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Please find attached the presentation by Mr. Aidan O'Leary, Head of Administration and Finance, OSCE Mission to Bosnia and Herzegovina, delivered to Session A 4 of the 12<sup>th</sup> OSCE Economic Forum, Prague, 31 May – 4 June 2004.

# **Economic Development in Bosnia and Herzegovina**

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## Macroeconomic Summary

- In 2003, GDP remained at 60% of its pre-war level
- Estimates of future growth vary
- An IMF programme, combined with the currency board exchange rate regime, has brought about significant improvements
  - general government deficits reduced through massive fiscal adjustments
  - inflation is declining and inflationary pressures remain subdued
  - external debt levels have fallen to low levels and action is underway to restructure the domestic debt burden to ensure it is low / manageable
- Merchandise trade deficit remains large and its persistence suggests difficulties linked with BiH export and productive capacity

After the high real growth rates observed during the reconstruction period, annual growth has slowed to 3-4%. GDP remains at around 60% of its pre-war level. Estimates of future growth vary. Some speculate that growth will slow over the coming years as the impact of the “peace dividend” tails off with donor and IFI inflows dwindling. Acceleration in the pace of structural reforms (public sector, State companies) may also begin to act as a drag on economic growth. The more upbeat assessments argue that the informal sector is vibrant and could act as a key growth sector. It is postulated that the economy is on a 4-5% growth trend and that this could rise to 6-7% if EU accession prospects clarified. This scenario relies on the large informal economy coming into the open as the tax base is broadened and rates are reduced together with the prospect of increased FDI.

The IMF programme and currency board exchange rate regime have both yielded significant improvements. Deficits have been reduced through massive fiscal adjustments – public spending reduced from 60% of GDP in 2000 to 47% in 2003 – and economic planning continues to focus on public administration reform to bring further reductions. Inflation has been declining and inflationary pressures remain subdued. External debt levels have fallen to low levels by international standards and action is underway with the assistance of the US Treasury to restructure the domestic debt burden to ensure it remains low and manageable.

The merchandise trade deficit (excess of imports over exports) remains large and its persistence suggests difficulties linked with BiH export and productive capacity. Over time, this could endanger currency stability with potential effects on inflation and debt servicing. Despite high levels of private transfers, primarily remittances from abroad, and with reducing levels of foreign assistance, FDI will become increasingly important as a source of funding and export production in the coming years.

## BiH Macroeconomic Trends

|                  |       | 1998         | 1999         | 2000         | 2001         | 2002         | 2003         |
|------------------|-------|--------------|--------------|--------------|--------------|--------------|--------------|
| Real GDP Growth  | %     | <b>15.6</b>  | <b>9.6</b>   | <b>5.6</b>   | <b>4.5</b>   | <b>5.5</b>   | <b>3.5</b>   |
| Inflation Rate   | %     | <b>-0.3</b>  | <b>3.4</b>   | <b>5.1</b>   | <b>3.1</b>   | <b>0.3</b>   | <b>0.4</b>   |
| Unemployment     | %     | <b>37.4</b>  | <b>38.9</b>  | <b>39.7</b>  | <b>40.1</b>  | <b>41</b>    | <b>41</b>    |
| Gen Govt Balance | % GDP | <b>-19.9</b> | <b>-22.4</b> | <b>-16.3</b> | <b>-10.4</b> | <b>-7.1</b>  | <b>-3.4</b>  |
| Trade Balance    | % GDP | <b>-48.4</b> | <b>-42.8</b> | <b>-32.1</b> | <b>-32.8</b> | <b>-36.8</b> | <b>-36.6</b> |
| External Debt    | % GDP | <b>71.6</b>  | <b>68.2</b>  | <b>59.2</b>  | <b>46.4</b>  | <b>38.9</b>  | <b>35.4</b>  |

Source: European Commission, Occasional Paper No.5 (January 2004)

The statistical trends upon which this summary is based were obtained from an EC Occasional Paper circulated in January 2004 which in turn is based on data provided by the IMF, WB, BiH Central Bank and others. There are two important caveats to note.

Firstly, it is difficult to obtain a clear view of developments in the real economy as national statistical sources fail to capture the large informal sector which is estimated to account for anything between 30-50% of GDP. The extremely high official unemployment rate of 41% helps to illustrate the point – anecdotal evidence strongly suggests the actual unemployment rate is much lower (15-20%).

2002 GDP per capita was estimated at Euro 1,400 – amongst lowest in the region and ranked as a ‘lower middle-income economy’ for World Bank purposes. Important to note the assumption that BiH has a population of around 4 million. With no census since 1991 and given the large scale displacement of citizens throughout the 1990s, this figure needs to be treated with caution.

Revision is dependent upon the availability of more accurate and reliable statistical data, any revision is likely to result in an upward adjustment of BiH economic well-being.

# BiH Economic Strategy

- Poverty Reduction Strategy Paper
- Key Goals
  - to secure real economic growth of 5% a year to achieve its 1991 GDP level by 2010
  - to restore the international creditworthiness of Bosnia and Herzegovina
- Critical pillar underpinning this strategy is encouraging private sector growth, seeking foreign investors to complement domestic investment
- Implementation requires improvement of the business investment environment and a strengthening of the capacity of State Institutions
- Notwithstanding the existence of a policy framework, economic factors remain prevalent

How is this situation to be taken forward. The Poverty Reduction Strategy Paper is the BiH Government's first economic development strategy and sets out its proposed goals and activities for the period 2004-2007. Its key economic goals include the securing of real economic growth of 5% a year to achieve its 1991 GDP level by 2010 and the restoration of the international creditworthiness of Bosnia and Herzegovina. If successful, BiH will have taken almost 20 years to achieve the economic living standards that it enjoyed prior to the break-up of the former Yugoslavia.

A critical pillar underpinning this strategy is encouraging private sector growth, seeking foreign investors to complement domestic investment. The planning assumptions adopted is that the private sector share of GDP will rise from 40% to 75% of GDP by 2007 and that FDI inflows will almost triple to Euro 750 m p.a. by that same period. Whilst the potential benefits of FDI on host economies through knowledge transfer, access to marketing and distribution networks and improvements in the international competitiveness of firms are clear, these targets remain very challenging by any standards.

Implementation requires major improvements of the business environment for domestic and foreign investment and the strengthening of the capacity of State Institutions. Although the general trend is towards reducing obstacles, creating investor friendly settings and promoting FDI, options do exist in terms of the nature and balance of the policies to be applied. Locational and economic advantages differ, the cost of implementing some measures may be higher than others and governments also differ in their perception of how best to attract FDI. At State level alone, a number of structures are being developed or put in place to address these policy issues – an Office for Coordination of Economic Research and Monitoring, a Ministry for Foreign Trade and Economic Relations, a Foreign Investment Promotion Agency as well as an Export Credit Agency

A national policy framework is necessary to attract FDI to both increase the benefits as well as assuage the concerns. However, these should be seen in the broader context of the determinants of FDI, amongst which economic factors predominate. The absence of a policy framework may be decisive in preventing FDI from entering a country in the first instance but once an enabling framework is in place, economic factors – whether market, resource or efficiency based, assert themselves. Unfortunately, neither the inflows of FDI nor the benefits of such inflows are automatic.

## Securing Economic Growth in BiH

- In the absence of abundant natural resources, only companies generate wealth
- Competitiveness depends on the capacity of national industry to innovate and upgrade - microeconomic factors come to the fore
- Develop national investment objectives and priorities for each of the applicable sectors
- Develop and upgrade targeted sectors to compete effectively in sub-regional/ regional/global markets over the short/medium/long term
- Critical importance of moving from general commitments to specific and targeted actions – operationalising the plan

In the absence of abundant natural resources, it is up to companies generate wealth. Competitiveness depends on the capacity of national industry to innovate and upgrade i.e. microeconomic factors come to the fore. Companies gain advantage against the world and region's best competitors because of pressure and challenge – they benefit from having strong domestic rivals, aggressive home-based suppliers and demanding local customers. Competitive advantage is created and sustained through a highly localised process. Ultimately, a Country's success in particular industries comes about because their home environment is the most **forward looking, dynamic and competitive**.

No country can hope to maintain comparative advantage in all industry sectors. Choices must be made and it becomes necessary to develop national investment objectives and priorities for each of the applicable sectors. In BiH, those sectors which have been identified and targeted for growth include food processing, forestry and food products, tourism and services, textiles, energy and light manufacturing. It is likely that these will evolve over time and with experience. The development approaches and timelines involved with each sector are necessarily different and distinct.

The aim is to develop and upgrade these targeted sectors to compete effectively in sub-regional/ regional/global markets over the short/medium/long term. Large scale privatisation of attractive sectors such as banking, telecoms and utilities will ultimately yield modernisation and efficiency benefits but do not necessarily contribute directly to the bottom line of enhancing the productive and export capacity of the country. In BiH, the experience with privatisation in the late 1990s was not a positive one and thus it is important that future investment deliver both quantitative and qualitative benefits. Competition in the market for greenfield investment is particularly intense.

For BiH, to make this happen it is critical to move from general commitments and intent to specific and targeted actions – operationalising the plan. Existing capacity at all levels of government needs to be strengthened to achieve the goals set.

## **BiH Reform Agenda**

- **Jobs and Justice Agenda**
  - Economic Reform
  - Rule of Law Reform
  - Defence Reform
  - Education Reform
  - Public Administration Reform
- Polling and field presence feedback consistently indicates that poor economic performance, unemployment and the lack of economic opportunity remains the key concern of citizens
- International Civilian Co-ordination through a High Representative, Board of Principals and Task Forces

This brings us to the work of the international community as a whole in Bosnia and Herzegovina.

The Jobs and Justice Agenda elaborates the key elements of the BiH reform agenda and forms the backdrop to the programming and political support provided by the OSCE Mission to the BiH authorities and other international actors with the implementation of their reform pledges. None of these strategic areas – Economic Reform, Rule of Law Reform, Defence Reform, Education Reform and Public Administration Reform - may be treated in isolation but form part of an interlocking agenda. Economic reform is an overarching issue which underpins the economic regeneration of Bosnia and Herzegovina.

In terms of relative priority, independent polling and field presence feedback consistently indicates that poor economic performance, unemployment and the lack of economic opportunity remains uppermost in the concerns of BiH citizens.

Streamlining under the auspices of the Peace Implementation Council rationalised the international presence and assigned programmatic leads in line with institutional core competence. International activities are coordinated within the framework of a Board of Principals and Task Forces.

## How Can the OSCE Add Value ?

- In co-operation with the EU, World Bank and other relevant actors and consistent with the Economic Strategy document, work with the government within the framework of PRSP
- Support the conduct of a survey of potential industry segment investors to obtain their feedback on Bosnia and Herzegovina as an investment location
- Exchange of information and best practice
- Support the authorities at Municipal and Cantonal level to create a business investment friendly environment
- No lengthy learning curves

How can the OSCE add value in the Economic Reform field ? In co-operation with the EU, World Bank and other relevant actors and consistent with the Economic Strategy document, work with the government within the framework of PRSP

**Task 1.** Assist and support the authorities of BiH to conduct a survey of potential sub-regional, European, CIS, Middle-East and North American industry segment investors to obtain their feedback on Bosnia and Herzegovina as an investment location, to obtain factual material for policy makers and to highlight areas of superior performance for promotion and areas of weaker performance for improvement. The main foreign investors in BiH at the moment are Croatia, Lithuania, Kuwait, Slovenia and Austria, there is a need to develop much clearer understanding of why investors come to do business within particular sectors and why others do not.

**Task 2.** Facilitate and support the transfer of expertise and experience in the area of FDI from a number of OSCE member states who have been particularly successful in recent years. Among the areas of focus will include

1. the provision of expert support to the governments development of its foreign investment policy statement, national investment objectives and priorities
2. the provision of expert support on the marketing strategies and support services necessary to develop and maintain linkages between government, local business associations and foreign investors in specific industry segments
3. the provision of expert support for the development of tax and other incentive arrangements to attract and retain foreign investors in specific industry segments prioritised for investment.

Best practice and lessons learned need to be incorporated from countries with a demonstrable track record i.e. expert assistance will be sourced from Government, investment promotion authorities and academic institutions in countries that have recently achieved enhanced economic performance through attracting and retaining FDI inflows such as Ireland, Czech Republic, Hungary and Slovakia.

**Task 3.** Utilising the OSCE field presence, assist and support the authorities at Municipal and Cantonal level to create a business friendly environment, with particular focus on streamlining the registration and other administrative processes required of business by law.

Finally, it is important to note that BiH does not have the luxury of a lengthy learning curve to successfully address the investment attraction and retention issue.