BOSNIA AND HERZEGOVINA: Political stalemate could cause further delays in investment

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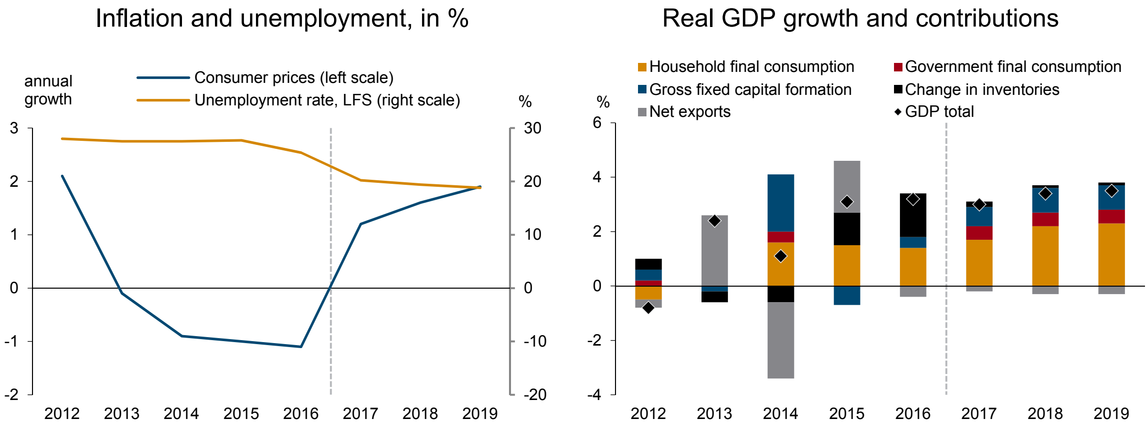
The economy lost momentum in the second quarter, although overall it is likely to post growth of around 3% this year. Growth should pick up even further in the rest of the forecast period, driven by remittances, a gradual improvement in the labour market, tourism and exports. Political risk will remain elevated ahead of the 2018 election, which is having an impact on investment spending, although it is unlikely significantly to derail medium-term growth.

Figure 32 / Bosnia and Herzegovina: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The next general election is now only a year away, and tensions in the run-up to polling could create challenges for the economy. However, political noise in BiH is nothing new, and the usual verbal sparring is unlikely to have a material impact on growth. Investors and economic agents in Bosnia are well aware of the high risk of political instability in the country.

Many key actors appear already to be in pre-election mode, meaning that there is even less impetus for reform than usual. Moreover, there is no longer a clear parliamentary majority to pass laws, meaning an effective stalemate. The government has still not returned a questionnaire from the European Commission that it received last December as part of its accession process (other candidate countries had already completed the process by this point). In July, Bosnia was the only one of the Berlin Process partner countries not to sign the Transport Community Treaty (this was finally done in

September). The treaty aims to create an integrated transport network in the region in order to support economic integration with the EU.

The IMF Extended Fund Facility (EFF) is subject to the usual delays, and meeting the conditions will remain challenging. The government failed to adopt new, higher tariffs on gasoline and laws on banking deposit insurance required under the IMF agreement, meaning that the latest IMF disbursement – earmarked for funding improvements in transport infrastructure, and due to be released in May – has been delayed. It is likely that a compromise will eventually be found, although with the election approaching, the room for an agreement on the issues required for the release of IMF funding that all sides can accept could be limited in the next year. Meanwhile, regional tensions continue to rumble on. BiH is currently engaged in a heated spat with Croatia, which plans to build the Pelješac Bridge to connect two parts of its territory – the Pelješac peninsula and the rest of the country – and thereby bypass Bosnia's Neum corridor. Bosnia has argued that this will block the access of large ships from the Neum harbour to the sea. However, in June the European Commission approved the project, and Croatia has received EU funds for construction.

Growth slowed in the second quarter, but we expect this to be temporary. The economy expanded by 1.7% year on year in real terms in Q2, down from 2.8% in the first three months of the year. We still think that full-year growth will come in at around 3% this year, with high frequency indicators suggesting a pick-up in momentum during the third quarter. Merchandise exports rose by an average 23% year on year in July-August, compared with 15.5% in the first half of the year. Working-day adjusted industrial output increased by 6.3% in July-August, compared with 2.3% in January-June. Retail trade also continued to expand robustly (4.9% average growth in July-August), albeit a slight slowdown from the first half of the year (6%).

Private consumption is by far the biggest section of the economy, and remains the key to overall growth. Total employment rose by an average 3.5% year on year in January-July, a material improvement on recent years. Nominal net earnings growth has also increased, rising by 1.7% year on year on average in January-July. Having risen to 2.2% year on year in May, consumer price inflation has since fallen back, rising by 1% in August, thereby providing some support to real income growth. As in much of the rest of Europe, the phasing out of positive base effects from low energy prices in early 2016, plus continued slack in the labour market, is likely to keep inflation at historically low levels during the forecast period.

Construction activity is weak, reflecting delays to the disbursement of financing. Real construction output fell by 2.2% year on year in January-June. Construction relies heavily on external financing, meaning that the weakness is likely to persist as long as IMF disbursements are delayed.

The export base is still small and narrow, which will continue to limit the contribution of the external sector to growth. However, it is gradually growing and diversifying, and will become slowly more important. Merchandise exports were equivalent to 32% of GDP in 2016, double the level of 2003, and up from 28% in 2010. Moreover, data show that the reliance on commodity exports is declining; mineral products were 8% of exports in 2016 and base metals 17%, down from 17% and 23%, respectively, in 2010. Over the same period, the share of total exports made up of chemicals, plastics and rubber, textiles, footwear and headwear, machinery and mechanical appliances, and transport equipment all increased.

Nevertheless, the external deficit is large, and will remain so during the forecast period. The current account shortfall was equivalent to 5.1% of GDP in 2016, although it should be a bit narrower this year and in 2018-19. The current account deficit narrowed by over 6% year on year in Q1, driven by improvements in the services and secondary incomes surpluses. Services benefited from growth in goods processing, tourism and transport, while secondary income rose as a result of higher remittances, linked to better growth in key remittance sources in Western Europe. Bosnia's tourism industry is growing quickly; tourist nights rose by 11% year on year on average in H1. Merchandise exports also rose strongly in Q1, increasing by 19.7% year on year. However, imports – which remain much bigger – increased by 12.8%, meaning that the goods deficit still widened year on year. According to the central bank, a large part of the rise in nominal imports reflected higher prices for oil and oil products. Stronger domestic demand also likely contributed.

The Stabilisation and Association Agreement (SAA) with the EU, signed in 2015, should have a positive effect on the external accounts over the medium term, although is unlikely to be a game changer on its own. Foreign direct investment (FDI) inflows could rise somewhat in line with trends seen previously in other CESEE countries on the way to EU membership. However, this effect will be limited by Bosnia's particularly tortuous EU accession process, as well as clear accession fatigue in Brussels and other EU capitals. The primary means of financing the current account deficit will probably remain 'other' investment, chiefly loans on concessional terms, which means that Bosnia's current account deficit is not as risky as for other countries. Net foreign exchange reserves have generally remained in the range of 6-7 months of import cover, providing reasonable cover for the currency board arrangement.

The fiscal position has strengthened, helped by higher value-added tax revenue on the back of stronger consumption. 2017 started positively, with revenue up by 6.6% year on year in Q1. The delay in IMF financing is an issue from the fiscal perspective, although the budget has been bolstered by a repayment of debt from the USSR (honoured by Russia). However, it is not clear that positive fiscal trends will continue, particularly if IMF disbursements continue to be delayed. Moreover, ahead of the 2018 election there is some risk of fiscal slippage.

Credit growth is picking up, driven by stronger private sector demand, from both non-financial corporations and households. Although the banking sector is still not in perfect shape, asset quality and stability indicators are improving, which should mean that the sector can further support growth during the forecast period. Non-performing loans (NPLs) fell to 11.5% of the total in Q1 2017, their lowest level since 2010. The ratio of tier 1 capital to risk-weighted assets reached 14.8% in Q1.

Although political noise and delays to the IMF programme could generate some volatility in quarterly growth rates, overall we expect real GDP to expand at a reasonably strong rate – above 3% – during the forecast period. Growth will be driven primarily by private consumption, underpinned by positive momentum in the labour market and earnings. The traditional factors that stand behind growth in Bosnia – remittances and multilateral loans – will remain important. However, positive trends in other areas such as tourism and manufacturing exports should also continue, and these sectors will gradually increase their share of overall growth. Assuming that compromises between local actors can be found, infrastructure projects currently held up by political arguments related to IMF-mandated legislation will also contribute positively to growth during the forecast period.

Table 7 / Bosnia and Herzegovina: Selected economic indicators

	2013	2014	2015	2016 [1)]	2016	2017	2017	2018	2019
					January-June			Forecast	
Population, th pers., mid-year [2)]	3,531	3,526	3,518	3,515	.	.	3,515	3,510	3,510
Gross domestic product, BAM mn, nom. [3)]	26,779	27,359	28,586	29,899	14,205	14,849	31,200	32,800	34,600
annual change in % (real)	2.4	1.1	3.1	3.2	2.7	2.2	3.0	3.4	3.5
GDP/capita (EUR at PPP) [3)]	8,100	8,300	8,800	9,000	.	.	.	.	.
Consumption of households, BAM mn, nom. [3)]	22,521	22,830	23,157	23,538	.	.	.	.	.
annual change in % (real)	0.0	1.9	1.8	1.7	.	.	2.2	2.8	2.9
Gross fixed capital form., BAM mn, nom. [3)]	4,808	5,330	5,097	5,189	.	.	.	.	.
annual change in % (real)	-1.2	11.5	-3.5	2.5	.	.	4.0	5.0	5.0
Gross industrial production									
annual change in % (real)	5.2	0.2	3.1	4.4	4.7	2.1	3.0	4.5	5.1
Gross agricultural production [4)]									
annual change in % (real)	15.2	-14.2	5.0	2.0	.	.	.	.	.
Construction output total									
annual change in % (real)	-2.4	6.8	-3.2	-1.0	-1.7	-3.0	.	.	.
Employed persons, LFS, th, April	821.6	812.0	822.0	801.0	801	816	820	830	840
annual change in %	1.0	-1.2	1.2	-2.6	-2.6	1.8	1.8	1.1	1.1
Unemployed persons, LFS, th, April	311.5	308.0	315.0	273.0	273	211	208	200	195
Unemployment rate, LFS, in %, April	27.5	27.5	27.7	25.4	25.4	20.5	20.2	19.4	18.8
Reg. unemployment rate, in %, eop	44.5	43.6	42.9	40.9	41.6	39.4	.	.	.
Average monthly gross wages, BAM	1,291	1,290	1,289	1,301	1,295	1,316	1,330	1,370	1,410
annual change in % (real, gross)	0.2	0.8	1.0	2.0	2.0	0.5	0.8	1.1	1.1
Average monthly net wages, BAM	827	831	830	838	834	848	850	870	900
annual change in % (real, net)	0.2	1.3	1.0	2.0	2.0	0.5	0.8	1.0	1.0
Consumer prices, % p.a.	-0.1	-0.9	-1.0	-1.1	-1.4	1.1	1.2	1.6	1.9
Producer prices in industry, % p.a.	-1.8	-0.5	0.6	-2.1	-2.7	2.6	2.2	1.8	2.1
General governm.budget, nat.def., % of GDP									
Revenues	42.6	43.7	43.2	42.7	.	.	45.2	45.4	45.4
Expenditures	44.8	45.8	42.5	41.5	.	.	46.0	46.2	46.3
Deficit (-) / surplus (+)	-2.2	-2.0	0.7	1.2	.	.	-0.8	-0.8	-0.9
Public debt, nat.def., % of GDP [5)]	43.5	44.0	45.0	45.2	.	.	44.9	44.7	44.5
Stock of loans of non-fin.private sector, % p.a.	2.9	1.7	2.0	3.5	2.2	6.2	.	.	.
Non-performing loans (NPL), in %, eop	15.1	14.2	13.7	11.8	12.1	11.1	.	.	.
Central bank policy rate, % p.a., eop [6)]	.	.	.	.	.	.	.	.	.
Current account, EUR mn [7)]	-728	-1,033	-826	-776	-434	-406	-730	-750	-790
Current account, % of GDP [7)]	-5.3	-7.4	-5.7	-5.1	-6.0	-5.3	-4.6	-4.5	-4.5
Exports of goods, BOP, EUR mn [7)]	3,397	3,501	3,678	3,935	1,844	2,175	4,220	4,450	4,720
annual change in %	9.5	3.0	5.1	7.0	4.0	17.9	7.2	5.5	6.1
Imports of goods, BOP, EUR mn [7)]	7,027	7,527	7,355	7,535	3,580	3,997	7,840	8,220	8,650
annual change in %	-0.7	7.1	-2.3	2.4	1.3	11.6	4.1	4.8	5.2
Exports of services, BOP, EUR mn [7)]	1,223	1,253	1,378	1,436	635	681	1,480	1,570	1,660
annual change in %	-1.0	2.5	9.9	4.3	1.5	7.2	3.0	6.1	5.9
Imports of services, BOP, EUR mn [7)]	392	401	445	457	187	192	480	510	540
annual change in %	-2.2	2.1	11.2	2.7	0.0	2.4	5.0	6.0	6.0
FDI liabilities, EUR mn [7)]	239	408	334	247	119	198	230	.	.
FDI assets, EUR mn [7)]	64	7	85	6	7	10	50	.	.
Gross reserves of NB excl. gold, EUR mn	3,530	3,908	4,307	4,768	4,371	4,735	.	.	.
Gross external debt, EUR mn [5)]	7,138	7,245	7,787	8,204	.	.	8,250	8,400	8,550
Gross external debt, % of GDP [5)]	52.1	51.8	53.3	53.7	.	.	51.7	50.1	48.3
Average exchange rate BAM/EUR	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558	1.96	1.96	1.96

1) Preliminary. - 2) According to census October 2013. - 3) According to ESA'10 (FISIM not yet reallocated to industries). - 4) Based on UN-FAO data, from 2015 wiiw estimate. - 5) Based on IMF estimates. - 6) Bosnia and Herzegovina has a currency board. There is no policy rate and even no money market rate available. - 7) Converted from national currency.

Source: wiiw Databases incorporating national statistics and IMF. Forecasts by wiiw.