

# Strategy Bosnia and Herzegovina

January 2008



## Key facts

|                       |   |
|-----------------------|---|
| Official name:        | Bosnia and Herzegovina  |
| ISO country code:     | BA; BIH   |
| Population (in 1000): | 3842.8  |
| Area (sq km):         | 51209.2   |
| Border countries:     | Croatia, Serbia,<br>Montenegro  |
| Admin. distribution:  | two entities (Federation of<br>Bosnia and Herzegovina<br>(FB&H) and Republika<br>Srpska (RS)) and district<br>Brcko |
| Capital city:         | Sarajevo  |
| Official languages:   | Bosnian, Croatian, Serbian  |
| Ethnic groups:        | Bosniak (Muslim) (48 %),<br>Serb (37.1 %), Croat<br>(14.3 %)  |
| Presidency:           | Zeljko Komsic (chairman),<br>Haris Silajdzic,<br>Nebojsa Radmanovic   |
| Prime Minister:       | Nikola Spiric   |
| High Representative:  | Miroslav Lajcak   |
| Currency:             | Bosnian convertible mark  |
| Currency code:        | BAM   |
|                       | 1 BAM = 0.511292 EUR  |
|                       | 1 EUR = 1.95583   |

Source: The World Factbook (by the CIA), Agency for Statistics of BiH, Raiffeisen RESEARCH

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## Highlights

■ Bosnia and Herzegovina finally initialled the Stabilisation and Association Agreement (SAA) with the European Union in Sarajevo on 4 December 2007. According to the High Representative of the International Community and EU Special Representative Mr Lajcak there is a realistic chance for the country to sign the SAA with the EU by the end of June 2008.

■ The real GDP has grown by 5.2% yoy on average since the year 2000. This is supported by the significantly higher volume of industrial production, as well as by increases in public spending, resulting from the increase in the budget income and strong investment activity by the state.

■ By ratifying the Central European Free Trade Agreement (CEFTA) at the beginning of September 2007, the pre-conditions were created for placing domestic products in a wider and stronger market. CEFTA will enable strengthening of mutual economic relations between the members of this free-trade zone covering Albania, Bosnia and Herzegovina, Montenegro, Croatia, Kosovo, Moldova and Serbia.

■ According to central bank governor Kemal Kozaric there will be no surprises in the monetary policy for the current year and the exchange rate against the EUR would not be changed. The foreign exchange reserves have continuously grown since the introduction of the currency board in 1997.

## Key economic figures and forecasts

|                                      | 2003  | 2004  | 2005  | 2006  | 2007e | 2008f | 2009f |
|--------------------------------------|-------|-------|-------|-------|-------|-------|-------|
| Nominal GDP (EUR bn)                 | 7.4   | 8.1   | 8.7   | 9.8   | 10.5  | 11.2  | 11.9  |
| Real GDP (% yoy)                     | 3.0   | 6.3   | 4.3   | 6.2   | 5.5   | 5.8   | 5.5   |
| Industrial output (% yoy)            | 3.8   | 12.0  | 7.5   | 11.0  | 8.0   | 9.0   | 8.0   |
| Unemployment rate (avg, %)           | 41.5  | 42.0  | 44.0  | 45.5  | 44.0  | 42.8  | 41.9  |
| Nominal wages, whole economy (% yoy) | 8.6   | 4.3   | 6.7   | 8.9   | 8.0   | 8.0   | 7.0   |
| Producer prices (avg, % yoy)         | 0.8   | 1.5   | 2.0   | 4.5   | 2.7   | 2.2   | 2.0   |
| Consumer prices (avg, % yoy)         | 0.6   | 0.4   | 3.6   | 7.4   | 1.5   | 4.2   | 2.7   |
| Consumer prices (eop, % yoy)         | 0.6   | 0.4   | 4.3   | 6.0   | 4.9   | 3.2   | 2.2   |
| General budget balance (% of GDP)    | 0.7   | 1.6   | 2.4   | 2.9   | 2.6   | 2.0   | 1.5   |
| Current account balance (% of GDP)   | -19.4 | -18.4 | -20.3 | -10.7 | -13.9 | -13.3 | -13.3 |
| Official FX reserves (EUR bn)        | 1.44  | 1.75  | 2.14  | 2.79  | 3.63  | 4.19  | 4.70  |
| EUR/BAM (avg)                        | 1.956 | 1.956 | 1.956 | 1.956 | 1.956 | 1.956 | 1.956 |
| USD/BAM (avg)                        | 1.737 | 1.572 | 1.573 | 1.552 | 1.428 | 1.397 | 1.449 |
| EUR/USD (avg)                        | 1.126 | 1.244 | 1.243 | 1.260 | 1.370 | 1.400 | 1.350 |

Source: wiiv, Raiffeisen RESEARCH



**Raiffeisen  
RESEARCH**

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# One foot in the EU's door

## Home affairs

During 2007, political relations in Bosnia and Herzegovina (BiH) were primarily characterised by increasing disagreement between the leaders of the country's political parties, resulting in decreasing efficiency in the legislative and executive authorities' activities. Therefore, in its report, the European Commission stated that the activities of the BiH authorities must strictly focus on creating and implementing the measures necessary for speeding up the reform process. Nevertheless, based on past experience we should be optimistic and believe that with some support from the International Community local politicians will manage to improve the capacity to implement the reform process. The development of relations within BiH's political system should contribute vastly to the establishment of necessary preconditions for more efficient engagement of the state bodies.

Mr Miroslav Lajcak, the current High Representative of the International Community as well as the Special Representative of the EU, started his term of office vigorously, determined to encourage local political leaders to implement the constitutional reforms and accelerate the process of European integration. At the beginning of October negotiations on the reform of the police system failed: this reform was a key condition of the European Commission for execution of the Stabilisation and Association Agreement. Following this, the High Representative faced the significant resistance from the leaders of certain political parties. This finally resulted in the resignation of Mr Nikola Spiric, the country's Prime Minister. Therefore, during the last quarter of 2007, the BiH Council of Ministers operated in the technical term of office. The Prime Minister's resignation complicated the current situation. Nevertheless, we expect the consultations on the appointment of a new Prime Minister by the BiH Council of Ministers to finish in the coming weeks, and the new/old Prime Minister should be again Mr Nikola Spiric.

Under these circumstances, the Mostar Declaration, which was executed on 28 October 2007 is a progressive step and may be a very good start for solving the disputes related to the upcoming negotiations on constitutional reforms. As for the constitutional reforms, it should be noted that in the mid 1990s, the Dayton/Paris Peace Accord brought peace and stability to Bosnia and Herzegovina, but

## Key political persons

|  |   |
|--|---|
| <b>High Representative and EU Special Representative</b> | Miroslav Lajcak   |
| <b>Three-member Presidency</b>                           | Zeljko Komsic (chairman)<br>Haris Silajdzic<br>Nebojsa Radmanovic |
| <b>Prime Minister</b>                                    | Nikola Spiric   |
| <b>Federation of Bosnia and Herzegovina</b>              |   |
| President  | Borjana Kristo  |
| First Vice-President                                     | Mirsad Kebo   |
| Second Vice-President                                    | Spomenka Micic  |
| Prime Minister   | Nedžad Brankovic  |
| <b>Republic of Srpska</b>                                |   |
| President  | Rajko Kuzmanovic  |
| First Vice-President                                     | Adil Osmanovic  |
| Second Vice-President                                    | Davor Cordas  |
| Prime Minister   | Milorad Dodik   |

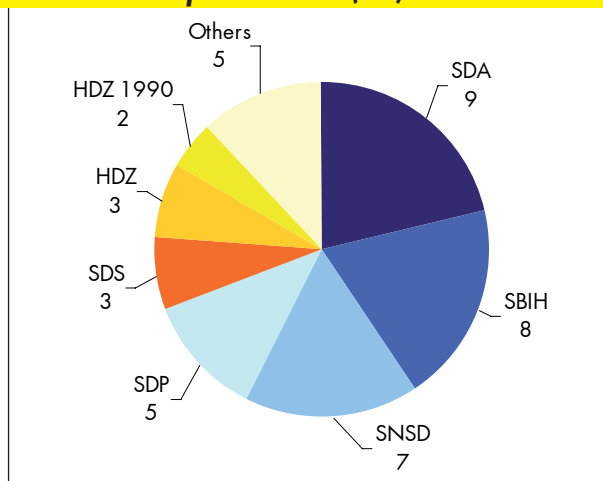
Source: [www.parlament.ba](http://www.parlament.ba)

## Main political parties

|  | Orientation  |
|--|--------------|
| <b>Governing parties</b>                     |              |
| Party of Democratic Action (SDA)             | right        |
| Party for Bosnia and Herzegovina (SBIH)      | right        |
| Party of Independent Social Democrats (SNSD) | center-left  |
| Party of Democratic Progress (PDP)           | center-left  |
| Croatian Democratic Union (HDZ)              | right        |
| Croatian Democratic Union 1990 (HDZ 1990)    | right        |
| Democratic People's Party (DNZ)              | right        |
| People's Party for Improvement (NSRB)        | center       |
| <b>Opposition parties</b>                    |              |
| Social Democratic Party (SDP)                | left         |
| Serbian Democratic Party (SDS)               | right        |
| Democratic People's Alliance (DNS)           | center       |
| Bosnian-Herzegovinian Patriotic Party (BPS)  | center-right |

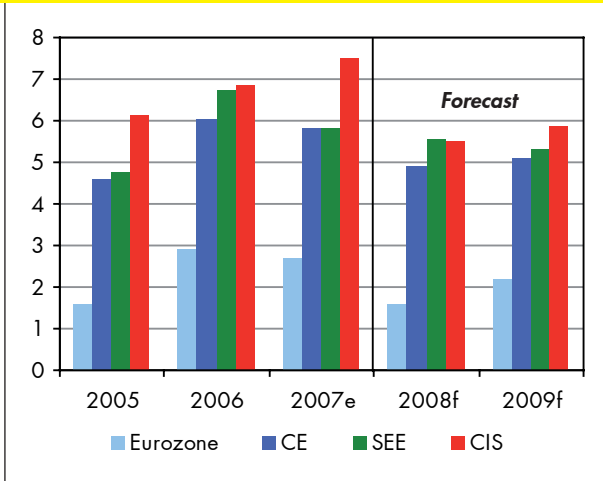
Source: [www.parlament.ba](http://www.parlament.ba)

## Seats in the parliament (42)



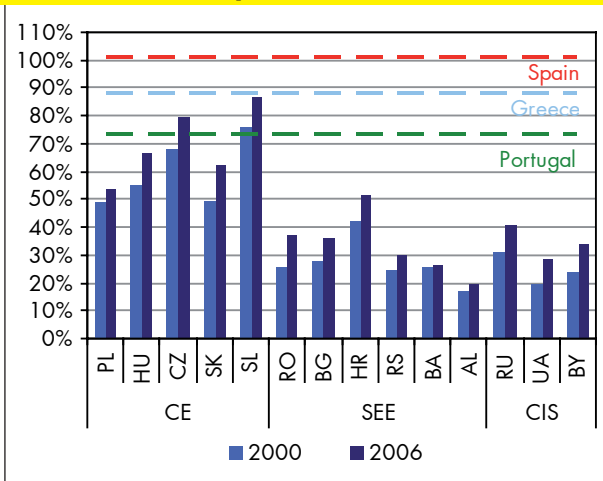
Source: [www.izbori.ba](http://www.izbori.ba), Raiffeisen RESEARCH

**Real GDP (% yoy)**



Source: Thomson Financial Datastream, wiw, Raiffeisen RESEARCH

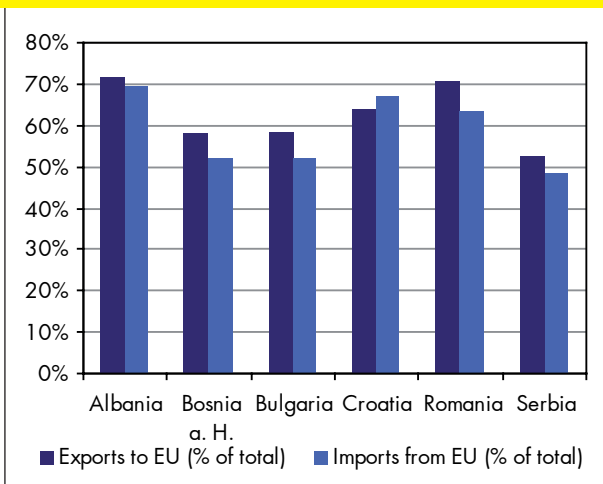
**Room to catch up**



GDP per capita (at PPP) in % of EU-27 avg

Source: wiw, Raiffeisen RESEARCH

**Trade with EU**



Data as of 2006

Source: Thomson Financial Datastream, Raiffeisen RESEARCH

Annex IV to the Accord, which at the same time represents the Constitution of BiH, defined quite a complex institutional structure. This institutional structure significantly limits the reform capacity of the BiH authorities. Of course, the current situation may be sidestepped by the adoption of constructive and compromise constitutional solutions, which would provide for more efficient operation of the state in general. Therefore, the political heads of the Council for Peace Implementation emphasize that the representatives of the most influential political parties in BiH should contribute significantly to creating constitutional solutions which would enable the state to work more decidedly on joining the European Union. The next round of constitutional negotiations will take place in Brussels at the end of January.

In conclusion, it should be pointed out that all other disagreements in BiH political relations should be resolved through necessary constructive engagement of the local politicians supported by the International Community.

**Foreign affairs**

The integration process with the European Union should be the main goal of BiH, followed by the signing of Stabilisation and Association Agreement in the near future, which would represent the basis for full membership of the EU. Bosnia and Herzegovina finally initialled the Stabilisation and Association Agreement with the European Union in Sarajevo on 4 December 2007. This became possible after BiH Council of Ministers adopted the action steps related to the police system reform. This was the key condition of the European Commission for BiH to continue the integration process with the EU. In the near future, the country must also make improvements especially in the public administration and further reform of public broadcasting.

From a historical point of view, the process of BiH's political integration into Europe started in the second half of 1990s, when a whole range of political, technical and economic conditions was adopted, defining the development of political relations between the European Union and Bosnia and Herzegovina. In 1998, CTF - Consultative Task Forces were established and the EU document - the 'Road Map' was published in the following year. Notwithstanding the previous significant events in relation to the EU, the milestone moment in the

European integration process was the opening of negotiations on the Stabilisation and Association Agreement in November 2005. In the very beginning, the negotiations went relatively swiftly and at the end of 2006 they were technically completed.

The main obstacle to execution of the Agreement was the unsuccessful reform of the BiH police system in the first eleven months of 2007. At the same time, Bosnia and Herzegovina also needs to improve the efficiency of public administration and continue further reform of the public broadcasting service. Although in the past period the SAA was not executed quickly enough, which caused a delay in EU integration compared to other states in the region, we take a positive view of future relations with the EU. In this context, the aforementioned Mostar Declaration is grounds for optimism about stronger engagement of the governing coalition, which should make an additional effort to implement the action steps related to final police reform according to the principles defined by the European Commission. At the same time, the High Representative of the International Community and EU Special Representative Mr Lajcak has said "If BiH maintains December's positive climate, there is realistic chance for the country to sign the SAA with the EU by the end of June 2008."

As for overcoming public administration inefficiency, the BiH Council of Ministers and the governments of the entities made significant progress in 2007. The Coordinator for Reform of Public Administration was appointed for four-year term, and the common platform was also approved for the implementation of the Public Administration Reform Strategy. These steps were welcomed and the European Commission allocated EUR 4.5 mn for implementation of this project.

At the same time, we have also seen progress in the enhancement of the entire legal system in BiH, where the High Judicial and Prosecutorial Council, as independent and professional bodies, have played a key role in significant improvement of the judiciary system. In addition to other elements, this should result in a higher level of professionalism and lead to continued enhancement of the efficiency of the legal system in general. Once more, we should emphasize that BiH's participation in the Stabilisation and Association Process is crucial and extremely important, and the SAA should be signed in the first half of 2008.

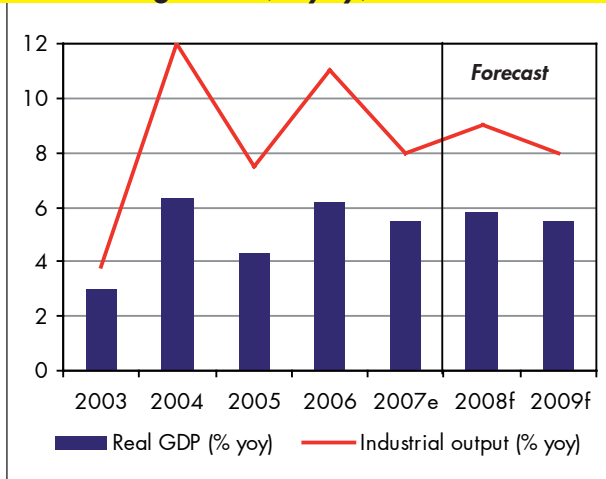
### EU integration: key events

|      |  |
|------|--|
| 1995 | The Dayton-Paris Peace Agreement brought the war to an end and established two entities of roughly equal size in Bosnia and Herzegovina: the Federation of BiH and the Republika Srpska.   |
| 1997 | Regional Approach: The EU establishes political and economic conditionality for the development of bilateral relations.  |
| 1998 | EU Declaration. Establishment of the EU/BiH Consultative Task Force (CTF), a joint vehicle for technical and expert advice in the field of administration, the regulatory framework and policies.  |
| 1999 | The EU proposes the Stabilisation and Association Process (SAP) for five countries of South East Europe, including BiH.  |
| 2000 | Publication of the EU Road Map. This document set out 18 essential steps to be undertaken by BiH before the work on a Feasibility Study for the opening of negotiations on a SA Agreement could be begun.                                    |
| 2000 | The Feira European Council states that all the SAP countries are "potential candidates" for EU membership.   |
| 2000 | Zagreb Summit: the SAP is officially endorsed by the EU and the Western Balkan countries (including BiH).  |
| 2001 | First year of the CARDS assistance programme specifically designed for the SAP countries.  |
| 2002 | The first EU Special Representative, Lord Paddy Ashdown, is appointed to BiH (being simultaneously the High Representative).   |
| 2003 | Thessaloniki Summit: the SAP is confirmed as the EU policy for the Western Balkans. This confirms the EU perspective for the countries.  |
| 2003 | The Commission produces a Feasibility Study assessing BiH's capacity to implement a Stabilisation and Association Agreement.   |
| 2003 | The European Union Police Mission (EUPM) is launched as the first European Security and Defence Police (ESDP) mission.   |
| 2004 | The EU decides on the first European Partnership for Bosnia and Herzegovina.   |
| 2005 | European Commission recommends the opening of negotiations for a Stabilisation and Association Agreement with BiH. These negotiations are officially opened in Sarajevo on 25 November after the Council adopted the negotiating directives. |
| 2006 | The first Reform Process Monitoring (RPM) meeting is held replacing the Consultative Task Force. An updated European Partnership for BiH is adopted.   |
| 2006 | Dr. Christian Schwarz-Schilling is appointed as new High Representative/EU Special Representative.   |
| 2007 | The Instrument of Pre-Accession comes into force. Technical talks for a SAA are finalised.   |
| 2007 | Miroslav Lajcak is appointed as new High Representative/EU Special Representative.   |
| 2007 | The EU initials the Stabilisation and Association Agreement with Bosnia and Herzegovina in Sarajevo (4 December 2007).   |
| 2008 | The visa facilitation agreement and readmission agreement enter into force.  |

Source: European Commission

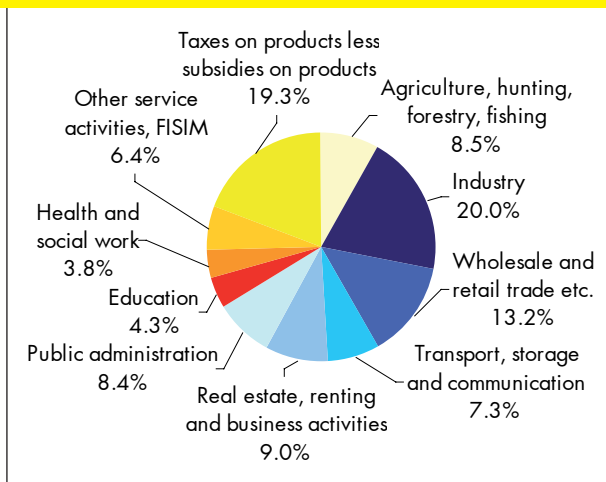
## Robust economic growth stimulated by industrial production

### Real GDP growth (% yoy)



Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

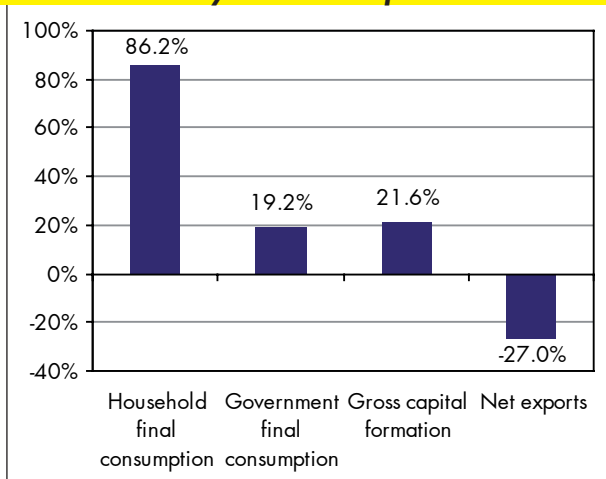
### Sectoral contribution to GDP



Data as of 2006

Source: Agency for Statistics of BiH, Raiffeisen RESEARCH

### Contribution by kind of expenditure



Data as of 2006

Source: Agency for Statistics of BiH, Raiffeisen RESEARCH

The robust increase in economic activity was the most significant characteristic trend in BiH's economy in 2006, as the real GDP growth rate reached 6.2%. At the same time, industrial production also generated a very respectable growth rate of 11%. The expansion of industrial production resulted primarily from increases in production of metal and chemical products, machines and equipment and wood products.

We do not expect that the significant GDP expansion has been maintained in 2007, especially taking into account the falling pace of industrial production development in Republika Srpska and widening deficit in foreign trade. Nevertheless, this does not imply a significant decrease in the real GDP growth rate: on the contrary, according to the available economic indicators published for 2007, GDP should reach almost 5.5%, a downward correction of 0.7% compared to the forecasts.

In this context, it should be underlined that economic growth in 2007 was stimulated by higher industrial production in the Federation of BiH, which increased by 11.6% in the first nine months, according to unofficial data. This trend has been accompanied by a stronger-than-average expansion in production of furniture, chemical products and coke as well as an increase in the publishing-printing industry. On the other hand, it should be noted that industrial production would have reached even higher values if energy production had not been weak due to mild weather conditions in the first quarter of 2007 (thus decreasing energy consumption). As noted, in the first 9 months of 2007, Republika Srpska generated a symbolic increase in industrial production of only 0.1% yoy. It also saw a significant decrease in energy production, which fell by 10.7%. Production of intermediary products increased by 0.4%, while production of capital products decreased by 0.3%. Especially positive trends in this entity were achieved in the production of durable consumer goods, where production volume increased by 64% partly due to the low base values.

Generally, the BiH economy continues to generate significant real growth rates in the country's GDP. This is supported by the significantly higher volume of industrial production, as well as by increases in public spending, resulting from the increase in the budget income and strong investment activity by the state.

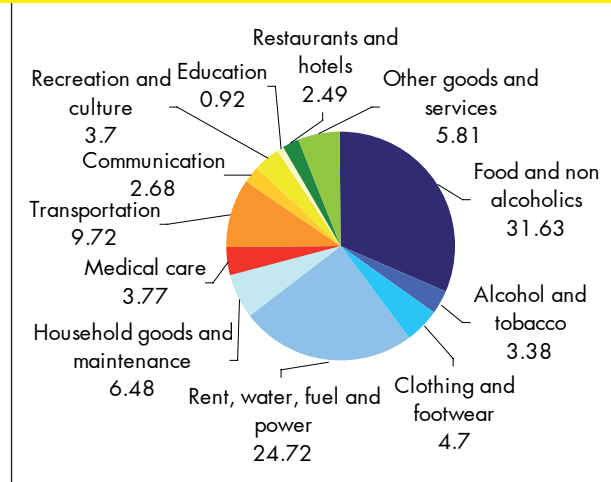
Implementation of tax reform and the introduction of the Value Added Tax (VAT) instead of the Sales Tax generated stronger inflationary pressure in 2006, as average inflation reached 7.4%, i.e. 6.0% at the end of the year (end of the period). After the effects of VAT introduction faded, the conditions were created for reducing inflationary pressure, and in the first half of 2007, the consumer price index was less than 1%. In the context of measuring inflationary trends, we should stress that significant improvements were made in 2007, and the Statistics Agency of BiH has fully adjusted the Consumer Price Index to the International Statistics Standards. The main components of this index were food and spirits (31.63%), housing, water, and energy/power products (24.72%), while the smallest weighting is for prices of education (0.92%) and services of restaurants and hotels (2.49%).

According to the Agency for Statistics the CPI reached 4.9% by the end of 2007, and this is almost totally due to increases in the prices of energy, electricity, housing costs and food prices. In the near future, price stability may be undermined by dynamic rises in energy market prices and increase in oil prices and food prices as well. Therefore, we expect that the average inflation might rise from 1.5% in 2007 to 4.2% in 2008.

One of the biggest problems in Bosnia and Herzegovina is unemployment. Mid 2007, registered unemployment amounts to 44.2%, i.e. there are 530,190 unemployed, and 668,240 employed persons. Analysis of employment structure by sectors shows that 47.6% of citizens are employed in services, 32.6% in industry and 19.8% in agriculture. It should be emphasized that, if calculated according to ILO methodology, the unemployment rate is significantly lower, closer to 30%, thus indicating significant unregistered business activities in the country. Although unemployment based on ILO methodology is significantly lower than the registered rate, this is still far too high unemployment and measures are required for its gradual elimination.

To solve the problems on the labour market, the state and entity governments need to take proactive measures and implement thorough reforms to neutralize the structural disadvantages and high tax burdens on the salaries of the employed people. Moreover, projects for improving the educational system, work skills and capabilities of the unemployed should be implemented.

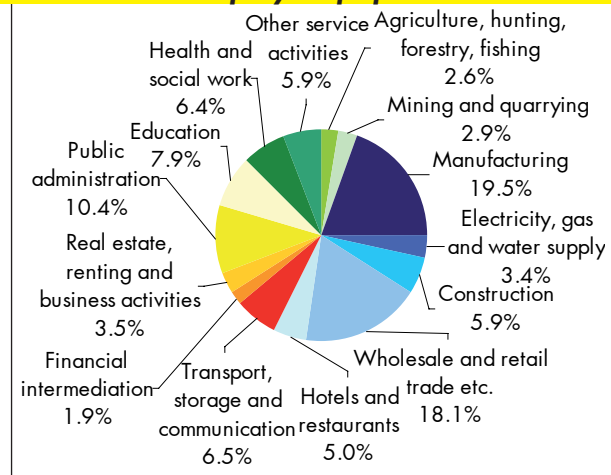
## Structure of the Consumer Price Index



Data as of September 2007

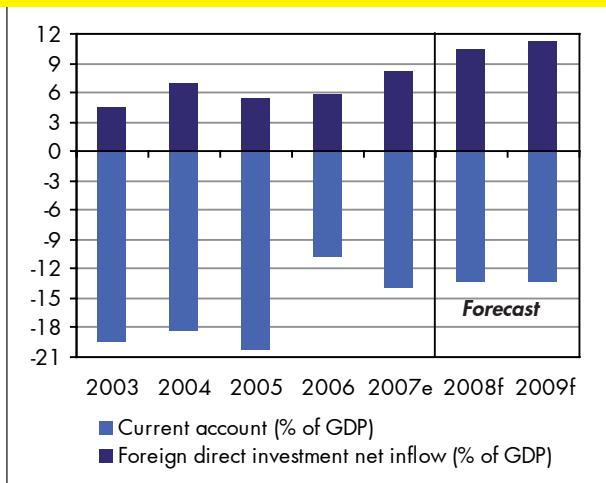
Source: Agency for Statistics of Bosnia and Herzegovina

## Structure of employed population



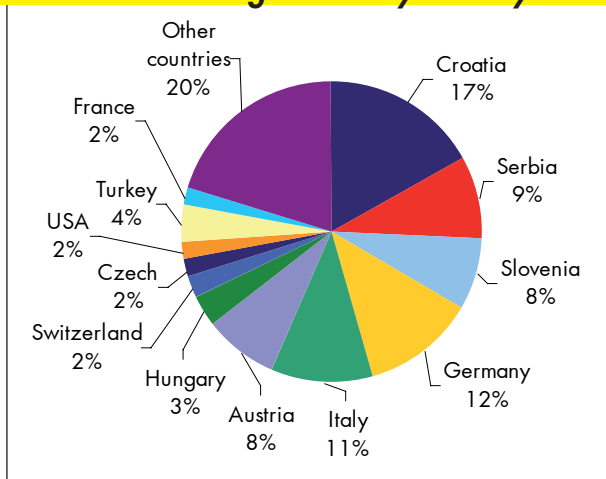
## FDI needed EU approach might help

### Current account and FDI inflows



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

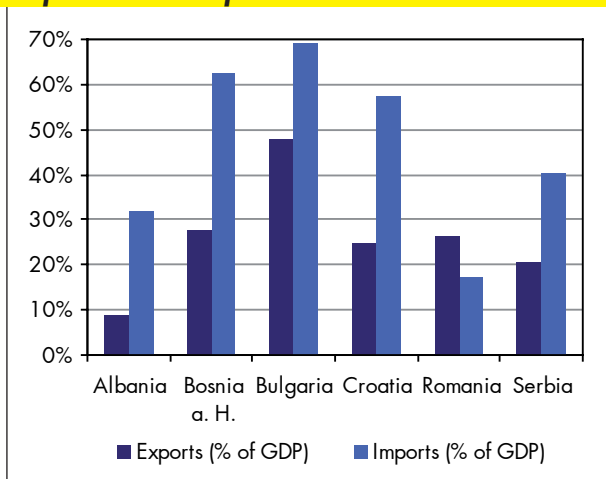
### Structure of foreign trade by country



First semester of 2007

Source: Thomson Financial Datastream, wiw, Raiffeisen RESEARCH

### Exports and imports



Data as of 2006

Source: Thomson Financial Datastream, wiw, Raiffeisen RESEARCH

The current account deficit on the balance of payments prior to 2006 reached 20% in relation to the nominal Gross Domestic Product. In 2006, however, this deficit decreased significantly to 10.7% of GDP, due to the decrease in the trade deficit initiated by higher goods exports (+28% yoy), while goods imports over the last year remained the same. It should be noted that the decrease in the foreign trade deficit in 2006 was also affected by accumulating stocks of imported goods before VAT introduction.

Nevertheless, the current account deficit is rather high, especially considering that it increased in 2007: the released figures for the first six months indicate that imports of goods increased by 28.8% compared to the same period of the previous year, while the exports of goods increased by 18.5%. This is the result of the weaker export performance of domestic industry, which reflects the deficit increase in foreign trade balance owing to the openness of BiH's economy, which finally results in a higher current account deficit on the balance of payments.

By ratifying the Central European Free Trade Agreement (CEFTA) at the beginning of September 2007, the pre-conditions were created for placing domestic products in a wider and stronger market. CEFTA will enable strengthening of mutual economic relations between the members of this free-trade zone covering Albania, Bosnia and Herzegovina, Montenegro, Croatia, Kosovo, Moldova and Serbia. On the other hand, the domestic economic sector's weaknesses and further increase of domestic market openness, which amounted to 89.9% measured by the proportion between foreign exchange trade and GDP in 2006, indicate that BiH executive authorities should implement proactive economic policies aimed at strengthening the domestic economic sector and export orientation. In the coming period, market agents will need to improve their business philosophy and practices by higher efficiency and competitiveness and using the benefits of the free trade zone.

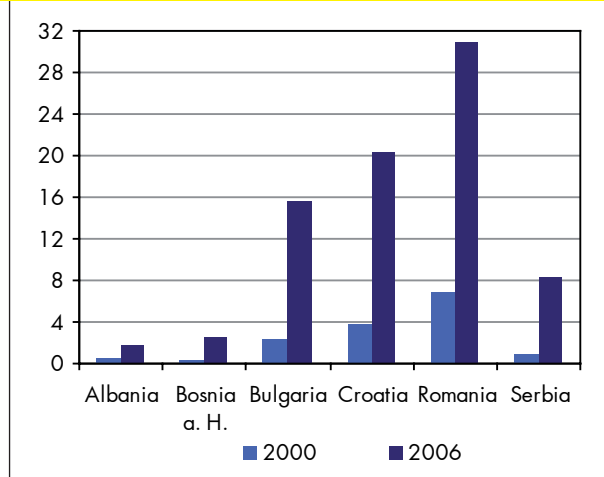
Relative to the structure of foreign trade, in the first half of 2007 Bosnia and Herzegovina developed the most intensive goods exchange with the European Union countries, so that exports to these countries reached the value of 59.3% of the total amount of exported goods, while imports account for 46.6% of total imported goods. A detailed

analysis shows that the biggest contribution to the foreign trade with the EU countries comes from Italy, Germany, Slovenia, and Austria. It should be underlined that the high trade deficit on the current account in the balance of payments is mitigated by the current transfers from abroad, i.e. significant FCY inflows of private individuals living and working overseas. In 2006, for example, the value of these cash inflows was EUR 1.64 bn.

The aspects discussed above show that BiH needs stronger Foreign Direct Investment (FDI). The total FDI value from the mid of 1990s until the end of 2006 amounted to EUR 3.01 bn. In 2006, total FDI reached EUR 564 mn or 5.8% of nominal gross domestic product. In 2007, we expect significant growth of these investments, mostly as a result of privatising Telecom of RS, sale of which was agreed as of the end of 2006, and the actual transaction was effected in 2007. The total value of this agreement is ca EUR 650 mn. Therefore, in 2007, it is estimated that the FDI value was around 8% of GDP. By observing the structure of these investments by country of origin, most FDI originates from Austria (45%), Slovenia (12%), and Croatia (11%). On the other hand, the investment structure by industrial sectors indicates that the investment in the sector of financial intermediation is dominant, i.e. investments in banking the value of made up 46% of the total FDI in BiH between 2003 - 2006.

The detailed privatisation strategy of the key companies owned by FBiH should significantly contribute to the investment increase in BiH. This strategy is expected to generate income from the privatisation of the large state companies, in which case these funds would be used for financing the infrastructure and strategic projects of this entity. The privatisation programme until 2010 focuses on selling majority state ownership in telecommunication companies (BH TELECOM Sarajevo and HT Mostar), which would generate between EUR 1.75 and 2 bn. Also, the programme includes selling the minority ownership in the power-supply sector, as well as selling the state companies such as military, public utility companies or other smaller state companies. This supports the claims that the sale of the state ownership in these companies will provide inflows of FDI over the entire period before 2006. Also, privatising the biggest aluminium company in BiH, Aluminij dd Mostar, should not be neglected. This privatisation policy will certainly help to balance the total foreign payment balance.

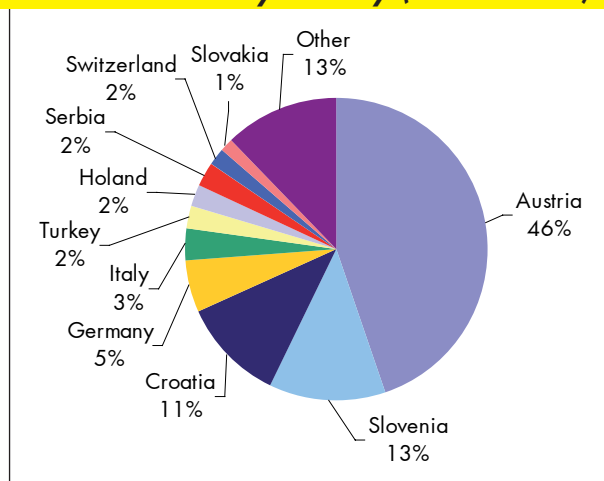
## Strongly rising investments in SEE



Inward FDI stock (EUR bn)

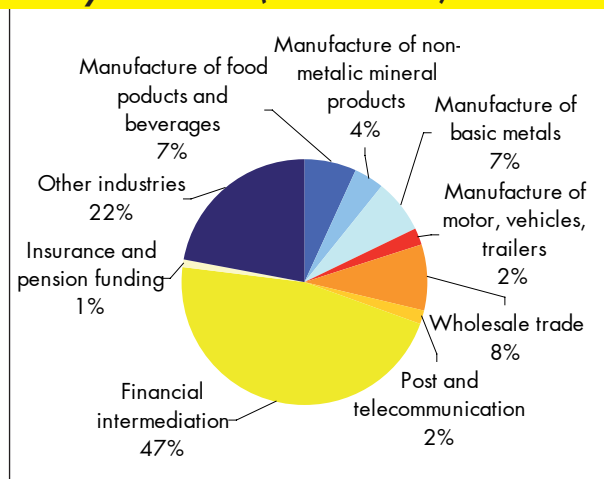
Source: wiw, Raiffeisen RESEARCH

## Net FDI inflows by country (2004 -2006)



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

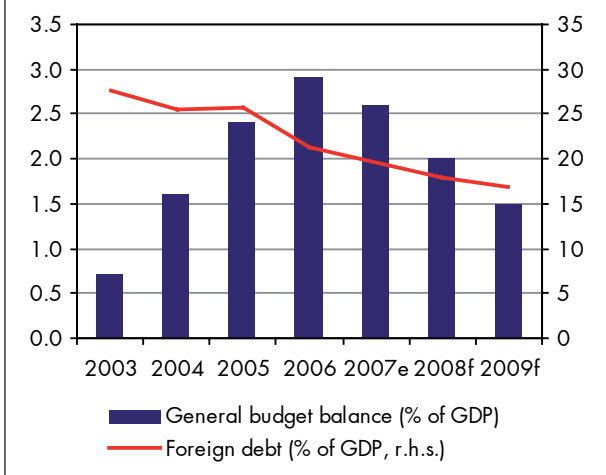
## FDI by industries (2003 -2006)



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

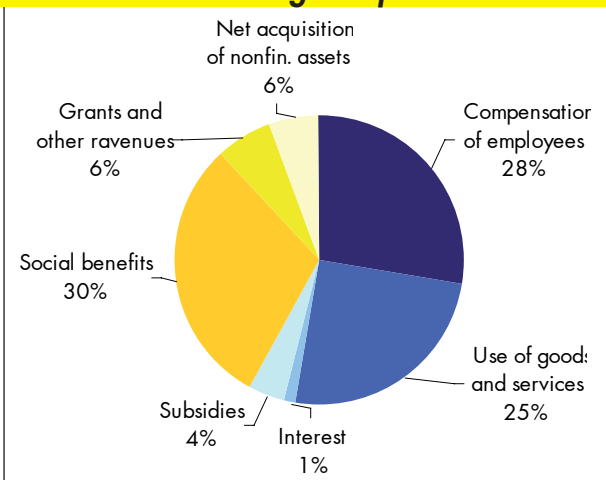
## Tax system reform developing in the right direction

### General budget balance and foreign debt



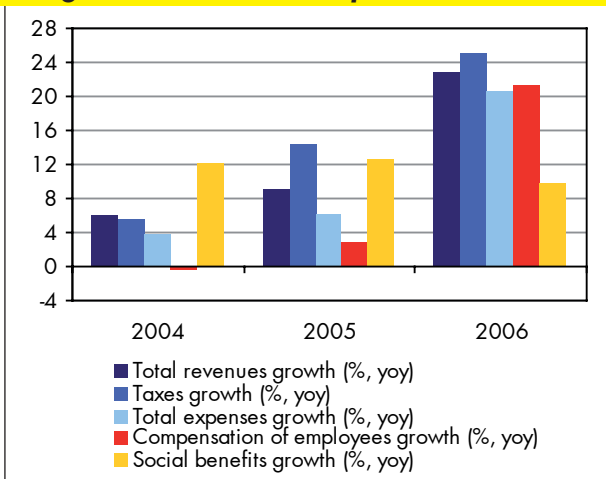
Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

### Structure of the budget expenses



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

### Budget revenues and expenses



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

Successful implementation of tax system reform and the introduction of the value added tax in 2006 were based on the intensified consolidation effects and further growth in the budget surplus. Thus, the surplus of the consolidated state budget as of the end of 2006 was 2.9% of GDP or EUR 283 mn. Therefore, it is significant that the total tax revenues grew at an extremely high rate of 25.2% yoy. At the same time, the increase in the budget revenues neutralised the progressive growth of the total budget costs which grew at a rate of 21% yoy.

Reviewing the non-revised data of the state and entity authorities, the trends of the budget revenues during the first half-year have been positive, and the consolidated revenue amount at the state level grew by 15% compared to the same period last year. The forecast based on the results of the first 10 months of 2007 implied revenue growth from the value added tax to the amount of EUR 2.3 bn, which is almost 10% higher than the forecast value of the Indirect Taxation Authority. At the same time, the State Budget is under pressure due to expenses, and in the first two quarters of 2007 expenses increased by 15% compared to the same period of the previous year. Based on the structure of budget expenses for 2006, the highest share in the total state expenses relate to the social benefits and employee compensation in public administration.

The tax system reform is still developing in the right direction, which resulted in the adoption of the new Citizens' Income Tax Law. Also, for harmonising tax regulations at the state level, the profit tax rate of the companies in the Federation of BiH has been corrected, and this rate is currently 10% throughout Bosnia and Herzegovina. Although BiH has not yet signed the agreement with the International Monetary Fund, the recommendations of this institution are crucial for managing state finances. Therefore, steps for complete functioning of the Fiscal Council should be taken in the coming period which would enable coordination between the state and entities governments in terms of more efficient control of a possible future expansion of public consumption. This is extremely important considering the constant pressure on State consumption related to the increase in salaries of employees in public administration, which as of the end of the first half of the year were 10% higher compared to the beginning of the year. Also, continuation of the prudent management of state consumption policy is important for infrastructure investments planned in the years to come.

## Stable currency board FX reserves continuously growing

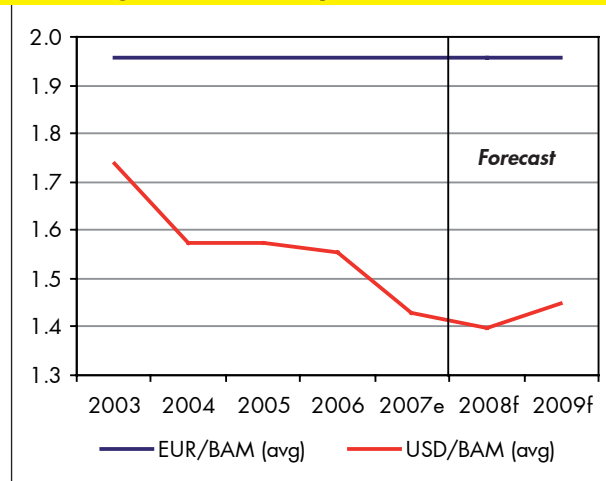
The monetary policy of the Central Bank of Bosnia and Herzegovina is defined by the currency board, according to which the local currency is pegged to the euro. The monetary authority started operating in this form in August 1997. It is managed by the Governing Board, which consists of 5 members. The central monetary institution is highly independent, based on legal provisions. According to the existing monetary regime, any participation of the Central Bank in the open market, via purchase and sale of the money market instruments, is eliminated, therefore this monetary policy has negative influence on the development of domestic money market. This also indirectly influences the non-existence of the local debt capital market.

The fixed-rate policy based on the rules of the currency board, means unlimited convertibility of the domestic currency to a "reserve" currency (EUR). This principle is satisfied by prudent managing the FCY reserves, which should ensure the international liquidity of the country, stability of domestic currency and its fixed rate of BAM 1.955830 to EUR 1. The fixed rate of domestic currency to EUR is operationally maintained by cover of monetary liabilities by net FCY reserves of this institution.

Looking at the trends of the monetary base value over the past periods, its upward trend is obvious. In December 2006, an increase of 23.6% was generated compared to the same month 2005, and in the first three quarters of 2007 alone, growth amounted to a respectable 19.1%. On the other hand, the widest monetary aggregate M2, including monetary aggregates M1 (cash outside banks and demand deposit in BAM) and Quasi-Money (time and saving deposits in BAM, demand deposits in foreign currency and savings and time deposits of all domestic sectors, excluding the central government), generates enviable growth rates, primarily due to term and demand deposits. Thus, in 2006, monetary aggregate M2 generated an increase with the relative value of 24.7%, and in the first three quarters of 2007, slightly over 17%.

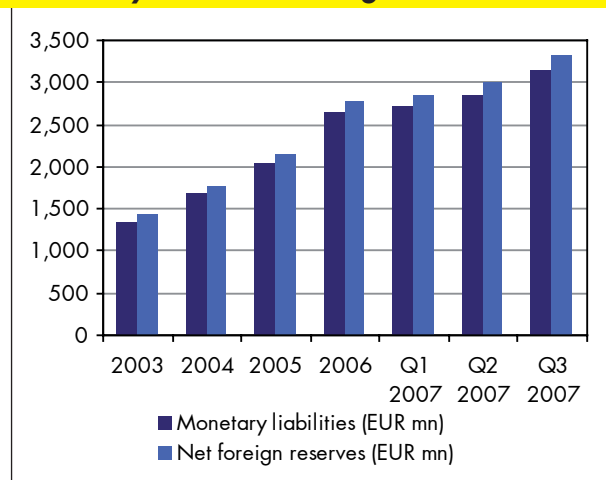
The monetary authority in Bosnia and Herzegovina performs its functions appropriately, and the results in the area of preserving monetary stability indicate the successful implementing the existing monetary policy. To improve its activities, additional efforts on raising the quality of statistical reporting need to be made. This approach will contribute to significantly higher transparency and more consolidated reviewing of trends within the monetary system.

### Exchange rate development



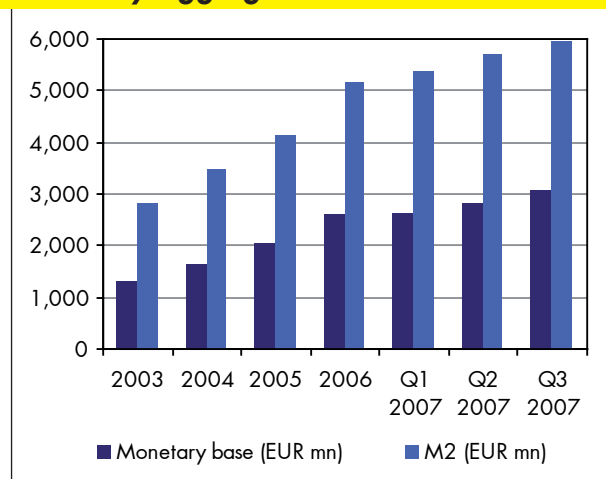
Source: Thomson Financial Datastream, wiiw, Raiffeisen RESEARCH

### Monetary liabilities foreign reserves



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

### Monetary aggregates



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

## Market consolidation on the back of international mergers

### Banking sector development

|                                       | 2004   | 2005   | 2006   | H1 2007 |
|---------------------------------------|--------|--------|--------|---------|
| Total assets, EUR mn                  | 4764.0 | 5999.2 | 7510.4 | 9038.7  |
| growth in % yoy                       | 21.2   | 25.9   | 25.2   | 20.3    |
| Total credits, EUR mn                 | 2789.8 | 3606.6 | 4527.9 | 5200.7  |
| growth in % yoy                       | 31.7   | 29.3   | 25.5   | 14.9    |
| Credit to private enterprises, EUR mn | 1428.9 | 1643.9 | 2075.6 | 2352.4  |
| growth in % yoy                       | 48.0   | 15.0   | 26.3   | 13.3    |
| Credit to households, EUR mn          | 1361.0 | 1756.5 | 2227.1 | 2574.8  |
| growth in % yoy                       | 37.0   | 29.1   | 26.8   | 15.6    |
| Total deposits, EUR mn                | 3534.1 | 4486.5 | 5604.8 | 6860.4  |
| growth in % yoy                       | 31.8   | 26.9   | 24.9   | 22.4    |
| Deposits from households, EUR mn      | 1302.4 | 1672.4 | 2149.6 | 2414.6  |
| growth in % yoy                       | 30.0   | 28.4   | 28.5   | 12.3    |
| Total deposits, in % of total credits | 126.7  | 124.4  | 123.8  | 131.9   |

Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

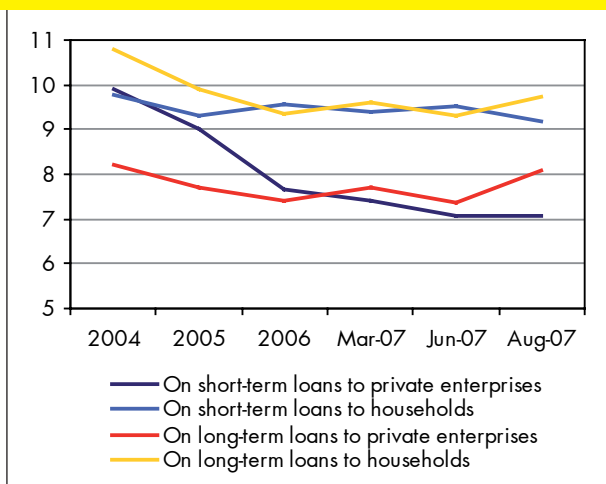
### Credit ratings

|                   | S&P  | Moody's | Fitch |
|-------------------|------|---------|-------|
| <b>LCY rating</b> |      |         |       |
| Long-term         | n.r. | B2      | n.r.  |
| Short-term        | n.r. | n.r.    | n.r.  |
| <b>FCY rating</b> |      |         |       |
| Long-term         | n.r. | B2      | n.r.  |
| Short-term        | n.r. | n.r.    | n.r.  |
| <b>Outlook</b>    | n.r. | stable  | n.r.  |

n.r. ... not rated

Source: Bloomberg, Raiffeisen RESEARCH

### Interest rates of commercial banks



Source: Thomson Financial Datastream, CB BiH, Raiffeisen RESEARCH

The character and characteristics of the overall BiH financial system show that it is basically bank-driven, which is confirmed by the data that the assets of this system at the end of 2006 amounted to 76.9% of GDP, while the assets of the insurance sector were 2.3% of GDP. As for the leasing companies, this sector grew significantly in 2006, but the final value of the agreements of these financial companies only reached 2.4% of nominal GDP.

Continuously high growth rates and stronger efficiency and success of the operations are the basic characteristics of the banking system in BiH. In 2006, banking sector assets increased at the rate of 25.2%, and at the end of the year, they reached the value of EUR 7.5 bn. In 2007, the banking system continued the trend of strong growth, thus in the first six months, the total bank assets increased at the rate of 20.36%. Total deposits of the corporate sector, including state-owned enterprises, increased by 14.54%. The structural characteristics of this part of the financial system indicate that its consolidation reached an equally satisfactory level. In the context of M&A transactions, the banks owned by Intesa Sanpaolo Group merged. Also, foreign banks have continued entering the market. The Austrian Steiermärkische Bank und Sparkassen took a controlling share of ABS banka, while the Eastern-European financial group IEFK entered the market by independently establishing I.E.F.K. banka ad Banja Luka.

Following the most recent statistics on interest rate trend in the BiH system of commercial banks, for the period between 31 Dec 2006 and 31 Aug 2007, the average interest rates on BAM short-term loans to households decreased 38bp. At the same period, for credit instruments intended for privately owned companies, there was a stronger decreased of 61bp, and the average interest rate at the end of the period was 7.05%. The interest rates on long-term BAM loans to private enterprises obviously increased in the relevant period, and this rate was 8.08%. As for households, there was an increase of 39bp. Considering that the overall monetary policy of BiH is pegged to EUR and that LT loans are mostly pegged to EUR via a currency clause, we should not expect any significant decrease in interest rates in the near future, which was the case in the past few years. Decrease of interest rates and the interest rate margin in the coming years should be only a result of trends of the BiH credit rating and competition in the banking sector.

## Real GDP (% yoy)

| Countries       | 2006       | 2007e      | 2008f      | 2009f      |
|-----------------|------------|------------|------------|------------|
| Poland          | 6.2        | 6.4        | 5.3        | 5.5        |
| Hungary         | 3.9        | 1.7        | 2.2        | 2.7        |
| Czech Rep.      | 6.4        | 6.1        | 4.9        | 5.5        |
| Slovakia        | 8.5        | 9.0        | 7.5        | 6.0        |
| Slovenia        | 5.7        | 6.0        | 5.0        | 5.0        |
| <b>CE</b>       | <b>6.1</b> | <b>5.8</b> | <b>4.9</b> | <b>5.1</b> |
| Croatia         | 4.8        | 5.9        | 5.0        | 5.2        |
| Bulgaria        | 6.1        | 5.5        | 5.5        | 5.8        |
| Romania         | 7.9        | 5.5        | 5.5        | 5.0        |
| Serbia          | 5.7        | 7.5        | 6.0        | 6.0        |
| Bosnia a. H.    | 6.2        | 5.5        | 5.8        | 5.5        |
| Albania         | 5.0        | 6.0        | 6.0        | 6.5        |
| <b>SEE</b>      | <b>6.7</b> | <b>5.8</b> | <b>5.5</b> | <b>5.3</b> |
| Russia          | 6.7        | 7.5        | 5.5        | 6.0        |
| Ukraine         | 7.3        | 7.3        | 5.5        | 5.0        |
| Belarus         | 9.9        | 8.1        | 6.0        | 5.5        |
| <b>CIS</b>      | <b>6.9</b> | <b>7.5</b> | <b>5.5</b> | <b>5.9</b> |
| Turkey          | 6.1        | 4.4        | 5.5        | 6.0        |
| <b>Eurozone</b> | <b>2.9</b> | <b>2.7</b> | <b>1.6</b> | <b>2.2</b> |
| USA             | 2.9        | 2.0        | 1.4        | 2.5        |

Source: wiw, Raiffeisen RESEARCH

## Consumer prices (avg, % yoy)

| Countries       | 2006       | 2007e      | 2008f       | 2009f      |
|-----------------|------------|------------|-------------|------------|
| Poland          | 1.0        | 2.4        | 3.1         | 2.8        |
| Hungary         | 3.9        | 8.0        | 5.2         | 3.5        |
| Czech Rep.      | 2.5        | 2.8        | 5.5         | 3.0        |
| Slovakia        | 4.5        | 2.8        | 2.5         | 3.0        |
| Slovenia        | 2.5        | 3.6        | 4.8         | 3.5        |
| <b>CE</b>       | <b>2.2</b> | <b>3.5</b> | <b>4.0</b>  | <b>3.0</b> |
| Croatia         | 3.2        | 2.9        | 4.1         | 3.0        |
| Bulgaria        | 7.3        | 8.4        | 8.0         | 5.0        |
| Romania         | 6.6        | 4.8        | 6.0         | 4.5        |
| Serbia          | 12.7       | 6.8        | 8.5         | 6.0        |
| Bosnia a. H.    | 7.4        | 1.5        | 4.2         | 2.7        |
| Albania         | 2.5        | 3.1        | 3.4         | 3.0        |
| <b>SEE</b>      | <b>6.8</b> | <b>5.0</b> | <b>6.1</b>  | <b>4.4</b> |
| Russia          | 9.8        | 9.1        | 11.5        | 8.6        |
| Ukraine         | 9.1        | 12.8       | 16.5        | 9.7        |
| Belarus         | 7.0        | 8.5        | 13.6        | 12.1       |
| <b>CIS</b>      | <b>9.6</b> | <b>9.5</b> | <b>12.1</b> | <b>8.8</b> |
| Turkey          | 9.6        | 8.6        | 7.0         | 5.5        |
| <b>Eurozone</b> | <b>2.2</b> | <b>2.1</b> | <b>2.5</b>  | <b>2.1</b> |
| USA             | 3.2        | 3.0        | 3.1         | 2.5        |

Source: wiw, Raiffeisen RESEARCH

## Current account balance (% of GDP)

| Countries       | 2006         | 2007e        | 2008f        | 2009f        |
|-----------------|--------------|--------------|--------------|--------------|
| Poland          | -3.2         | -4.0         | -4.8         | -5.5         |
| Hungary         | -6.5         | -5.3         | -5.4         | -5.2         |
| Czech Rep.      | -3.1         | -3.3         | -3.5         | -3.0         |
| Slovakia        | -7.0         | -2.8         | 0.2          | 0.5          |
| Slovenia        | -2.9         | -3.0         | -2.5         | -2.5         |
| <b>CE</b>       | <b>-4.0</b>  | <b>-3.9</b>  | <b>-4.0</b>  | <b>-4.2</b>  |
| Croatia         | -7.7         | -7.9         | -8.0         | -7.8         |
| Bulgaria        | -15.8        | -23.0        | -21.5        | -18.5        |
| Romania         | -10.4        | -14.0        | -13.0        | -11.0        |
| Serbia          | -11.5        | -16.3        | -14.5        | -13.5        |
| Bosnia a. H.    | -10.7        | -13.9        | -13.3        | -13.3        |
| Albania         | -7.6         | -7.3         | -7.4         | -7.0         |
| <b>SEE</b>      | <b>-10.7</b> | <b>-14.2</b> | <b>-13.3</b> | <b>-11.7</b> |
| Russia          | 9.6          | 6.3          | 4.5          | 3.3          |
| Ukraine         | -1.5         | -2.9         | -5.1         | -5.8         |
| Belarus         | -4.1         | -6.5         | -7.2         | -7.3         |
| <b>CIS</b>      | <b>8.1</b>   | <b>5.0</b>   | <b>3.2</b>   | <b>2.0</b>   |
| Turkey          | -7.9         | -7.4         | -5.7         | -5.9         |
| <b>Eurozone</b> | <b>-0.2</b>  | <b>0.1</b>   | <b>-0.4</b>  | <b>-0.3</b>  |
| USA             | -6.5         | -6.6         | -6.0         | -5.5         |

Source: wiw, Raiffeisen RESEARCH

## General budget balance (% of GDP)

| Countries       | 2006        | 2007e       | 2008f       | 2009f       |
|-----------------|-------------|-------------|-------------|-------------|
| Poland          | -3.8        | -2.2        | -3.2        | -3.5        |
| Hungary         | -9.2        | -5.9        | -4.1        | -3.9        |
| Czech Rep.      | -2.9        | -2.5        | -2.5        | -3.3        |
| Slovakia        | -3.7        | -2.5        | -2.3        | -1.8        |
| Slovenia        | -0.8        | -0.6        | -0.8        | -0.5        |
| <b>CE</b>       | <b>-4.3</b> | <b>-2.8</b> | <b>-3.0</b> | <b>-3.2</b> |
| Croatia         | -3.0        | -3.0        | -2.9        | -3.0        |
| Bulgaria        | 3.6         | 3.0         | 3.0         | 2.0         |
| Romania         | -1.9        | -2.7        | -3.5        | -2.5        |
| Serbia          | 1.7         | 0.5         | -0.5        | -1.0        |
| Bosnia a. H.    | 2.9         | 2.6         | 2.0         | 1.5         |
| Albania         | -4.1        | -4.8        | -7.5        | -5.0        |
| <b>SEE</b>      | <b>-0.8</b> | <b>-1.5</b> | <b>-2.1</b> | <b>-1.8</b> |
| Russia          | 7.6         | 5.5         | 5.5         | 4.8         |
| Ukraine         | -0.7        | -1.0        | -3.0        | -3.0        |
| Belarus         | 2.2         | -0.5        | -2.0        | -2.5        |
| <b>CIS</b>      | <b>6.6</b>  | <b>4.7</b>  | <b>4.4</b>  | <b>3.8</b>  |
| Turkey          | -0.4        | -2.3        | -2.1        | -1.8        |
| <b>Eurozone</b> | <b>-1.5</b> | <b>-0.8</b> | <b>-0.8</b> | <b>-0.8</b> |
| USA             | -2.6        | -2.0        | -2.4        | -2.0        |

Source: wiw, Raiffeisen RESEARCH

## Exchange rate EUR/LCY (avg)

| Countries    | 2006  | 2007e | 2008f | 2009f |
|--------------|-------|-------|-------|-------|
| Poland       | 3.90  | 3.78  | 3.55  | 3.50  |
| Hungary      | 264.1 | 250.9 | 256.9 | 260.0 |
| Czech Rep.   | 28.3  | 27.7  | 26.6  | 25.5  |
| Slovakia     | 37.2  | 33.8  | 32.5  | 32.5  |
| Slovenia     | 239.6 | 239.6 | 239.6 | 239.6 |
| Croatia      | 7.32  | 7.35  | 7.28  | 7.23  |
| Bulgaria     | 1.96  | 1.96  | 1.96  | 1.96  |
| Romania      | 3.52  | 3.34  | 3.58  | 3.40  |
| Serbia       | 84.4  | 80.2  | 78.3  | 78.1  |
| Bosnia a. H. | 1.96  | 1.96  | 1.96  | 1.96  |
| Albania      | 123.1 | 123.6 | 122.0 | 120.9 |
| Russia       | 34.5  | 35.8  | 34.9  | 34.5  |
| Ukraine      | 6.36  | 6.89  | 7.01  | 6.63  |
| Belarus      | 2702  | 2940  | 3080  | 3240  |
| Turkey       | 1.81  | 1.79  | 1.65  | 1.72  |
| USA          | 1.26  | 1.37  | 1.40  | 1.35  |

Source: wiw, Raiffeisen RESEARCH

## Exchange rate USD/LCY (avg)

| Countries    | 2006  | 2007e | 2008f | 2009f |
|--------------|-------|-------|-------|-------|
| Poland       | 3.09  | 2.76  | 2.54  | 2.59  |
| Hungary      | 209.6 | 183.2 | 183.5 | 192.6 |
| Czech Rep.   | 22.5  | 20.2  | 19.0  | 18.9  |
| Slovakia     | 29.5  | 24.7  | 23.2  | 24.1  |
| Slovenia     | 190.2 | 174.9 | 171.2 | 177.5 |
| Croatia      | 5.81  | 5.36  | 5.20  | 5.36  |
| Bulgaria     | 1.55  | 1.43  | 1.40  | 1.45  |
| Romania      | 2.80  | 2.44  | 2.56  | 2.52  |
| Serbia       | 67.0  | 58.6  | 55.9  | 57.9  |
| Bosnia a. H. | 1.55  | 1.43  | 1.40  | 1.45  |
| Albania      | 97.7  | 90.2  | 87.1  | 89.5  |
| Russia       | 27.4  | 26.2  | 24.9  | 25.5  |
| Ukraine      | 5.05  | 5.03  | 5.01  | 4.91  |
| Belarus      | 2145  | 2146  | 2200  | 2400  |
| Turkey       | 1.43  | 1.30  | 1.18  | 1.27  |
| Eurozone     | 0.79  | 0.73  | 0.71  | 0.74  |

Source: wiw, Raiffeisen RESEARCH





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### Abbreviations

#### Currencies and Countries

|     |                   |
|-----|-------------------|
| BAM | Bosnian Marka     |
| BGN | Bulgarian Lev     |
| RSD | Serbian Dinar     |
| CZK | Czech Koruna      |
| EKK | Estonian Kroon    |
| HRK | Croatian Kuna     |
| HUF | Hungarian Forint  |
| LVL | Latvian Lats      |
| LTL | Lithuanian Litas  |
| PLN | Polish Zloty      |
| RON | Romanian Leu      |
| RUB | Russian Rouble    |
| SIT | Slovenian Tolar   |
| SKK | Slovak Koruna     |
| TRY | Turkish Lira      |
| UAH | Ukrainian Hryvnia |

#### Economic abbreviations

|       |   |
|-------|---|
| avg   | average   |
| yoY   | year on year                                    |
| LCY   | Local Currency                                  |
| GDP   | Gross Domestic Product                          |
| C/A   | Current Account                                 |
| T/B   | Trade Balance                                   |
| FDI   | Foreign Direct Investments                      |
| CPI   | Consumer Price Index                            |
| PPI   | Producer Price Index                            |
| FX    | Foreign Exchange                                |
| ULC   | Unit Labour Costs                               |
| %-chg | percentage change<br>(not in percentage points) |
| pp    | percentage points                               |
| bp    | basis points                                    |

#### Stock Exchange Indices

|        |                       |
|--------|-----------------------|
| BET    | Romanian stock index  |
| BUX    | Hungarian stock index |
| PX     | Czech stock index     |
| RTSI   | Russian stock index   |
| WIG 20 | Polish stock index    |

#### Equity related

|     |                             |
|-----|-----------------------------|
| DY  | Dividend yield              |
| EG  | Earnings growth             |
| LTG | Long term (earnings) growth |
| P/E | Price earnings ratio        |
| UR  | Under Revision              |
| RS  | Recommendation suspended    |

Eurozone Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovenia, Spain  
 CE Central European countries - Poland, Hungary, Czech Republic, Slovakia, Slovenia  
 SEE South East European countries - Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia  
 CIS European CIS (Commonwealth of Independent States) countries - Russia, Ukraine, Belarus

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