Centralna banka
BOSNE I HERCEGOVINE
Централна банка
БОСНЕ И ХЕРЦЕГОВИНЕ

REPORT ON MACROECONOMIC IMBALANCES FOR 2024

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ABBREVIATIONS

CBBH	Central Bank of Bosnia and Herzegovina
CF	Consenus Forecast
CPI	Consumer Price Index
EA	Euro Area
EC	European Commission
ECB	European Central Bank
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GVA	Goss value added
PPI	Producer Price Indeks
AL	Albania
BA/BH	Bosnia and Herzegovina
BG	Bulgaria
HR	Croatia
ME	Montenegro
NM	North Macedonia
RO	Romania
RS	Republic of Serbia
SI	Slovenia

1. SUMMARY

The previous decade was marked by weak convergence with developed countries, brought about by slow reform processes. BH reached only 35% of the average EU development level at 2023 end, with the slowest decreasing of economic gap with developed countries. The modest growth of real economic activity from the previous year, continuing in the first half of 2024, is realised mainly through the growth of service sector accompanied by trade deficit deepening, further inflation pressure on average consumer prices and labour costs and continued record high growth of real estate prices, already bringing about considerable macroeconomic imbalances.

On the basis of the set of quantitative indicators of macroeconomic imbalances, internal imbalances were seen during 2023 in the form of continuing high unemployment rate and the imbalances in the form of high real estate price growth, and external imbalance related to further growth of unit labour costs with a negative effect on competitiveness. Having in mind that, according to the spring round of the CBBH projections, insufficient decrease of unemployment is expected, further growth of real estate and labour prices in 2024, increase of internal and external imbalances is expected in the period ahead. Having in mind a strong pressure of core prices, being under the increasing pressure of labour costs and electric energy prices growth, domestic prices are expected to bring about the main inflation pressure on the deepening of the existing imbalances in the period ahead.

A high share of public sector employment, with increasingly visible negative demographic changes, including continuing negative natural growth of population and outflow of working population, represent an important source of macroeconomic imbalances in medium and long terms. The effect of labour on potential growth will continue to make a negative contribution due to negative natural growth of population, ageing of population and emigration, which will additionally make difficult the decreasing of economic gap with developed countries and make more complex the functioning of education, pension and health systems. Having in mind that in recent years inflation pressures and labour market pressures have become increasingly strong, with the growth of the number of retired persons being faster than the growth of the number of employees, structural reforms in segments of social and development policies are very much needed.

Following the two years of continuing decline, private sector debt slightly increased remaining substantially below the treshold set as macroeconomic imbalance. Private debt decomposition reveals that its changes were brought about by inflation, credit growth and real GDP changes. Despite the tightening of banks' credit standards, and despite the expected growth of financing sources costs, the recorded credit growth rate in BH was above expectations. In conditions of inflation pressures, a positive impact on lending came from the increased demand for loans and favourable lending rates, staying at rather low levels throughout 2023. With the projected growth rates of loans and economic activities for 2024, the increase of private sector debt to GDP ratio can be expected.

External imbalance indicators in BH do not indicate excessive imbalances, as current account deficit has not represented a source of imbalance in the recent five years. Taking into account a regular revision of historical data series of balance of payments statistics, the three year average level of current account deficit expressed in per cents of GDP in 2023 remained at the same level as in the previous year. In 2023, international investment position was not a source of imbalance. It improved, expressed as a percentage of GDP in 2023, mainly as a result of nominal GDP growth, but also the net outflow on the basis of other investment.

2. MACROECONOMIC IMBALANCE PROCEDURE

With purpose of increasing the resilience of the EU economy, macroeconomic imbalance procedures were set up (MIP), including the monitoring of fourteen indicators grouped as indicators of external imbalance and competitiveness, internal imbalance indicators and labour market, i.e. employment indicators. The macroeconomic position of countries does not depend only on fiscal and monetary policy, but a wider range of economic relations in the segments of competitiveness, labour market and financial stability. The trend of macroeconomic imbalance indicators is especially important after a significant change of economic conditions caused by the corona crisis, inflation pressures and decreased external demand. In assessing the consequences of the mentioned crises on macroeconomic stability and development of macroeconomic imbalances, forecasts and high frequency data are used, which were used in order to obtain the first projections of macroeconomic imbalances trends in 2024. The economic activity projections are especially important in periods of strong macroeconomic shocks as a significant number of macroeconomic imbalance indicators is expressed in per cents of GDP. Compared to 2022, some macroeconomic imbalance indicators according to the latest available official data for 2023, mainly expressed in per cents of GDP, saw deteriorated values due to a slower growth of GDP. The slower growth in 2023 resulted from a decline of foreign demand, due to weak economic circumstances in the most important foreign trade partner countries. Due to continued inflation pressures, a number of the existing macroeconomic vulnerabilities additionally deteriorated in 2023 (Table 2.1), which is particularly related to the increase of unit labour cost, high growth of real estate property prices and insufficient decline of unemployment rate. Continuing record high growth of real estate property prices, with a decline of affordability, indicates the signs of overheating and is one of the key macroeconomic imbalances which is assessed to need systemic monitoring in the period ahead.

Table 2.1: Macroeconomic Imbalance Indicators in 2023

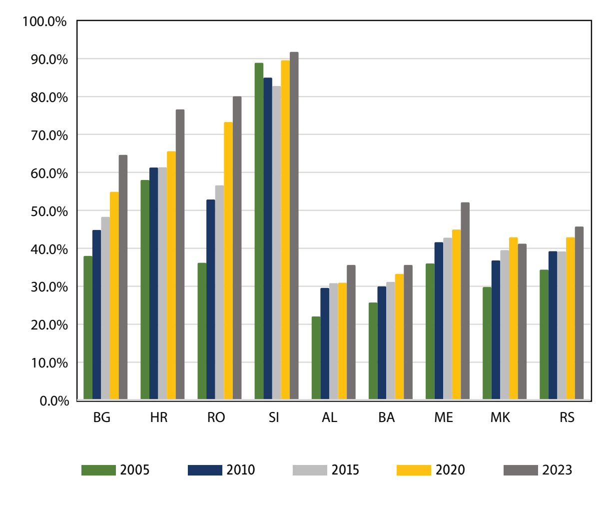
	External imbalances and competitiveness indicators					Internal imbalance indicators						Employment indicators		
2023	Balance of payments current account - three year average (GDP%)	Net balance of foreign investment (GDP %)	Real effective exchange rate - three year change (%)	Share in global exports of goods and services - five year change (global export %)	Nominal index of unit labour cost - three year change (%)	Residential property price index - one year change (%)	Private sector credit flow. consolidated - GDP %	Private sector debt. consolidated - GDP %	Gross debt of general government - GDP %	"Unemployment rate - three year average (%)"	"Financial sector total liabilities. unconsolidated -one-year change (%)"	Activity rate - three year change (pp)	Long-lasting unemployment - three year change (pp)	Youth unemployment rate - three year change (pp)
Reference value	From -4 % to 6 %	-35%	"±5 % (euro area) ±11 % (outside euro area)"	-6%	"9 % (euro area) 12 % (outside euro area)"	6%	14%	133%	60%	10.0%	16.50%	(- 0.2 pp)	0.5 pp	2.0 pp
Bosnia and Herzegovina	-3.0	-22.9	3.5	13.2	23.0%	7.5%	3.5%	49.15%	26.9%	15.4%	3.4%	2.9%	-2.0%	-17.8%
European Union			3.4%		10.5%	-0.3%			83.3%	6.5%		2.6%	-0.3%	-3.0%
Euro area			1.4%		9.8%	-1.1%			88.6%	7.1%		2.5%	-0.4%	-3.6%
Belgium	-0.2	65.2	0.0	-2.8		2.3%	2.0%	156.5%	104.5%	5.8%	0.4%	2.1%	0.1%	0.2%
Bulgaria	-1.1	-7.6	8.5	16.7	26.5%	9.9%			22.0%	4.6%		1.8%	-0.4%	-5.3%
Czech Republic	-2.4	-13.2	24.2	1.2	17.2%	-1.7%			44.2%	2.5%		0.7%	0.2%	0.3%
Denmark	10.1	49.8	-1.0	11.9	5.7%	-4.2%	4.3%	196.6%	30.4%	4.9%	0.6%	1.8%	-0.4%	-0.1%
Germany	5.9	70.2	1.9	-7.0	10.3%	-8.4%	-0.2%	111.4%	64.3%	3.3%	0.7%	2.4%	-0.1%	-2.1%
Estonia	-2.4	-21.3	15.7	15.5	30.6%	5.9%			20.7%	6.1%		2.0%	0.1%	-1.0%
Ireland	11.5	-105.9	-1.2	26.7	11.9%	3.1%			43.3%	5.0%		6.7%	-0.3%	-5.1%
Greece	-7.8	-140.1	-1.2	6.3	0.3%	13.8%	2.0%	96.4%	168.8%	12.8%	-0.9%	4.2%	-4.3%	-11.3%
Spain	1.3	-52.8	-0.8	1.0	8.4%	4.0%	-2.3%	111.6%	107.5%	13.4%	0.6%	2.3%	-0.7%	-9.6%
France	-0.8	-29.4	-1.8	-6.1	9.9%	-0.4%	1.8%	155.4%	110.6%	7.5%	3.6%	1.9%	-0.1%	-4.3%
Croatia	-0.2	-21.6	4.3	19.5	12.6%	11.9%	3.9%	73.3%	63.5%	6.9%	17.4%	3.0%	-0.1%	-2.1%
Italy	0.4	7.0	0.7	-0.9	5.8%	1.3%	-0.9%	97.7%	137.3%	8.4%	-3.1%	3.2%	-0.9%	-7.1%
Cyprus	-8.7	-96.4	0.3	23.2	0.8%	2.9%			77.4%	6.8%		3.2%	-0.2%	-1.3%
Latvia	-4.2	-24.6	10.8	8.3	25.8%	3.7%			43.5%	7.0%		-1.4%	-0.6%	-2.6%
Lithuania	-0.8	1.3	12.8	23.9	36.3%	9.8%			35.6%	6.7%		0.3%	-0.2%	-5.8%
Luxembourg	7.4	33.8	-1.5	4.7	20.9%	-9.1%			25.7%	5.0%		1.9%	0.0%	-4.4%
Hungary	-4.1	-43.2	10.2	5.0	33.7%	7.0%	1.9%	72.3%	73.4%	3.9%	-7.4%	2.9%	0.3%	0.3%
Malta	1.0	71.4	-0.5	20.1	0.2%	6.2%			51.8%	3.5%		4.7%	-0.6%	-2.4%
Netherlands	9.1	54.6	2.4	3.5	9.2%	-1.9%	-0.5%	208.8%	47.2%	3.8%	-0.2%	2.1%	-0.2%	-2.4%
Austria	1.3	16.6	1.8	-0.4	12.1%	-2.9%			75.5%	5.4%		1.8%	-0.6%	-1.3%
Poland	-0.7	-32.3	9.2	23.8	23.1%	8.8%	1.0%	57.1%	50.8%	3.0%	10.8%	4.3%	0.2%	0.6%
Portugal	-0.2	-72.5	-1.4	5.7	9.1%	8.2%	0.9%	130.3%	99.0%	6.5%	-1.9%	3.8%	0.2%	-2.2%
Romania	-7.8	-39.8	6.7	11.3	27.2%	3.3%	2.0%	40.4%	50.6%	5.6%	16.7%	2.7%	0.4%	0.2%
Slovenia	2.3	3.7	1.1	2.5	18.5%	7.2%	0.4%	60.2%	68.5%	4.2%	10.5%	1.4%	-0.5%	-4.4%
Slovakia	-4.3	-54.1	7.5	-1.4	16.9%	-0.2%	2.3%	85.5%	57.9%	6.2%	3.0%	2.0%	0.1%	-0.6%
Finland	-1.0	9.7	-1.9	-3.5	13.9%	-5.7%			76.7%	7.2%		2.6%	0.1%	-4.8%
Sweden	6.1	33.2	-7.5	4.4	10.7%	-5.3%	1.7%	202.1%	35.9%	8.0%	3.1%	1.9%	0.6%	-1.5%

Source: EUROSTAT, CBBH, BHAS

3. ECONOMY PERFORMANCE AND OUTLOOK

The period from the beginning of the new century has been marked by a slow convergence towards developed countries with BH reaching only 35% of the average EU development level at 2023 end. In distant 2005, BH and Albania had reached 25% and 22% of the EU development, still recording the lowest levels of development after almost two decades (Graph 3.1). At the same time, BH, together with North Macedonia, has seen the slowest decrease of economic gap with developed countries. On the other hand, significant economic benefits of joining the Union are evident in the case of Croatia (76% of the EU development level) having decreased the gap by 15% in the ten year period, and Slovenia which reached 92% of the average EU development level, with the 8% gap decrease in a decade, or Romania which became closer to the EU standard by 25% in this period. Romania showed the strongest standard increase, having in mind that in the beginning of 2000, it was just slightly above BH. Yet, on the basis of the latest European Commission convergence report, this country did not meet the four key convergence criteria (price stability, public finance, exchange rate and convergence of long-term interest rates), while on the other hand, Bulgaria met all the criteria except for price stability, and Croatia met all the criteria needed to access the euro area. So, macroeconomic circumstances in those countries were quite diverse, regardless of quite similar development levels measured by the GDP per purchasing power standard, therefore a number of quantitative and also qualitative indicators need to be taken into account with regard to full convergence.

Graph 3.1: GDP per Purchasing Power Standard, (EU 27=100)

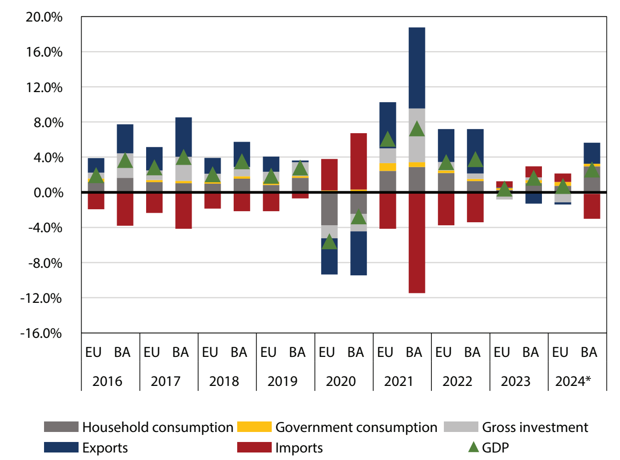


Source: EUROSTAT, BHAS

After many global supply chains had been disrupted during the pandemic, there was a short-term change of economic activity structure in BH, with exports, particularly exports of goods, growing faster than the years long average level, while the very exports of goods recorded the strongest decline in 2023, continuing also in the first half of 2024.

The GDP growth structure in the country and the EU before the pandemic had pointed out similar contributions of the main components on the average (Graph 3.2 below), followed by a short-term deviation of export contribution, which was again balanced in the previous period. The decline of exports from the previous year was continued in the first half of 2024, due to a strong decline of exports of goods (8.3% decline compared to the first half of 2023), which was under the impact of long-lasting weak economic conditions in the most important trade partner countries, firstly Germany. Yet, in 2024, a positive contribution of the total exports is expected, due to the recovery of exports of goods in the second half of the year, and mainly due to the considerable growth of exports of services with only the growth of foreign tourists' arrivals in the first half of the year of 14% at the annual level indicates very positive trends in service sector. Consequently, in the same period, a growth of imports is expected, resulting from high dependence of exports on the imports of materials and raw materials.

Graph 3.2: Contributions of GDP Components, Expenditure Approach



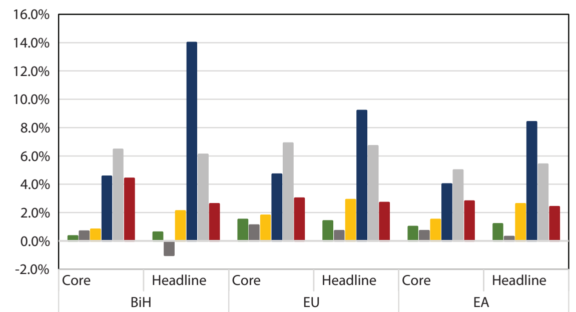
Source: EUROSTAT, BHAS

Note: *Contributions of components in 2024 represent an annual change of value added in the first quarter for the EU. Projection of the GDP trends in BH for 2024 is based on the CBBH projection of the GDP.

The economy outlook in the period ahead mainly depends on continuing reducing of inflation pressures which are under the increasing impact of core inflation growth. During 2022 and 2023, record high inflation rates were seen, due to the effects of a number of factors particularly a strong growth of food and energy prices, and the effects of expansionary monetary policies of leading central banks in the previous decade, but also fiscal policies of most countries during the pandemic period. Additionally, the increase of profit margins brought about record high levels of consumer prices, which caused a rapid change of monetary policy and introduction of restrictive measures. Initially, high inflation rates were mainly caused by the growth of exogenous prices, particularly those of oil, food and energy, followed by the increasing effect of endogenous factors on price growth.

Having in mind how high inflation rates affect the real standard of living of households, union pressures became increasingly frequent to increase nominal wages in order to adjust real income of households with a strong price growth. The mentioned pressure and the increasing problem of lack of qualified workers brought about a faster growth of core inflation, which was stronger in the local market and the EU market than the headline inflation rates during 2023. Comparing the expected headline and core inflation in the local and foreign markets for 2024 (Graph 3.3), it is evident that a continuing faster growth of core inflation than headline inflation is expected, due to the increasing impact of the domestic prices, which might lead to the deepening of inflation spiral.

Graph 3.3: Annual Change of Core and Headline Inflation



	BiH Core	BiH Headline	EU Core	EU Headline	EA Core	EA Headline
2019	0.3%	0.6%	1.5%	1.4%	1.0%	1.2%
2020	0.7%	-1.0%	1.1%	0.7%	0.7%	0.3%
2021	0.8%	2.1%	1.8%	2.9%	1.5%	2.6%
2022	4.5%	14.0%	4.7%	9.2%	4.0%	8.4%
2023	6.5%	6.1%	6.9%	6.7%	5.0%	5.4%
2024*	4.4%	2.6%	3.0%	2.7%	2.8%	2.4%

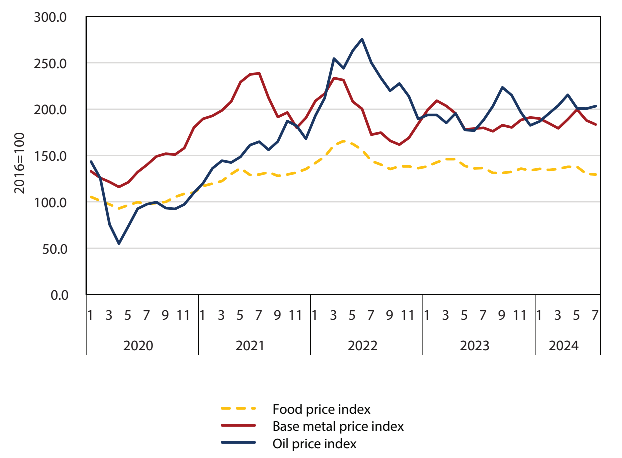
Source: BHAS, CBBH, EUROSTAT, CF and EC

Note: The core and headline inflation projections for the EA are based on the July CF projection, while the projection of core and headline inflation for the EU is an EC projection from May of this year.

4. EXTERNAL SECTOR

The economic activity in 2023 was under a strong effect of geopolitical tensions and weak global demand, which was particularly obvious in the second half of the year, when inflation rates stabilised. Following the turbulent year of 2022, prices in international energy market stabilised in 2023, despite significant chances that supply chains may be disrupted again due to intensification of conflicts in the Middle East. A rather mild winter, successful diversification of supply sources and rational use of reserves kept the energy prices rather stable, except for short term fluctuations. Despite the programme of reduced oil deliveries by the leaders of the OPEC+ countries, the oil prices remained rather stable due to reduced demand mainly in Chinese market, the largest oil importer but also the growth of reserves in the USA (Graph 4.1).

Graph 4.1: Index of Stock Exchange Commodity Prices

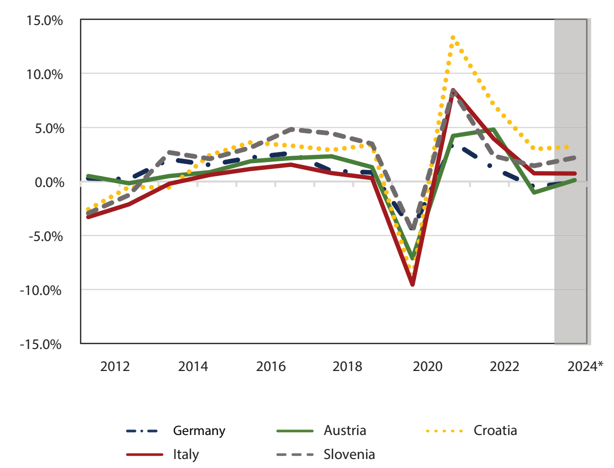


Source: IMF database

Global economic activity in 2023 was impacted by several factors, including the post-pandemic recovery, persistent inflation, strong geopolitical tensions and restrictive monetary policy. Global growth was slower compared to the previous years, taking into account high inflation which hit most of the economies, including the USA, the European Union and many developing market economies (Graph 4.2). Persistent inflation, brought about by disruptions in supply chains, growth of food and energy prices and increased production costs, started to stabilise as early as in the beginning of the year due to the introduced restrictive monetary policy measures by the leading central banks. Despite the increasingly low unemployment rates in the EU and the USA, and also nominal growth of earnings, the restrictive monetary policy measures gave results, with the annual inflation rate declining throughout 2023 to reach the pre-pandemic level in the first half of 2024. It should be stressed that core inflation exceeded the growth of headline inflation, due to high inflation rates for services, and lower demand for energy.

Keeping high reference interest rates of the European Central Bank and the Federal Reserves throughout 2023 slowed down the final consumption and investment, but the US economy showed a much higher level of resilience compared to European one.

Graph 4.2: Real Growth of Main Trade Partners' GDPs



Source: EUROSTAT
Note: 2024* Projection of the European Commission, Spring Forecast

The projection of global economic growth in 2024 was kept at the level of 3.2%[1], with the main generators of growth being India and China with the rates of 7.0% and 5.0%, respectively, and also the USA (2.6%). Inflation in the service sector continued to make pressure on core inflation, and together with strong geopolitical tensions, delays the normalisation of monetary policy and more considerable decrease of reference interest rates. Potential risks for global economic growth are mainly related to strong geopolitical tensions, mainly the war in Ukraine and the Middle East, but also tensions in the Asian-Pacific region, which could additionally destabilise global markets, disrupt trade routes and increase the energy and raw material prices. Disruptions in energy supply, sharp increases of oil and gas prices could increase production costs and decrease availability of energy, which could slow down economic growth, particularly in energy dependent regions. The mentioned potential risks would also have an inflationary effect, which would postpone a more considerable decrease of interest rates, The global trade size also depends largely on the performance of Chinese economy, which is under a strong pressure of problems in real estate sector, lower domestic demand and trade tensions with the West.

The economic outlooks of the EU, our most important trade partner, were revised slightly upwards in the spring round of projections, to the level of real economic growth in 2024 of 1.0%[2], forecasting a growth of economic activity

[1] Source: World Economic Outlook, July 2024
[2] Source: European Commission, European Economic Forecast, Spring 2024

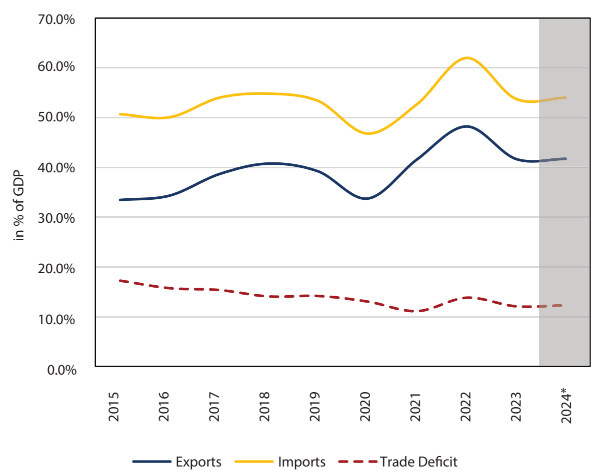
for almost all member countries (the forecasted decline of economic activity in Estonia of 0.5%). The projected growth among the EU countries is quite unequal, ranging from 4.6%, which is a real growth forecast for Malta, 3.3% in Croatia and Romania to the stagnation in Finland and negligible growth in Germany (0.1%). Despite the expected growth of domestic demand in Germany, it is not expected to be sufficient to compensate for investments which are forecast to stay much below the pre-pandemic level due to high financing costs.

Macroeconomic imbalances in the EU in respect of external imbalances did not deepen significantly from the view of investment position and real effective exchange rate, taking into account the single market rules and monetary policies. The exceptions are Estonia and Lithuania, which in 2023, compared to 2022, came much closer to the reference levels speaking of the three year change of real effective exchange rate. On the other hand, even five countries (Ireland, Latvia, Luxembourg, Slovakia and Sweden) came close to the reference levels of macroeconomic imbalances related to the three year average of the current account expressed in per cents of GDP, whereas Germany, unlike 2022, exited the potential risk area. Despite more difficult conditions of transport via the Red Sea and also growth of costs of ensuring container shipments, four countries of the EU (Czechia, Spain, Italy and Slovakia) unlike previous year, exited the potential risk area related to the share of the value of exports of goods and services in global exports. Global geopolitical, and trade tensions between China and Western countries, represent a potential risk for the global supply chains and trade, which would have a negative impact on global economic growth. So, the main trade partners of BH in 2023 did not show significant macroeconomic imbalances, but a low level of economic activity expected in 2024 could significantly affect foreign demand.

External imbalance indicators in BH do not indicate excessive imbalances, as in the last five years the current account deficit does not represent the source of imbalance. Taking into account a regular revision of historical data series of balance of payments statistics, the three year average of current account deficit expressed in per cents of GDP in 2023 remained at the same level as in the previous year (3.0%, Statistical Appendix 1). In 2023, there was a significant decrease of current account deficit by the high percentage of 30.4% which, with the downward revision of the current account deficit data for previous years, kept the three year average expressed in per cents of GDP the same for 2021-2023. As in earlier years, the main generator of current account deficit is trade deficit, as a consequence of the commodity account deficit.

In 2023, there was a decline of the value of foreign trade commodity exchange, mainly as a result of the price effect taking into account that the prices of various stock exchange goods (oil, gas, base metals etc.) were at a much lower level in the reporting year compared to 2022, but also due to the decline of demand in the markets of the main trade partner countries especially in the second half of 2023 (Graph 4.3). The values of exports and imports of goods decreased by 4.3% and 2.6%, respectively. A higher rate of decline of the value of exports compared to imports, and also the position of BH as a net importer in the international market of goods, resulted in the record high foreign trade commodity deficit in 2023 in the amount of KM 10.20 billion. A low level of economic activity in the main trade partner countries in the second half of 2023 resulted in a decline of demand for BH goods, which continued in 2024, when the contraction of exports of goods was recorded, accompanied by the growth of import value, resulting in a high current account deficit. Decline of demand affected some of the most important product groups for exports, those being mineral origin products (electric energy), base metals and furniture.

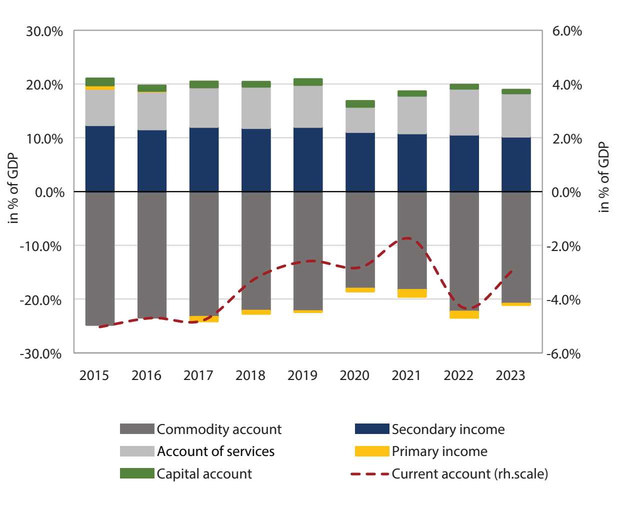
Graph 4.3: Exports, Imports and Trade Deficit



Source: BHAS
Note: *Data for 2024 are the CBBH projection

Good indicators in the tourism sector mainly brought about record net inflows in the account of services in 2023, in the value of KM 3.95 billion. The largest contribution was made by net inflows on the basis of foreign tourists' spending which reached the value of KM 2.26 billion, which is a growth of 5.8%. It should be stressed that net inflows on this basis are reduced by significant outflows on the basis of domestic tourists' spending in foreign countries. Despite a decline of industrial production output in trade partner countries, net inflows on the basis of goods processing (Lohn jobs) increased by 7.6%. The growth of 1.6% was also recorded in net inflows on the basis of services of transport, stimulated by high volume of commodity exchange with foreign countries. Despite a modest volume of economic activity in developed countries, net inflows on the basis of workers' remittances recorded growth of 4.5%, mainly as a consequence of good results in labour market and nominal adjustment of wages. According to the spring projections of the CBBH, a growth of remittances of 6.1%.is expected in 2024. The data in the first six months of 2024, speaking of international commodity trade, indicate strong potential risks and uncertainties, mainly related to low demand related to exports of goods mainly due to the decline of demand in the markets of the main trade partner countries.

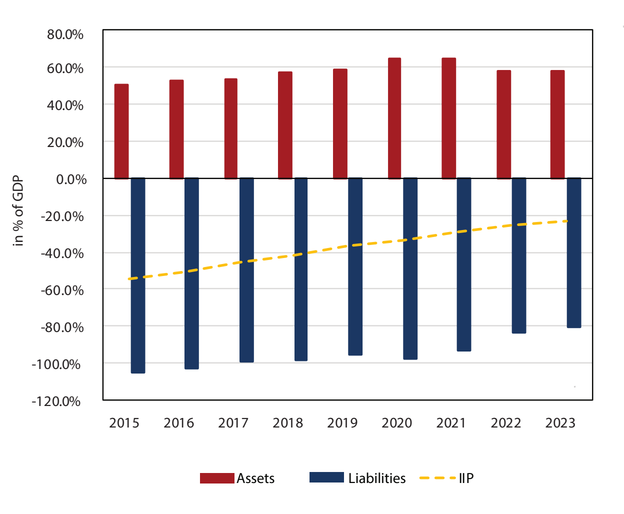
Graph 4.4: Current and Capital Accounts



Source: CBBH

In 2023, international investment position (IIP) did not represent a source of imbalances. In the reporting year, IIP, expressed in relation to GDP, stayed on a continuing downward trend, being at the level of 22.9% of GDP in 2023, which is the fourth successive year when this indicator did not exceed the reference value (Graph 4.5 and Table 2.1).

Graph 4.5: International Investment Position



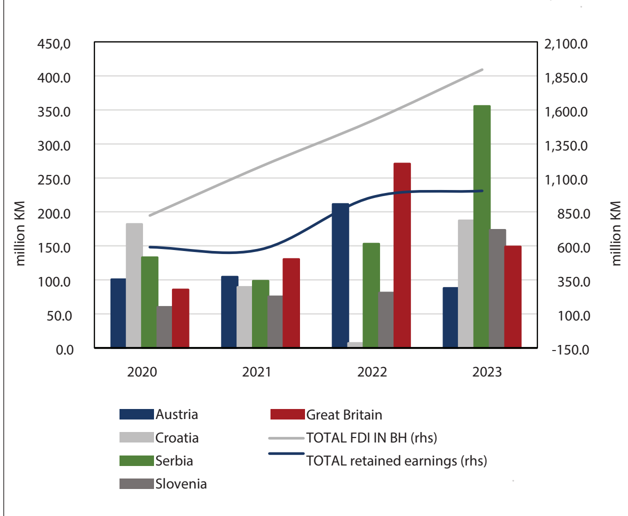
Source: CBBH

International investment position, expressed in per cents of GDP, in 2023 recorded improvement, mainly resulting from a significant asset growth (7.4%) compared to liabilities growth (3.8%), but also the nominal growth of GDP. The increase of assets resulted from increases in the categories of currency and deposits (KM 932.3 million) and investments in debt securities (KM 394.8 million). Economic policy focused on attracting foreign investment in production activities, increase of exports and decrease of foreign debt remains the key task for improving international investment position.

Diversification of exports with the support to small and medium size companies accompanied by technological modernisation would increase competitiveness in international markets. The development of transport and energy infrastructure with the improvement of investment climate would contribute to additional attraction of foreign direct investment. According to the data for the first quarter of 2024, investment position slightly deteriorated, with the growth of foreign direct investment and increase of debt of corporate sector in the form of loans and trade loans.

In 2023, foreign direct investments amounted to KM 1.90 billion, representing a growth of 24.9% and the highest amount since 2007 (Graph 4.6). Out of this amount, even 53.0% is related to retained earnings, while the remaining amount represents investments in debt instruments and other forms of investment. By countries where direct investments are coming from, the largest contribution to the growth of foreign investments in BH in 2023 was made by the investments from Russia (KM 376.3 million), Serbia (KM 355.6 million), the Netherlands (KM 237.7 million) and Germany (KM 204.9 million). The share of retained earnings in direct investments of the most significant foreign investors in 2023 was much lower compared to the previous year. The data for the first quarter of 2024 indicate the growth of foreign direct investment of 4.0%, out of it, more than 60.0% is related to reinvested earnings.

Graph 4.6: Inflow of Foreign Direct Investment



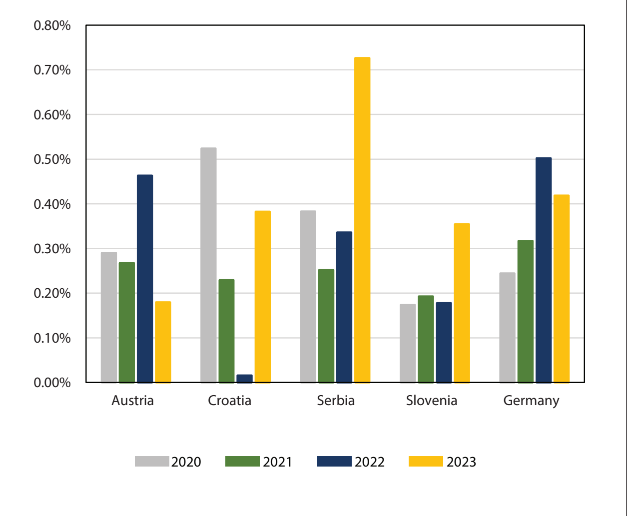
Izvor: CBBiH

The expected low level of economic activities in the countries which are the main foreign investors in BH, and also high costs of financing investment projects brought about by restrictive monetary policy, represent the basic external risks for the inflow of foreign direct investment, and also international investment position on the whole. Croatia, Serbia, Austria, Slovenia and Germany represent the most significant investor countries in BH. The total value of investments of these countries makes more than half of the value of all investments in BH. The investments of Serbia and Germany in BH in 2023 accounted for 0.7% and 0.4% of GDP of BH, respectively (Graph 4.7).

Also, the investments of Croatia and Slovenia in BH in 2023 were at the level of 0.4% of GDP of BH. The projected growth rates of economies of Germany and Austria at negligible levels of 0.1% and 0.3%, respectively, could deter potential investors from further investing in BH. Besides, other investor countries do not expect a considerable economic growth in 2024 either, the Netherlands 0.8%, Slovenia 2.3% and Croatia 3.3%. A slightly slower stabilisation of headline inflation in relation to core inflation delayed a considerable decrease of reference interest rates of the main central banks, which kept the financing costs of investment projects at a high level. In addition to external factors, BH is facing also significant internal factors, such as labour market, demographic challenges and political instability. Emigration, especially that of young and educated people, is a significant problem for BH taking into account that the lack of qualified workers can make more difficult for foreign companies to find the necessary skills in the local market. In addition, traditional problems remain a complex political system, low efficiency of administration and underdeveloped infrastructure.

Generally, the foreign direct investment trend at the global level in 2024 will be in the light of unstable economic outlooks, high interest rates and geopolitical tensions. Investors are expected to be very cautious with regard to investments in industries sensitive to supply chains disruptions. Also, national authorities define increasingly strict rules with regard to decarbonisation, while investments in technology are expected to be guided by digital transformation. BH authorities defined a number of reforms with purpose of implementing the Growth Plan for the Western Balkans focused on creating conditions to provide sustainable (green) energy, digital transition, better IT infrastructure, including improvement of cyber security.

Graph 4.7: Flows of Foreign Direct Investment in Per Cents of GDP in BH



Source: CBBH, BHAS

Text box 1: Potential impact of carbon tax on the exports of goods from BH

Climate changes represent a global problem, so the solution means taking measures globally For the EU, climate changes are one of the main global challenges, so the Council of the European Union adopted for this purpose the Carbon Border Adjustment Mechanism (CBAM)[3], requiring importers to report on direct and indirect emissions of greenhouse gases in the goods they import. The purpose of this mechanism is to prevent the so-called "carbon leakage", i.e. attempt to decrease the risks that climate objectives of the EU could be endangered by production transfers into the countries with less ambitious decarbonisation policies. "Carbon leakage" takes place when companies seated in the EU transfer carbon intensive production abroad into the countries with less restrictive climate policies in effect than in the EU, or when products from the EU are replaced by imported products whose production includes considerable emissions of carbon. From January 2026, the EU will start introducing customs on the imports from countries that to not price carbon at the EU market rate, which could significantly impact producers with high carbon emissions among its trade partners. The mechanism is focused on the imports of high carbon emission products to the EU, with full compliance with international trade rules. These measures would cover products from the areas of production of iron and steel, aluminium, electric energy, cement and artificial fertilizers. This system is a supplement to the EU Emissions Trading System (ETS)[4] – which is the base of the EU policy for struggling against climate changes – by introducing equal rules of imports of some goods into the customs area of the European Union.

The implementation of the mechanism will take place in two stages. The first stage (transition) started on 01 October 2023 and will last until 31 December 2025, representing a transition period whose purpose is to collect data for the fine adjustment of the mechanism form, without payment for any financial adjustment. The second stage of implementation starts from 1 January 2026 representing the final stage of the mechanism implementation. In this stage of implementation, importers of goods from the EU will be purchasing CBAM certificates for the quantity of carbon dioxide (CO_2) which was generated during the production (direct and indirect emissions) of imported goods. The price of the certificate will be the weekly average auction price of EU ETS allowances in euros per tonne of emitted CO_2.

On its path to the full membership in the EU, BH will need to act with much more determination in the direction of its energy transition in order to adjust its industrial and ecological standards with the standards of the EU, its most significant export market. The purpose of transformation is increasing competitiveness and avoiding additional customs duties on the exports of its products to the EU market.

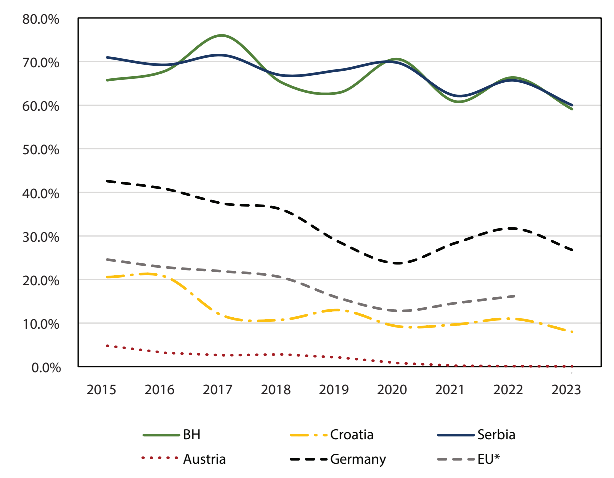
[3] Carbon Border Adjustment Mechanism. More details on: https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en
[4] EU Emissions Trading System. More details on: https://climate.ec.europa.eu/eu-action/eu-emissions-trading-system-eu-ets/what-eu-ets_en

One of the measures to achieve these objectives is the implementation of CBAM mechanism, which is aimed at regulating carbon emissions in international trade. Its implementation would enable the countries to charge taxes or fees on import products which were produced with high carbon emissions. Carbon tax was designed to decrease the emission of greenhouses gases by essentially increasing the price of fossil fuels, decreasing at the same time demand for goods and services producing high carbon emissions. Emission of greenhouses gases causes climate changes, which can be reduced by taxation of carbon emission at any point of production process. Carbon tax in its simplest form covers only carbon dioxide (CO_2) emission. However, this tax could cover other greenhouse gases such as methane or nitrous oxide, by taxation of such emissions on the basis of their potential effect on global warming[5].

Carbon tax firstly affects the energy cost price, so the effects of this tax would be felt both by households and economy in BH. The introduction of such tax is one the preconditions to access the EU, otherwise BH could face significant export taxes. BH is one of the most significant producers and exporters of electric energy in Europe and the largest one among the Western Balkans countries[6]. In long term, potential problem is a fact that in 2023, more than half of electric energy in BH was produced by using coal, i.e. in thermal power plants (Graph 4.8). Despite a significant number of implemented and announced projects related to obtaining of electric energy from renewable sources, less than 3.0% of electric energy in BH in 2023 was obtained by the energy of wind and sun. Competitiveness of electric energy producers in BH is also endangered by price trends, mainly in European market. The energy crisis and the war in Ukraine forced European countries to undertake a sharper change from fossil fuels to renewable sources of energy. The results of European energy transition are visible in the beginning of 2024 when renewable sources had the share of 44% in electric energy production in Europe[7]. Integration into the single European market of electric energy without a considerable change to renewable source of energy would make local producers of electric energy completely uncompetitive. The first seven months of 2024 were particularly challenging regarding the exports of electric energy to European market. A rather mild winter, and successful diversification of energy sources in the European market impacted a decline of demand for electric energy, so the exports from BH saw an annual decline in the first seven months by 55.4%.

The decline of export value was firstly the result of price effect[8], but also lower produced quantities in BH due to decreased output in thermal power plants and poor hydrological conditions.

Graph 4.8:The Share of Electric Energy Obtained from Coal



Source: www.ourworldindata.org
Note: *At the moment of writing the Text box, the data for the EU level for 2023 were not available

Besides the direct effect on electric energy price produced by the use of fossil fuels, carbon tax directly increases production costs, particularly for energy intensive industries such as steel, aluminium and cement, which are significant exporters from BH. As companies have higher costs for energy and raw materials, these costs can be transmitteds to the final price of exported goods. This could make BH exports less competitive at international market where similar products are available at lower prices due to lower production costs or absence of carbon tax. Historically, base metals represent the most significant product group of exports of BH (Graph 4.9), whose prices on international markets were very volatile over the last five years under the impact of various geopolitical, epidemiological and distribution factors. Additional tax burden in the form of carbon tax would rise the cost price of metal industry products which would make them less competitive on a highly price sensitive market.

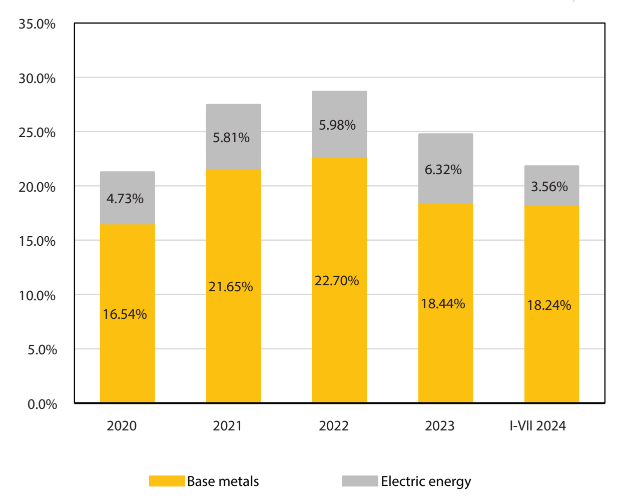
[5] In this paper, potential effects of this tax on the exports of some kinds of goods from BH will be considered, without detailed analysis of the way of taxation, such as trade in carbon emissions, carbon tax, issues related to the tax effects or possible subsidies or reallocation of income.

[6] Higher value of electric energy exports than BH in 2023 were recorded only by Germany (EUR 1.21 billion), Austria (EUR 1.03 billion) and the Netherlands (EUR 628.7 million). Source: EUROSTAT. Available at: https://ec.europa.eu/eurostat/databrowser/view/ds-045409__custom_12668779/default/table?lang=en

[7] Elisabeth Cremona, Dr Chris Rosslowe (13 Mart 2024): "Putting the mission in transmission: Grids for Europe's energy transition".

[8] Electric energy price at Budapest stock exchange in the first seven months of 2024 were on the avarege lower by 26.8% than in the same period of the previous year. Source: www.statista.com Available at: https://www.statista.com/statistics/1314534/hungary-monthly-wholesale-electricity-price/

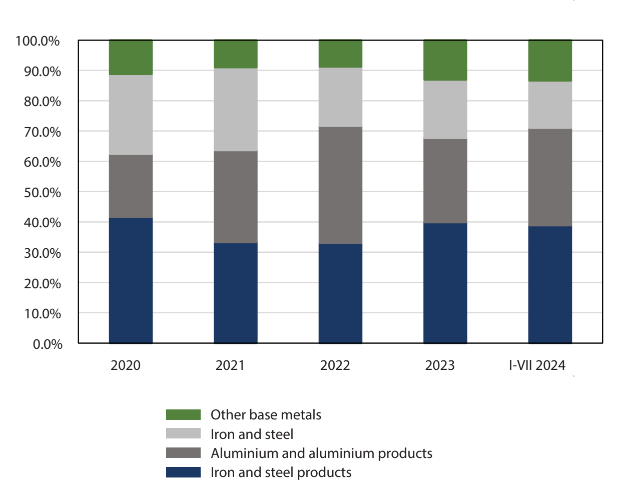
Graph 4.9: The Share of the Value of Base Metals and Electric Energy Exports in the Total Exports from BH



Source: BHAS

In BH exports, within base metals, the most significant place is taken by iron and steel and their products, as well as aluminium and aluminium products (Graph 4.10) with the share of around 90.0%. As the implementation of the CBAM is directly focused on these product groups, inadequate pace of energy transformation of BH metal industry can impact a significant decline of competitiveness and the value of exports of this economy sector.

Graph 4.10: The Structure of Base Metals Exports



Source: BHAS

Taking into account only the exports of base metals and electric energy, the cumulative share of which in the last five years was around 25% of the value of the total exports of goods from BH, it is obvious that the introduction of carbon tax due to unadjusted ecological norms would have a strong impact on the total exports from BH. Additional complicating circumstance is the fact that the most important export market for BH products is the EU market,[9] with very strict ecological regulations.

Although carbon tax could initially make BH goods more expensive, the introduction and implementation of this tax would make BH closer to the EU ecological standards, and potentially facilitate access to the EU market. However, taking into account less strict ecological regulations in the domestic market, BH exports could have problems in competing with cheaper alternatives from the countries without carbon tax. Therefore, small and medium size companies, which account for a significant part of BH economy, could face challenges due to increased production costs, while limited funds for investing in energy efficiency could bring about decrease of export capacities.

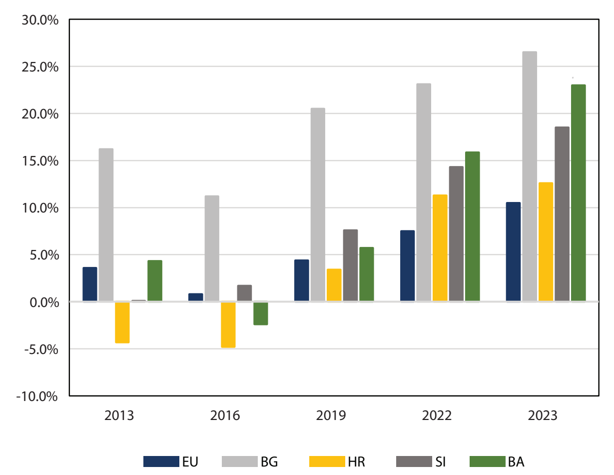
Impact of carbon tax on exports from BH is multiple. Although in the beginning it could be a challenge due to increase of production costs and decrease of competitiveness, it also offers a possibility for long term economic transformation. BH industry should adjust to a new economic environment through innovation, investment in green technologies and adjustment with international environment standards. The path to energy transformation includes the developing of climate regulations with strict control of their implementation, and investment in infrastructure of energy from renewable sources. Initial steps which BH should undertake on its path of energy transition are the establishment of appropriate legal regulations and making economy closer to legislation. The Ministry of Foreign Trade and Economic Relations with the support of the EU has prepared the analysis of potential impact of CBAM and ETS on 6 selected sectors in BH: steel, iron, cement, artificial fertilizers, aluminium and electric energy. The objective of the analysis was to show the assessed effects in the period 2026-2030 by sectors, and overall. The conclusion of the analysis was that in the initial stage, the best solution would be gradual introduction of ETS, in parallel with the effects of CBAM, as in that way, the funds collected from the ETS would stay in BH budgets (as the ETS taxes all produced goods in the country, while the CBAM taxes only goods exported) and could be used as support to decarbonisation and more just transition. As a precondition, the Working Group was formed to set up the Emission Trading System and Monitoring, Reporting and Verification System, which is one of the most significant preconditions for the successful implementation of the CBAM.

[9] In the first seven months of 2024, even 74.3% of the value of exports of goods from BH is exported to the EU market. Source: BHAS

5. COMPETITIVENESS AND PRICES

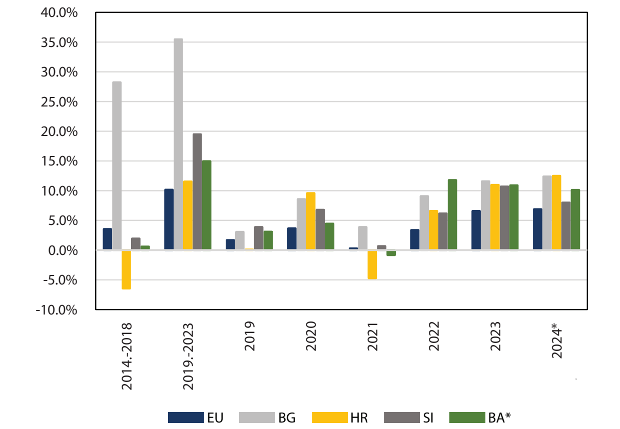
Competitiveness in 2023 deteriorated as a result of a productivity slowdown, due to the decline of commodity exports, but also the increasing pressure of growing costs on operations, with labour costs particularly standing out. Observing the three year change of unit labour cost (Graph 5.1), it is visible that labour costs significantly increased in recent years resulting , among other reasons, also from the increasing lack of working population in the European continent. Therefore, in 2023, most of the presented countries showed a higher than reference value of macroeconomic imbalance. The growth of unit labour cost in BH is particularly visible through the growth of gross wages, which is partly related with the growth of minimal wage, but also the union pressure in most activities, which is particularly strong in the activities with under-average payment. The trend of the domestic real unit labour cost in recent years followed the trend from comparable countries, with real labour cost in the previous five year period creating stronger pressure on competitiveness for entrepreneurs than it was seen in previous periods (Graph 5.2). Yet, still significantly lower levels of average labour cost in the country compared to foreign countries, as well as a huge economic gap, certainly bring about the increasing interest of local workers for going abroad (see Chapter 8). Having in mind a significant pressure regarding offer, and the increasing pressure of workers to adjust the standard with increasing prices and the standards of comparable countries, we can expect a more significant growth of this indicator in the period ahead.

Graph 5.1: The Three Year Change of Nominal Unit Cost by Selected Countries



Source: EUROSTAT, BHAS, CBBiH

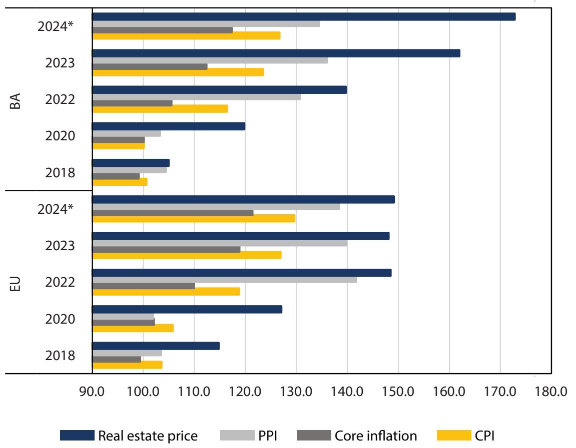
Graph 5.2: Change of Real Unit Cost



Source: EUROSTAT, BHAS, CBBH
Note: *The 2014-2018 period represents a five year change compared to the 2009-20013. The 2024 forecast is related to the official data from the end of the first quarter of year, whiole that for BH includes the CBBH projections based on the spring round of medium-term macroeconomic forecast.

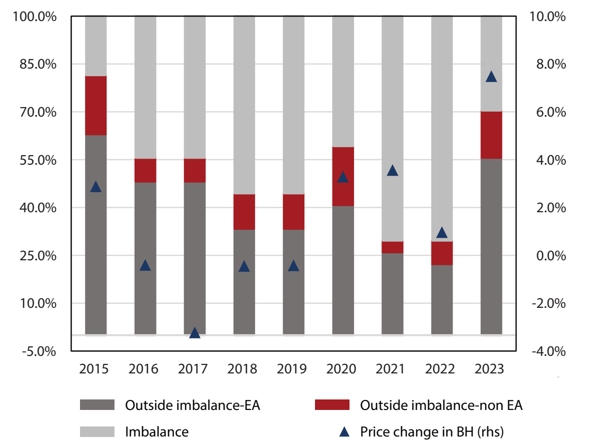
After the corona crisis and the war in Ukraine brought about, among other, record high inflation pressures which were caused by exogenous prices, in the latest period, the growth of average consumer price continued, due to the increasing pressure of growing core inflation, and the continuing expansionary growth of real estate prices. Observing the trend of average prices (Graph 5.3), a considerable price growth is visible compared to the base year. Producers and tradesmen in food industry, and in other activities, raised the prices of their products significantly in recent period, regardless of numerous measures passed by policy makers, which is particularly reflected in the growth of core inflation. Core inflation is under the additional pressure of the growth of real wages, profit margins (Graph 5.6 in Text Box 2), and union requests due to the strong negotiation power of workers, based on significantly lower living standard of households in comparison with the EU countries, which contributes to a large and continuing emigration of working population. Having in mind a strong effect of increase of labour costs and profit margins on the growth of the total prices and real estate prices (Text box 2), pressure can be expected in the period ahead on the increase of some macroeconomic imbalances, mainly competitiveness and further deterioration of residential real estate affordability.

Graph 5.3: Average Price Trend, 2015=100



Source: EUROSTAT, BHAS, CBBH
Note: *Average consumer and producer prices in 2024 refer to the first half of the year, while EU real estate prices refer to the end of the first quarter of 2024 according to the latest official data, and domestic real estate prices are an estimate of the CBBH for 2024.

Graph 5.4: The Structure of the Countries Exceeding the Real Estate Price Growth Imbalance



Source: EUROSTAT, CBBH
Note: Imbalance means growth above the reference value of deflated real estate prices, whereas for B&H, the deflator is used in the construction industry.

Real estate prices in the EU were on record high levels during 2022, followed by a decline of prices, mainly due to the implemented restrictive measures of monetary policy. In the domestic market, there is still insufficient offer, and weak availability of other financial instruments, which causes continuing strong growth of these prices. Due to the change of monetary policy, which was in effect for slightly longer than two years, the real estate prices in the EU are under the pressure of high interest rates and weaker purchasing power of households, which brought about a decline of real estate prices in 2023 in the EU, which was particularly strong in the euro area countries. In the local market, this indicator in recent years recorded a strong nominal and even real growth, which is also expected in 2024, due to a weaker transmission of interest rate growth from the euro area to local interest rates, and a weaker offer of real estate properties in the domestic market. Observing the structure of all the EU countries according to the indicator of excess of growth of deflated real estate prices (Graph 5.4)[10], it is evident that most countries in 2023 recorded the values under the reference value for imbalance, i.e. lower annual real growth than 6.0%, with imbalance recorded in the local market at the same time.

Text box 2: Reasons of resilience of domestic real estate market

Regardless of the continuing upward trend of issued construction permits for residential real estate, the production index in residential building during 2023 was stagnating. Such trend suggests that the growth of licences was still not fully reflected in the market, which eagerly waits for the calming down of high growth of real estate prices which is a particular burden for young people. As already stated, a decline of real estate prices in the EU took place due to restrictive monetary policy and lower purchasing power of households, which resulted in lower interest of investors for construction permits issuance, which decreased by 20% only in 2023. According to the deterioration of macroeconomic bases, the EU real estate market is already showing the signs of slowdown or even a decline of prices in a large number of countries, while similar signs are still not in sight in the local market. Numerous reasons affect the resilience of the local real estate market.

Various indicators of residential real estate prices ratios and their macroeconomic determinants still indicate the imbalances which are not likely to be short-lasting. During 2022 and 2023, real estate prices had the record high growth, which amounted to 16.3% on the average. On the other hand, nominal net available income recorded a lower growth (14%), while the other unobserved income which is an integral part of household income includes the estimated return on investment in real estate property [11]. Therefore, real estate price growth has a positive impact on the available household income. Producer prices in residential building (Graph 5.5) in 2023 recorded a much lower growth (4.8%) than real estate prices, which was continued in the first half of 2024 (3.8%). Renting prices are mainly defined as a contractual liability on longer period of time, so they lag behind other prices, including real estate prices.

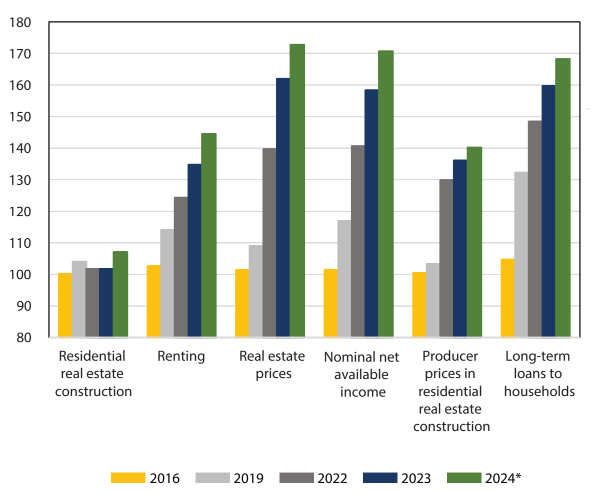
[10] The calculation includes 20 euro area countries and 7 countries outside the euro area, which are parts of the EU. In 2023, 19 countries were outside imbalance, i.e. they had a lower growth of deflated real estate prices than 6%, including 15 EA countries (55.5% share in the EU structure) and 4 countries (15.0%) outside the EA. Other 8 EU countries (share of 30%) recorded imbalance in this area.

[11] Technical paper: Macroeconomic model of Bosnia and Herzegovina, p. 9; available at https://cbbh.ba/Content/Archive/1141

So, as early as in 2023, slightly higher renting prices were recorded (8.4%) compared to the long lasting trend (3.2% from the beginning of 2015 to 2023). For this reason, in the previous two years, the residential real estate prices and renting prices ratio gap (estimate for 2024 is 1.21)[12] increased compared to the long term trend, having been closed until the beginning of 2022. In other words, increase/decrease of real estate price was followed by the identical increase/ decrease of renting prices. Gap increase, with the mentioned time lag of renting price adjustment suggests that probably pressure on increase of renting prices will appear in the period ahead.

The ratio of long-term loans to households and residential property prices was significantly lower than the long term trend, so in the previous two years, for the first time, it was below one implying that real estate property prices increase much faster than the standardised value of long-term loans to households, mainly intended for purchasing housing units. The trend of this ratio recently implies that additional personal funds need to be allocated for the purchase of housing unit, which is a usual practice when processing a loan application, but it also implies that the new sources of financing are needed for adaption and fitting of apartments, which becomes increasingly expensive and difficult in the time of continuing increase of prices of construction materials and lack of qualified workers. Insufficient supply of residential real estate is illustrated by increased gap between real estate prices and works performed in residential building. The mentioned gap increased by 47% in three years, leading to the conclusion that the residential real estate prices, regardless of various positive effects regarding demand which contributed to price growth (such as inflows of remittances from workers living abroad, wage growth, increase of tourism and similar) in recent years were under the considerable impact of insufficient supply in the market, which is particularly visible in the capital and other larger cities in the country.

Graph 5.5: Trend of indices of Selected indicators in Residential Real Estate Construction, 2015=100



Source: BHAS, CBBH

[12] Estimated real estate prices for 2024 are based on medium term macroeconomic projections of the CBBH, while renting prices include the latest available official data from the end of July 2024.

The growth of construction material costs, which increased strongly during the corona crisis due to disruptions in logistics, slowed down in the previous two years, but on the other hand, labour costs continued to increase very strongly under the impact of the general growth of wages and further strong lack of workers, particularly for construction and craft services. Comparing the trends of GDP deflator, reflecting the production unit price by showing costs of labour, gains and taxes, at the economy level (5.5% in 2023) and in construction activity (8.4% at the same time) it is possible to see the main price pressures in the previous period. At the level of the total economy, unit labour costs made the main price pressure on the total prices with a larger tax share, while in construction activity, the strongest effect on the prices was that of the unit profit (Graph 5.6). The unit profit[13], which measures average profit per unit of output, has become a significant driver of GDP deflator in the last three years both at the level of construction and at the level of economy, which is partly caused by increase of productivity, and also higher profit margins. In recent years, wages were growing very quickly, resulting from high inflation and increase of negotiation power of employees, which increased because of the lack of workers, among other reasons (see Chapter 8). Regardless of the unemployment which is still high, there is a lack of workers with certain qualifications, especially in construction activity, which creates pressure on growth of wages. The growth of unit profit depends on the company's ability to adjust its production prices according to the changes of production costs, but also the recent insufficient offer in labour market, particularly in construction, brings entrepreneurs in more favourable situation when determining construction work price, which finally has a significant impact on the final real estate price in the market.

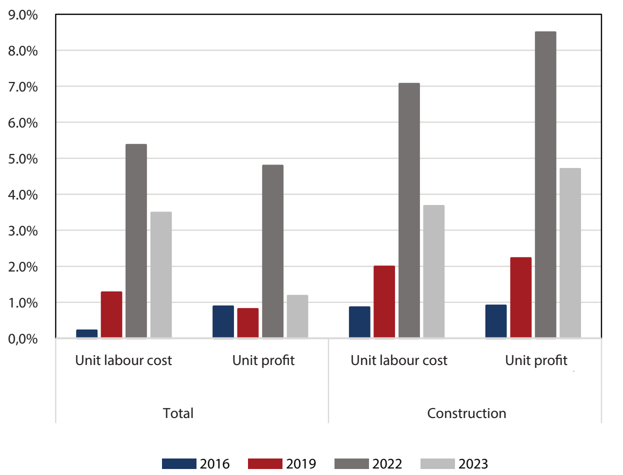
The annual growth of gross operating surplus, determining the trend of unit profit14, in 2023, at the economy level amounted to 5.5% (while it was 17.4% at the construction activity level), much above the average for all activities. Taking into account that construction activity, with auxiliary service activity and financial activity has by far the strongest growth of gross operating surplus, it is clear that profitability of these sectors significantly impacts the unit profit and the price trend of deflator. At the same time, profitability per employee, which includes a gross operating surplus per employee, in the largest activities of industry and trade recorded no or slight change of 0% and 0.6%, respectively, while on the other hand, employees' funds per worker recorded two digit growth rates for almost all activities. Observing the ratios of productivity and labour costs per employee in 2023 (Graph 5.7), it can be additionally confirmed that public sector activities with a significant number of employees in the total structure (see Graphs 8.1 and 8.2) record high labour costs per employee with the lowest productivity rates.

[13] Calculated as ratio of gross operative surplus and real GDP.

[14] One of shortcomings of using gross operating surplus and mixed income is that they do not include only profit but also some other income, but, as further breakdown is not possible, it is used as relevant variable for calculating unit profit.

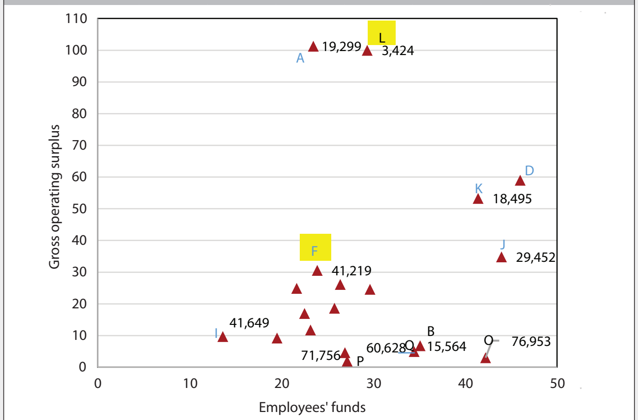
The lowest rates of profitability, besides public sector activities, were recorded in the activities of water supply and mining, which are also in majority public ownership, which confirms that activities from majority public sector record significantly weaker results than private sector activities. Although it should be taken into account that mainly those activities are focused on social care, it is obvious that the share of this sector in the total employment, which is much higher than in the comparable countries brings about slower economic convergence with developed countries.

Graph 5.6: The Structure of GDP Deflator at Economy and Construction Levels



Source: BHAS, CBBH
Unit taxes are not shown since they are negligible for the construction industry.

Graph 5.7: Profitability and Labour Cost per Employee in 2023



Source: BHAS, CBBH
Note: The amounts by the activities refer to the total number of employees in the mentioned activities at 2023 end. The real estate activity recorded a profitability ratio per worker of 584, but for the sake of clarity, it is shown at the upper limit. Activities: A - Agriculture; B – Mining; C – Manufacturing industry; D – Production and supply of electric energy and gas; E –Water supply; F –Construction; G – Wholesale and retail trade; H – Transport and warehousing; I – Hotel and catering industry; J – Information and communication; K – Financial activities; L – Real estate business; M – Expert and technical activities; N – Administrative activities; O – Public administration and defence; P – Education; Q – Health Care; R – Art and Entertainment; S – Other service activities.

As the record high real estate price growth was seen in the previous two years, and it is increasingly difficult to engage a building contractor or craftsmen, the interest of the public in operations of these activities increases, mainly for the activity of residential building construction.

Taking into account the separated operation of this activity, during 2023, the profit of this activity in BH increased at the annual level by 15.3%, while the profit is more than twice higher than in 2021 (Table 2.2). Indicators of profitability and cost effectiveness point out exceptional operation, particularly workers productivity and return on equity. Net sale margin for residential real estate is by 500 basis points higher than in 2022, but the slowdown of increasing prices of construction materials had a favourable effect on business results of companies in residential construction and real estate business. In recent years, companies engaged in residential construction managed to achieve a continuing growth of income with stable, and later high profit margins, and decreased their relative debt.

Table 2.2: Analysis of Financial Statements in 2023 in Residential and Non-residential Construction Activity

million KM

Balance sheet items/indicators	**2021**	**2022**	**2023**
Total oeprating assets	2,251,146	2,705,126	3,062,607
Capital and reserves	864,277	976,815	1,043,500
Long-term liabilities	256,327	399,733	452,586
Total income	1,182,084	1,559,422	1,739,621
Net business result	123,859	159,149	265,408
Number of employees	11,205	14,908	11,083
The number of involved entities	583	651	686

Source: Dun&Bradstreet
Note: 686 companies from Bosnia and Herzegovina's housing construction segment participate in this analysis.

A continuing high price level of real estate compared to macroeconomic bases increases the probability of a stronger price decline. Such turnover at the market could be initiated only by a sharp decrease of demand or significantly higher offer, which includes increasingly difficult factors in perspective, taking into account a lower offer in work performance. The table above interestingly shows that a number of employees decreased significantly in 2023 regardless of record high performance, resulting probably from engagement of agencies bringing foreign construction workers from distant countries[15]. Bank exposure to household mortgage loans is increasing, due to the fact that the values of real estate properties significantly increased, but also that towards companies in the fields of housing construction and real estate business. Having in mind a higher exposure of bank system to the business real estate market through collateral, a possible sharp decline of market value of real estate could bring about a decrease of investment coverage by the value of received collateral and increase the risk of pressure on bank balance sheets with non-performing loans. The growth of collateral prices, with further growth of interest rates on housing loans consequently brings about the growth of private sector debt.

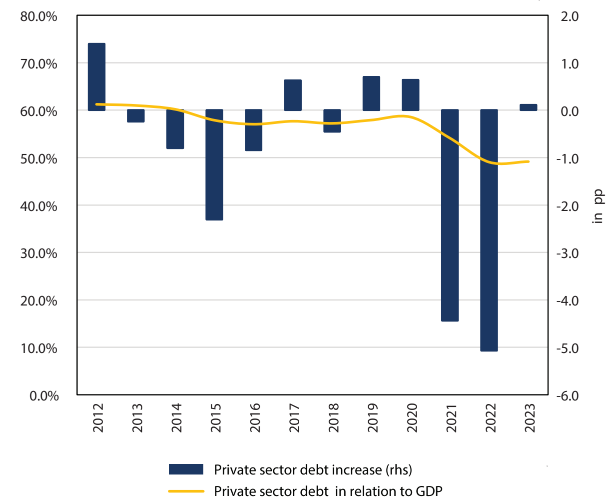
[15] According to the data of Labour and Employment Agency of BH, 4,586 work permits were issued in 2023, while that number was 3,780 a year ago, with the highest number of foreigners employed in construction sector and service activities.

6. PRIVATE SECTOR DEBT

Relative value of private debt in BH[16] at 2023 end slightly changed upwards compared to the previous year, and it remained significantly below the level determined as macroeconomic imbalance. Banking sector in BH in 2023 was stable, profitable and without significant growth of credit, foreign exchange or market risks. The growth of bank profitability was recorded accompanied by high liquidity, decreased share of non-performing loans, strong increase of bank foreign assets and in conditions of growth of bank loans with slight upward changes of interest rates. In 2023, the rate of annual credit growth was 6.5% and was the highest in the previous four years. In conditions of inflation pressures, lending was under a positive impact of the growth of demand for loans and favourable lending rates, which were kept at rather low levels during 2023. Stronger credit growth brought about a slight decrease of negative gap of the loans to private sector and GDP ratio in 2023. Financial cycle indicators in 2023 indicate that lending is still in the negative stage of the cycle, without tangible overheating risks.

Inflation, nominal GDP growth and acceleration of lending contributed to stopping the private debt decline which was recorded during the previous two years (Graph 6.1). The balance of the total private debt increased by 7.6% at the annual level, but the nominal GDP increased by roughly the same percentage (7.3%), so in this year, a slightly higher value of relative private debt was registered compared to 2022 (49.2%, in relation to 49%, expressed in per cents of GDP).

Graph 6.1: Private Debt in Bosnia and Herzegovina



Source: EUROSTAT, CBBH
Note: The increase is presented in relation to the previous year.

Although the ECB eased its restrictive monetary policy in early June and then again in September 2024, lowering its key interest rates by 25 bp each, it is expected that financing conditions in the euro area will remain tight. Still high interest rates in the euro area will continue to put pressure on the growth of borrowing costs on the domestic market[17]. In accordance with the latest available mid-term estimates of the CBBH, from April 2024, the economic activity growth of 2.6% is expected in 2024, on an annual basis. In 2024, a growth of loans to corporates of 4.6% is projected, with a slightly more dynamic nominal growth of loans to households of 6.4%. Such trends could potentially affect the growth of private debt during 2024. According to the latest available data on banks' credit activity, the realized annual growth rate of loans is a high 9.7%, at the end of July 2024, which indicates the continuation of an even stronger growth trend in bank loans[18].

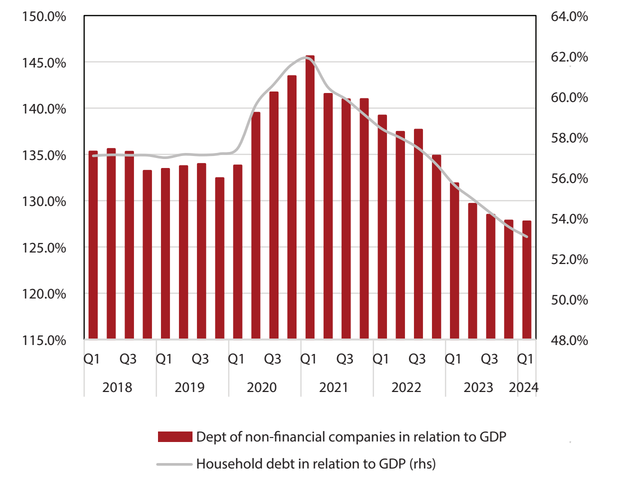
The trends of private debt in the euro area during 2023 was strongly influenced by the transmission mechanism of the ECB's monetary policy, which was effective for most euro area countries. Given that inflationary pressures in the euro area remained elevated during 2023, the ECB continued to resolutely tighten monetary policy. The multiple increase in the reference interest rates of the ECB reduced the money supply, and the nominal interest rates of the banks in the euro area rose sharply again during 2023. As the increases in interest rates on loans were faster and higher than in previous episodes of monetary policy tightening, the decline in credit activity in the euro area that began in 2022 continued in 2023. The annual growth rate of loans to households in the euro area was 0.3% in December, which is mainly a reflection of the slowdown in mortgage loans. Almost identical annual loan growth rates at the end of December 2023 (0.4%) were also recorded in the sector of non-financial companies. This type of credit growth, under the influence of the restrictive monetary policy of the ECB and the economic activity trends, influenced the continuation of the private debt reduction during 2023 (Graph 6.2).

[16] Private debt of Bosnia and Herzegovina includes bank loans to non-government sector and non-financial public companies (except other financial institutions), debt securities of non-government and non-financial sector and loans of other financial institutions (loans to public and other non-financial companies and loans of other non-resident sectors).

[17] According to the latest available data on the trends of average weighted interest rates on loans from BH banks at the end of July 2024, a growth of 30 bp was recorded in relation to the same period of the previous year.

[18] According to the latest CBBH nowcast on the inflation and GDP trends in the first nine months of 2024, the annual real GDP growth of 2.5% is expected, which is almost identical to the last estimate from April according to the medium-term macroeconomic model for activity growth in 2024 (2.6%).

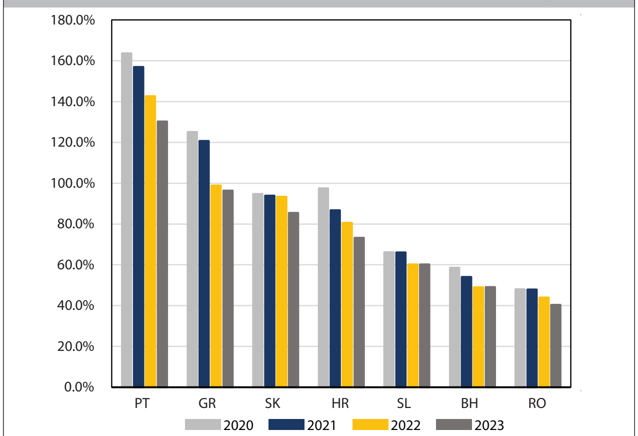
Graph 6.2: Private Debt of euro area countries in relation to GDP



Source: ECB

On the basis of statistical data published so far (EUROSTAT), contrary to the economic trends in Bosnia and Herzegovina, credit activity of banks and private sector debt in most EU countries grew more slowly than economic activity. As during several previous years, of all EU countries, only Romania (40.4%) has a lower private debt than Bosnia and Herzegovina. Also, in all small and open economies of the euro area, with the partial exception of Slovenia, the trend of private debt reduction continued (Graph 6.3). The continued reduction of private debt, as well as, the relative reduction of public debt within the framework of the new fiscal rules, along with the beginning of the interest rates reduction by the ECB, have a favorable effect on the stability of the banking system in the EU.

Graph 6.3: Private Debt in Relation to GDP by Countries



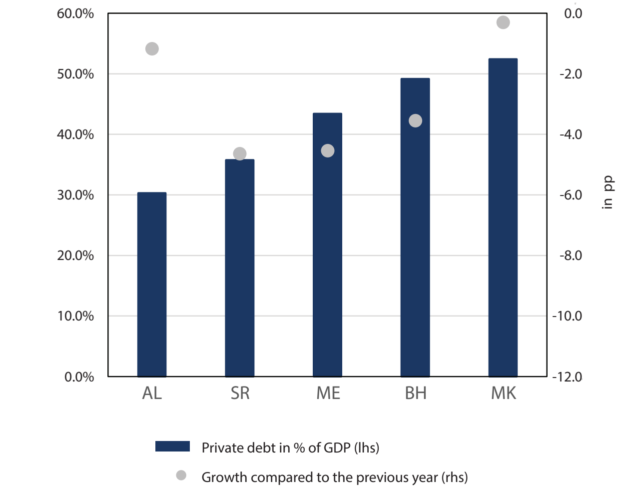
Source: EUROSTAT, CBBH

Note: The comparison of the size of the private debt of Bosnia and Herzegovina with a group of countries in the region, as well as, with a group of countries from the EU and the euro area, should not be taken for granted, because the methodology for calculating private debt is not harmonized by country. Some countries tie private debt to the form of ownership of the company, so that it includes only bank loans given to private companies. However, loans given to public companies according to the methodology applied by Bosnia and Herzegovina are included in private debt.

In comparison with the countries of the region, which, like BH, aspire to EU membership, the state of private debt is unchanged compared to last year, and BH private debt is still one of the highest among the observed countries.

Along with the reduction of private debt of comparable countries, private debt in BH remained among the highest compared to neighboring economies, but far below the level that could be labeled as macroeconomic imbalance (Graph 6.4). Albania's private debt is below a third of GDP, and with extremely persistent inflation in Serbia and the restrictive monetary policy of the National Bank of Serbia, Serbia's private debt has been reduced below 40% for the first time.

Graph 6.4: Private Debt in Countries in the Region in 2023



Source: www.ceicdata.com, CBBiH

In addition to the pronounced nominal growth of economic activity, credit activity in the key sectors of the BH economy and partial changes in net foreign assets affected BH private debt. On average, the low annual growth of lending interest rates during 2023 and still extremely low real interest rates on loans, along with generous domestic sources of financing, created higher credit dynamics than in 2022. Surveys on Lending Activity of Banks, conducted by the CBBH among banks[19], indicated that banks expected a slowdown in credit activity in 2023. Despite the tightening of credit standards in banks, and despite the expected significant increase in the cost of financing sources, credit growth in Bosnia and Herzegovina exceeded expectations. The realized growth of total loans was realized almost entirely in the private non-financial companies sector and the household sector. In 2023, despite the tightening of financing conditions, banks offered loans to non-financial companies at only slightly higher interest rates compared to 2022. At the same time, the company's external indebtedness continued to grow. Within loans to households, which were driven by an increase in consumption, the highest growth was recorded in consumer and housing loans. In 2023, housing loans recorded a growth of 8.4%, but the structure of household loans was almost unchanged compared to the previous year.

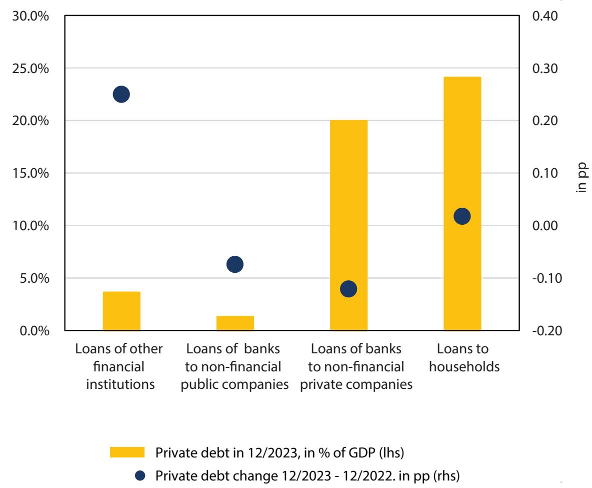
[19] file:///C:/Users/ms35e41/Downloads/Anketa%20o%20kreditnoj%20aktivnosti%20banaka%20u%20BiH_Q1%202024%20bos.pdf

A significant decrease in non-performing loans with the aforementioned growth in total loans in 2023 had an impact on the reduction of the share of non-performing loans in total bank loans, so that at the end of 2023, the share of non-performing loans in the total amounted to 3.8%. This value is the lowest value recorded since 2009 and is the result of continued accounting write-offs of assets assessed as a loss, for which provisions have been fully made.[20] During the first part of 2024, asset quality continued to improve, with the quarterly rate of share of non-performing loans in total loans to legal entities, and to the household sector, remaining low. Until the end of 2024, if the bank's credit activity continues to move at the rates from the first part of the year, it is possible to potentially expect a deterioration in the quality of the credit portfolio in the banking sector.

In 2023, in addition to the moderate growth of the loan portfolio, a significant increase in the foreign assets of banks (14.4%) can be highlighted due to the large difference in the change of foreign and domestic interest rates. During 2023, banks simultaneously continued to reduce foreign liabilities (18.4%), which confirms that the domestic sources of funds in the banking sector under the given circumstances were sufficient to meet the existing financing needs of all sectors. Annual changes in foreign liabilities, including data from July 2024, indicate the end of the downward trend (started in the middle of 2020). Thus compared to a year ago, foreign liabilities are 20% higher. Such trends of foreign liabilities are a possible consequence of pronounced credit growth in the first half of 2024, and therefore of the additional needs for bank financing sources. The annual growth of net foreign assets of one billion KM in 2023 was potentially one of the limiting factors for the more pronounced growth of private debt. In the first seven months of 2024, foreign assets of banks continued to grow, with the balance of foreign assets compared to the end of 2023 being KM 955 million higher.

In 2022, the ratio of loans in the sectors of households and non-financial private companies to GDP decreased on an annual basis by about 3 pp, and in 2023, there were almost no changes (Graph 6.5). And the part of private debt related to lending to non-financial public companies and loans from other financial institutions during 2023 was kept at approximately the same level of GDP. With the projected growth rates of credit and growth of economic activity for 2024, it is possible to expect a significant increase in the ratio of private sector debt to GDP.

Graph 6.5: Private Debt of Bosnia and Herzegovina by Sectors in 2023



Source: CBBH

Survey on Lending Activity of Banks[21], carried out during 2023, showed that banks expect a tightening of credit standards for granting loans to non-financial companies, and the expected change in lending conditions moved in the same direction, with negative implications for the growth of private debt. The achieved annual credit growth rate of the private non-financial companies sector exceeded expectations, and the main causes of the growth in demand for loans were, in addition to the financing of capital investments and working capital, the lack of alternative sources of financing and debt restructuring. The private debt of the households in 2023, from the side of credit supply, was affected by the same limiting factors related to credit standards and lending conditions, but much less intensively than for non-financial companies. The decrease in demand in the previous year was replaced by an increase in demand for all types of household loans in 2023.

Due to the growth of the Euribor value, during 2023, a significant decrease in newly approved loans with a variable interest rate and an initial fixation period of up to one year was recorded [22]. The trend of reducing the share of loans with a variable interest rate or a fixation period of up to one year in newly approved loans was much more intense than in previous years. The demand for loans with a fixed interest rate grew due to the expectation that reference interest rates on the international market will remain high for a long time, and at the same time, the supply of these loans by banks followed the demand.

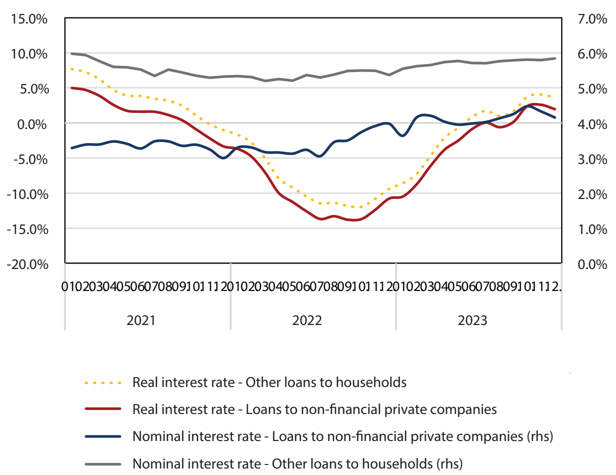
[20] In accordance with the decisions on credit risk management and determination of expected credit losses (Official Gazette of the FBiH, 44119 and Official Gazette of the RS, 48/19), a bank is obliged to carry out an accounting write-off of the balance sheet exposure two years after having recorded in its bookkeeping the expected credit losses in the amount of 100% of the gross bookkept value of the exposur, and having declared it fully due, except for the exposure based on financial leasing.

[21] Survey on Lending Activity of Banks for the I, II and III q 2024.

[22] Before the ECB started increasing reference interest rates, the share of this type of newly approved loans in total loans was above 70%, and during 2023 it fell below 40%.

The Entities' Banking Agencies, immediately after the ECB started raising interest rates in July 2022, made Decisions on temporary measures to mitigate the risk of interest rate growth [23], and this Decision was also in force during 2023. Interest rates have either only slightly changed compared to the end of 2022 (housing loans), or a slight increase was recorded, as in the case of non-purpose consumer loans and non-financial companies. With the weakening of inflationary pressures, real interest rates continued to rise during the year, and by the end of the year the spread between nominal and real interest rates decreased significantly (Graph 6.6). A reduction in the real value of private sector debt can have a positive effect on debt servicing, and potential rising borrowing costs could slow down credit dynamics in the future.

Graph 6.6: Selected Real Interest Rates in BH Banks



Source: CBBH, BHAS

[23] The primary goals of the measures are timely management of credit risk, formation of additional provisions for expected credit losses for credit risk level 1 and 2 in case of a significant increase in interest rates and mitigating the consequences of a potentially significant increase in the amount of debt repayment. The regulator's expectations are that the adopted measures will limit the actions of banks that could adversely affect citizens and the economy and, ultimately, the growth of systemic risks.

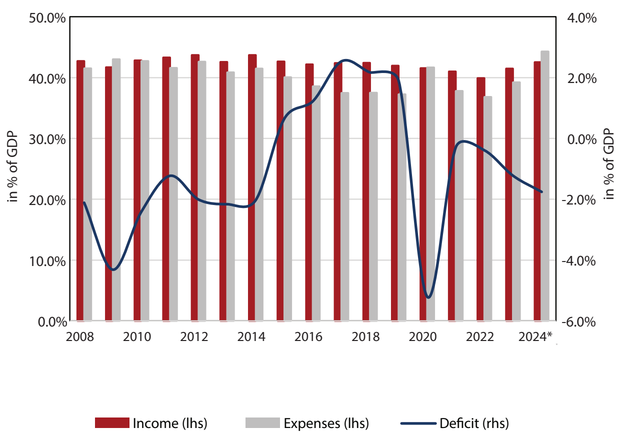
7. PUBLIC FINANCES AND DEBT

The state's fiscal position worsened in 2023. Significant allocations for current consumption were recorded, and entity governments specifically allocated funds for the most vulnerable categories of the population. The structure of government spending, dominated by current spending, has influenced the deepening of the fiscal deficit, which may be even more significant in the future.

Fiscal indicators in 2023 indicate a strong growth of revenues and expenditure, with a slightly stronger intensity of public expenditure growth. The higher intensity of expenditure growth can be explained by the increase in current consumption of the government sector, which represented a fiscal response to mitigating the consequences of high prices for vulnerable categories of the population. Government spending was focused on higher nominal allocations for pensions, salaries in the public sector, as well as one-time cash payment to vunerable categories. In 2023, there were no significant investments as well as withdrawals of funds from foreign creditors under concession conditions.

Given that the growth of expenditures was more significant than total revenues, an increase in fiscal imbalances was recorded. More concretely, in 2023, a deepening of the fiscal deficit was recorded, which amounted to 1.2% of GDP, while a further increase in the deficit is predicted in 2024[24] (Graph 7.1). The projected deficit in 2024 will be subject to change and will not reflect the final and official data, primarily due to possible deviations between nominal GDP growth projections for 2024.

Graph 7.1: General Government Budget



Source: CBBH, BHAS
Note: *The 2024 data is in accordance with the Global Framework of Fiscal Balance and Policies in BH, for the period 2024-2026.

After several years of positive trends in the growth of budget revenues, a short-term sharp decline in 2020, due to the COVID-19 pandemic, and their strong recovery in 2021, the growth of total public revenues in nominal amount continued in 2023. Revenues growth is primarily the result of keeping the general level of prices at a high level, strengthening private consumption, but also the growth of revenues from services in the tourism sector. Revenues from indirect taxes, in the first seven months of 2024, increased strongly by 13.2% compared to the same period in 2023.

From the aspect of expenditures, the two largest items within government spending, allocations for social benefits and salaries of employees, recorded significant growth in 2023 (KM 2.02 billion, 18.3%, on an annual basis). It is certain to expect a further increase in the government's liabilities in 2024 based on already implemented, and future, announced adjustments of pensions, as well as union pressures related to adjustment of wages, especially in the health and education sectors (KM 333 million in 2024, planned increase in gross wages in accordance with the Global Framework of Fiscal Balance and Policies in BH for the period 2024-2026).

Current consumption increased through higher allocations for salaries in the public sector, procurement of goods and services, as well as for social allocations. The public sector is a significant generator of economic activity, among other things, through the salaries of employees, and on the other hand, the aforementioned increase has a positive effect on private consumption (income growth and strengthening the purchasing power of households), at least in the initial period. Private consumption in 2023 accounted for 67.9% of GDP. In addition, a significant number of employees in the public sector (about 25%) with incomes that are 20-25% higher than the average net salary significantly contribute to the growth of the level of consumption, which stimulates economic activities in the country. As in previous years, the investment activity of the public sector in 2023 was at a fairly low level, which was further aggravated by political challenges, due to which BH was denied significant funds from EU funds, planned after obtaining candidate status. In 2024, according to the Global Framework of Fiscal Balance and Policy in BH for the period 2024-2026, investments in the amount of KM 1.95 billion are planned.

Due to the inflationary pressures that eased in the second half of 2023, the entity governments allocated significant funds to mitigate the negative consequences for vunerable categories of the population, and therefore the governments put more focus on current and less on capital spending. The larger engagement of funds approved for infrastructure projects and projects in the electric power sector, foreseen in the BH Public Investment Program for the period 2023-2025, has been suspended[25]. In accordance with the above, the expected significant effects of public investments on the overall economic activity, in the medium and long term, did not happen.

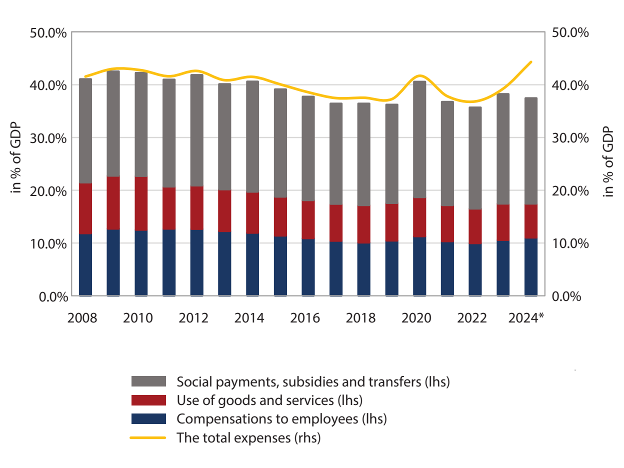
[24] Source: Global Framework of Fiscal Balance and Policies in BH for the period 2024-2026, March 2024

[25] The Public Investment Program of the Federation of Bosnia and Herzegovina for the period 2023-2025 and the Public Investment Program of Republika Srpska for the period 2023-2025

Long-term fiscal consolidation and restrictive fiscal policy, before the outbreak of the pandemic and the war in Ukraine, created space for fiscal policy to respond to the consequences of inflationary pressures. The growth of revenues from indirect taxes as a result of inflation has further increased this space. On the other hand, the current expansionary fiscal policy may threaten fiscal sustainability as there has been a significant increase in financing needs. In 2023, government spending was significant at 39.2%, expressed as a percentage of GDP. The structure of government spending, which in nominal terms has had a significant growth trend in recent years, represents a potential source of internal imbalances due to its orientation towards current consumption (salaries and social benefits). The structure of total government spending, on average for the period 2006-2023, about 30% expressed as a percentage of GDP, consists of allocations for salaries in the public sector and social benefits (Graph 7.2). Although budget revenues recorded strong growth and exceeded the plan in the first part of 2024, the space for financing certain government measures from indirect tax revenues will be narrowed in the future. Fiscal trends in the future will largely depend on whether the proposals on tax policy changes and fiscal reform will be implemented, which could be reflected in the amount of collected revenues. Therefore, the aforementioned vulnerable structure of government spending may influence the deepening of the fiscal deficit in the future.

In addition to the above, the pension funds were additionally burdened during 2023 due to, among other things, regular and extraordinary adjustment of pensions, but also due to demographic changes. The projected deficit in pension funds in the first half of 2024 has deepened and is higher by 0.4 percentage points compared to the same period of the previous year, and amounts to 1.0% of GDP.

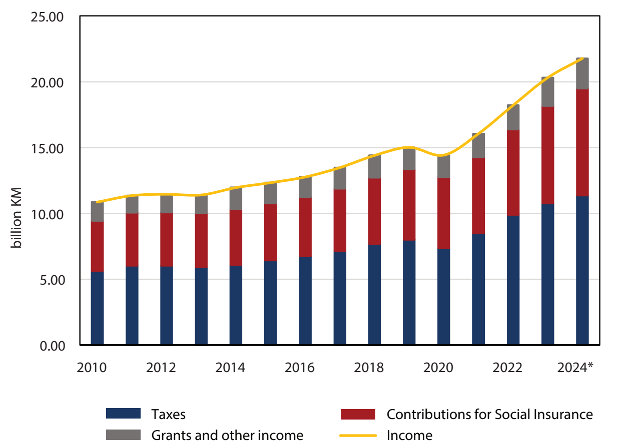
Graph 7.2: Structure of Expenses



Source: CBBH
Note: *The 2024 data is in accordance with the Global Framework of Fiscal Balance and Policies in BH, for the period 2024-2026.

In recent years, budget revenues have ranged between 40 and 43%, expressed as a percentage of GDP. After the strong growth of budget revenues in 2021, and their further growth in 2023, high-frequency data indicate a certain continuation of the trend in 2024. According to the latest projections of the Indirect Taxation Authority (from June 2024), in 2024, revenues from indirect taxes are expected to grow by 9.7% on an annual basis (Graph 7.3), but with a downward revision tendency in the following projection period in in case of tax policy changes. At the same time, revenues from direct taxes are growing with the increase in the number of employees and the growth of wages in the public sector, as well as, in other sectors following a significant increase in the minimum wage in both entities. (Chapter 8).

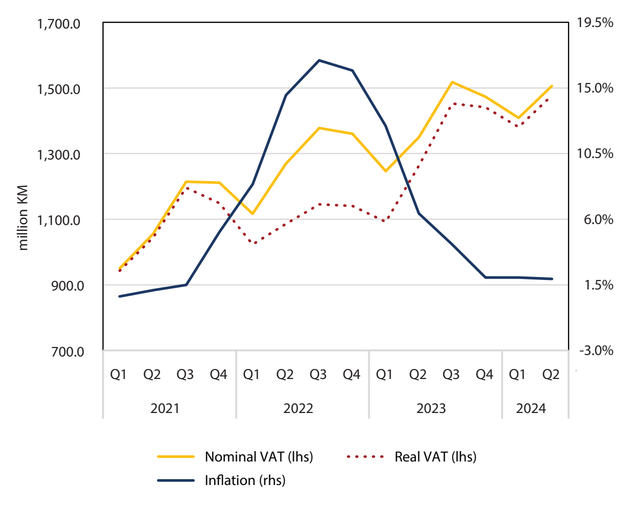
Graph 7.3: Income Structure



Source: CBBH
Note: *The 2024 data is in accordance with the Global Framework of Fiscal Balance and Policies in BH, for the period 2024-2026.

Revenues from value added tax (VAT) have had the record amounts in previous years, except for the pandemic year 2020. Net VAT revenues amounted to KM 5.59 billion in 2023, which is 9.0% more than the previous year. In addition to the growth of private consumption, increased imports, as well as positive trends in the service sector, one of the factors that also influenced the strong growth of the revenues on this basis, is the maintenance of prices at a high level during 2023 (See text box in CBBH Bulletin 2 2024). Inflation slowed down in the second half of 2023, and stagnated in the first half of 2024 (Graph 7.4).

Graph 7.4: Inflation Impact on the Growth of Revenues from VAT

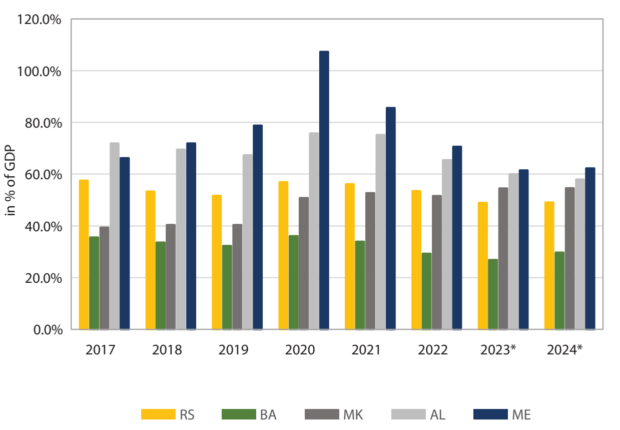


Source: BHAS, Indirect Taxation Authority, CBBH

At the end of 2023, the public indebtedness of BH government sector amounted to KM 13.16 billion (26.9%, as a percentage of GDP), which, compared to the countries of the region, still ranks it among the moderately indebted countries, in accordance with Maastricht criteria (Graph 7.5)[26]. Bosnia and Herzegovina, like many other countries, used fiscal measures to support vulnerable categories of the population during the pandemic, but also due to the strengthening of inflationary pressures, intensified after the outbreak of the war in Ukraine. Public debt remained almost unchanged in the countries of the region (Graph 7.6). In 2023, entity governments in BH allocated significant funds to mitigate the consequences of inflationary pressures for vunerable categories (the Federation of Bosnia and Herzegovina allocated KM 756 million or 2.4% of GDP, while the RS allocated KM 416 million or 2.6% of GDP a).[27]

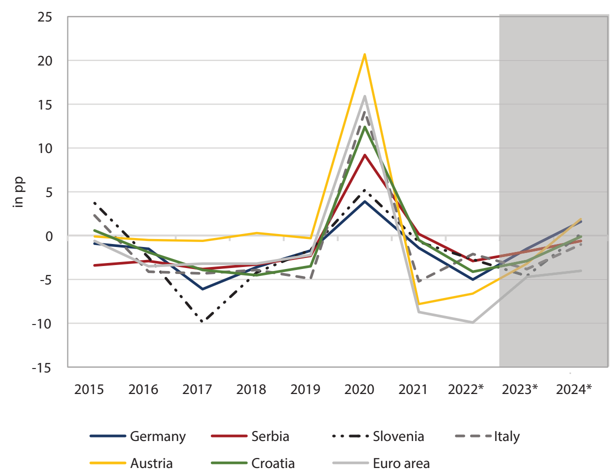
Although the level of indebtedness is relatively low in BH, the dynamics of borrowing in the future may represent a liquidity risk, bearing in mind the limited access to financing, but also the entity's significant financing needs in 2024 (about 6% of GDP in the Federation of BiH and 9.8 % of GDP in RS).

Graph 7.5: Public Debt in Selected Countries



Source: MMF, WEO April 2024
Note: * Projection

Graph 7.6: Annual Changes in Public Debt Expressed in Per Cents of GDP



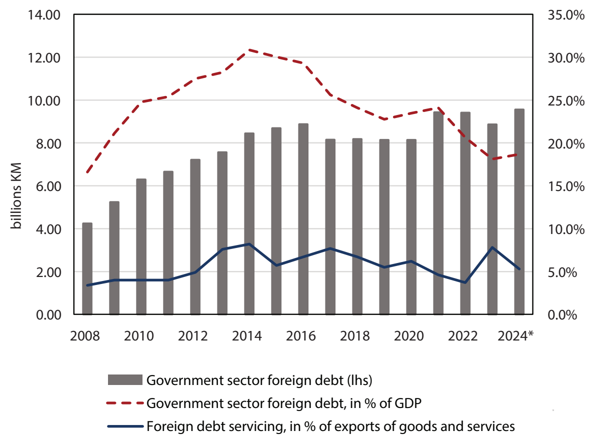
Source: MMF, WEO April 2024
Note: * Projection

During 2023, the external debt of the general government sector recorded a significant decrease (KM 616.1 million or 6.5%), and at the end of the year it amounted to KM 8.86 billion. The planned repayment of external debt for 2024 amounts to KM 1.36 billion (14.7% of planned revenues from indirect taxes), which is a slight decrease compared to the previous year (0.6 percentage points). Consequently, it is planned to maintain the fiscal space at approximately the same level. In the period from 2008-2016, more intensive borrowing by the government abroad (Graph 7.7) significantly contributed to the financing of the current account deficit and government spending (Graph 7.8). However, since there were no government borrowings from foreign creditors under favorable concessional terms and for the financing of infrastructure projects in 2023, the external debt of the government sector was also reduced, as well as the significance of net public external borrowing in financing the current account deficit. In the last three years, there has been no significant withdrawal of funds from foreign creditors, under concession conditions, for capital projects. If the capital investments intensify in the coming period, the withdrawal of funds from foreign creditors under favorable conditions could also have a positive effect on foreign exchange reserves, in addition to a positive contribution to the financing of the current account deficit, Borrowing under concessional conditions, as a rule, means less sensitivity of the value of the remaining debt and the repayments to the changes of market conditions.

[26] BH is not subject to the obligation to fulfill this criterion. The information is mentioned as for the records sake.

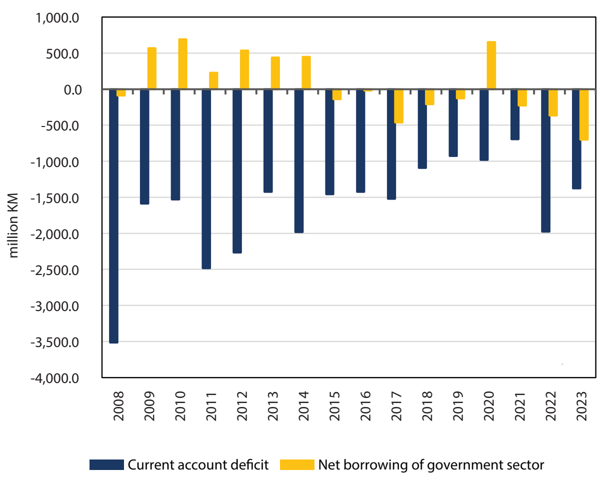
[27] https://www.imf.org/en/countries/bih?selectedfilters=Article%20IV%20Staff%20Reports#whatsnew

Graph 7.7: General Government Sector Foreign Debt



Source: CBBH, Ministry of Finance and Treasury BH and Global Fiscal Framework 2024-2026
Note: * Projection

Graph 7.8: Net Borrowing of Goverment Sector and Current Account Deficit



Source: CBBH

Text box 3: Limitations of the public sector influence on competitiveness in the EU, with reference to Bosnia and Herzegovina

The European Union implements a comprehensive regulatory framework that is intended for fair market competition, as well as for mitigating the effects of market disturbances. The market competition policy monitored and implemented by the European Commission includes strict rules on state subsidies, public procurement policies, as well as, measures that prevent the creation of monopoly. According to data from the European Commission[28], state subsidies in the EU amounted to approximately 1.5% of GDP in 2023. These subsidies are strictly regulated to prevent distortion of market competition. Various control mechanisms implemented by the European Commission are used to stimulate economic growth and avoid unfairly favoring certain companies.

On the other hand, EU directives regulating public procurement ensure transparent and competitive public procurement procedures. Eurostat data show that public procurement accounts for around 14% of the EU GDP[29], and compliance with these directives is essential to maintain fair market competition.

According to Transparency International's Corruption Perception Index (CPI), in 2023, EU countries generally score well, with an average score of around 76 out of 100. This high level of transparency is key to the maintaining competitive markets and preventing public sector interventions from leading to market disturbances. In the past five years, the EU has successfully reduced violations of rules related to market competition by 15%[30], which indicates the effective implementation of market competition policies and regulations.

Despite the existence of the EU regulatory framework and efforts to minimize negative impacts on market competition, there are still certain challenges. For example, uneven application of regulations or delays in the implementation of certain regulations can lead to temporary market disruptions. Nevertheless, the whole EU approach helps to maintain a competitive and balanced internal market.

On the other hand, BH faces significant challenges in harmonizing its regulatory framework with EU standards. BH has a score of 38 out of 100 on Transparency International's Corruption Perceptions Index for 2023[31] (Grafikon 7.9). This result puts Bosnia and Herzegovina in an unenviable position, and indicates a significant concern about corruption in the public sector. The BH CPI result shows only modest changes over the years. Historically, the country has struggled to improve its score, but corruption problems have persisted. For example, in 2020 BH achieved a score of 35, and in 2021 a score of 36. A slight improvement in 2023 to 38 indicates some progress, but the general trend indicates ongoing challenges. BH has 38 points, which is relatively low compared to European countries. In the Western Balkans region, it is at the bottom of the ranking, with countries such as Montenegro and Serbia. This low rating highlights BH's existing problems with the management and integrity of the public sector. According to the European Commission's Progress Report for 2023[32], BH has fulfilled only about 50% of the recommendations related to improving competitiveness and the regulatory environment. This limited progress affects the effectiveness of public sector interventions in strengthening market competition.

[28] https://data.consilium.europa.eu/doc/document/ST-14689-2023-INIT/en/pdf

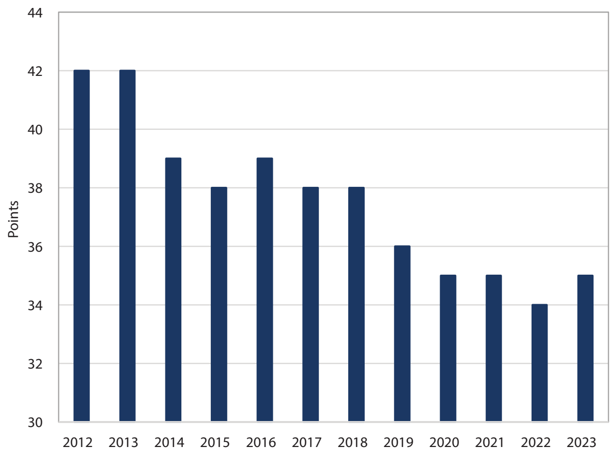
[29] https://single-market-economy.ec.europa.eu/single-market/public-procurement_en

[30] https://european-union.europa.eu/priorities-and-actions/actions-topic/competition_hr

[31] https://ti-bih.org/bosnia-and-herzegovina-worst-in-the-region-according-to-the-corruption-perception-index-bih-completely-devasted-by-corruption-the-situation-is-getting-worse/?lang=en

[32] https://www.eeas.europa.eu/delegations/bosnia-and-herzegovina/izvje%C5%A1taj-o-bosni-i-hercegovini-za-2023_bs?s=219

Graph 7.9: Transparency International Corruption Perceptions Index 2023



Source: Transparency International BH

Public procurement in BH represents about 10% of GDP. However, according to the World Bank Report on Public Sector Management Reform in Bosnia and Herzegovina[33], there are significant problems with transparency and efficiency. According to the aforementioned Report, approximately 40% of public procurement procedures in BH indicate significant irregularities, which affect the fairness and competitiveness of the market. In this sense, a comprehensive reform is necessary in order to improve the transparency and efficiency of the public procurement process itself. According to the recommendations of the World Bank, among other things, the implementation of electronic public procurement systems and stronger supervision can help to solve the mentioned problems.

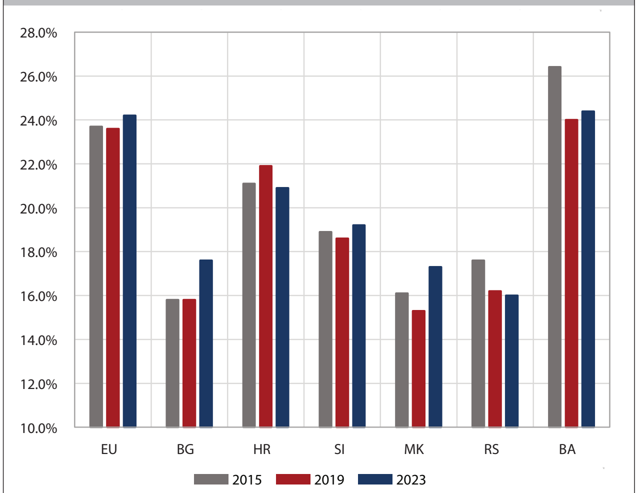
State aids and subsidies in BH make up about 3% of the GDP. The absence of an effective regulatory framework means that these aids are often unevenly and unfairly distributed, which can have a negative effect on market competition and lead to inefficiencies in the functioning of the market. The lack of regulation and of the state aid monitoring mechanisms in BH worsens market distortions. Improving the regulatory framework and harmonizing it with the EU standards can eliminate the mentioned problems. Strengthening the capacity and independence of regulatory institutions in Bosnia and Herzegovina is crucial for the effective implementation of market competition policies. This entails strengthening legal and institutional frameworks to ensure their closer alignment with the EU standards. The negative effects of the perception of the corruption high level can deter foreign investment and create an unfavorable business environment. Investors are more cautious about the potential legal and financial risks associated with corruption.

[33] https://www.worldbank.org/en/country/bosniaandherzegovina/brief/supporting-public-sector-management-reform-in-bosnia-and-herzegovina

8. LABOUR MARKET - PRIORITIY OF REFORMS

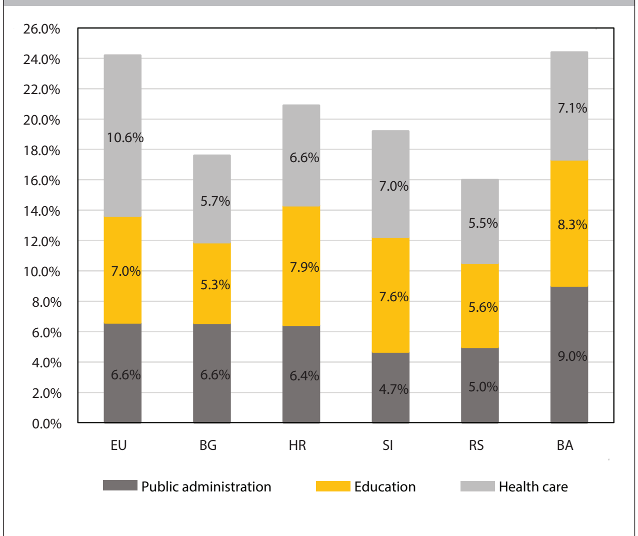
A significant share of employment in the public sector, especially in public administration, a dramatic decline in the number of births and the problem of population aging represent an important source of macroeconomic imbalances in the medium and long term. The share of employment in the public sector is stagnating (Graph 8.1), despite the significant growth in the number of employees in the private sector, and it is still much higher compared to neighboring countries. Observing the structure of employees in the public sector, according to the latest available data (Graph 8.2), it is evident that BH records the largest share of public administration in public sector employment, while in other countries, employment in healthcare and education is more significant. However, it is noticeable that the shares of employees in education and healthcare are higher than in neighboring countries, which indicates the rigidity of the labour market, taking into account only the fact that the number of people enrolled in the education system has dropped dramatically in recent time. (Graph 8.3). Bearing in mind that in the last decade, we have recorded the slowest closing of the economic gap compared to the EU average (see Chapter 3), and that there are also numerous public companies in other activities such as mining, communications, electricity and water supply, structural reforms are urgently needed in order to speed up closing of the above mentioend gap.

Graph 8.1: Share of Public Sector Employees in the Total Employment



Source: EUROSTAT, BHAS
Note: Public sector includes the following activities: O (Public administration and defence, mandatory social insurance), P (Education) and Q (Activity of health care and social help).

Graph 8.2: Structure of Employees in Public Sector in 2023

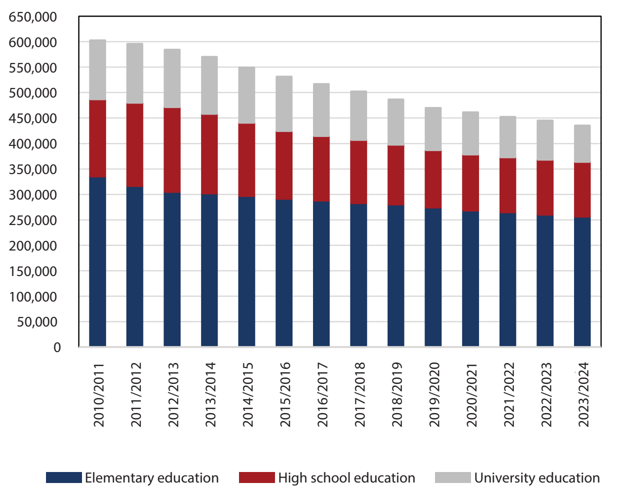


Source: EUROSTAT, BHAS

The huge economic lagging behind developed countries contributes to negative natural population growth and an increasingly rapid outflow of the working-age population. The ever-increasing pressure of rising prices of goods and services and the price of real estate undermines the already weak economic standard of the population, which in addition to relatively high labour costs in the EU (see Chapter 5) forces the population to emigrate. The fact that the high school education system records the largest number of enrollments in the craft professions, where professional construction work, health care and catering are particularly distinguished, indicates that today many students in the early education phase are preparing for potential emigration. It is illustrative that in the period shown (Graph 8.3), the education system recorded a significant decrease in the number of students in all categories of education[34], which at the end of this period was reduced by 167,353 students, with 47.2% of the total drop coming from primary school education, while 26.3% and 26.5% from secondary and university education, respectively. In addition to the decrease in the number of students, the existing educational programs lag significantly behind the neighbouring countries, as indicated by all the conducted international tests in education. The evident decline in pupils' number can be attributed to demographic changes, which are reflected in the high negative natural population growth (Graph 8.4) and the lowest fertility rate in the neighbouring countries and the EU, the emigration of the population, but also the lack of much-needed structural reforms, which are only declaratively mentioned by the policy makers.

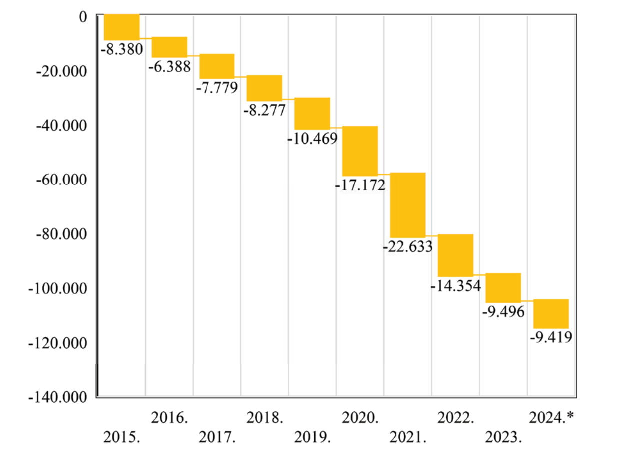
[34] Apart from the preschool age, which is not relevant for comparison with earlier years due to the low base.

Graph 8.3: Structure of Student Population in Education System



Source: BHAS

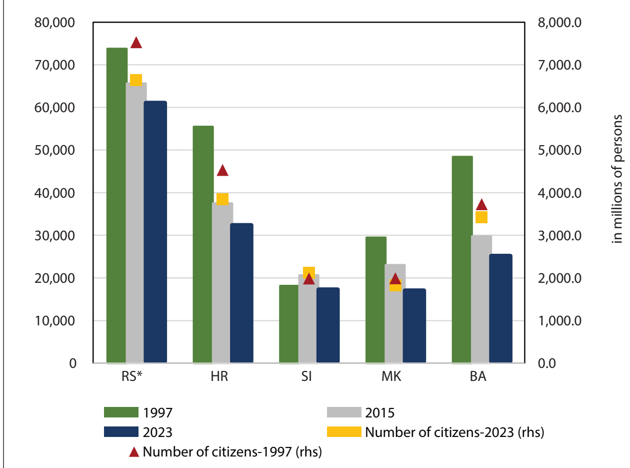
Graph 8.4: Cumulative Natural Increase of Population in Ten Year Period



Source: BHAS, CBBiH
Note: *The projection for 2024 is related to official data from the end of the first quarter, and growth trends from the other quarters of previous years.

The negative natural population growth is caused by a dramatic drop in the number of births (Graph 8.5), which is expected to be halved at the end of this year compared to the first available data from 1997. The other neighbouring countries mostly recorded significant decrease in the number of births, albeit at a lower intensity. On the other hand, Slovenia, as the most economically developed country in the region, has recorded a slight decline in births since the beginning of the observation period.

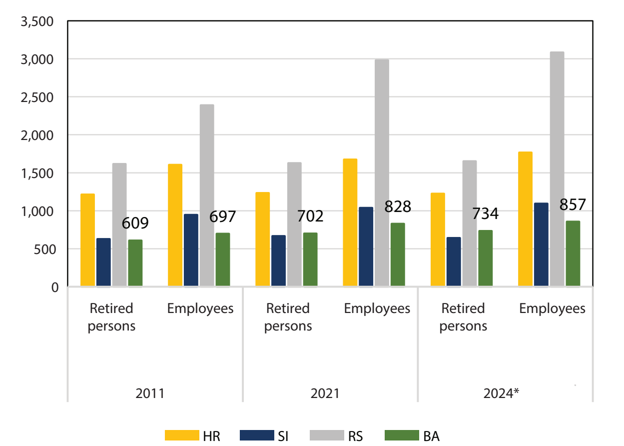
Graph 8.5: The Number of Births and the Total Number of Citizens per Countries



Source: EUROSTAT, BHAS
Note: *For Serbia, the first available data are from 2000, so they have been included instead of 1997.

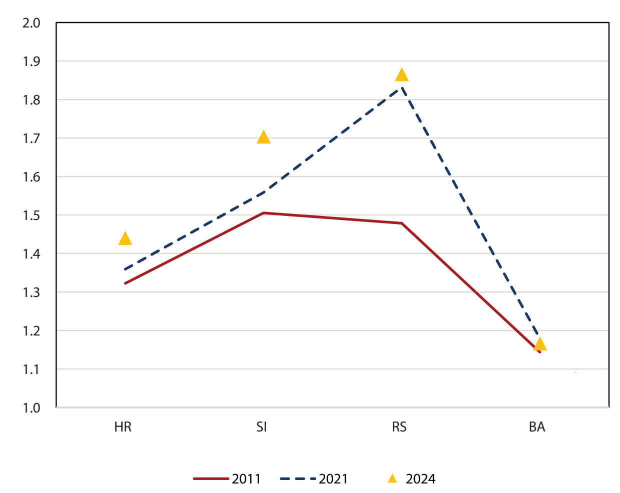
The decline in the number of births, regardless of the additional emigration of the population, along with the increasingly strong growth in the number of pensioners, represents a crucial challenge for the macroeconomic sustainability of pension and social funds in the coming period. In the last three years, the number of pensioners has been growing faster than the number of employed persons (Graph 8.6), which leads to a significant increase in budget costs. When comparing the latest data from 2024 with the end of 2011, Bosnia and Herzegovina recorded the largest increase in the number of pensioners among the selected countries (125 thousand, while other countries recorded a negligible increase). Due to the strong growth in the number of pensioners, the coverage ratio of the pension funds in BH has been stagnant for many years, while in neighboring countries it shows a trend of improvement over the years (Graph 8.7).

Graph 8.6: The Number of Employed and Retired Persons in Selected Countries



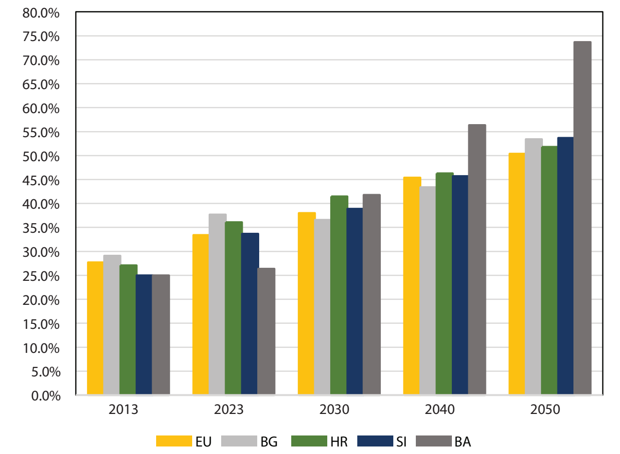
Source: EUROSTAT, Federal PDI Fund, Pension-Disability Insurance Fund of RS
Note: *The number of employees for surrounding countries has been taken over from 2023 end according to the EUROSTAT methodology, while the number of retired persons is from the end of the the first half of 2024. The data for BH include the number of employees from May while the number of retired persons is from the end of June 2024

Graph 8.7: The Ratio of Pension Funds Coverage



Source: EUROSTAT, Federal PDI Fund, Pension-Disability Insurance Fund of RS

Graph 8.8: Long-term Projection of Dependency Ratio

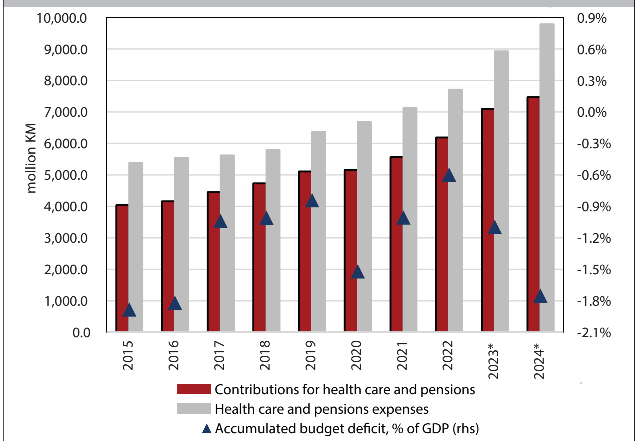


Source: EUROSTAT, BHAS, CBBiH
Note: The data for 2012 and 2022 have been taken over from BH Labour Survey, while those for other years are from the Analysis of Population and Projection of Population for the period 2020 – 2070.

Negative natural growth, growth in the number of pensioners along with continuous growth in the expected age of the population and a decrease in the share of the working population further complicates the operations of pension and health funds. The official projection of the population trends, which implies a continuation of the negative trend of natural growth, an increase in life expectancy, and relevant data on migration from Eurostat and other sources, indicate a dramatic decline in the working age population in the coming period, which will significantly change the age structure of the population in the coming decades. According to the projection of the European Commission (EC), the share of the EU population over 65 years will be 30% in 2060, while it was 18% at the end of 2013. As a result of the change in the overall structure of the population, the dependency ratio (Graph 8.8) is projected to be 50.4% in 2050, while it was 27.7% at the end of the base year in 2013, which implies that in the EU, instead of every four active persons, there will be two active persons for one person over the age of 65. Comparing the domestic ratio with the EU countries, BH still records a similar or even slightly lower share of dependency according to the estimates of the BHAS Labor Force Survey[35], with the fact that the long-term projection of the United Nations Population Fund (UNFPA) indicates a dramatic increase in dependency in the coming decades. According to the aforementioned projection, the ratio is predicted to be 73.7% in 2050, which implies that BH will have 1.4 active persons for one person over the age of 65. The aforementioned official data and projections of future trends in the labor market point to a much-needed demographic development strategy and its implementation, with the aim of increasing the active population number and reducing the share of the dependent population.

The growth in the number of pensioners and the record growth of inflation in recent times have caused the increasing costs of maintaining the pension and health sectors. On the other hand, the nominally largest amount of collected contributions was also recorded (Graph 8.9), but taking into account that too low levels of average pensions and still pronounced inflation require a further increase in the costs of financing pension and health funds in the coming period, it is possible to expect a further deepening of the budget deficit.

Graph 8.9: Financial Operations of Pension and Health Funds



Source: BHAS, CBBH, Federal PDI Fund , Pension-Disability Insurance Fund of RS.
Note: *Projection of spending in health sector for 2023 and 2024 is based on the linear trend from the previous period, while the projection of expenses for pensions in 2024 is based on the July end official data. Income from contributions for health care and pensions for 2024 is based on the official data from the end of the first half of the year, while the GDP projection is based on the official CBBH projection.

[35] dependancy ratio

STATISTICAL APPENDIX

Attachment 1: Indicators of Macroeconomic Imbalances in Bosnia and Herzegovina

Group of indicators	Indicators	Reference value	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Indicators of external imbalances and competitiveness	Balance of payments current account balance - three year average (GDP%)	Od -4 % do 6 %	-9.8%	-8.7%	-7.3%	-8.0%	-7.8%	-7.1%	-5.9%	-5.7%	-4.8%	-4.2%	-3.5%	-2.9%	-2.4%	-3.0%	-3.0%
	Net balance of foreign investment (GDP %)	-35%	-52.3%	-53.7%	-56.2%	-57.9%	-56.4%	-56.7%	-54.2%	-50.5%	-45.7%	-41.5%	-36.8%	-33.5%	-28.9%	-25.7%	-22.9%
	Real effective exchange rate - three year change (%)	±5 % (europodručje). ±11 % (izvan europodručja)	1.5%	2.2%	0.2%	-1.6%	-2.0%	-3.4%	-5.2%	-4.8%	-4.5%	-1.0%	-1.1%	-1.4%	-2.4%	2.8%	3.5%
	Share in global exports of goods and services - five year change (global export %)	-6%	n/a	-1.6%	-12.1%	-1.3%	0.3%	-5.1%	0.7%	10.8%	32.5%	30.6%	24.7%	15.2%	20.7%	15.7%	13.2%
	Nominal index of unit labour cost -three year change (%)	9% (europodručje). 12% (izvan europodručja)	24.5%	13.3%	8.9%	4.7%	4.3%	1.7%	-1.8%	-2.4%	-3.1%	1.0%	5.7%	10.1%	6.9%	15.9%	23.0%
Indicators of internal imbalance	Residential property price index, deflated - one year change (%)	6%	24.4%	-5.1%	-6.8%	-6.2%	-1.3%	-1.7%	2.9%	-0.4%	-3.2%	-0.4%	-0.4%	3.3%	3.6%	1.0%	7.5%
	Private sector credit flow, consolidated (GDP %)	14%	-3.8%	-0.7%	1.2%	1.3%	1.0%	0.5%	1.0%	1.7%	3.4%	3.2%	3.6%	-1.1%	2.1%	2.6%	3.5%
	Private sector debt, consolidated (GDP %)	133%	62.7%	60.7%	59.9%	61.2%	61.0%	60.2%	57.9%	57.0%	57.7%	57.2%	57.9%	58.5%	54.06%	49.03%	49.15%
	Gross debt of general government (GDP %)	60%	25.9%	30.2%	32.8%	36.5%	37.6%	41.6%	41.4%	40.0%	35.6%	33.6%	32.3%	36.1%	33.9%	29.3%	26.9%
	Unemployment rate - three year average (%)	10%	25.5%	24.9%	26.3%	27.6%	27.7%	27.7%	27.6%	26.9%	24.5%	21.4%	18.2%	16.7%	16.4%	16.3%	15.4%
	Financial sector total liabilities, unconsolidated - one year change (%)	16.5%	-1.9%	-0.7%	-0.5%	1.0%	5.5%	5.5%	4.5%	5.5%	8.7%	10.0%	8.3%	4.0%	11.0%	2.9%	3.4%
Employment indicators	Activity rate - three year change (pp)	(- 0.2 pp)	1.2%	1.6%	0.2%	0.9%	-2.2%	-0.7%	0.2%	-1.1%	-2.5%	-4.5%	-2.3%	12.0%	11.5%	11.8%	2.9%
	Long-time unemployment - three year change (pp)	0.5 pp	-6.7%	-2.7%	2.1%	2.8%	0.4%	1.0%	-0.3%	-1.1%	-6.5%	-7.5%	-9.7%	-5.0%	-1.5%	-0.4%	-2.0%
	Youth unemployment rate - three year change (pp)	2.0 pp	-26.5%	-1.5%	21.9%	29.6%	2.8%	8.3%	-1.3%	-8.1%	-27.0%	-37.7%	-37.8%	-20.1%	-1.3%	3.8%	-17.8%

Source: CBBH

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