

COUNTRY REVIEW

Bosnia & Herzegovina



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EULER HERMES COUNTRY RISK GRADE: D

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- A currency board has helped provide a stable exchange rate and fairly low inflation.
- Foreign exchange reserves currently cover almost 5 months of imports.

Weaknesses

- Persistent ethnic-nationalistic pressures.
- Highly ethnically fragmented government which hinders efficient policymaking.
- Very slow process of reform implementation.
- Regional instability.
- Widespread poverty and high unemployment.
- Small manufacturing base concentrated on low-value-added products.
- Main export destinations are other emerging Eastern European countries.
- Sharply rising public debt.
- Unsustainably large current account deficits.
- Relatively high external debt burden.
- Very weak business environment, including a very weak and inefficient judicial system.

KEY RISKS

- **Political instability**
- **Recession-related increase in the number of insolvencies**
- **External liquidity risk**
- **Sovereign default (in the event that foreign aid is interrupted)**

Country Risk Assessment

Ratings	Bosnia & Herzegovina		Median		Peers	
	Latest	Previous	Grade D	Serbia	Ukraine	Kazakhstan
Systemic Political Risk:	P3-	P3-	P3-	P3-	P3-	P3-
Systemic Economic Risk:	E6	E6	E6	E6	E6	E6
ME rating:	ME6	ME5	ME6	ME6	ME6	ME6
<i>Structure</i>	6.0	6.0	6.0	5.7	5.0	4.0
<i>Policy</i>	5.6	4.6	5.6	5.2	6.0	5.6
<i>Solvency</i>	3.9	3.5	4.3	6.0	6.0	5.5
<i>External Liquidity</i>	6.0	4.6	4.6	4.8	6.0	6.0
SBE rating:	SBE6	SBE6	SBE5	SBE4	SBE5	SBE5
COUNTRY GRADE:	D	D		D	D	D

Nomenclature:

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Sarajevo
Population:	3.773 mn (2008e)
GDP:	USD 18490 mn (2008e)
Currency:	Marka (BAM)
Form of state:	Emerging Federal Democratic Republic
Head of government:	Chairman of the Council of Ministers Nikola SPIRIC (since 2008)
Next elections:	Parliaments at state and entity levels: October 2010 Three-member presidency: October 2010

Major Industries (% of GDP at market prices, 2006)	Global Assumptions	2009	2010	
Services	66.0%	Real GDP grth (% yr/yr) *	-3.9	0.9
Industry	24.0%	Inflation (% av) *	-0.1	1.3
Agriculture	10.0%	Dated Brent (USD/b)	61	72
		* Major economies		

Main Exports (% of total, 2008)		Main Imports (% of total, 2008)	
Base metals	26.0%	Mineral products	17.4%
Mineral products	11.7%	Machinery	15.9%
Machinery & mechanical appliances	11.5%	Base metals	12.1%
Wood & wood products	7.2%	Foodstuffs	8.6%
Lead Export Markets (% of total exports, 2009)		Lead Import Markets (% of total imports, 2009)	
Emerging Europe	53.3%	Emerging Europe	50.2%
Croatia	17.1%	Croatia	15.0%
Serbia	13.4%	Serbia	10.4%
Germany	14.7%	Germany	11.3%
Italy	12.7%	Italy	10.1%

Basic indicators

Selected economic indicators	2006	2007	2008e	2009e	2010f
Nominal GDP (USD mn)	12,262	15,221	18,490	16,979	17,468
Population (mn)	3.78	3.78	3.77	3.77	3.77
GDP per capita (USD)	3,243	4,029	4,901	4,505	4,639
Real GDP growth (% yr/yr)	6.9	6.0	5.4	-3.3	0.5
Inflation (% eop)	4.6	4.9	3.8	0.0	2.3
Fiscal balance (% of GDP)	2.2	-0.1	-4.0	-5.2	-5.0
Current account balance (% of GDP)	-8.0	-10.5	-15.0	-9.9	-10.1
External debt/GDP (%)	47.9	47.5	44.5	53.0	57.5
External debt/Exports of goods & services (%)	129.9	126.8	120.0	167.9	174.6
Debt-service ratio (%)	11.5	8.0	8.0	11.3	12.3
Foreign exchange reserves (USD mn)	3,371	4,525	3,515	4,090	4,210
Import cover (months)	5.0	5.1	3.3	5.0	4.8
Exchange rate assumption, BAM:USD (av)	1.56	1.43	1.34	1.40	1.40
Exchange rate assumption, BAM:EUR (av)	1.96	1.96	1.96	1.96	1.96
e: CRU estimate; f: CRU central forecast					

Sources: Central Bank, Agency for Statistics, IMF, World Bank, UN, Euler Hermes Country Risk Unit

Political Stability

The 1992-1995 civil war between ethnic Croats, Bosniaks and Serbs came to an end with the Dayton Peace Agreement of 1995, which set up a complicated political entity comprising the Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (often referred to as the Federation or as FBH). The RS is highly centralised and predominantly populated by Bosnian Serbs, accounting for about one third of the total population. The FBH, populated mostly by Bosniaks and Bosnian Croats, is divided into 10 cantons and highly decentralised. The central government of Bosnia and Herzegovina (BiH) has only limited responsibilities—including customs, foreign affairs, external debt service—even though ministries of justice, security and defence have been created at state level in recent years, the state presidency assumed central command of the military in 2003 and a state-wide VAT was introduced in 2006. The Office of the High Representative (OHR) oversees the civilian-political aspects of the Dayton agreement and co-ordinates the activities of international organisations in the country. Since 2002 the High Representative has also been the EU's Special Representative. Current officeholder is Valentin Inzko from Austria. The OHR has used its powers (pass/veto laws, ban political parties, remove individuals from office, civil service) extensively in the past. As BiH is supposed to become increasingly self-governing, the post of the OHR was expected to be replaced by a lower-key EU mission in mid-2007. However, this was delayed because Kosovo's desire for independence raised tensions within the region and the RS has since claimed more autonomy. In February 2008 the countries involved in the Dayton Peace Agreement decided 2008 to extend the OHR's mandate indefinitely until a set of positive benchmarks have been fulfilled.

Nationwide elections in October 2006 were won by the SNSD in the RS and the SzBiH in the FBH while the three ethnic-nationalistic parties (the Serb SDS, the Croat HDZ and the Bosnian SDA) weakened. Coalitions were required at all levels and highly ethnically fragmented governments have slowed progress on constitutional, economic and structural reforms. This is unlikely to change until late 2010—when elections are again due at all levels of government—and probably also not thereafter.

International relations remain comparatively poor. Regional relations with other former Yugoslav republics continue to improve only gradually and are affected by trade restrictions. The EU signed a Stabilisation and Association Agreement—the first step to EU membership—with BiH in June 2008. However, given the slow pace of reforms in BiH and the EU's own dwindling appetite for enlargement, the next step on the way to the EU—the granting of Candidate status—appears still a long way off. Reform delays also caused NATO in late 2009 not to offer BiH a Membership Action Plan—the first stage for nations wishing to join the alliance. The IMF is also frequently critical of BiH's reform progress and has repeatedly called for greater fiscal discipline. Nonetheless, the Fund approved a three-year EUR1.1bn Stand-By Arrangement (SBA) in July 2009, though only after weeks of wrangling over cuts in war veterans' benefits. In the wake of the global financial crisis, the funding is intended to support BiH's currency board, to shore up public finances and to secure sufficient external financing and banking liquidity.

Overall, systemic political risks are substantial. Risks of localised ethnic clashes remain, ethnic nationalism is very strong and probably rising and international involvement remains necessary to hold the country together.

Economic Stability

The civil war caused extensive destruction of physical capital and GDP fell to around 20% of its pre-war level. Supported by high levels of international aid and driven by reconstruction efforts, the economy then grew strongly from 1996 to 1999, but has slowed to an annual average of about 5% in 2000-2008. The relatively small manufacturing base is concentrated on low-value-added products and the economy is dependent on emerging Eastern European markets, which account for more than 50% of exports. Services account for about 66% of GDP, industry for 24% and agriculture for 10%. The economy is classified as an upper middle income economy by the World Bank with GNI per capita of USD4,510 in 2008. However, unemployment is still widespread and 14% of the population lived below the national poverty line in 2007, with a further 20% in danger of falling into poverty in the event of an income shock.

In the wake of the global financial and economic crisis, the economy shifted from 5.4% growth in 2008 to an estimated contraction of 3.3% in 2009. We expect a return to modest growth of about 0.5% in 2010. Private consumption will be constrained by the aftermath of the crisis, particularly increased unemployment, restricted access to credit, as well as fiscal tightening under the IMF SBA.

A currency board exchange-rate regime—which pegs the convertible marka (BAM), the local currency, at 1.96 to the EUR—has been in place since 1995 and is probably among the strongest institutions in

BiH. It has generally served well to keep annual average inflation in check, even though fluctuating prices of oil and food—the latter comprises about 55% of household purchases—tend to cause some volatility (average inflation 7.4% in 2008, -0.4% in 2009). The IMF did not find evidence of a significant real exchange rate misalignment in mid-2009 and the central bank's current official reserves are sufficient to cover the whole monetary base, such that we expect the currency board to remain in place in 2010-2011.

The fiscal position looks less favourable. The fiscal deficit widened to 4% of GDP in 2008 and an estimated 5.2% in 2009, partly owing to some revenue shortfalls but also uneven implementation of IMF-agreed fiscal tightening measures. Public debt surged from 22% of GDP in 2006 to about 35% in 2009 and is forecast to rise further in 2010. The rapid debt increase also reflects a (partial) recognition of various domestic claims against the government (such as foreign exchange deposits, war damage claims, wage arrears, and restitution claims). In terms of entities, the RS appears to be in a better fiscal position than the FBH.

BiH's external position remains weak. Despite debt reduction agreements with the Paris club and commercial banks and substantial international aid, post-war economic progress has been attained at the expense of sizeable and worrisome external imbalances. The country has persistently run substantial current account deficits. The deficit was around 15% of GDP in 2008, 10% in 2009 and we expect another 10% in 2010. With the exception of 2006-2007 when net foreign direct investment (FDI) inflows were substantial largely thanks to non-recurring privatisation measures, net FDI coverage of the current account deficit has always been below 50%, requiring the remaining financing gap to be met through new external indebtedness. Hence, gross external debt has continued to increase to approximately USD9bn at end-2009 (about 53% of GDP or 168% of export earnings) and is forecast to rise further in the near future. However, as a large part of total external debt is on concessional terms and a substantial share of the commercial debt has been restructured on favourable terms, the debt-service ratio will remain a manageable 12% in 2010. Foreign exchange (FX) reserves are currently about USD4bn, sufficient to cover almost five months of imports.

Overall, BiH will remain highly dependent on international transfers in the future and is still far from attaining self-sustaining growth. External liquidity and debt risks will remain high.

Structural Business Environment

The Structural Business Environment is well below average, with serious impediments to strong, sustainable growth and business transactions. Although some indicators in our assessment overall signal an improvement of the business climate on paper, the unresolved political problems and remaining major weaknesses continue to discourage investors and to impose major obstacles for doing business. Positive elements include the government's general pro-business stance, relatively few formal restrictions on capital flows and foreign investment and the fairly solid banking sector. However, little progress has been made since BiH's application for WTO membership in 1999, and co-ordination between the two entities on trade policy is inadequate. Other major areas of weakness comprise weak governance, diluted ownership, burdensome and opaque regulations and business procedures, widespread corruption and the virtually non-existent rule of law which makes it very difficult to enforce contracts and property rights. The judicial system is weak, inefficient and does not cover commercial activities and bankruptcy procedures adequately. Moreover, BiH continues to suffer from organised crime and black market activity.

The banking sector appears fairly solid as a result of consolidation and openness. It is dominated by foreign banks which control 21 out of a total 30 banks and account for 95% of total assets. Negative news about foreign parent banks caused strains in the banking system in late 2008, with a mini run on local banks and a 16% decline in the central bank's FX reserves up to May 2009. But the situation stabilised quickly thanks to prompt emergency cash from the parent banks, commitments of the six major foreign banks (accounting for 60% of total bank assets) to maintain their exposure to their Bosnian subsidiaries and the IMF SBA that was finalised in mid-2009. We do not expect a systemic banking crisis in our central case scenario, but some caution is appropriate. FX-denominated lending accounts for over 70% of total bank lending, raising the possibility of currency mismatches in household and corporate sectors. The share of non-performing loans to total loans has increased from 3% in mid-2008 to 4.8% in Q3 2009 and is set to rise further, weighing on banks' profitability and their willingness and ability to lend. Private sector credit growth has already fallen to just 4% yr/yr in mid-2009.

Charts

