Bosnia and Herzegovina

OUTLOOK

Based on strong domestic demand and favourable external conditions, economic growth will accelerate in Bosnia and Herzegovina to slightly below 7 % in 2007. But in the long run this strong economic momentum will be sustainable only if political forces join up in pressing ahead with economic, institutional, legal and administrative reforms. Up to now, however, the political elite has been unable to take advantage of the favourable economic climate in order to push forward with major structural adjustments, even though, admittedly, the privatisation process has gathered some momentum recently. With a view to maintaining the macroeconomic stability achieved so far, Bosnian policymakers will have to cope with an increasing fiscal burden, high unemployment and a current account deficit which is unsustainable in the long run. Yet despite the high external imbalances, the currency board arrangement remains credible.

MOODY'S LT FC RATING
B2/Stable

S&P'S LT FC RATING
Not rated

FITCH LT FC RATING
Not rated

SPREAD AVG (AUG) N.A.
EMBI+ Spread on Euro Curve

Macroeconomic data and forecasts

	2005	2006	2007f	2008f	2009f
Nominal GDP (EUR bn)	8.7	9.8	10.6	11.7	12.8
Per capita GDP (EUR)	2,250	2,540	2,760	3,040	3,330
Real GDP, yoy (%)	4.3	6.2	6.7	6.5	6.3
Inflation (CPI), yoy, eop. (%)	4.3	6.0	3.7	2.2	2.8
Inflation (CPI), yoy, avg. (%)	3.8	7.4	1.8	3.4	3.1
Unemployment rate, avg. (%)	44.1	44.5	44.0	42.5	41.0
Exchange rate BAM/EUR, eop./avg.	1.96	1.96	1.96	1.96	1.96
Current account balance/GDP (%)	–19.8	–10.7	–16.9	–17.5	–18.0
FDI/GDP (%)	4.9	3.5	12.0	5.5	6.0
Budget balance/GDP (%)	2.4	2.9	2.3	1.9	1.3
Public debt/GDP (%)	25.6	21.3	19.3	17.5	16.0
Total external debt/GDP (%)	57.9	57.1	58.4	59.7	61.2

Source: CBBH, Agency for Statistics of BiH, Federal Office of Statistics, RS Institute of Statistics, UniCredit Group New Europe Research Network.

MAIN TOPICS

- In the first nine months of 2007 BiH's political forces were unable to break the long-lasting political deadlock regarding the police and constitutional reform, though both are a precondition for signing an SAA with the EU.
- Early indicators record strong economic momentum for 2007, with economic growth expected to accelerate to 6.7 % on the back of strong domestic demand.
- Although inflation will accelerate on rising food and energy prices toward year-end 2007, the inflationary environment remains benign.
- The budget closed Q1 2007 with a huge surplus, but given a higher wage outflow and stepped-up public investments, the next quarters will see substantial fiscal easing.
- Due to brisk domestic demand and the related high import propensity, external imbalances widened massively in Q1 2007, despite booming exports. However, financing concerns are mitigated for the time being by record high FDI inflows and foreign exchange reserves.

Political discord overshadows solid economic performance

Stalling political reforms

The expected reform stimulus following the formation of new governments in the spring has yet to materialise. As in the last decade, crucial political issues such as the police and public broadcasting reform have fallen victim to policymaking along ethnic lines. But the new High Representative Miroslav Lajcak, who took office on 1 July 2007, seems determined to wrap up police reform talks by the end of the year. This could at last pave the way for the signing of a Stabilisation and Association Agreement (SAA) with the EU, for which technical negotiations were wrapped up in December 2006. The main political success in recent months was the ratification of the CEFTA free trade agreement (signed at year-end 2006) by the state parliament on 5 September 2007.

Strong economic growth

According to the most recent, detailed statistical data, GDP reached EUR 9.8 bn in 2006 corresponding to per capita GDP of EUR 2,540, while economic growth accelerated to 6.2 %. The growth drivers were manufacturing, trade, finance, transport, storage and communication, as well as real estate and other business activities. Given its strong sustained momentum in 2007 we expect the manufacturing industry to remain the key pillar of growth, albeit against the background of an uneven development in the two entities. While growth in industrial output accelerated significantly in the FBiH to +13.1 % in H1 2007, it slowed to a meagre 0.3 % in the RS, following two years of double-digit growth rates. But other early indicators (e.g. strong wage and credit growth, booming retail sales) also imply strong sustained economic momentum, which is expected to result in GDP growth of 6.7 % in 2007.

Budget in surplus

For the fourth consecutive year in a row, the general government budget recorded a surplus in 2006, reaching a huge EUR 285 mn or 2.9 % of GDP. Budget revenues grew by 22.9 % to 44.8 % of GDP as a result of the introduction of VAT in 2006. But the windfall revenues also whetted the state's spending appetite (in particular in the run-up to the parliamentary elections) with expenditures climbing by 20.6 % to 41.9 % of GDP over the year, reflecting an oversized public sector. Similarly, Q1 2007 results revealed a huge surplus of EUR 160 mn (Q1 2006: EUR 103 mn), albeit against the background of provisional budget financing, which sets limits on state expenditures. Thus, given the anticipated fiscal easing in the remainder of 2007 with a view to both wage policy and public investments, the budget is expected to close with a smaller surplus of just over 2 % of GDP in 2007.

Given strong economic growth and huge budget surpluses, (foreign) public debt has been decreasing strongly since 2001, reaching EUR 2.1 bn or 21.3 % of GDP. Domestic debt is practically non-existent, but is expected to rise rapidly in the coming years given the generous compensation schemes (e.g. restitution, war damage, frozen foreign currency deposits) adopted in 2006. In order to settle commitments based on frozen foreign currency deposits, initial plans call for the launching of a new bond issue in January 2008 with an estimated value of over EUR 1 bn. In this respect, with the introduction of regulatory borrowing ceilings in the RS on 30 March 2007 an important step has been made toward strengthening fiscal discipline in BiH. According to the regulations, the forecasted debt service is limited to 18 % of previous year's budget revenues. While a similar regulation was passed at state level in 2005, it is still waiting approval in the FBiH.

Low inflation

Inflationary pressures that emerged in 2006 following the introduction of VAT have largely subsided. Hence, in light of a huge base effect, retail price inflation averaged only a moderate 1.3 % in the first eight months of 2007. Given the currency board regime and the related indirect monetary tightening (recent and planned ECB rate hikes), inflationary pressures are also expected to remain benign for the rest of the year, even though rising food and energy prices might bring some upward pressure toward year-end 2007. Nevertheless, we see inflation averaging out at a low 1.8 % in 2007. The fading base effect, continuously high energy and food prices, planned adjustments to regulated prices, as well as a lax wage policy (with a 25 % wage increase in the public sector planned for next year in the RS) are, however, expected to push inflation to just below 4 % in 2008.

Rising external imbalances

After a short improvement in the current account balance in 2006 as a result of the VAT introduction, BiH's external imbalances again widened considerably in Q1 2007, with the current account deficit more than doubling in year-on-year terms (although against the background of a strong base effect) and reaching some EUR 267 mn or 2.5 % of estimated 2007 GDP (Q1 2006: EUR 114 mn or 1.2 % of GDP) on the back of a massive widening of the trade deficit. All other sub-balances of the current account generated a more or less larger surplus than in Q1 2006 and thus countered a further deterioration of the current account. In the coming quarter a similar picture should characterise developments given a further increasing trade deficit, with exports growing by 11.6 % and imports expanding by 18.4 % in Q2 (even from a much higher base). However, the financing concerns are mitigated this year due to record FDI inflows following major privatisation successes (e.g. Telekom Srpska). Moreover, the strong capital inflows boosted the country's foreign exchange reserves to a record level of EUR 3.2 bn as of end-July, covering over five months of imports of goods and services and thus providing a significant cushion in the event of unexpected market shocks.

Event	Date	Reading
Budget 2008	Q4 2007	Given the loose wage policy and ambitious public investment programs fiscal relaxation is expected for 2008, with the generous compensation schemes adopted in 2006 additionally burdening the budget.