

NEWSLETTER

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MACROECONOMIC UPDATE

To no surprise, recent macroeconomic indicators confirm the spread of the global financial and economic crisis onto the BiH economy. The financial sector stability has been maintained, but credit growth has been reversed from an average monthly rate of 2.1% to a -0.4% in December. In addition to the lack of credit, the export sector is suffering from weak prices and foreign demand. Trade figures for December, were just released showing a gloomy picture: exports shrank 4.1% (yoy), and imports 3.4%. Although the drop in exports is larger than that in imports, exports still grew in November 1.9%, while imports dropped 3.4%. The largest drops in December (yoy) are not, as one would think in the metals sector (although dropping significantly from peaks in summer 08), but exports in the category of machinery and mechanical appliances (mostly automotive), as well as chemical industry. Surprisingly, on the back of power production and the start of production in the Bosanski Brod refinery, industrial production indexes for December remain very strong: 9.4% yoy increase in the federation and 99.6% increase in the RS (almost entirely the result of the Brod refinery launch of production). The sharp drop in fuel food and metal prices lead to a -0.6% monthly deflation in December. Substantially lower commodity prices are also likely to result in a significant shrinking of the current account deficit.

MACROECONOMIC INDICATORS

	Annual		Quarterly				Monthly				
	2007	2008	2008				2008				
			Q1	Q2	Q3	Q4	VIII	IX	X	XI	XII
Industrial Production											
FBH (% change y-y)	9.1	8.0	-1.5	5.1	0.0	0.0	5.2	14.9	16.0	10.5	9.4
RS (% change y-y)	1.4	16.8	9.0	10.7	0.0	0.0	6.2	5.5	0.5	22.9	99.6
Gross Monthly Wage											
FBH (% change y-y)	9.7	n/a	12.2	13.1	15.4	12.5	14.3	16.1	14.9	11.1	n/a
RS (% change y-y)	10.3	29.3	22.3	31.4	32.3	30.7	31.8	31.6	30.7	30.7	30.6
Cost of Living /CPI*											
FBH (% change y-y)	1.5	7.7	6.8	8.5	9.5	5.8	9.6	8.7	8.0	5.6	4.0
RS (% change y-y)	1.8	7.2	6.1	8.2	9.3	5.1	9.4	8.7	6.6	5.1	3.6
Current Account Balance (Millions of €)	-1,160	n/a									
Trade Balance (Millions of €)	-4,071	-4,303	-1,077	-1,290	-1,157	-780	-427	-286	-241	-354	-186
Exports of Goods (Millions of €)	3,035	3,432	801	911	919	801	280	315	298	275	227
% change y-y	15.0	13.1	14.8	19.0	16.2	2.6	12.0	16.9	9.0	1.9	-4.1
Imports of Goods (Millions of €)	7,106	7,736	1,878	2,201	2,076	1,581	707	601	539	629	413
% change y-y	22.0	8.9	27.4	20.9	11.3	-18.8	13.0	0.1	-20.0	-3.4	-33.7
Foreign Exchange Reserves (Mil. of €)	3,425	3,219	3,376	3,339	3,494	3,219	3,479	3,494	3,274	3,184	3,219
Broad Money (Millions of €)	6,263	6,532	6,341	6,541	6,865	6,532	6,787	6,865	6,524	6,465	6,532
% change y-y	21.6	4.3	18.1	14.3	14.8	4.3	14.8	14.8	7.5	6.0	4.3
Credit to Non-govt Borrowers (Mil. of €)	6,052	7,317	6,450	6,911	7,231	7,317	7,115	7,231	7,328	7,354	7,317
% change y-y	28.1	20.9	28.7	28.7	27.1	20.9	27.4	27.1	26.1	24.1	20.9

GLOBAL FINANCIAL AND ECONOMIC CRISIS: EFFECTS ON THE BIH ECONOMY, MITIGATION, AND ADAPTATION MEASURES

The World Bank and the Directorate for Economic Planning conducted a joint analysis of the global financial and economic crisis and its impact on the BiH economy. The main findings and proposed measures to mitigate the impact of the crisis are outlined below.

As is already evident in macroeconomic statistics, the BiH economy is not immune to the impact of the global financial and economic crisis, even if financial stability has been maintained. The consequences of the global crisis have begun infecting the BiH economy through three main transmission mechanisms: the credit crunch, fall in export prices and demand, and a drop in remittances. Like the rest of transition economies, BiH is almost certain to experience a drastic reduction in the rate of growth. In 2009, real GDP growth is likely to drop by seventy percent, or even more, and the recovery is expected to be slow even after 2009. The export and construction sectors are likely to be hit more than others, at least initially. Since some companies may shed workers, and the income from remittances may drop to some households, poverty may increase. In spite of the drop in exports, the downturn in economic activity and falling commodity prices will reduce BiH's current account deficit (CAD) and inflation prospects, but financing CAD will become more challenging. As a result of falling metal prices, nominal export growth is expected to be negative. On the other hand, drastically reduced fuel and food prices from their peaks last year, but also falling metal prices, will result in a negative nominal import growth. Consequently, CAD is likely to shrink significantly. However, as a result of the credit crunch and a poor global economic outlook, the access to foreign funding for local banks will be reduced, its cost will increase, while level of foreign direct investments may also drop. Hence, a part of the CAD may have to be financed by drawing foreign currency reserves.

SHORT TERM POLICY MEASURES TO MITIGATE THE IMPACT OF THE CRISIS

An attempt to mitigate the impact of the crisis will have to involve a well coordinated effort at all levels of government. Many of the policy proposals by the World Bank and the DEP, especially a possible fiscal stimulus, could not be implemented without a concerted and well-organized coordination at all levels of government. Hence, it is necessary to strengthen and expand the institutional arrangements for better coordination.

Efforts to secure the stability of the monetary and financial system ought to be continued and reinforced. The Central Bank reacted swiftly to restore depositor confidence and improve banking sector liquidity. The currency board arrangement with its strict rules may be the principle reason BiH has not experienced the banking or a balance of payments crisis. Hence, this arrangement has to be preserved as it is. Measures to support entities development banks should in no way undermine the stability of the banking system or put public finances at risk.

In case of a sharp economic downturn, the authorities may consider a temporary and targeted fiscal stimulus, which would have to be financed from additional external sources. A well designed fiscal stimulus has the potential to support growth and employment during the slow-down. However, it would have to meet all of the above criteria or it could potentially have negative consequences, such as increasing CAD and rendering its financing substantially more difficult, reducing external financing options for private sector, substantially increasing public debt and inflation prospects.

The governments should improve the structure of public spending: increase the share of public investment, reduce the share of the wage bill, and reduce the share of social expenditures by targeting them to those in need. A potential fiscal stimulus would have to target exclusively investment spending, which is currently relatively low. Accelerating the implementation of on-going large public investment projects, particularly those that have already secured external financing, is a priority. However, reducing the share of the social and wage bill spending is urgent and necessary to leave more room for investment. The wage bill can be reduced through improved pay and employment policies. The fiscal effort for social spending is very high particularly when compared with the low percentage of those in need who actually benefit from it. Improving the efficiency and targeting of social benefits to those in real need, would be a much more effective way to protect the vulnerable (and creating fiscal space for public investments) than scaling up existing programs.

Enterprise performance could be enhanced by reducing the rate of social contributions for health, facilitating access to credit, and reducing the cost of regulatory compliance. Social contributions for health are very high by international standards, especially in the Federation BH; they increase the cost of labor for enterprises and should be reduced in a sustainable way, along with the streamlining of social expenditures as discussed above. The lack of investment and export finance for the private sector could be mitigated by instituting credit lines from the government. Any such arrangement has to be transparent with proper safeguards and risk-management procedures. Finally, there are some quick-fix measures to improve the ease of doing business and reduce costs.

MEDIUM AND LONG-TERM MEASURES



Other priority reforms, beyond immediate crisis mitigation, ought to be intensified and accelerated to enable BiH to restore robust economic growth once the global crisis is over and to enhance the pace of European integration. The crisis should not distract the focus of the authorities from medium-term reforms, as these reforms will be critical for the country to be internationally competitive and restore rapid growth in the post crisis period. We have made an attempt at identifying the priority medium and long-term reforms, but other important reforms

may spring to life through dialogue with the private sector, situation analysis, and a process of identification of binding constraints to economic growth. The priority medium and long-term reform measures include: i) develop a truly single economic space; ii) improve fiscal coordination, including planning and execution of public investment projects; iii) continuously engaging in improving the structure and efficiency of public spending to support economic growth, job creation, and poverty reduction; iv) continuous improvements of the tax system; v) strengthen banking supervision by, inter alia, unifying the two banking agencies; vi) complete the privatization process and engage in restructuring poorly performing voucher-privatized enterprises; vii) continue improving the business environment; viii) improve the efficiency of investments in education, and invest in “out-of-school” skills development; ix) develop an integrated energy strategy, coordinate sector investments, and improve energy efficiency.

ACTIVE WORLD BANK PROJECTS IN BOSNIA AND HERZEGOVINA

Project	Status	Commitment (US\$ million)	Available for disbursement (US\$ million)
Agriculture and Rural Development	effective	21.00	19.05
Avian Influenza Preparedness	effective	5.00	4.98
Community Development	effective	20.00	3.00
ECSEE APL 3 (Power IV)	effective	36.00	35.82
Employment Support II	effective	12.00	0.01
Forest Development and Conservation	effective	7.10	2.69
GEF - Forest and Mountain Protected Areas	signed	3.40	3.40
GEF - Neretva and Trebisnjica Management	signed	6.00	6.00
GEF - Water Quality Protection	effective	8.90	8.44
Health Sector Enhancement	effective	17.00	8.22
Land Registration	effective	15.00	13.11
Road Infrastructure and Safety	effective	25.00	25.00
Small Scale Commercial Agriculture	effective	12.00	0.83
Solid Waste Management	effective	26.00	11.84
Solid Waste Management II	approved	40.00	40.00
Urban Infrastructure and Service Delivery	effective	25.00	15.2
	TOTAL	279.40	197.59

FIRST IBRD LOAN APPROVED IN BIH - SOLID WASTE MANAGEMENT II

On November 25, 2008, the World Bank Board of Executive Directors approved financing for the Second Solid Waste Management Project in BiH in the total amount of US\$ 40 million.

Building up on the successes of an ongoing Solid Waste Management Project under which four regional landfills were constructed, and two more are being completed, benefiting 1.7 million people, the Second Solid Waste Management Project will continue to improve the availability, quality, environmental soundness, and financial viability of solid waste management services in the country. The project will support construction of 6 - 8 new sanitary landfills by the end of 2014.

Financing from the World Bank in the amount of US\$ 40 million includes interest free IDA credit in the amount of US\$ 15 million and IBRD loan in the amount of US\$ 25 million. This is the first time that the World Bank approved a portion of a more commercial although still competitive financing under IBRD conditions in BiH.

"By introducing IBRD financing, the World Bank signals confidence in BiH and confirms that the country has entered a new, partnership phase of relationship with the World Bank", stated Marco Mantovanelli,

DOING BUSINESS REFORM MEMO IDENTIFIES STEPS THAT NEED TO BE TAKEN TO IMPROVE BUSINESS ENVIRONMENT

The Doing Business Reform Memo for Bosnia and Herzegovina, prepared at the request of the BiH authorities, was released in December 2008. On the basis of the current status and reform activities in 10 areas monitored by the Doing Business, the Reform Memo identifies a set of short- and medium-term recommendations for improvement of business environment. The recommended measures include some legislative changes and institutional reform interventions, but most are relatively simple administrative actions, typically involving elimination of a need either to submit the same information to two or more different governmental institutions, or to make multiple visits to the same institution to comply with a single regulatory requirement. In the current global financial crisis context, when most businesses struggle for survival, such quick interventions relieve companies from regulatory burden, save increasingly scarce human and financial resources, and help restore business confidence.

The minimum capital requirement is just one example of an obsolete regulation which no longer adequately protects investors and poses an unnecessary bureaucratic obstacle. In both starting a business and dealing with licences areas, the processes need to be streamlined through reduction of preliminary requirements and consolidation of approvals and licencing procedures. In the area of registering property, full computerization of the processes at the land registry offices should reduce enormous backlogs; in addition, cutting the property transfer tax from 5% (currently highest in South East Europe) should motivate most owners to update their property records. And, while the reform of the tax system is underway, and some results are already evident with regard to the tax rates, it would still be highly beneficial to reduce the number of tax payments and combine payments, where possible, since currently an entrepreneur has to make 51 payments, which take on average 368 hours to complete.

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