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Bosnia and Herzegovina: politics still hamper economic development

At present, the political atmosphere is chilly in Bosnia and Herzegovina (BiH). The leaders of Republika Srpska consider the entity's far-reaching autonomy endangered: Representatives of the international community, including the current High Representative Paddy Ashdown, want more power to be given to the central government. From time to time this causes annoyance. The idea of building up a country-wide police, army, tax authority, social security administration, electricity grid management, telecommunications system or even statistical office and putting such bodies under one central command has always provoked fierce opposition, in an open or hidden way. Though not all citizens are opposed to the implementation or strengthening of central institutions, they could not achieve or sustain a majority in the various parliaments of the country. Among the successes one can list the creation of a central bank for the whole country immediately after the war, as foreseen in the Dayton agreement, and, a few years later, the introduction of the convertible mark (BAM) as the countrywide legal tender. Another encouraging step was a single Indirect Tax Authority (ITA), which started its work in January 2005 as a preparatory step for the introduction of a countrywide value-added tax system. The ITA has started collecting indirect taxes – which are not yet value-added taxes – and distributes revenues to BiH institutions. After meeting claims of institutions at the state level, the residual goes to the Federation (65.7%), the Republika Srpska (30.5%) and the Brčko District (3.8%). The new system, to be completed by the VAT introduction on 1 September 2005 or 1 January 2006, will make it much easier for BiH manufacturers to sell their products countrywide. Slowly, BiH is thus becoming a uniform economic space, something which has been torpedoed for a decade.

Difficulties with more cohesion are not only (hu)man-made. The Neretva valley, with Mostar as its urban centre and Neum as its costal area, opens towards the Adriatic Sea and has an economic focus differing from the rest of the country. Three regional centres to the north, Bihać, Banja Luka and Tuzla are, from an infrastructure point of view, linked to the plain adjacent to the Sava river, where the Balkans' most important traffic lines, the motor- and railway between Belgrade and Zagreb, are located, both of them directly linked to the EU. From these three centres, driving a car or truck south to Sarajevo or Mostar requires more time and effort than going to, say, Zagreb. Post-war Sarajevo's economic basis has been its function as a capital where all representatives of the international community and of some transnational companies settled and opened their offices. They have hardly enough time to visit the more remote parts of the country, including even Banja Luka. A motorway, under construction now, will link Banja Luka to Croatia's motorway, not

to Sarajevo. The precondition for more cohesion within BiH would be the modernization of traffic lines between the country's regional centres, something that would require considerable investment.

A major problem with present structures is that the constitution, which has evolved from the Washington (March 1994) and the Dayton (December 1995) Agreements, foresees an amount of state institutions that would hardly be affordable even for a rich country. They employ a large number of persons and the public institutions' aggregate wage bill, together with social security expenditures, absorb most of the funds the state authorities are able to collect or to get transferred. The social security system pays small average amounts to a large number of persons: pensioners, disabled persons and unemployed. Public institutions are the country's most important employer, but are lacking efficiency. As the number of institutions is larger than the number of tasks to be fulfilled, an overlapping of competences is frequent, and their activities are often based on incompatible rules.

Several large companies had dominated the pre-war economy. They were integrated in larger production chains, and some of them had expanded their activities worldwide. After 1995, the necessary preconditions for their recovery were lacking and they continued as walking dead. A few of them did better than the rest, such as the aluminium producer in Mostar, now a company with private owners. Recently hope for a recovery and massive expansion of the steel factory in Zenica has spread thanks to the involvement of a global player, LNM, as direct investor. Logistics will require an upgrading of transport ways, as large amounts of input will have to be imported and most of the output will have to be shipped abroad. This very large project is likely to stimulate a wider range of business activities and further foreign investment. A number of other foreign companies, most of them from the wider neighbourhood, have recently signalled interest in the purchase of a majority share in the petrol distributor Energopetrol.

In several sectors of the economy, a large number of small and medium-size enterprises are active. Metallurgy, including the production of car components, has been a traditional stronghold of the BiH economy, and a lot of activity is going on in this field. The same is true for wood processing, textiles and clothing, food production and construction. In all these sectors, foreign direct investors are present to some extent. FDI stocks totalled, thanks to an inflow of close to EUR 0.4 billion in 2004, EUR 1.4 billion at the end of the year, most of it concentrated in metallurgy and banking.

The fixed exchange rate – approximately 2 BAM per EUR in the context of a currency board arrangement – has proved very helpful. It allowed to overcome the population's initial deep distrust with the banking sector, and inflation, measured by the retail price index, is stable. However, the average gross monthly wage rate is relatively high: it was more than EUR 380 in 2004, and thus higher than in Bulgaria (EUR 149), Romania

(EUR 204) and even Slovakia (EUR 377). The overall price level is probably not much lower than in Slovakia and thus much above Bulgarian and Romanian levels. In other words, being competitive is difficult for BiH producers of tradable goods. Statistics indicate that exports cover only about one third of imports, and there is no sign that in the

nearer future this ratio will increase substantially. It would, however, not be justified to blame the wage level alone for this fact. The EU has granted favourable conditions for imports from BiH, but enterprises are not in a position to make much use of it. One of the reasons for that is the lack of a state agency that after its accreditation by the EU would make sure that exports meet EU standards. In its feasibility study from November 2003 the European Commission listed a number of improvements to be achieved before negotiations on a Stabilization and Association Agreement (SAA) can start. Progress is slow despite popular support for quick and comprehensive EU integration.

Another crucial barrier for more international competitiveness of BiH enterprises is the lack of funds to be invested in new equipment and sometimes even production material. The profits earned by BiH manufacturers are not sufficient to finance larger investment projects, and long-term credits, as required for the purchase of new equipment, are costly if accessible at all. Commercial banks are hesitant to grant such loans, not matter that they have collected a relatively large amount of deposits, which they prefer to lend to households or invest abroad. Only with fair bankruptcy procedures becoming the rule and with well-functioning real estate markets might banks start regarding loans to the manufacturing sector as a business with bearable risk.

During the next few years, the GDP will continue to grow by some 5% p.a. Industrial production will go on rising at a higher rate, fuelled by rather strong export growth. Over time, export-oriented enterprises may gain strength also in terms of political influence. Overcoming obsolete institutional and political structures will then become much easier. Inflation is likely to re-emerge temporarily in the context of the VAT introduction. Unemployment can be assumed to remain stable, disregarding the fact that nobody knows its genuine extent since reliable measurement practices are so far non-existent.

Table BA

Bosnia and Herzegovina: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 ¹⁾	2005	2006
								forecast	
Population, th pers., mid-year	3654.0	3725.0	3781.0	3798.0	3828.0	3832.0	.	.	.
Gross domestic product, BAM mn, nom.	7559	8990	10050	10960	11650	12255	13000	13700	14400
annual change in % (real)	15.6	10.0	5.5	4.5	5.5	3.5	6	5	5
GDP/capita (EUR at exchange rate)	1049	1234	1359	1475	1556	1635	1730	.	.
GDP including NOE, BAM mn, nom. ²⁾	.	12802	14160	15410	16170	16887	17900	.	.
GDP/capita, incl. NOE (EUR at PPP - wiiw)	.	4660	4940	5230	5520	5670	6090	.	.
Gross industrial production									
annual change in % (real) ³⁾	23.6	8.0	7.9	4.9	5.7	5.1	12	10	10
Employees total, th pers., end of period	651.3	630.9	640.6	625.6	637.7	634.0	.	.	.
annual change in %	.	-3.1	1.5	-2.3	1.9	-0.6	.	.	.
Reg. unemployed, th pers., end of period	398.5	409.3	421.2	422.2	441.9	459.6	.	.	.
Reg. unemployment rate in %, end of period	38.0	39.3	39.7	40.3	40.9	42.0	42	42	42
Average gross monthly wages, BAM	454	503	541	652	661	716	747 ^{1-X}	.	.
annual change in % (real, net) ⁴⁾	.	9.7	4.0	14.8	-0.6	7.3	.	.	.
Retail prices, % p.a.	13.3	3.7	4.8	3.1	0.4	0.6	0.2 ^{1-X}	0.5	0.5
General government budget, in % of GDP									
Revenues	.	57.7	53.8	49.7	44.1	43.3	.	.	.
Expenditures	.	65.5	60.7	53.1	44.2	42.6	.	.	.
Deficit (-) / surplus (+), % GDP	.	-7.8	-7.0	-3.3	-0.2	0.8	.	.	.
Public debt in % of GDP	.	.	58.8	48.2	42.2	34.0	.	.	.
Current account, EUR mn	-644.6	-966.3	-1050.0	-1273.3	-1695.3	-1895.3	-1838.0	-1700	-1600
Current account in % of GDP	-16.8	-21.0	-20.4	-22.7	-28.5	-30.2	-27.7	-24.3	-21.7
Gross reserves of CB excl. gold, EUR mn ⁵⁾	144.7	442.6	522.2	1378.7	1260.0	1421.7	1743.5 ^{IX}	.	.
Gross external debt, EUR mn ⁵⁾⁶⁾	.	1914.7	2073.6	2260.6	2193.8	2054.2	2083.6 ^{IX}	.	.
FDI net inflow, EUR mn	59.6	165.9	158.6	132.8	281.8	337.6	400 ⁷⁾	.	.
Exports of goods, BOP, EUR mn ⁵⁾	592.4	780.7	1226.3	1268.1	1168.5	1303.0	1629.0	2000	2400
annual growth rate in %	.	31.8	57.1	3.4	-7.9	11.5	25.0	23	20
Imports of goods, BOP, EUR mn ⁵⁾	3372.5	3875.3	4226.7	4576.4	4692.2	4974.1	5284.6	5600	5900
annual growth rate in %	.	14.9	9.1	8.3	2.5	6.0	6.2	6	5
Exports of services, BOP, EUR mn ⁵⁾	394.9	416.9	462.6	528.4	528.8	588.4	685.2	.	.
annual growth rate in %	.	5.6	11.0	14.2	0.1	11.3	16.5	.	.
Imports of services, BOP, EUR mn ⁵⁾	246.3	272.6	307.5	318.5	339.5	366.5	379.7	.	.
annual growth rate in %	.	10.7	12.8	3.6	6.6	8.0	3.6	.	.
Average exchange rate BAM/USD	1.761	1.834	2.119	2.186	2.077	1.734	1.575	.	.
Average exchange rate BAM/EUR (ECU)	1.972	1.956	1.956	1.956	1.956	1.956	1.956	1.96	1.96
Purchasing power parity BAM/USD, wiiw ⁸⁾	.	0.646	0.669	0.682	0.677	0.677	0.664	.	.
Purchasing power parity BAM/EUR, wiiw ⁸⁾	.	0.738	0.758	0.776	0.765	0.777	0.763	.	.

Notes: BAM: ISO code for the convertible mark in Bosnia and Herzegovina. - 1) Preliminary. - 2) GDP figures including the Non-Observed Economy (NOE) are based on IMF estimates. - 3) wiiw estimates based on weighted averages for the two entities (Federation BH and Republika Srpska). - 4) wiiw calculation. - 5) Converted from the national currency to EUR at the official exchange rate. - 6) General government foreign debt. - 7) wiiw estimate. - 8) Rough estimates based on World Bank and wiiw; price level presumably higher.

Source: wiiw Database incorporating national statistics; IMF, wiiw forecasts.