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Economic perspectives on Bosnia and Herzegovina in the period of global crisis

Fikret Causevic

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Bosnia and Herzegovina as a small open economy

Bosnia and Herzegovina (BiH) is a small open economy whose share in world GDP over the past five years has been 0.035%, and whose share in the world's population has been 0.048%.[1] Due to the war in Bosnia (1992-1995) the country's GDP was reduced from USD10.7 billion (1991) to USD3.2 billion (1996). From 2001 to 2010 the country has managed to increase its GDP per capita from 25% to 75% of the world average GDP per capita.[2]

The Central Bank of Bosnia and Herzegovina (the Bank) was established in August 1997 and the single currency (the Convertible Mark - KM) was introduced in June 1998. Since its establishment the Bank has been functioning as a currency board. The exchange rate of the KM has been fixed (1EUR=KM1.95583). The only monetary policy instrument available to the Bank is the required reserves ratio In accordance with the Law on the Central Bank of BiH, the Bank is not allowed to pursue the lender of last resort function, and it is prevented from conducting open market operations. Therefore, the Bank is completely insulated from the possibility of influencing interest rates and the money supply.

In terms of the Mundell-Fleming IS-LM-BP model[3], the supply of money in BiH is fully endogenous. Monetary policy is therefore a passive segment of economic policy, and exchange-rate policy is based on a hard peg. Both the interest rate and the exchange rate are thus passive instruments.[4] Since financial liberalization in BiH in the period 1998-2003,

[1] The author's calculation based on the World Bank data (http://data.worldbank.org/country/bosnia-and-herzegovina)
[2] The author's calculation based on the World Bank data.
[3]The seminal papers for the development of IS-LM-BP model were: Mundell, Robert A. (1963). "Capital mobility and stabilization policy under fixed and flexible exchange rates". *Canadian Journal of Economic and Political Science* 29 (4): 475–485.; Fleming, J. Marcus (1962). "Domestic financial policies under fixed and floating exchange rates". *IMF Staff Papers* 9: 369–379.
[4]Changes in the money supply in an economy with a currency board regime are determined by changes in the current account balance. See more in: Hanke, S.. L.Jonung, K.Schuler (1993) *Russian currency and finance: a currency board approach to reform*, Routledge, pp. 62-70. (http://books.google.ba/books?id=avtbA3ZIYX8C&pg=PA14&lpg=PA14&dq=russian+currency+and+finance&

the banking system has been privatized and under the full control of foreign banks. Current account convertibility has been fully adopted, while capital account convertibility, with an exception of the possibility of buying majority stakes in companies in the military industry, games of chance and public information, has also been established.

In other words, BiH is a classical example of a small open economy where the only active segment of macroeconomic policy is fiscal policy. BiH is also an economy to which we can fully apply the Mundell-Fleming 'impossible trinity' of macroeconomic policy.[5] The manner in which fiscal policy is pursued, therefore, has great significance for the direction of the business cycle and the balance of payments equilibrium. In line with the Mundell-Fleming model, an increase in government spending can be financed in the two following ways: by an increase in taxes, and by issuing public debt (government bonds). The issuance of long-term government bonds to finance infrastructure (capital) projects has not been practiced in BiH since the war. The only long-term bonds that have been issued in BiH so far were government bonds of the two entities (Federation of BiH – FBiH; - and Republic of Srpska - RS). These bonds were issued to compensate for the so-called pre-war frozen foreign currency savings as an internal public debt inherited after the breakup of former Yugoslavia.

Economic growth and reforms in the 1997-2007 period

According to The Economist, BiH was the 17th fastest growing economy in the world in the period 1997-2007. The average growth rate for the period was 11.2 percent in real terms.[6] From 1996 to 2000, the average growth rate was above 25 percent. This was mainly due its recovery from a very low base (in 1991 BiH GDP was USD 10.2 billion, while in 1996 it was only USD 3.2 billion). Between 1996 and 2000, financial resources were largely channelled into the reconstruction of housing, infrastructure, and public services. Resources available for business sector development were much more modest and

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[5]On the impossible trinity and quadrilemma see: http://economics.ucsc.edu/research/downloads/quadrilemma-aizenman-11.pdf

[6] The Economist, *The Pocket World in Figures 2010*, Profile Books, London, 2009, p.32.

limited in scope. Employment growth between 1996 and 2000 was largely due to the large scale of reconstruction projects in the aforementioned sectors.[7]

In the next period (2001-2008), economic growth was predominantly based on enabling greater capacity exploitation in business and industry, privatisation, restructuring, strengthening the financial sector, and attracting foreign direct investment. Thanks to the tender privatization some of the most important foreign investors came to the manufacturing industry of BiH. The most prominent foreign investors in the manufacturing are: Arcelor Mittal Zenica (steel production), Global ISPAT Company (coke production), Heidelberg Cement Gmbh (cement production), Neftegazovaya Innovatsionnaya Korporatsiya OAO (Oil Rafinery), Prevent Group (leader cover for cars), Alumina Factory Birac Zvornik (alumina and zeolit production), CIMOS TMD Gradacac (automotive), Mann Hummel Tesanj (automotive), Alloy Wheels Jajce (automotive industry), Meggle (milk and diary production), and Hayat-Natron-Kastamone Entegre (paper and pulp production).

After the war in BiH, thorough and speedy reforms were carried out in the banking sector. Thanks to a newly adopted legislative framework that was compatible with the European and international standards, the banking sector in BiH has been rapidly improved. The Law on Foreign Direct Investment (1998) was adopted in the meantime, allowing non-residents to buy stakes and shares in domestic private and state-owned banks, or to establish new commercial banks. At the end of 2000 Raiffeisen Bank was the first commercial bank from Western Europe deciding to enter the Bosnian market. Raiffeisen Bank Sarajevo became a market leader in BiH in the period of 2000-2011, with a market share of 17.9% in 2011. In addition to Raiffeisen Bank Sarajevo, the next five biggest banks in the banking sector are the following: UniCredit Mostar (17.2%), Hypo-Alpe-Adria Group (Banja Luka and Mostar – 16.9%), NLB Group (Tuzla and Banja Luka – 9.9%), Intesa

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[7] Kreimer, A., R.Muscat, A.Elwan, M.Arnold (2000) *Bosnia and Herzegovina: Post-Conflict Recountruction – Country Case Studies*, The World Bank, Washington. http://lnweb90.worldbank.org/oed/oeddoclib.nsf/DocUNIDViewForJavaSearch/2F51C7E5E306C53D85256ED10079278A/$file/bosnia_post_conflict.pdf

Sanpaolo Sarajevo (6.1%), and Nova Banka Banja Luka (4.2%). In 2011, Austrian banks controled 42.3% of the market share, Italian banks 23.3%, and Slovenian banks 14.1%.[8]

From 2004 to 2010 total assets of the banking sector grew by 124%, credit to enterprises by 143%, and credit to households by 136%. In the same period, total assets grew from 59.6% to 86.1% of GDP, credit to enterprises from 20.2% to 31.6% of GDP, and credit to households from 17.1% to 26.1% of GDP. However, credit expansion and the increase in banking system assets were most remarkable in the period of 2005-2008. In that period, the average (annual) rate of growth of credit to enterprises was 23.6%, while credit to households and total assets grew by 26.4% and 22.7% respectively.

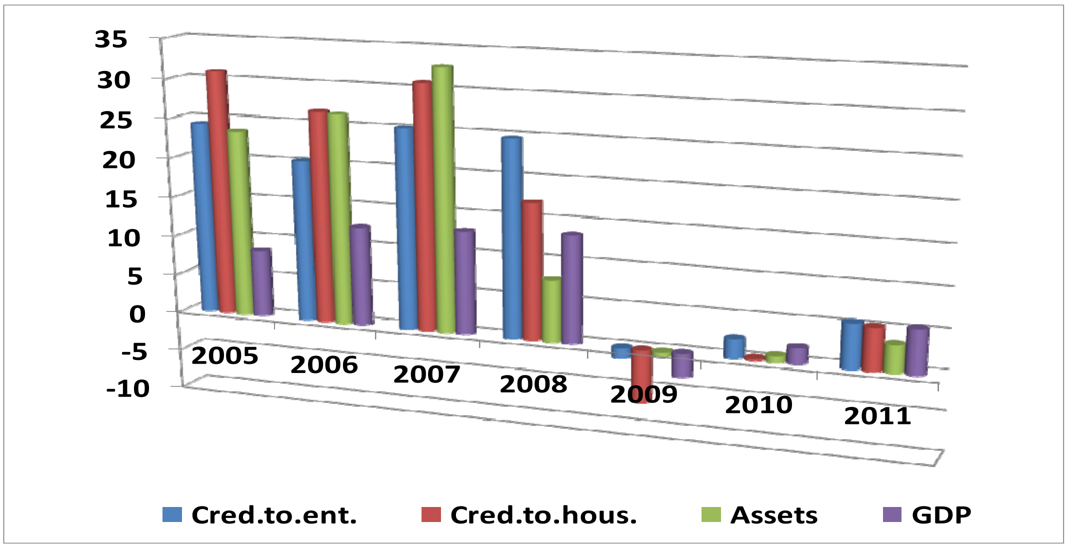
Economic trends in Bosnia and Herzegovina in the period of crisis 2008-2011

The global financial and economic crisis spilled over from Western Europe to BiH in the last quarter of 2008. The spill-over effects of the crisis in Western Europe to BiH were confirmed by data indicating a decrease of GDP and credit activity in the first two quarters of 2009. In the year of recession GDP dropped by 3.1%[9], credit to households by 6.6%, and credit to enterprises by 1.2% compared to the previous year. The total amount of credit extended to households and enterprises, therefore, decreased by 3.8%, compared with a remarkable growth in lending activity during 2008. Credit to enterprises and households in 2008 increased by 22.8%.[10] A big difference in credit activity in 2008 and 2009 caused a sharp decrease in household consumption and business investment.

[8] Sources: the Federal Banking Agency and the Banking Agency of Republic of Srpska.
[9] Sources: Agency for Statistics of Bosnia and Herzegovina (www.bhas.ba); the International Monetary Fund
[10] Source: Central Bank of Bosnia and Herzegovina (www.cbbh.ba)

Chart 1 - Percentage change in credit activity and assets, and nominal GDP growth rates (year-on-year)

BOSNIA AND HERZEGOVINA 2005-2011



Source: Based on data of the Central Bank of Bosnia and Herzegovina

In 2010, due to the tightening of procedures for approving loans and the growth of non-performing loans in the credit portfolio of commercial banks in BiH credit activity to enterprises increased by only 2.8% in the period January to May, compared to December of 2009. This increase was followed by a reduction in lending activity between May and September. In December, the outstanding amount of loans to enterprises increased compared to the previous three months and was higher by 5.3% than a year previously. In contrast to the modest growth of loans to enterprises the loans to households were reduced. The total amount of loans extended in December 2010 was slightly lower (by 0.4%) compared to December 2009.

In 2011, credit activity (to enterprises and households) grew by 5.5%, savings of households grew by 6.1%, and total deposits grew by 5.8%.[11] Access to credit has become more difficult due to the stricter procedures for credit approval, caused by the growth of non-performing loans (NPLs). NPLs to total credit ratio has increased from 5.8% to 11.2%.[12] This modest increase in lending activity in 2010 and 2011 was not sufficient to create the

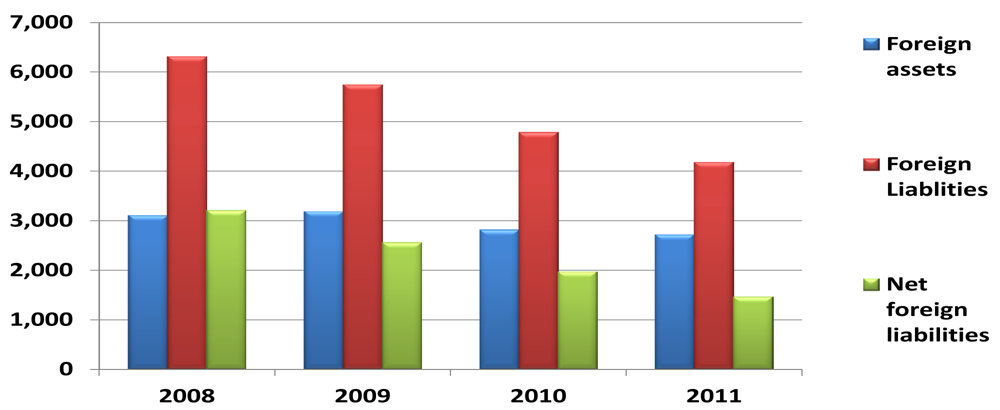
[11] Source of data is the Central Bank of Bosnia and Herzegovina (http://www.cbbh.ba/index.php?id=33&lang=en&sub=mon&table=konsolidovani_bilans_komercijalnih_banaka_bihh)

[12] Central Bank of Bosnia and Herzegovina, *Financial Stability Report 2010*, Sarajevo, 2011.

necessary increase in households' consumption and business investments that would spur the economic growth. According to the IMF data real economic growth in BiH was 0.5% in 2010. Comparing this figure with a decline in economic activity in 2009 it is obvious that this has not been sufficient to bring the economy back on track. According to the IMF staff mission report for 2011 the IMF has decreased its growth projection from 2.2% to 1.7% for 2011.

In the 2008-2011 foreign liabilities of commercial banks in BiH decreased by 33.8% (EUR1.09 billion) as a result of the impact of financial crisis on mother-banks in Western Europe. Drop in foreign liabilities was offset by growth in domestic deposits by 18.9% (EUR993 million).

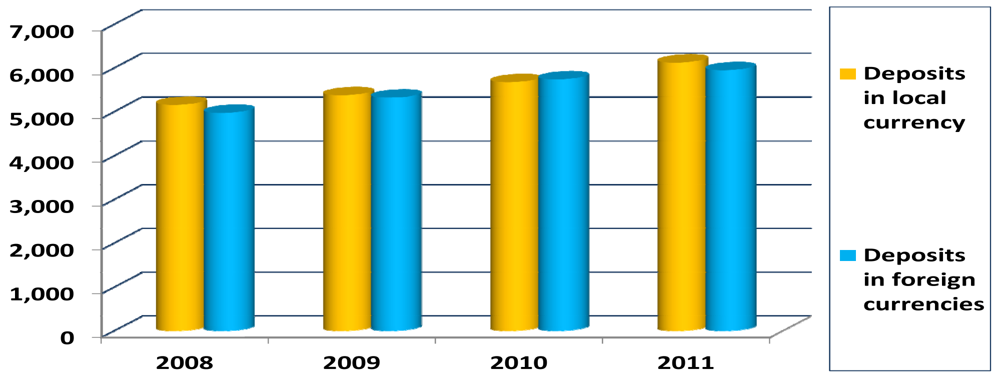
Chart 2 - Foreign assets, foreign liabilities and net foreign liabilities (foreign liabilities - foreign assets) of commercial banks in Bosnia and Herzegovina: 2008-2011 (*in millions of KM*)



Source: based on data published by the Central Bank of Bosnia and Herzegovina

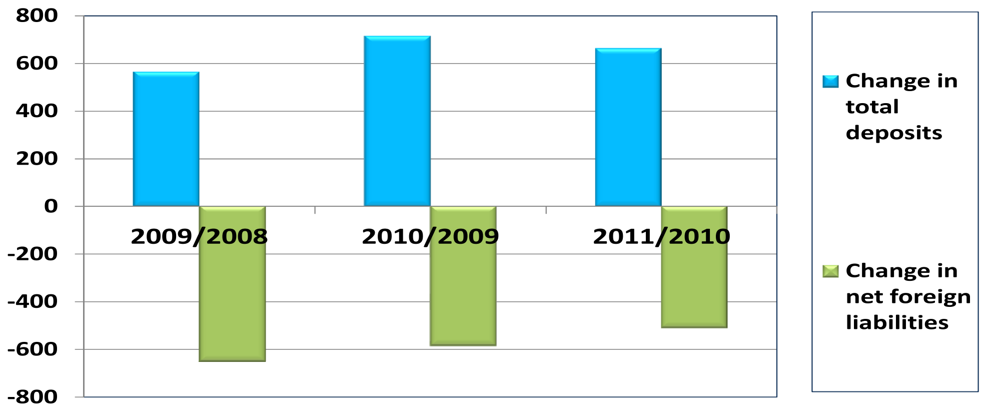
Net foreign liabilities, as the difference between foreign liabilities and foreign assets of commercial banks in BiH during the same period fell by EUR1.75 billion. Specifically, foreign liabilities decreased from EUR3.23 billion (2008) to EUR2.14 billion (2011), while foreign assets decreased from EUR1.59 billion (2008) to EUR1.39billion (2011).

Chart 3 - Deposits of commercial banks in Bosnia and Herzegovina 2008-2011 (*in millions of KM*)



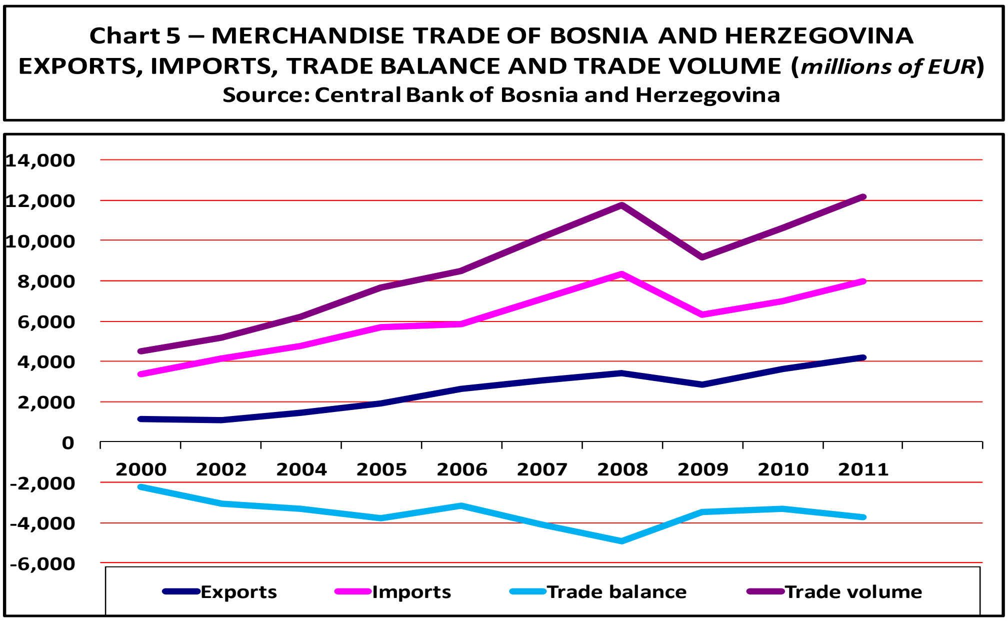
Source: based on data published by the Central Bank of Bosnia and Herzegovina

Chart 4 - Changes in total deposits and net foreign liabilities of commercial banks in Bosnia and Herzegovina
(in millions of KM)



Source: based on data published by the Central Bank of Bosnia and Herzegovina

On the other side, the positive effect of economic crisis on the BiH economy was a significant reduction in the trade and current account deficits in 2009-2010. In 2009, the trade deficit was reduced by 27.7%. This reduction, however, was not caused by an increase in the exports as opposed to trends in 2010. In 2010 the BiH economy saw the highest increase in merchandise exports. The exports increased by 15% and trade deficit was reduced for 12% even though credit activity was very modest. In 2011, despite the increase in exports of 18% the trade deficit had increased in comparison with 2010 by around 10% due to a significant increase in imports during 2011.[13]



Fiscal discipline and fiscal sustainability

Fiscal discipline in BiH, which used to be fairly high in the 2003-2007 period, has been disrupted due to a spill-over of financial and economic crisis, on the one hand, and due to a lack of cost-effective structure of public expenditures (having a predominant share of social security outlays), on the other. In the pre-crisis period of 2003-2008, BiH and other Western Balkan countries showed a higher level of fiscal discipline in comaprison with other regions of countries in transition on average. While average *budget deficit of transition countries* ranged between 2.1% and 0.3% of GDP in 2003 and 2005 respectively, *the budget deficit* of Western Balkan countries stood at 1.5% in 2003, while *their budget surplus* was 0.4% of GDP in 2005. When the global economic crisis struck in 2008, the average budget deficit of Western Balkan countries was slightly lower than the average for transition countries.

[13] Sources of data for the BiH foreign trade are: the Central Bank of Bosnia and Herzegovina and the Agency for Statistics of Bosnia and Herzegovina.

Table 1 – Consolidated budget balances of Western Balkan countries

- in per cent of GDP

Country	2003	2005	2007	2009
Albania	-4.9	-3.5	-3.5	-7.4
Bosnia and Herzegovina	2.3	2.2	-0.1	-4.0
Croatia	-3.4	-2.8	-2.3	-4.1
FYR Macedonia	-0.6	0.3	0.6	-2.7
Montenegro	-3.1	2.1	6.4	-5.3
Serbia	-1.1	1.0	-1.9	-4.5
AVERAGE	*-1.5*	*0.4*	*0.3*	*- 4.7*

Source: EBRD, Transition Report 2009; source of data for 2009 is the IMF.

While the budget deficit of Western Balkan countries averaged 1.2% of GDP, *BiH had an average budget surplus of 2.2% of GDP in the 2003-2005 period.* On the other hand, when measured by the ratio of total public expenditures to GDP, the average expenditures in the Western Balkans amounted to 37.3% of GDP in the 2003-2008 period, i.e. they were 2.7% of GDP higher than the average for transition countries in the same period. BiH had the highest public expenditures, while its public spending in the above period averaged 44.7% of GDP or 18% above the regional average.

Table 2 - Total budget expenditures of Western Balkan countries

- in per cent of GDP

Country	**2003**	**2005**	**2007**	**2008**
Albania	24.1	25.1	25.7	27.4
Bosnia and Herzegovina	41.5	42.1	47.4	47.9
Croatia	43.1	42.1	42.0	40.7
FYR Macedonia	33.4	35.2	33.8	34.2
Montenegro	43.5	41.2	45.4	44.4
Serbia	41.7	42.9	42.4	40.5
AVERAGE	*36.8*	*37.3*	*38.9*	*38.9*

Source: EBRD, Transition Report 2009, London 2009.

When analyzing the total public expenditures and particularly social transfers, in the former Yugoslav republics of the Western Balkans, one must bear in mind that in the aftermath of the war in the former Yugoslavia, many people in BiH, Croatia and Serbia have been affected in terms of diminished working ability (disabled civilians and war veterans, children left without one or both parents). Their number is particularly high in BiH, where lists of beneficiaries of social welfare provided to civilian and military victims of war include about 269,000 people. This is one of the main reasons (the second reason is the country's complicated administrative structure) why public expenditures in BiH are above the regional average. However, in the 2003-2005 period, the average public expenditures in BiH almost equalled those in Serbia and Montenegro, but were still lower than in Croatia. A major increase in public expenditures in BiH was caused by unrealistic projections of budget revenues for the 2007-2008 period.

It is impossible to explain the increase in fiscal discipline, measured by public revenues and budget surpluses generated in BiH in the 2003-2007 period, without looking into key factors that led to an increase in the tax base. Unfortunately, the key factors that led to the increase in tax base (fiscal capacity) in BiH did not include fast creation of new jobs. Although the effective unemployment rate was reduced in the pre-crisis period, lower unemployment or higher employment and higher average wages were not the key factors that explain growth of fiscal capacity. There were two leading factors of growth of fiscal capacity in BiH. The first was introduction of VAT in 2006 with a flat tax rate of 17%. This flat tax rate caused an increase in fiscal burden of consumers since the weighted average tax rate of sales taxes from May 2001 through the end of 2005 was 13.5%.

The other, more important reason of an increase in fiscal capacity in the 2006-2008 period was a credit expansion of both credit to enterprises and credit to households in the same period. From 2004 to 2008, an additional purchasing power of KM4.1 billion (EUR2.2 billion) was generated in BiH based on newly-approved credit to households. In the same period, credit to enterprises grew by KM4.2 billion (EUR2.3 billion). Hence, the aggregate increase in purchasing power in that period, based on credit expansion, amounted to EUR4.5 billion, which is the equivalent of 40% of GDP achieved in 2008. Credit expansion, higher purchasing power and the resulting increase in the tax base, coupled with an introduction of VAT (in 2006) at a flat rate of 17%, which, in turn, increased the fiscal burden on consumption by approximately one-fourth, were the grounds for unrealistic budget projections in Bosnia and Herzegovina during 2007 and the first half of 2008. A sudden drop in credit activity during 2009 and 2010 (see chart 1) meant significantly less fiscal revenues, which resulted in a budget deficit of 4.0% against projected expenditures in 2009.

According to the IMF report it is predicted that the total public debt of Bosnia and Herzegovina will increase from 39.1% of GDP in 2010 to 43% of GDP in 2011, while the fiscal deficit will be reduced from 4.5% to 3% of GDP on a consolidated basis. [14] The consolidated balance of public revenues and expenditures (the fiscal balance of General Government) includes all revenues and expenditures of the budgets of all administrative levels in Bosnia and Herzegovina (Budget of BiH, the two entities' budgets, budgets of ten cantons in the Federation of BiH, and budgets of all municipalities in both entities), and the revenues and expenditures of all public social insurance funds (pension funds, health insurance funds, and unemployment insurance).

[14]Source: International Monetary Fund, IMF Executive Board Concludes 2010 Article IV Consultation with Bosnia and Herzegovina - Public Information Notice (PIN) No.. 10/154, December 3, 2010. This document is available on the website: http://www.imf.org/external/np/sec/pn/2010/pn10154.htm .

Table 3 – Fiscal balance of General Government in Bosnia and Herzegovina

\- *Per cent of GDP*

	2006	2007	2008	2009	2010*	2011*
Fiscal revenues	47.2	46.7	45.9	44.6	45.9	45.8
Fiscal expenditures	46.1	47.1	49.5	50.2	50.4	48.8
Fiscal balance	1.1	- 0.3	- 3.6	- 5.7	- 4.5	- 3.0
External public debt	21.1	18.2	17.2	21.7	26.2	29.4
Total public debt	21.4	32.9	30.8	35.4	39.1	43.0

Source: International Monetary Fund, Public Information Notice No. 10/154, December 3, 2010 (www.imf.org) . *The IMF estimates.

Problems of fiscal instability in the two entities (FBiH, and RS) and a lack of the public revenues to finance public expenditures in the year of recession (2009) resulted in the signature of Stand-By Arrangement (SBA) between BiH and the IMF in the total amount of SDR1014.6 million (special drawing rights). That amount is equivalent to 600 percent of Bosnian quota at the IMF. By the end of 2011 the total amount of SDR338.2 million had been withdrawn (an equivalent of 200% of the country's quota). Total liabilities of BiH to service the debt based on existing use of resources from the SBA amounted to SDR355.3 million, of which the interest was SDR17 million and the principal was SDR338.2 million. The total public debt of BiH was well below the average level of public debt in the euro-zone countries in 2011 (55% of the level of public debt in the euro-zone countries).[15]

Table 4 – Projected payments to the IMF based on existing use of resources and present holdings of SDRs

\- millions of SDR

	2011	2012	2013	2014	2015
Principal	0	22.83	136.97	146.27	32.13
Charges and interest	5.05	5.00	4.09	2.10	0.76
Total	**5.05**	**27.83**	**141.06**	**148.37**	**32.89**

Source: http://www.imf.org/external/np/fin/tad/exfin2.aspx?memberKey1=75&date1key=2011-02-02

[15] Based on data published by the IMF, the EBRD, the Ministry of Finance and Treasury of Bosnia and Herzegovina, and the Central Bank of Bosnia and Herzegovina.

State-owned capital as the basis for fiscal sustainability and potential source of funds for development projects

The creditworthiness and liquidity of BiH in the future will depend on its fiscal capacity and ability of generating income from the assets owned by the two entities' governments (the Government of FBiH and the Government of RS). In this context, the quality of assets owned by the two entities determines Bosnia's borrowing capacity and its ability to service the public debt on a regular basis (its solvency and liquidity). The most valuable assets owned by the Government of FBiH have been its majority stakes in the following companies:

- Public Enterprise Elektroprivreda BiH dd Sarajevo – electricity production (90% ownership)
- Public Enterprise BH Telecom dd Sarajevo – telecommunications (90% ownership)
- Public Enterprise Elektroprivreda HZ HB dd Mostar – electricity production (90% ownership), and
- Public Enterprise HT Mostar dd Mostar – telecommunications (50.1% ownership)

The net book value of the assets of these companies (the book value of equity) and the book value of stakes owned by the Government of FBiH in these four companies at the end of 2010 amounted to EUR2.69 billion and EUR2.36 billion respectively.[16] According to the Ministry of Finance of FBiH the total public debt of FBiH (internal plus external) amounted to EUR 2.69 billion.

The company with the highest book value of equity in RS is the Mixed Holding Elektroprivreda Republike Srpske ad Trebinje. The book value of equity in this company as of 31 December 2010 amounted to EUR607 million[17] and the book value of stake owned

[16]Sources: JP Elektroprivreda BiH dd Sarajevo, Annual Report 2010, Sarajevo, 2011,available at: http://www.elektroprivreda.ba/np/pusers/admin/dok/GI-BH-10i.pdf;
JP Elektroprivreda HZ HB, Annual Report 2010, Mostar, 2011, available at: http://www.ephzhb.ba/Izvjesca/GI_2010_hr_final.pdf
Hrvatske telekomunikacije d.d. Mostar, Annual Report 2010, Mostar, 2011, available at: http://www.hteronet.ba/upload/natjecaji/prilog_br_2_124959.pdf
JP BH Telecom dd Sarajevo, Annual Report for 2010, Sarajevo, 2011, available at: http://www.bhtelecom.ba/1229.html

[17]Source: Elektroprivreda Repbulike Srpske, Annual Report 2010, Trebinje 2011, available at: http://www.ers.ba/index.php?option=com_content&view=article&id=118&Itemid=113&lang=ba

by the Government of RS was EUR395 million. The RS Government sold its 67% stake in Telekom Srpske (telecommunication) for the total amount of EUR646 million to Telekom Srbije (a Serbian based telecom operator owned by the Government of Republic of Serbia) in 2007. The financial resources from the transaction have been used for financing development projects and projects at the municipality level through loans extended by the Investment-Development Bank of Republic of Srpska (the bank is owned by the RS Government). Additional sources for servicing the public debt obligations of RS will be predominantly based on the fiscal capacity of RS and to a much lesser extent on the possibility of selling the state-owned capital, since the most liquid stake of the RS Government ownership in the business sector had been already sold. According to the Ministry of Finance of RS the total public debt of RS in 2010 amounted to EUR1.79 billion.

Based on the above analysis, the public debt servicing and additional borrowing capacity of FBiH is quite high as measured against the Government of FBiH's ownership. The Government is still the owner of the book value of capital in the four major infrastructure companies totaling EUR2.35 billion. The market value of these companies is higher than the book value as the four companies have been able to earn substantial profits. Over the last five years the average (yearly) net profit of BH Telecom has been approximately EUR75 million. During the recession of 2009, special attention was focused on FBiH and its alleged financial collapse. From the above data it is obvious that the net public debt of FBiH is not large (net public debt as a difference between the public debt and the assets owned by the government). For BiH (and its two entities) the major characteristic is that the value of state-owned capital is greater than the total value of public debt. However, the ownership of capital affects the solvency but does not mean the ability to pay due obligations (liquidity), unless there are regular inflows of money coming from dividends, and/or one-time large inflows of money based on privatization.

Table 5 – State-owned capital in four largest companies in the Federation of BiH

Company	Book-value of the equity As of 31 December 2010 (millions of EUR)	Stake owned by the Government of FBiH (milions of EUR)
JP Elektroprivreda BiH dd Sarajevo	1,489	1,340
JP BH Telecom dd Sarajevo	558	502
JP Elektroprivreda HZ HB dd Mostar	479	431
HT Mostar dd Mostar	165	83
TOTAL	**2,691**	**2,356**

Sources: JP Elektroprivreda BiH dd Sarajevo, Annual Report 2010, Sarajevo, 2011,available at: http://www.elektroprivreda.ba/np/pusers/admin/dok/GI-BH-10i.pdf;
JP Elektroprivreda HZ HB, Annual Report 2010, Mostar, 2011, available at: http://www.ephzhb.ba/Izvjesca/GI_2010_hr_final.pdf
Hrvatske telekomunikacije d.d. Mostar, Annual Report 2010, Mostar, 2011, available at: http://www.hteronet.ba/upload/natjecaji/prilog_br_2_124959.pdf
JP BH Telecom dd Sarajevo, Annual Report for 2010, Sarajevo, 2011, available at: http://www.bhtelecom.ba/1229.html

In that sense for the successful conduct of future economic policy and implementation of major capital projects at the entity and inter-entity and cross-border level it is necessary for the entities' governments to determine the timing of investment activities and financial resources to finance capital projects. In order for BiH and its entities, over the medium term, to ensure sufficient funds for regular funding of liabilities arising from the repayment of foreign debt and to fund capital projects - without which it is not possible to encourage the development cycle - it will be necessary to use the assets owned by the Government of BiH and its entities to provide additional financial resources, to avoid constant pressure of the default. In this sense, the two entities - FBiH and RS, and particularly FBiH who still owns major stakes in the most attractive companies in FBiH, could use one of the following three options:

1) Make a decision on privatization of capital available in the four largest infrastructure companies (sales of the minority or majority shares depending on the time schedule of privatization). Part of the privatization revenues may be deposited in special accounts opened at banks for servicing of the foreign debt on a regular basis.

2) Another option is to use a certain amount of the privatization revenues for establishing the investment fund that would invest available funds in securities of countries in Western Europe, and that would be a guarantee for future regular servicing of foreign debts, and for financing capital projects on the basis of public-private-partnership.

3) A less conventional option of the issue of government bonds could be the government bonds denominated in the KM and “covered” by a guarantee of the EU Guarantee Fund for BiH (or preferably for the Western Balkans). In other words, the Fund would guarantee issuance of bonds in local currency. Issue of government bonds with a guarantee of the Fund would be a safer source of financing capital projects in BiH and these financial assets as such would contributed to the development of domestic capital market, which would allow for more successful structuring of portfolios of the commercial banks and investment funds. The Guarantee Fund would be a guarantee for the fiscal stability, and it would have the right of semiannual audit of public finances at the state and entity levels in BiH. Also, the Fund could be provided with “a guarantee for equity swap option” – replacement of the warranty activated (in case of inability of BiH and its entities’ to meet their obligations) for the equity in major infrastructure companies. Another possibility is to provide the Fund with the ownership of the “golden share” in the five largest infrastructure companies in BiH (mentioned in the previous part of the text). By using the "golden shares" the Fund would be able to control and improve business operations in large public companies, and if necessary to use the profits of these companies for regular settlement of liabilities arising from the foreign public debt.

Development potential of the BiH economy

BiH has significant potential for development of automotive, wood processing, and metal processing industries. Development of agro businesses combined with tourism is another possibility. The population of BiH is 3.8 million and its area is 51,129 square kilometers. In the North, in the West and in the South of BiH there are very good natural potentials for agri-businesses. Experience in the production of metals, cars, furniture, joinery and prefabricated houses existed in the prewar period (BiH had a trade surplus in the last five years before the breakup of Yugoslavia of which 40% had been export to Western Europe). BiH's potentials for tourism development are very good. The United States Agency for International Development (USAID) has financially supported the development of clusters in wood processing, agri-business and tourism in an effort to link the economic potentials of the two BiH entities. The capital of BiH – Sarajevo – was host to XIV Olympic Winter Games (in 1984). Mountains Bjelasnica, Igman, and Jahorina have excellent terrains for skiing and for rapid expansion of winter tourism. Una, Neretva, Vrbas and Drina rivers have already become well known for rafting. The Una river is one of the cleanest rivers in the Western Balkans and is known for its beauty. The Sarajevo Film Festival (SFF) has become a top-ranking film festival in Southeastern Europe. Thanks to the festival as well as to the MESS (Theatre Festival) and Sarajevo Jazz Festival, Sarajevo has become one of the cultural centres of the Balkans. The development of religious tourism began some twenty years ago. Medjugorje in the South of BiH (western Herzegovina) is a pilgrimage of Catholic believers. In the last twenty years, this place was visited by more than 2 million tourists.

Doing business in BiH has not been easy since the end of the war. However, some of foreign direct investors in BiH have succeeded to triple or quadruple its total turnover, export and income in only five years (2003-2008). Good examples have been Arcelor Mittal Zenica, CIMOS TMD Gradacac, and Alloy Wheels Jajce. Although BiH has suffered a huge human capital loss during the 1992-1995 war, BiH is still ranked as a country with high human development index (United Nations Development Programme – Human Development Report 2010). Skills and knowledge inherited from the prewar period make it less costly to train workers in BiH in comparison with some other countries in which automotive, metal processing or wood processing industries have not been developed. In June 2008, the BiH authorities signed the Stabilization and Association Agreement (SAA) with the EU. Also, BiH is a member of CEFTA – a regional free trade agreement for the Western Balkans. Geographical position of BiH in the heart of Sout East Europe makes it potentially attractive for FDI because of its proximity to the EU and locational advantages as a platform for the relatively low cost production and free access to the EU and the regional markets.

Bosnia and Herzegovina and the Western Balkans

Prospects for the development of BiH will depend largely on the prospects for economic growth in Western Europe and the Western Balkans - regions with which BiH has had the most intensive economic cooperation - both in foreign trade and in foreign direct investments. In this context, for BiH, the Western Balkans, and the European Union one of the key challenges in the next period will be the possibility of enhancing economic cooperation and linking the Western Balkan economies based on the implementation of cross-border projects to the benefit of all investors involved in such projects.[18] In light of this, joint financing of such cross-border projects could solve some problems, and thus contribute to increase in public and private business investment, increase in employment, improve cooperation in the Western Balkans, reduce the gap in GDP per capita between the region and the EU, and link the financial markets in the region in order to reduce transaction costs.

[18] One of the possible ways of financing was presented by the author of this paper. See: Causevic, Fikret, „What type of fiscal policy is needed to foster the economic development of the Balkans?“, published in: Association Bourgogne Balkan Express, „Accession of the Western Balkans to the EU: Evaluating a process“, Workshop held on 11 May 2010, Sciences Po Paris, Paris, June 2010, pp. 61-66. http://ec.europa.eu/enlargement/pdf/publication/20100609_att4639135.pdf

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About the author

Fikret Causevic was born in 1963 in Bihac, Bosnia and Herzegovina. He took his master degree in 1995 and PhD degree in 2003 at the School of Economics and Business, University of Sarajevo. From 1989 to 2006 he worked at Sarajevo Institute of Economics and he was Deputy Director of the Institute from 1999 to 2006. Since 2008 Fikret has been Associate Professor at the School of Economics and Business, University of Sarajevo. He teaches courses on Economics, International Finance and International Banking at the undergraduate and graduate studies. From 2002 to 2010 he was a Visiting Fellow under the South East Europe Faculty Development Programme at the London School of Economics and Political Science – LSE Global Governance (Centre for the Study of Global Governance). He is a member of the GDN – Global Development Network (the World Bank), and the SEERN – the South East Europe Research Network.

Since 2008 he has been associated fellow of two centres of the Academy of Sciences and Arts of Bosnia and Herzegovina – the Centre for Social Sciences and the Centre for Systemic Research. Since 2003 he has published five monographs and two books. International edition of his „Economic Sovereignty and Global Capital Flows“ was published by Hyderabad University Press in October 2008. In adition to publications in the fields of international finance, financial markets and institutions, his main areas of interest as a researcher have been the labour market, fiscal policy, and monetary policy. In June 2009, the Presidency of Bosnia and Herzegovina elected him a member of the Governing Board of the Central Bank of Bosnia and Herzegovina. In May 2011, the Governing Body of St Antony's College elected Dr Causevic to the Alpha Bank Visiting Fellowship for the academic year 2011/2012.

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ABOUT SEESOX

SEESOX
South East European Studies
@ OXFORD

SEESOX
European Studies Centre
St Antony's College
University of Oxford
OX2 6JF

Telephone: +44 1865 274537
Fax: +44 1865 274478
E-mail: julie.adams@sant.ox.ac.uk

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