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Bosnia and Herzegovina – Meeting Copenhagen Economic Criteria for EU Accession

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Within the Copenhagen criteria, the EU established a two-fold set of economic conditions to evaluate the economic readiness for membership of applicant countries. Candidates are required to have a functioning market economy as well as the capacity to cope with competition on the EU market. A comparison of past and present economic indicators of Bosnia and Herzegovina (BiH) with the indicators for the new member states that joined the EU in 2004 and 2007 indicates that the group of countries with formal candidate status in 2006 (Turkey, Croatia, FYROM) and other economies in the SEE region set the proper benchmark for an analysis of economic policy. Although BiH does not yet have a formal EU candidate country status, it has been under assessment to see whether it meets Copenhagen criteria within the Stabilization and Association Process (SAP) since 2005.

The EC analysis led to the following overall picture common to all countries (Poland, Lithuania, Romania and Croatia) chosen for comparison with BiH:

- Trade integration and FDI have progressed substantially (except for Romania and BiH). However, in Romania, there has been a reversal from initial trade liberalisation, mainly for macroeconomic reasons;
- The functioning of capital markets and competition rules has been improving everywhere, but is generally still far from satisfactory;
- The state of infrastructure remains poor (except for Croatia);
- Wage levels are still well below EU levels;
- Privatisation has progressed at different rates and the process remains to be completed
- Most applicants still need to restructure large, state-owned industries, which dominate local economies and tend to be very hard to reform for both social and economic reasons.

According to the European Commission, in 2005, the BiH economy operated only to a limited degree within the framework of functioning market principles. Further reform efforts were deemed necessary to address serious shortcomings in the competitiveness of the economy. To maintain macroeconomic stability and safeguard the sustainability of the currency board, a prudent macroeconomic policy mix is a priority. In order to strengthen the productive base of the economy, the largely loss-making corporate sector must be urgently and fundamentally restructured and privatisation accelerated. In addition, actions to reduce overall government interference in the economy and improvements in the business climate are essential. The flexibility of the labour market should be enhanced. The judicial system, in particular the handling of bankruptcies and property rights, should be strengthened. To successfully manage the fiscal challenges, coordination and analytical capabilities need to be improved and the size of public expenditures must be reduced in real terms.

These demanding tasks require firm political commitment and cooperation between different levels of government. In general, the functioning of market forces is hampered by the strong influence of the public sector in the economy and the weak business environment and legal climate. Despite some improvements, markets are also sometimes fragmented between entities.

Macroeconomic outlook

BiH had arguably some of the most difficult starting conditions for economic, political and social transformation among the countries emerging from the dissolution of the former socialist block. Violent military conflict in the early 1990s brought large losses of human life and the destruction of physical infrastructure and institutions. The conflict led to an extremely difficult and tense political environment and strained social relations in which the subsequent state building and political, social and economic reforms needed to take place. This perspective is important for understanding developments leading to the potential fulfilment of the Copenhagen criteria and integration with the EU. It signals a long and relatively slow catch-up process for BiH. Specifically, in the case of BiH, the Commission stresses achieving macroeconomic stability and a broad social consensus about economic policy in order to enhance the performance of a market economy. Maintaining sustainable macroeconomic stability is a necessary precondition on the road to EU accession.

The currency board arrangement in BiH has allowed for inflation stabilisation. It has also strongly reduced real effective exchange rate volatility in the past and is likely to play such a role in the future – possibly until the adoption

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of the Euro at some stage. This does not mean that the currency board does not cause any problems for the BiH economy. No single exchange rate and monetary regime is free from drawbacks. The point is rather that for a small, open, European economy trading mostly with Euro-zone countries or countries with stable currencies against the Euro, maintaining a peg is the best option.

BiH's macroeconomic prospects for the next 5-10 years strongly depend on domestic reforms, which will determine the pace of development and catch-up with the EU. The following three scenarios can be considered:

• **The Baltic scenario** assumes a coherent set of economic policies maintaining macroeconomic stability (in particular improving medium-term fiscal prospects) and reducing the tax and regulatory burden on the economy, thus allowing for a reduction in the scale of unregistered economic activity. Easing conditions for doing business, coupled with productivity gains and real wage restraints, could provide a major boost to BiH's production competitiveness and a surge in exports. This would be supported by increased FDI inflows, which would also grow due to prospects of eventual EU accession. The Baltic countries experienced rapid convergence in GDP per capita levels, as they needed nearly seven years to close the gap between their position and the EU25 average by 10 percentage points. In this optimistic scenario, BiH could reach a GDP per capital level in PPS equal to around 35% of the EU25 average before 2017.

• **The Bulgaria-Poland scenario** forecasts BiH to reach around 35% of the EU25's GDP per capita by 2021, 15 years from now, by following the path of the stop-and-go reforms of Poland and Bulgaria.

• **The FYROM scenario** is based on the experience of another ex-Yugoslavia country that recently acquired EU candidate status. The modest growth rates that have been registered in this country since 2003 imply that its GDP per capita in PPS is expected to increase from just above 24% of the EU25 average in 2003 to 27% in 2008. Assuming a similar pace of convergence for BiH, following this scenario would imply that by 2025, BiH would not even reach a level of 30% of average EU25 GDP per capita.

The privatisation process

A large-scale privatisation process is one of the most important institutional and structural features of every transition economy. It is especially relevant from the perspective of meeting the Copenhagen criteria. Prior to 1991, before the ownership transition was initiated in BiH, the number of entities owned by the state or with state shareholding stood at 2,508 companies and 40 banks. Privatisation has been carried out in parallel in both the Federation of Bosnia and Herzegovina (FBH) and Republica Srpska (RS) using somewhat different methods. Both privatisation processes have been conducted on three levels: small-scale privatisation, privatisation of large state-owned companies, and strategic companies. BiH has kept a large portfolio of state-owned companies in its possession and the privatisation of strategic firms has been slow. If one takes 2004 as a base year (six years after the official start of privatisation), the following results were achieved: the total value of privatised companies stands at 50% of total registered companies slated for privatisation. In RS, 4.5 billion worth of KM (Convertible Marks), or 53% of earmarked companies, were privatised. In FBH, the results were even poorer, with privatisation bringing in 5.3 billion KM, 39% of the planned level.

In 2005, private sector activity in BiH reached 55% of GDP, compared with around 50% in 2004. The privatisation process continues to reshape the overall structure of the economy. However, one of the problematic issues for the government is that it is pressing criminal charges against a previous government that had privatised one of the state-owned banks. Reopening previous privatisations, if considered a friction fight in politics, might tarnish BiH's image abroad and impact investors' risk calculations for further investments. In 2006, the privatisation process continued despite divisive political campaign debates.

Enterprise sector performance

Microeconomic analysis of BiH companies focuses on identifying comparative advantages, assessing productivity, and positioning the BiH enterprise sector towards potential competition on EU markets.

The sample of analysed enterprises in FBH is quite effective in terms of earnings before taxation (EBIT) and not very effective in terms of net income. Only 40% of firms indicated a positive net income in 2005 (20% in the public sector and 45% in the private sector). This is less than in 2002. All manufacturing firms had a positive net income in the whole period under analysis. There were also very impressive shares for strong-performing firms in construction. A much smaller number of profitable firms was observed in industry (35.5%), trade (40% - the sample average) and services (only 20%). In mining, quarrying, electricity, water supply, transportation, public construction and public services, not a single profitable firm was observed in 2005. Looking at the rate of return of the group (EBIT to revenues ratio), firms' performances appear to be much better, however. The average rate of return was set at a very impressive level of 11% in 2002 and 9.6% in 2005.

The analysed firms in FBH reported a strict policy of cost control. The cost level indicator (the ratio of total costs to total revenues in percents) was very low and declined in the period under analysis. Private sector firms were more effective in terms of reducing the cost level indicator than public ones.[1]

The average nominal monthly wage was increasing in FBH firms throughout the whole period under analysis, from KM 698 (EUR 358) in 2002 to KM 816 (EUR 418)

1 from 85.6% in 2002 to 79.5% in 2005 in the private sector and from 84.5% in 2002 to 85.4% in 2005 in the public sector).

in 2005. The nominal wage increase amounted to 17%. The nominal wage increase was supported by impressive labour productivity growth (total revenues to employment ratio). The total productivity level grew by 27% (a bigger increase than the nominal wage increase of 17%). Wages in manufacturing decreased in nominal terms (by 2.6%), which may suggest that manufacturing entrepreneurs kept their wages more or less stable. Entrepreneurs probably allocated profits for the purpose of investment rather than current wage increases. This approach is highly necessary in transition economies in the early process of building a market economy. This was confirmed by very strong investment outlay growth and impressive employment growth in manufacturing in 2005. The return of this investment may lead to an increase in manufacturing output and wage increases in the future.

A positive return on assets in the sample (the ratio of EBIT to total assets, as a percent of the total) is to a large extent supported by the fact that companies did not report their losses, reporting zero instead of negative EBIT values. However, the objective of the ROA (Return on Assets) analysis, as well as the analysis of efficiency, was to observe the trends in particular sectors. Only in the indicated sectors (industry, manufacturing, BiH Telecom and private construction) were assets utilised effectively. Our sample does not indicate a strong current ratio (greater than 2) in any of the analysed sections, with the exception of public transportation and public construction in 2005. In this repect, the analysed companies in FBH do not present strong liquidity or short-term financial strength. In many cases, firms may have trouble covering their short term obligations due to a high level of short term liabilities (this can be a reason for inter-enterprise charges or obligations for the state – taxes or social security contributions) or limited access to finance their duties. The worst sectors in this respect in 2005 were: services, trade and repairs, and mining and quarrying.

Total income before taxes in the sample of Banja Luka Stock Exchange (BLSE) listed companies accumulated a negative value of KM - 46.6 million in 2004 and doubled to KM - 93.1 million in 2005. The total value of assets, fixed assets and current assets declined in line with negative profits. Due to negative profits, rates of return (income before taxes to revenues in percentages) remained negative and declined from -2.2% in 2002 to -4.2% in 2005. Enterprise losses also influenced the negative values of ROA and ROE (Return on Equity) indicators, which also decreased, reflecting the poor financing possibilities of the firms analysed. Current ratio levels were also very low, which suggested their weak short-term financial strength. The cost level indicator acceded 100%, which reflects costs higher than revenues in the analysed companies (102% in 2004 and 104% in 2005). Increases in this indicator tend to be evidence of deep-seated ignorance of cost growth control. These cost increases are most likely due to poor corporate governance.

All sectors represented by the sample of BLSE listed companies have a poor financial stance, with the exception of electricity, gas and water supply, and telecommunications. Construction and transportation firms noted an improvement in effectiveness in 2005 over 2004. Industry, mining, manufacturing, trade and services firms noted a poor financial stance in 2004 and 2005.

Businesses in poor countries usually face a much higher regulatory burden than those in developed countries, including administrative costs, bureaucratic procedures and associated delays. Heavy business regulations and weak property rights have damaging effects on SME and big enterprises, and especially on private ones.

The elimination of the majority of business obstacles lies in the hands of the BiH government. The major policy challenges for the authorities should be to ensure dynamic inter-enterprise competition and the development of a friendly business environment. To achieve these goals, the government needs to provide proper incentives and market signals by reforming its own actions, especially in the indicated areas. Looking at the process of reducing business obstacles in the benchmark countries, we can expect that the BiH government is able to achieve significant improvements. More improvements are still required in infrastructure, firm financing and combatting street crime, where no progress has been made since 2002.

Conclusion

The key to improving the development potential of BiH, and at the same time fulfilling the Copenhagen economic criteria, lies in domestic reforms. Meeting the economic criteria requires, certainly in the case of transition economies, deep and lasting structural reforms that take time to be accomplished. The issue of track record[2], which was one of the factors considered by the Commission, becomes highly relevant.

Read more about this topic in CASE Report No. 72 'Bosnia and Herzegovina – Meeting Copenhagen economic criteria for accession to the EU' available at www.case-research.eu.

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2 In this context, track record means the irreversible, sustained and verifiable implementation of reforms and policies over a period long enough to allow for a permanent change in the expectations and behaviour of economic agents and the assessment that the achievements will be lasting.

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