, advocating fragmentation and seeking greater autonomy for the RS. The tensions between these parties make it very unlikely that a stable political coalition can be forged in the short term. Swift adoption of much needed reforms in the country's economy and complex political sector is thus equally unlikely.

BH's external relations are fragile, but have been improving over the last couple of years. The EU-led stabilization force (SFOR) is still present in the country and sometimes exacerbates political

tensions as they push for widespread reforms. However, the EU is gradually cutting back its presence. Relations with BH's direct neighbors (Croatia, Serbia and Montenegro) remain tense in the aftermath of the regional turmoil of the early 1990s, but improvements are being made through FTAs and regional co-operation for further integration into the EU. Also, the region's combined effort to catch the war-criminals sought after by the UN war crimes tribunal in The Hague, the last of which was arrested on July 20th of this year, has cleared the path for further reconciliation and has earned them much praise from the EU. A potential threat for regional reconciliation is the proclamation of independence by Kosovo, which continues to cause friction in the Balkan. Although increasing ethnic tensions could still potentially have a negative effect on bilateral relations, a reprise of the events of the early 1990s is unlikely.

One of BH's major political goals is integration into the European Union. In June of 2008, BH signed a stabilisation and association agreement (SAA) with the EU, agreeing on elaborate reforms before accession is considered. The slow pace of reforms after the last elections could negatively affect BH's EU-ambitions, as there is a chance that other EU-members will become less positive about enlargement of the EU. However, the likely EU-accession of Croatia in 2013 might provide a positive impetus, especially as the Croatian president has pledged to support BH and Serbia on their way to EU-integration.

Throughout 2010, reports were made that BH was being used as a recruiting and training base for Islamic militants by al-Qaeda. Exacerbated by the growing political tensions, Muslim extremism within BH is posing an increasingly large threat for stability in the country over the next year.

Economic policy

The political stalemate that followed the 2010 elections has worsened BH's economic problems and has heightened economic risk for 2011, as decisions for necessary reforms have been delayed. Although BH was making some progress during the last couple of years, the political impasse brings with it a great deal of uncertainty about the country's medium-run economic policies and prospects.

Over the next couple of years, BH's economic policy will mostly be shaped by demands from the IMF and from the EU. A major focus will thus be put on structural reforms, privatization and the abolition of custom duties for the rest of the EU.

Public debt has doubled over the last five years, from 22% of GDP in 2006 to an expected 44% of GDP in 2011. This increase was driven mostly by external borrowing for budget support and investment projects. Although public debt seems to be sustainable at the moment, reforms are necessary to prevent BH's debt burden from worsening.

The global financial crisis negatively affected BH's economy, triggering a collapse in both domestic and international demand, and forcing the government to turn to the IMF in early 2009 in the face of mounting financing pressures. A three-year stand-by arrangement worth 1.1 billion EUR was signed with the IMF in May 2009. Up until now, BH has managed to meet IMF-demands and to remain on good terms with the Fund. However, the enduring political turmoil might strain their relation.

Conditions for IMF-support are, among other things, changes in the country's financial sector and elaborate reforms in its fiscal policy in order to centralize and simplify its taxation policies and maximize fiscal revenues and foreign direct investment (FDI). Although BH successfully introduced Value-Added Tax (VAT) in 2006, its tax system is complex and lacks central guidance, creating major fiscal deficits. FBiH, RS and the Brcko district all have separate taxation systems and laws. BH is hoping to decrease its fiscal deficit in 2011 to 3% of GDP, down from 4.5% in 2010. Unfavourable taxes for international residents and companies are a major deterrent for international investments in BH. Furthermore, fiscal problems go hand in hand with corruption.

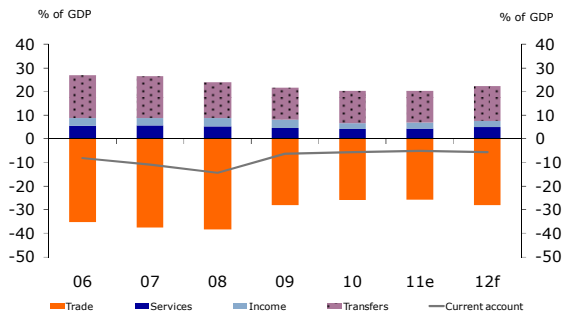
The K-marka, BH’s local currency, is pegged to the Euro. The peg to the euro could have some important consequences for BH’s competitiveness, as the currencies of two of BH’s top export markets (Croatia and Serbia) are floating. However, earlier concerns that the K-marka could be overvalued have been eased by the weakening of the euro during 2011. The peg to the euro and free capital flows within BH also mean that the country cannot yield a fully independent monetary policy. Still, BH has a stable monetary market and exchange rate and has managed to keep inflation low.

Balance of Payments

BH has a relatively large current account deficit. However, external deficits dropped during 2009/10, as the trade deficit shrank and remittances from Bosnians working abroad grew. The current account deficit is mainly driven by a large trade deficit, but is reduced somewhat by BH’s positive transfer balance. Although import prices are expected to rise, tighter fiscal policies will limit BH’s import demand, so the current-account deficit is expected to remain stable during the course of the next year at about 5-6% of GDP.

In 2010, FDI-flows reached their lowest level since 1998. The low levels are however mostly explained by the unrest in the euro zone, where most of BH’s foreign investment comes from. FDI-flows are expected to pick up again at the end of this year and continue the upward trend over the next couple of years. International reserves decreased during the last three years, but are expected to rise again over 2011/12.

Chart 2: Decomposition of current account balance



Source: EIU

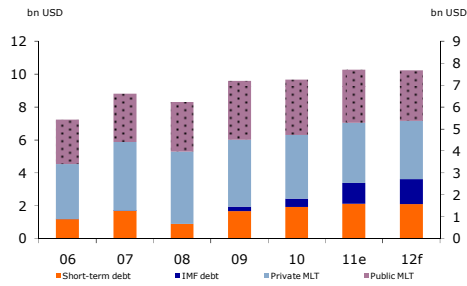
External position

BH’s external position is expected to remain stable over the next couple of years, but is vulnerable to a number of external shocks. Lower GDP-growth, exchange rate depreciation and higher primary deficits could worsen BH’s debt position. Last year, BH’s debt-to-GDP ratio was approximately 58% of GDP, somewhat lower than elsewhere in the region. It has increased markedly over the last couple of years, mainly due to the IMF-loan. Assuming that all-important reforms will not be put off indefinitely and none of the external shocks mentioned earlier will occur, external debt seems to be manageable in the coming years. However, if one of the external shocks does occur, the debt-to-GDP ratio could rise to 85-90%.

One worrying sign when looking at the way BH’s total debt is financed is the increase in arrears since 2009. A growth in the amount of debt that is left unpaid could strain relations with the country’s creditors, potentially exacerbated by a lack of useful reforms caused by the current political stalemate.

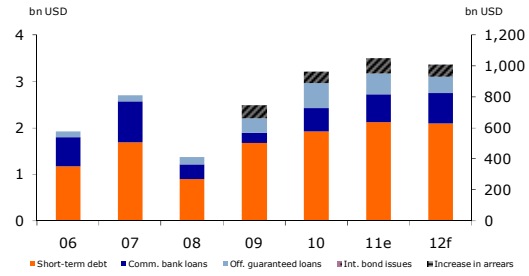
Short-term debt is relatively small in BH, comprising some 20% of total foreign debt.

Chart 3: Decomposition of total external debt



Source: EIU

Chart 4: Decomposition of total debt financing



Source: EIU

Bosnia and Herzegovina							
Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
<i>Key country risk indicators</i>							
GDP (% real change pa)	6.1	6.1	5.7	-3.1	0.8	2.1	3.0
Consumer prices (average % change pa)	7.2	1.6	7.4	-0.4	2.1	3.8	3.1
Current account balance (% of GDP)	-8.2	-10.8	-14.3	-6.3	-5.5	-5.2	-5.6
<i>Economic growth</i>							
GDP (% real change pa)	6.1	6.1	5.7	-3.1	0.8	2.1	3.0
<i>Economic policy</i>							
Budget balance (% of GDP)	1.1	-0.3	-3.6	-5.7	-4.5	-3.0	-2.3
Public debt (% of GDP)	22	33	31	35	39	44	45
M2 growth (% change pa)	24	22	4	2	7	10	13
Consumer prices (average % change pa)	7.2	1.6	7.4	-0.4	2.1	3.8	3.1
Exchange rate LCU to USD (average)	1.6	1.4	1.3	1.4	1.5	1.4	1.5
Recorded unemployment (%)	n.a.	29.0	23.4	24.1	27.2	27.6	27.3
<i>Balance of payments (mln USD)</i>							
Current account balance	-998	-1648	-2637	-1066	-917	-950	-990
Trade balance	-4298	-5704	-7097	-4754	-4293	-4670	-4980
Export value of goods	3381	4243	5194	4080	4937	5580	6080
Import value of goods	7679	9947	12291	8834	9230	10250	11070
Services balance	673	879	980	797	692	800	900
Income balance	393	460	640	587	428	480	480
Transfer balance	2234	2718	2841	2303	2257	2440	2610
Net direct investment flows	764	2042	908	245	50	650	1200
Net debt flows	899	1392	-450	1234	1395	1430	1080
Change in international reserves	841	1153	-1009	-270	-865	470	450
<i>External position (mln USD)</i>							
Total foreign debt	7242	8823	8303	9583	9678	10280	10260
Short-term debt	1171	1687	905	1677	1929	2120	2100
Total debt service due, incl. short-term debt	1208	1607	2133	1551	2160	2380	2560
International investment position	-851	-4	-1845	-2885	n.a.	n.a.	n.a.
Total assets	5478	8001	7046	7037	n.a.	n.a.	n.a.
Total liabilities	6328	8004	8891	9922	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	-35.1	-37.5	-38.4	-28.1	-25.8	-25.6	-27.9
Current account balance (% of GDP)	-8.2	-10.8	-14.3	-6.3	-5.5	-5.2	-5.6
Inward FDI (% of GDP)	6.3	13.6	5.0	1.4	0.3	3.6	6.7
Foreign debt (% of GDP)	59	58	45	57	58	56	58
Foreign debt (% of XGSIT)	95	91	75	108	104	97	88
International investment position (% of GDP)	-7.0	0.0	-10.0	-17.0	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	16	17	19	17	23	22	22
Interest service ratio incl. arrears (% of XGSIT)	2	3	3	3	4	3	2

* IHS Global Insight

Source: EIU

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