

Bosnia-Herzegovina Business Forecast Report Q2 2014

<https://marketpublishers.com/r/B9F4F592025EN.html>

Date: February 2014

Pages: 35

Price: US\$ 1,195.00 (Single User License)

ID: B9F4F592025EN

Abstracts

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Core Views

The domestic political environment remains heavily divided along ethnic lines, stunting structural reform and weighing on the country's EU membership ambitions. Increased international pressure may push the government to approve some long-delayed reforms, but progress is set to remain slow. We expect Bosnia's export-led recovery to continue through 2014, with gradually increasing support from domestic demand. We have raised our real GDP estimate for 2013 growth to 1.1% (from 0.8%), while maintaining our forecast for 2014 at 2.0%. Political instability in the run up to October's elections, high structural unemployment, and ongoing regional fragility remain downside risks in our outlook.

However, the government's Stand-By Agreement with the IMF will continue to anchor fiscal policy, and should ensure that a budget for 2014 is approved at both the entity and state levels before the end of the year.

Major Forecast Changes

We have revised up our estimate for 2013 real GDP growth, to 1.1% from 0.8% previously, although maintain our 2.0% forecast for 2014. We have revised our estimate for the 2013 current account deficit, due to a sharp reduction in the merchandise trade deficit in the first nine months in the year. We now estimate a shortfall of 6.9% of GDP, down from 9.0% in 2012, and falling further to 6.2% of GDP in 2014.

Key Risks To Outlook

The country's first post-war census was finally carried out in October 2013, an important achievement that nonetheless generates new risks given the potential impact the results could have on the country's complex power-sharing agreements.

The 2014 general election is also major source of uncertainty and risk, given the experience of 2010, when it took almost two years for coalition agreements to be settled at all levels of governments. A stalemate after the vote would further damage the country's investment climate and delay EU integration.

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2014 ELECTION CARRIES RISKS AND UNCERTAINTY the general election scheduled for October 2014 carries significant risks, given the political divisions and simmering ethnic tensions that continue to haunt Bosnia-Herzegovina. A repeat of the delays in post-election government formation seen in 2010 would be a setback for the country's economic recovery and risk inflaming social unrest. Looking ahead, reforms to the cumbersome political system are vital to speed up policy-making and keep the dream of EU integration alive.

Table: Political Overview foreign Policy

Falling Further Behind On The Road To The EU the next few months are vital for Bosnia-Herzegovina's EU membership ambitions, as politicians must approve essential constitutional changes before October's general election. The increased pressure from the EU should make a compromise possible, though even in this scenario the ongoing political divisions are likely to hamper the implementation of key reforms, leaving Bosnia lagging further behind other Balkan states on the road to Brussels.

Long-Term Political Outlook

Unity To Prove Elusive Over Next Decade

Tensions between ethnic groups in Bosnia will continue to weigh on the country's EU accession prospects, development potential and risk profile through the next decade, with a number of issues having the potential to result in a further deterioration in the political situation. That said, we expect the international community to remain firmly committed to Bosnia, which should prevent a relapse into large-scale armed conflict.

CHAPTER 2: ECONOMIC OUTLOOK

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Cautious Optimism As Recovery Takes Hold

Our core view for the Bosnia-Herzegovina economy is largely unchanged, with an expectation for the export-led recovery to continue with gradually increasing support from domestic demand. After positive monthly data we have raised our estimate for 2013 growth to 1.1% (from 0.8%), while maintaining our target for 2014 at 2.0%. Political instability in the run up to October's elections, high structural unemployment, and ongoing regional fragility remain downside risks in our outlook.

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Current Account Deficit Shrinks On Import Slump

We have revised our estimate for the 2013 current account deficit, due to a sharp reduction in the merchandise trade deficit in the first nine months in the year. We now estimate a shortfall of 6.9% of GDP for 2013, down from 9.0% in 2012, and falling further to 6.2% of GDP in 2014. Given our forecast for import growth to recover in line with domestic demand, we expect the current account deficit to remain over the medium-term forecast period.

Table: CURRENT ACCOUNT

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IMF Deal To Keep Budget Policy In Check the government of Bosnia-Herzegovina approved a 2014 budget, albeit with delays, which aims to cement the gains made in fiscal consolidation in recent years. The anchor of the IMF's Stand-By Agreement (SBA) should keep this plan on track, and ensure the country's financing needs are covered. However, political disagreements continue to undermine the execution of the budget, and pose a significant risk in the run up to elections.

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Return To Modest Inflation In 2014

With H213 in Bosnia-Herzegovina dominated by a deflationary trend, the overall average increase in consumer prices in full-year 2013 was just 0.2%. Prices are likely to remain subdued at the start of 2014, though we expect a return to inflation and an average increase in prices of 1.4% over the whole year. Our medium-term forecast is unchanged: we expect annual inflation to remain above the eurozone average, to the detriment of Bosnia's competitiveness.

Table: MONETARY POLICY

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Political Tensions To Slow Economic Convergence

Bosnia's economic and political convergence will continue to be hampered by underlying inter-ethnic tensions in the country. Over the long term, divisions among the

ethnic Serb, Croat and Bosnian political parties will continue to slow progress on a host of EU-related reforms. That said, while we do not expect Sarajevo to obtain EU membership by 2022, we nevertheless maintain a relatively sanguine outlook on the country's fundamental growth prospects.

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