

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

**STRATEGY FOR
BOSNIA AND HERZEGOVINA**

As approved by the Board of Directors at its meeting on 15 January 2014

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EXECUTIVE SUMMARY

Bosnia and Herzegovina (B&H) is committed to and applying the principles of multiparty democracy, pluralism, and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank.

At the same time, the functioning of the state in general, and of its democratically elected institutions in particular, is affected by the specifics of the country's constitutional set up. The 1995 Dayton Accords, which ended the war in B&H and paved the way to the country's stability, created a uniquely complex institutional structure and a fragmented policy-making apparatus. As a result, many of weaknesses common to other Western Balkan countries have been multiplied in B&H, which makes doing business there particularly challenging. Without comprehensive constitutional reform further progress towards a more efficient state, implementation of a meaningful reform agenda and EU approximation will be difficult to achieve.

Bosnia and Herzegovina's economy has been adversely affected by the global crisis in the past five years, but domestic factors have also contributed to the economic weaknesses in the country. Weak domestic demand, an unfavourable external environment and political stalemate have held back recovery. The high and growing unemployment, currently near 30 per cent, has also constrained consumption. At the same time, weaker growth in the Eurozone has negatively affected Bosnia's exporting activity and capital inflows. Inflation remains low reflecting the subdued domestic demand.

Bosnia and Herzegovina has significant economic potential in a number of sectors, but achieving this potential has been held back by a complex political framework and difficulty undertaking deep structural reforms. Therefore, the country's progress in transition has been effectively stalled for a number of years, and it lags behind other countries in south-eastern Europe on most cross-country reform and business environment indicators. A significant privatisation agenda exists but few major enterprises have been brought to the market.

In common with other countries in the region, Bosnia and Herzegovina's path to sustainable growth and development requires a much greater focus than before on an enabling business environment for private sector development, strengthened linkages between the two entities and with neighbouring countries, and greater exploitation of the country's natural comparative advantages. In the forthcoming strategy period the Bank will therefore focus on addressing the following challenges:

- **Restructuring and expansion of the local private sector.** Bosnia and Herzegovina has a strong industrial heritage, an abundant supply of energy, and significant resources to support processing industries. In order to support private sector expansion, the Bank will target local and foreign companies with a comprehensive range of products, including direct financing for large enterprises, while Local Enterprise Facility financing will be provided for restructuring and expansion of smaller local companies that currently face limited access to financing. The Bank will provide SME credit lines through local banks, microfinance loans, and non-financial Small Business Support through the Enterprise Growth Programme and Business Advisory Services. The Bank will continue an active policy dialogue on investment climate improvements.

- **Forging closer linkages with wider regional markets.** A small open economy such as Bosnia and Herzegovina can reach its full economic potential only by integrating closely with wider regional markets. Regional integration, both physical and commercial, will become even more important in the new strategy period as Bosnia and Herzegovina now has a border with the EU as of 1 July 2013, following Croatia's accession to the EU. The Bank will therefore continue to support infrastructure improvements and encourage greater private sector involvement in public infrastructure upgrades, as well as private investments supporting deeper regional integration via investment and trade flows, thereby strengthening transport and trade linkages with neighbours in the Western Balkans, including through targeted policy dialogue initiatives. As access to the EU market requires adherence to rigorous quality standards, the Bank will put a strong emphasis on improvements of standards both by direct financing to export-oriented companies, and through Small Business Support programmes.
- **Promoting a more efficient and sustainable use of resources.** Public entities and private companies make very inefficient use of existing resources, resulting in unnecessarily high energy costs and significant environmental damage. To support more efficient and sustainable use of resources, the Bank will focus on sustainable energy investments with high demonstration effects. Various instruments will be used, including the Western Balkans Sustainable Energy Direct Financing Facility, and indirect financing via local financial institutions through Western Balkans Sustainable Energy Financing Framework credit lines. The Bank will provide direct financing for energy and resource efficiency improvements for large corporate clients, both in the private and public sectors, and for the restructuring and commercialisation of municipal utility companies. The Bank will continue an active policy dialogue on sustainable use of resources, using technical assistance, in close cooperation with other donors.

In its activities in B&H, the Bank will seek to promote *internal* integration by actively seeking out investments that further deepen economic linkages between the two entities, and Brcko District, both with private companies and through institutional reforms in the public sector.

In all these activities the EBRD will seek to align its operation with the priorities of local authorities and closely cooperate with other International Financial Institutions and donors, including the European Union, both by co-financing selected projects and by coordinating policy dialogue initiatives. In particular, the Bank will coordinate, and if possible implement joint operations, with the European Investment Bank and the World Bank under the Joint IFI Action Plan for Growth.

1. THE BANK'S PORTFOLIO

1.1 Overview over Bank activities to date

During the current strategy period the Bank signed 46 projects for a total of €466.3 million, and mobilised co-financing of €1,006 million as of 31 December 2013. Since the start of operations in August 1996, the total cumulative business volume reached €1.675 billion and mobilised co-financing €2.033 billion. Only 3.5 per cent of the cumulative commitments were accounted for by regional projects. 46 per cent of cumulative business volume to date is in Infrastructure, 29 per cent in the Financial Sector, 14 per cent in the Industry, Commerce and Agribusiness and 11 per cent in Energy.

Table 1: Overview of the Bank's Portfolio in Bosnia and Herzegovina, end December 2013

SECTOR <i>Amount in EUR million</i>	NET CUMULATIVE BUSINESS VOLUME				CURRENT PORTFOLIO STOCK				
	Number of projects	Total Project Cost	EBRD signed	EBRD % of total	Number of projects	Portfolio	% of portfolio	Operating Assets	% of operating assets
Energy	6	337	188	11%	5	103	10%	66	11%
Natural Resources	1	25	17	1%	1	16	2%	14	2%
Power and Energy	5	312	171	10%	4	87	9%	52	9%
Financial Institutions	58	655	489	29%	24	162	16%	87	15%
Depository Credit (banks)	34	379	302	18%	10	67	7%	46	8%
Insurance, Pension, Mutual Funds	2	52	51	3%	1	50	5%	0	0%
Leasing Finance	5	50	50	3%	3	17	2%	17	3%
Non-depository Credit (non-bank)	18	174	86	5%	10	28	3%	24	4%
Industry, Commerce & Agribusiness	32	607	225	14%	15	56	6%	42	7%
Agribusiness	13	212	93	6%	4	24	2%	15	3%
Equity Funds	5	39	11	1%	4	7	1%	2	0%
Information & Communication Technologies	5	187	55	3%	1	2	0%	2	0%
Manufacturing and Services	7	148	61	4%	6	23	2%	23	4%
Property and Tourism	2	20	5	0%	0	0	0%	0	0%
Infrastructure	18	2,110	772	46%	17	664	67%	396	67%
Municipal & Environmental Infrastructure	8	150	81	5%	8	79	8%	12	2%
Transport	10	1,960	691	41%	9	585	59%	385	65%
TOTAL	115	3,708	1,675	100%	61	985	100%	591	100%

The active portfolio as of end December 2013 comprised 61 projects totalling €985 million. The Bank made good progress with the implementation of large infrastructure projects signed in the previous strategy period, with disbursements reaching €487.2 million during the current strategy period. As a result, the undrawn ratio improved from 53.1 per cent at the end of 2010 to 40 per cent at the end of December 2013.

Implementation of a few public sector projects remains however significantly delayed (Railways Restructuring, Sarajevo Water and Wastewater Rehabilitation), and one large sovereign project signed during the previous strategy period, Sarajevo Airport expansion, had to be cancelled because of the adverse impact of the economic crisis on airport operations. The value of impaired assets declined from Euro 7.1 million (1.6 per cent of operating assets) at the time of approval of current strategy in October 2010 to Euro 2 million (0.3 per cent of operating assets) in December 2013.

Table 2: Portfolio Development in Bosnia and Herzegovina, 2010-2013

<i>Amount in Eur million</i>	2010*	2011	2012	2013	Development in the strategy period (Oct 2010-Dec 2013)
Net Cumulative Business Volume	1,307.5	1,389.4	1,474.2	1,674.8	354.4
Current Portfolio Stock	921	908.2	883.3	984.5	80.5
Number of operations	94	100	107	115	24
Operating Assets	431.9	437.6	491.5	591.3	159.4
% Undrawn excl. Guarantees	53%	52%	44%	40%	
					<i>Cumulative</i>
Annual Business Volume	190.2	94.4	125.4	208	466.3
Number of operations	14	12	12	18	46
<i>of which private</i>	8	10	10	13	36
<i>of which public</i>	6	2	2	5	10
Gross Disbursements	116.3	97.7	164.6	201.4	487.2
Annual Cancellations	0.4	7	35.6	0	43
Active Pipeline Stock	220	294.3	142.8	137.6	
Private Sector Share (% Portfolio)	28%	25%	20%	18%	
Non Sovereign Share (% Portfolio)	28%	25%	20%	21%	

*Note: The previous country strategy was approved in October 2010; therefore, the bulk of Bank business in 2010 occurred under the country strategy for 2008-2010.

Portfolio ratio

The portfolio ratio improved from 35.8 per cent private sector (on a 5-year rolling basis) at the time of approval of current strategy to 37.4 per cent in December 2013 as a result of cumulative share of private sector projects at 41 per cent between the approval of current strategy in October 2010 and the end of December 2013. During this period the Bank signed 36 private sector operations and 10 public sector projects, with average size €4.6 million and €29.9 million, respectively. However, the country's portfolio ratio continues to fall significantly short of the target set out in Article 11.3 of the Agreement Establishing the Bank.

The current active public sector portfolio continues to be dominated by the large post-war reconstruction projects in the public sector signed during the last 15 years. The share of public sector projects is likely to remain significant, given the large scale of potential projects (and the comparatively small average size of projects in the private sector) to support stronger regional linkages and reform of public utilities. The Bank's expertise is clearly still needed in these sectors and its additionality unquestioned. The Bank will however pursue greater private sector participation in such projects, subject to market conditions, and focus on expanding its activities with private companies. This approach should result in gradual rebalancing of portfolio ratio in the medium to long term in line with the Bank's Portfolio Ratio Policy.

1.2 Implementation of the previous Country Strategy

The Strategy for Bosnia and Herzegovina, approved by the Board in September 2010, outlined the following strategic priorities:

Infrastructure and energy

- In the transport sector, provide support both for construction of new and rehabilitation of existing infrastructure, and facilitate a more commercial approach with greater involvement of the private sector;
- In the municipal and environmental infrastructure sector, focus both on sector reforms with local authorities and on institutional strengthening at the level of operating companies;
- In the energy sector, support the rehabilitation or replacement of existing thermal capacity to increase their efficiency and reliability and comply with EU emission standards, support further development of the transmission and distribution networks, and increase commercialisation of the energy sector to promote better functioning of the markets; and
- In energy efficiency, provide commercial loans to public utilities to finance energy efficiency measures and investments, and use existing facilities to deliver small energy efficiency and renewable projects, including through the Western Balkans Sustainable Energy Credit Line Facility (WeBSECLF).

Financial Sector

- Support MSMEs through local banks, leasing companies and non-bank microfinance institutions, and offer risk-sharing mechanisms; and
- Provide pre-privatisation investments in the banking and insurance sectors and support smaller locally-owned banks and MFIs, including with equity, in order to facilitate the entry of new strategic investors and spur further consolidation.

Industry, Commerce and Agribusiness sector

- Support strategic local and international investors, especially for large enterprises undergoing privatisation or restructuring. The Bank will actively seek projects in the agribusiness, industrial, property and tourism, wood and metals processing sectors;
- Support small and medium-sized local and foreign private companies through long term debt or equity, using the Local Enterprise Facility (LEF).
- Ensure that the Small Business Support (SBS) programmes continue to provide advisory services to SMEs.

Despite the difficult business environment and limited progress with structural reforms during the current strategy period, the Bank has succeeded in implementing a number of projects with a significant transition impact in line with approved strategic priorities:

The Bank supported reforms in the transport sector with continued financing for major motorways and bypass roads. The Doboje-Prnjavor motorway, the largest project during the current strategy period, is part of the fastest motorway connection of the capital of Republika Srpska, Banja Luka, with the capital of the country, Sarajevo. At the same time, this motorway will connect Banja Luka with the Corridor Vc motorway and thus support national

as well as international integration of Bosnia and Herzegovina. A key transition covenant of this project is progress with a PPP tender, based on best international practice, for the adjacent section of Corridor Vc. The Bank has also signed several financing agreements supporting reforms of the municipal water sector in both entities. Building on the lessons learned from its experience with the initially slow implementation of infrastructure projects during the current strategy period, the Bank will focus on structuring future public sector transactions to allow faster implementation, including potential technical assistance targeting public procurement.

In the financial sector, the Bank focused on alleviating the impact of de-leveraging under the umbrella of the Vienna Initiative and on the provision of financing to disadvantaged groups, including microenterprises in the agricultural sector, by providing several SME, energy efficiency, and microfinance credit lines. Policy dialogue on reform of the microfinance sector was intensified, and the Bank supported the first successful transformation of a microfinance institution into a commercial company which now has a full banking licence. This was the first tangible step in the transformation of local microfinance institutions into commercial entities, fully integrated into the local financial sector and subject to the same prudent regulation and supervision as other financial providers. In the new strategy period, the Bank will aim to expand on the successful support for SMEs and microfinance sector reform by introduction of new financial products targeting SMEs with the limited access to finance, e.g., female and rural entrepreneurs.

In the current strategy period, the Bank supported the local corporate sector through the Local Enterprise Facility and other dedicated investment vehicles such as the WeBSEDF. The Bank assisted a number of local companies in strengthening their operations and expansion, resulting in significant changes in relevant market structures and better services for consumers (examples include: retail sector, food production, cable TV, and telecommunications). The Bank also provided financing to several leading export-oriented companies to cushion the impact of the liquidity crisis and allow them to continue expanding production and exports while strengthening linkages to suppliers (edible oil sector, wood processing). Several high-profile energy efficiency investments with strong demonstration effects were also made, including one with the largest wood-processing company in the country, Natron Hayat. This project involved replacement of a coal-fired boiler with a biomass boiler, saving 275,000 tons of CO₂ per year. Strong demand for financing energy efficiency improvements in the private sector in the current strategy period will be used as a basis for greater focus on more efficient use of energy resources in the new strategy period as well as an expansion of energy efficiency financing to public sector (district heating based on biomass and energy efficiency in public buildings).

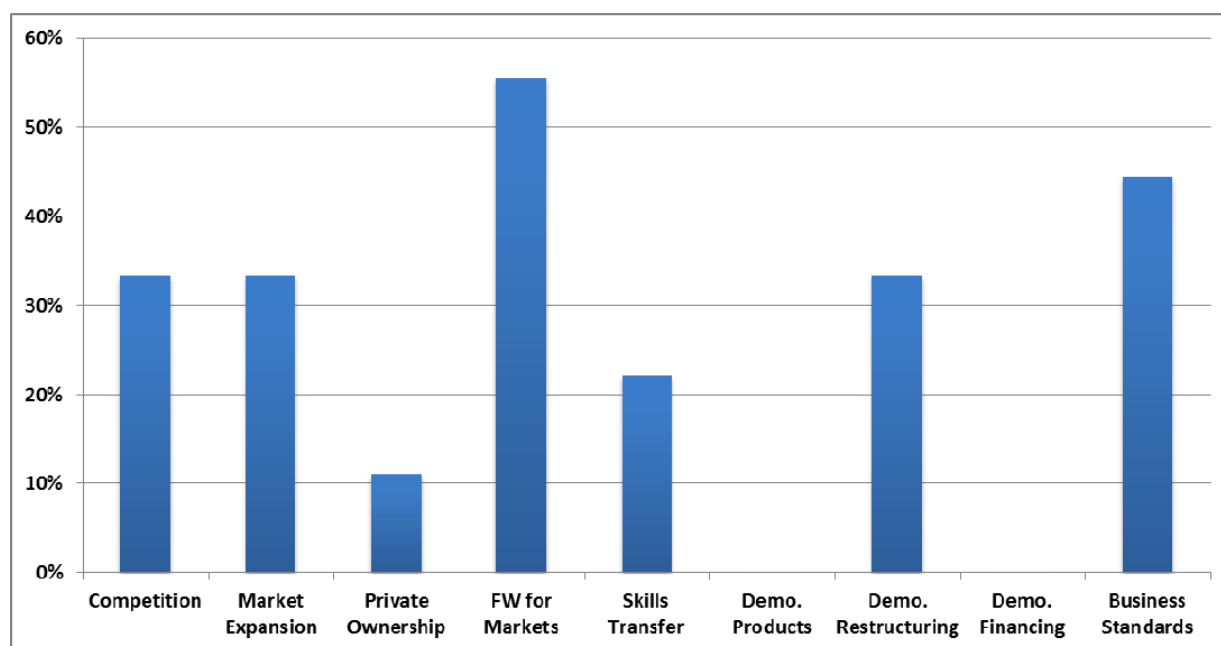
1.3 Transition impact of the Bank's portfolio

The Bank has addressed a number of transition objectives identified in the strategy through its activities in Bosnia and Herzegovina during 2010-2013. The strategic priority of assisting market expansion and increasing competition in the corporate sector was addressed by the Bank's operations with small and medium-sized private companies in agribusiness, ICT and manufacturing and services. Over forty per cent of new projects were signed in the corporate sector. Support of MSMEs through long term debt to locally-owned financial institutions was delivered through loans with commercial banks and microfinance institutions (one-third of all newly signed projects in B&H). Finally, support in both rehabilitation and modernisation of

the country's infrastructure, as well as institutional strengthening and capacity building has been addressed by the Bank's sovereign loans to companies in water and transport sectors.

Reflecting the equal distribution of projects addressing strategic priorities across three sector groups, the Bank's investment activity in B&H targeted a number of transition objectives. Around half of all projects addressed institutional and regulatory improvements and adoption of best corporate and business standards and practices. One-third of the new operations targeted increased competition through support of local companies, expansion of financial products to underserved areas through MSME loans to commercial banks, and demonstrating successful restructuring through increasing operating efficiency of the clients.

Figure 1. Addressed transition objectives (share of total) in Bosnia and Herzegovina, October 2010 – May 2013



As part of the internal control and accountability process, the Bank assesses a project's potential impact in addressing identified transition challenges¹. All new operations signed in B&H in the period from October 2010 to May 2013 were assessed as having Good transition impact potential. This is well above the institutional target of at least 80 per cent of projects to be rated Good or better, established to ensure high quality-at-entry of the Bank's operations from the transition impact perspective.

The Bank regularly monitors all projects to ensure that transition impact expected from its activity is ultimately delivered. The transition performance of projects in the B&H portfolio is good. Out of 29 operations under implementation in the active portfolio² at end-May 2013, twelve have already largely achieved their envisaged transition impact potential. This includes successful implementation of regulatory reforms and improved business standards for five road and railway development projects, and expansion of products to underserved

¹ See <http://www.ebrd.com/pages/research/economics/transition.shtml> for transition impact assessment and monitoring methodology

² All active operations more than 6 months since signing and are monitored for their transition impact at least once

areas and delivery of capacity building programme to local banks through five MSME support projects. 14 operations in the active portfolio are currently assessed as on track to achieving their envisaged transition objectives, including a number of projects addressing further regulatory and capacity improvements in infrastructure and energy sectors.

Three operations have not been successful in delivering expected transition impact. An air traffic management project has been facing physical implementation delays, which has not yet made realisation of regulatory improvements possible. A senior loan to a large microfinance institution has failed to achieve sustainable expansion of MSE loans availability due to the negative effect of the crisis on the client and sub-borrowers. Finally, a project in the manufacturing and services sector has not managed to achieve increased competition and improved standards as a result of the client's financial difficulties induced by the challenging market conditions. The expected transition impact of B&H's active portfolio, reflected numerically in the average rank³ at end-May 2013 stood at 3.79, better than both the institutional target of 4.35 and the result for the whole portfolio of the Bank (4.05).

Nine operations in B&H have been completed (i.e. fully re-paid by clients) during the strategy period. Eight of these projects have largely achieved their expected transition impact potential, including six operations with financial institutions in the country, where full disbursement to targeted underserved areas and technical cooperation assistance to address banks' capacity building have been delivered. Two projects in the corporate sector have also been successful in introducing new processes and improving their corporate standards. The remaining completed operation, a loan in the corporate sector, was prepaid before any benchmarks could be achieved.

2. OPERATIONAL ENVIRONMENT

2.1 Political Context

The complex system of checks and balances stemming from the Dayton constitutional set up hampers efficient functioning of the State. While there is no consensus in sight between the ethnic leaders and between the two Entities regarding the optimal future internal organisation of B&H, without a comprehensive reform of the constitutional set up, progress towards a more efficient state and implementation of the EU agenda will be difficult to achieve. There has been no meaningful progress on this track since the adoption of the previous Strategy.

Many of the challenges common to other Western Balkans countries, such as underdeveloped institutions, low capacity of the civil service, and a weak judiciary have been multiplied in B&H. This means that doing business in B&H is more difficult than in many other countries in the region, even if local businesses learnt over years how to circumvent various barriers.

The current central government was established on 10 February 2012. The 16 months delay in forming the government after the 2010 general elections highlights the country's institutional dysfunction. The central government is a broad coalition comprising key political parties and representing all three main ethnic communities. The central government remains weaker than the governments of the country's two constituent Entities (Federation of

³ The rank is a combination of the transition impact potential rating and risks to transition impact. The expected transition of each operation is usually monitored once a year and is ranked numerically from 1 to 8, with 1 to 3 indicating mostly realised impact, 3 to 6 – generally on track to achieve transition objectives, and 7 to 8 – minimum transition impact achieved or excessive risks.

Bosnia and Herzegovina and Republika Srpska). The next general elections both at the central level and at the level of the two Entities are due in 2014. The European Commission (EC) has noted that continuing failure to implement the 2009 verdict of the European Court of Human Rights (ECHR) to stop discrimination against ethnic minorities in B&H could seriously undermine the legitimacy and credibility of these elections.

Given that no solution has been found yet for the implementation of the above-mentioned verdict of ECHR and that the co-ordination mechanism at the state level for EU affairs has not been established, the EC decided in October 2013 to launch procedures for reducing the initially foreseen Instrument for Pre-Accession Assistance (IPA) 2013 programme for B&H by 54 per cent and to postpone discussions on IPA II until the country is back on track in the EU integration process. In the short run, such decision is not expected to have a significant impact on the Bank's operations in the country that do not involve EU funds. However, the Bank will need to take into consideration future developments in the relationship between the EU and B&H in the selection and prioritisation of its projects. The Council of the European Union at its last meeting on 17 December 2013 noted the inability of the B&H leaders to meet EU requirements that led to a "loss in IPA funds for 2013" and a "postponement of further decisions on IPA II", and expressed "serious concern that the EU integration process has stalled due to a lack of political will on the part of the B&H political leadership".⁴

See Annex 1 for a more detailed political assessment.

2.2 Macroeconomic context

Bosnia and Herzegovina's economy has been adversely affected by the global crisis in the past five years, but domestic factors have also contributed to the economic weaknesses in the country. Weak domestic demand, an unfavourable external environment and political stalemate have held back recovery. Consumption has been negatively impacted by austerity measures as well as a weakened contribution from remittances, which are significantly below crisis levels. The high and growing unemployment, currently near 30 per cent, has also constrained consumption. At the same time, weaker growth in the eurozone has negatively affected Bosnia's exporting activity and capital inflows. Inflation remains low reflecting the subdued domestic demand. It stood at just 0.8 per cent y-o-y in March 2013. The currency board – in place since 1997 – remains the key anchor for monetary policy.

A new Stand-by Arrangement (SBA) with the IMF was approved in September 2012. The 24-month US\$ 520.6 million SBA will provide a buffer against external shocks from the ongoing eurozone crisis as well as an anchor for structural reforms envisioned in the country's 2012-2014 economic programme. The new arrangement follows the expiration of a 36-month SBA, which was put on hold in 2011 due to political stalemate that left the country without a central government for over 15 months since the October 2010 elections. The first review was completed by the IMF board in December 2012 and the second review in May 2013. The economic programme envisions continued fiscal consolidation accompanied by structural fiscal reforms to safeguard medium-term fiscal sustainability.

The banking sector in Bosnia and Herzegovina remains reasonably liquid and well-capitalised, although the level of non-performing loans is rising. Foreign banks account for over 90 per cent of total assets in the B&H financial system, but the banking sector has not

⁴ Conclusions of the General Affairs Council, Council of the European Union, 17 December 2013, p.20.

been subject to the large credit outflows to parent banks, and the system remains fairly liquid. However, NPLs have been increasing substantially. By end-2012 they had reached 13.5 per cent, as compared to 7.1 per cent in 2010 and 5.9 per cent in 2009. Bosnia and Herzegovina has been a participant in the Vienna Initiative since 2009.

The weak external and domestic environment will likely constrain growth in B&H in the next two years. After negative growth in 2012, any recovery in 2013 is likely to be modest at best. Some upturn is expected in the medium term provided the global and regional outlook improves. However, the economy remains vulnerable on many fronts, not only because the whole region is struggling, but also because the internal complexity of the country's political structure and the poor investment climate are major deterrents to investment. There is also a risk of a deteriorating fiscal stance should the authorities, particularly in the Federation, fail to maintain their commitments under the IMF programme to fiscal consolidation as a result of strong pressure from various interest groups. Any slippage under the programme could jeopardise further funding from the European Union and the World Bank.

See Annex 7 for a table with Selected Economic Indicators.

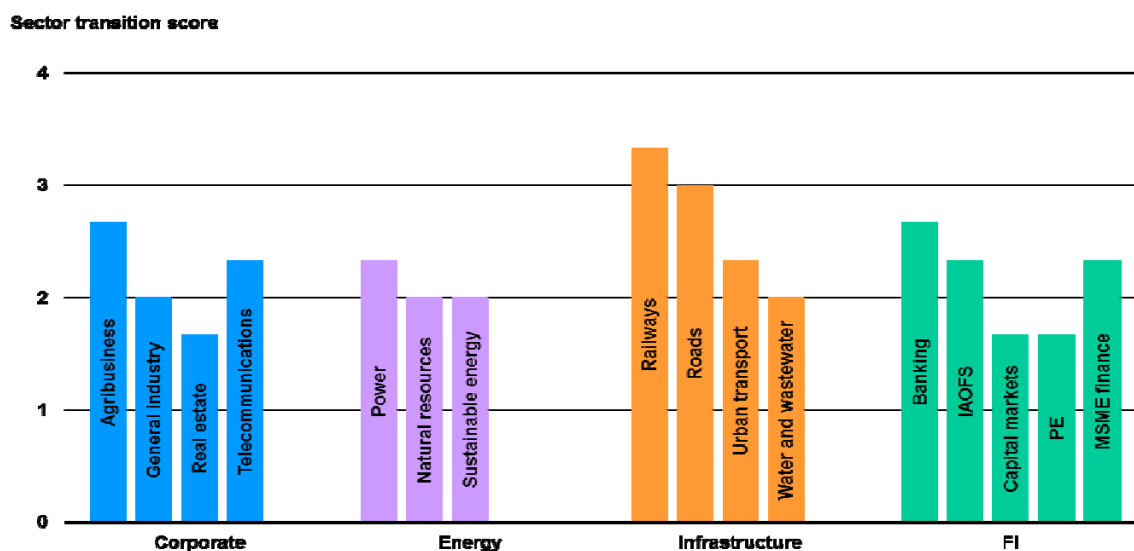
2.3 Structural reform context

Bosnia and Herzegovina has made slow progress in reforms, especially in recent years where it is difficult to point to concrete achievements in the reform sphere. In terms of the EBRD's country-level transition indicators, B&H has achieved a near maximum score (4) for price liberalisation and trade and foreign exchange system, reflecting the broadly liberalised and open nature of the economy. It also scores relatively highly (3) on small- and large-scale privatisation. The country scores most poorly on governance and enterprise reform (2-) as well as competition policy (2+), two areas in which reforms are traditionally more difficult and strong scores are associated with countries in advanced stages of the transition process.

At the sectoral level, limited progress has been made over the past three years. Most notable is the start of implementation of the first PPP in the transport sector in 2012, which includes the construction and maintenance of the Doboj-Vukosavlje motorway, part of the transnational transport corridor Vc. If successful, this project could be an important demonstration for other countries in the region. In other sectors many reforms have been pending for quite some time. Progress on privatisation has effectively stalled and private sector development is hampered by the weak business environment.

B&H still has a long way to go in the transition process. The sector transition scores, on a scale of 1 to 4+, are shown in Figure 2. The scores are based on an assessment of the remaining transition "gaps", in terms both of the structure of the market in question and of the strength of market-supporting institutions. In all but one of the sectors, the transition gaps in B&H are assessed as either "*medium*" or "*large*." The largest gaps are present in the non-bank financial institutions (capital markets and private equity) as well as in real estate. Significant transition gaps also remain in the energy sector, particularly in the natural resources and sustainable energy sectors, as well as in municipal and environmental infrastructure, particularly in water and wastewater.

See Annex 2 for a full Assessment of Transition Challenges.



2.4 Business environment

The business environment in B&H remains one of the most challenging in the region. Over the past two years, some reforms have been implemented to reduce the administrative barriers to starting a business, reducing the regulatory tax burden and making registering property easier. However, B&H still continues to rank very poorly on most indicators of the quality of the business environment. In the latest World Bank Doing Business Report, B&H ranked 126th out of 185 countries worldwide on overall ease of doing business, below all SEE peers and among the lowest in the entire transition region. The country ranks particularly poorly on the indicators of dealing with construction permits (163rd), the ease of starting a business (162nd), and obtaining electricity (158th).

B&H ranks somewhat better on the World Economic Forum's Global Competitiveness Indicator at 88th place out of 144 countries in terms of overall competitiveness. According to the WEF's GCI, the quality of public institutions in B&H is strong relative to regional peers (B&H ranks at 79th place on this indicator behind only two SEE countries) despite the complex political setting. On the indicators of the quality of the macroeconomic environment B&H is ranked 97th, which is slightly below average in the SEE region, but on the indicators of the quality of infrastructure B&H scores poorly. It is ranked second to last – at 143rd place of the total of 144 countries covered in the index – on the quality of its transport infrastructure.

In the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), which was carried out in 2009, businesses highlighted political instability, tax rates, the large informal sector and access to finance as their main obstacles to doing business.

According to the 2013 Transparency International Corruption Perceptions Index (CPI), B&H placed it 72nd out of 177 countries. This is unchanged from the previous year. Nevertheless, corruption remains a serious problem and is perceived by citizens as a widespread phenomenon.

2.5 Social context

Notwithstanding persistent economic and reform challenges, over the past decade per capita income and living standards in B&H have improved considerably. Real GDP per capita rose by 32 per cent in the decade up to 2012. However with a PPP adjusted income per capita at just over US\$ 8,000, B&H remains one of the poorest countries in Europe. According to Eurostat estimates, Bosnia and Herzegovina's GDP per capita in 2012, adjusted for purchasing power standards, is 28 per cent of the EU average.

B&H has one of the lowest labour market participation rates in Europe. According to the latest Statistics Office Labour Force Survey, the average participation rate in B&H was just 44 per cent, considerably lower than regional peers, which are at over 60 per cent and the EU average at over 70 per cent. This reflects to a large extent the exceptionally low participation rate among women, which stood at 33 per cent in 2012.

Despite its low labour participation rate, B&H still reports one of the highest unemployment rates in the region. Youth unemployment is a particularly acute problem. While the average unemployment rate for the whole population currently stands at 28 per cent, unemployment among those aged 24 or under exceeds 60 per cent. Youth unemployment is particularly high in the Federation, where it stood at close to 70 per cent in 2012.

There are considerable regional disparities in B&H. According to the latest household expenditure survey, which was conducted in 2007 by the federal and entity statistics offices, the household poverty rate was highest in the Brcko district at 26 per cent, followed by Republika Srpska at 22 per cent and the B&H Federation at 16.3 per cent. Across both entities, there were stark disparities between urban and rural populations. Poverty was significantly lower in urban areas compared to rural areas (in B&H, the rural poverty rate was 23.7 per cent compared to 10.8 per cent in urban areas).

Access to education is still below OECD standards. Primary school enrolment rates are around 90 per cent as compared to nearly universal rates in the OECD, and the primary school completion rate at 76 per cent is lower than most regional peers. According to data from the World Bank, B&H has also one of the lowest tertiary education enrolment rates in the region.

The global financial crisis affected B&H significantly, though to a lesser degree than in other SEE countries. Evidence from the EBRD-World Bank Life in Transition Survey (LiTS) shows that the perceived impact by its citizens was quite high. Over 60 per cent of households reported that the crisis affected them either a great deal or a fair amount, compared with a transition region-wide average of 42 per cent. A large proportion of households reported having to cut back on essential expenditures like staple food and health care to cope with the crisis.

2.6 Legal context

The legal environment continues to be complex and challenging. Some significant reforms have occurred in the past but more are needed. The country's multi-layered constitutional and political structure continues to have a negative impact on legal reform. The problems of the multi-layered legal structure are in evidence in a number of areas of law.

Corporate governance is regulated at the Entity level; two distinct corporate governance regimes exist and each Entity has its own primary and secondary legislation. In the judicial sector there are two separate legal systems and there is limited coordination at the federal level. The legal framework for the securities market is regulated at the Entity level and each has its own securities commission and stock exchange.

For some areas of law, B&H has laws on the books that meet or exceed the standard found in other EBRD countries of operations; however, in practice the application of those laws tends to be poor due to the failings of key institutions. The law on bankruptcy and insolvency has a score of ‘high compliance’ as compared with international standards; however, the practical functioning of the insolvency regime has weaknesses in terms of appropriate regulation of insolvency office holders. The law and framework on secured transactions is modern; however, in practice, enforcement is slow and susceptible to obstruction. Concerns as to court efficiency and its difficulty in coping with demands is seen as the weakest link of the regime, thus debtors are able to obstruct the enforcement process. The laws that apply to PPPs and concession are complex and fractured; a composite set of coexisting legislative acts at various levels regulate similar issues.

Prospects for Bosnia and Herzegovina depend largely on the implementation of practical legal reforms and integration both internally and regionally.

See Annex 3 for a more detailed assessment of the legal environment.

2.7 Energy efficiency and climate change context

Membership of the Energy Community is driving Bosnia’s energy policy to a large extent, together with domestic constraints and concerns. While this will over time ensure that priority is given to sustainable energy issues, at present, energy and other natural resources (including forests) are used inefficiently in both the public and private sector and significant investments in energy efficiency in power generation, industrial, public and residential sectors as well as legal and regulatory changes are long overdue.

Apart from the significant potential in improving energy efficiency, B&H has large unfulfilled potential in the area of renewable energy investments (hydro power, biomass, wind farms, solar energy production). Here however, their full utilisation would require legal and regulatory improvements, including on feed-in tariffs and concessions policy, and a greater role for the private sector.

In the municipal sector, utilities are still mostly unreformed, resulting in poor operational and financial performance and low level of services for customers. Tariff reform, financial and operational improvements with better defined relationship between the owners and the service providers, and investments into dilapidated infrastructure are key challenges in this area, and would enable investments in energy efficiency. Greater private sector contribution could also deliver energy efficiency improvements.

Adaptation

The Western Balkans region, including Bosnia & Herzegovina, is projected to experience temperature increases, reduced precipitation (especially during summer) and greater precipitation variability. As a consequence, Bosnia is anticipated to experience a greater

likelihood of seasonal water deficits. More variable precipitation may also result in fluctuations in river hydrology and more frequent extreme events such as floods.

3. STRATEGIC ORIENTATIONS

Bosnia and Herzegovina has significant economic potential in a number of sectors, but achieving this potential has been held back by a complex political framework and difficulties undertaking deep structural reforms. In common with other countries in the region, Bosnia and Herzegovina's path to sustainable growth requires a much greater focus than before on an enabling business environment for private sector development, strengthened linkages between the two entities and with neighbouring countries, and greater exploitation of the country's natural comparative advantages. In the forthcoming strategy period the Bank will therefore focus on addressing the following challenges:

- **Restructuring and expansion of the local private sector.** Bosnia and Herzegovina has a strong industrial heritage, an abundant supply of energy, and significant resources to support processing industries. In order to support private sector expansion, the Bank will target local and foreign companies with a comprehensive range of products, including direct financing for large enterprises, while LEF financing will be provided for restructuring and expansion of smaller local companies that currently face limited access to financing. The Bank will provide SME credit lines through local banks, microfinance loans, and non-financial assistance through the instruments of Small Business Support, the Enterprise Growth Programme and Business Advisory Services. The Bank will continue an active policy dialogue on investment climate improvements.
- **Forging closer linkages with wider regional markets.** A small open economy such as Bosnia and Herzegovina can reach its full economic potential only by integrating closely with wider regional markets. Regional integration, both physical and commercial, will become even more important in the new strategy period as Bosnia and Herzegovina now has a border with the EU as of 1 July 2013, following Croatia's accession to the EU. The Bank will therefore continue to support infrastructure improvements and encourage greater private sector involvement in public infrastructure upgrades, as well as private investments supporting deeper regional integration via investment and trade flows, thereby strengthening transport and trade linkages with neighbours in the Western Balkans, including through targeted policy dialogue initiatives. As access to the EU market requires adherence to rigorous quality standards, the Bank will put a strong emphasis on improvements of standards both by direct financing to export-oriented companies, and through Small Business Support programmes.
- **Promoting a more efficient and sustainable use of resources.** Public entities and private companies make very inefficient use of existing resources, resulting in unnecessarily high energy costs and significant environmental damage. To support more efficient and sustainable use of resources, the Bank will focus on sustainable energy investments with high demonstration effects. Various instruments will be used, including the Western Balkans Sustainable Energy Direct Financing Facility, and indirect financing via local financial institutions through Western Balkans Sustainable Energy Financing Framework credit lines. The Bank will provide direct financing for energy and resource efficiency improvements for large corporate clients, both in the private and public sectors, and for the restructuring and commercialisation of municipal

utility companies. The Bank will continue an active policy dialogue on sustainable use of resources, using technical assistance, in close cooperation with other donors.

Importantly, the Bank will seek to promote *internal* integration also by actively seeking out investments that further deepen economic linkages between the two entities, and Brcko District, both with private companies and through institutional reforms in the public sector.

In line with the implementation of the Strategic Gender Initiative, the Bank will attempt to develop and implement projects in relevant sectors and areas in Bosnia and Herzegovina, as it is a country with large gender gaps in the area of access to finance, labour practices and employment. The Bank will endeavour to work with its clients in the banking sector to identify ways, where appropriate, to support women entrepreneurs in terms of facilitating their access to finance and supporting their business activities. This engagement will also, where possible, ensure a link with services provided by the Bank's Small Business Support (SBS) programmes.

See Annex 8 for a Gender Profile.

3.1. Key Challenges and Operational Responses

3.1.1 Restructuring and expansion of the local private sector

Transition Challenges

- The share of the private sector in the economy is low relative to other countries in the region, due to a combination of the unfinished privatisation agenda (especially for some large companies) and the poor business environment. Many large local enterprises need to engage in deep operational, managerial and financial restructuring.
- SME's access to external sources of financing is limited, especially in recent years, which inhibits their ability to grow and create jobs in a country with an unemployment rate of around 30 per cent.
- Significant legal and regulatory reforms, including in the area of financial sector regulation, are still to be implemented.

Operational Response

The Bank will support expansion of the private sector, with an emphasis on high value-added innovative and export-oriented companies, via a comprehensive range of products, including direct loans and equity investments, LEF / Enterprise Expansion Fund (ENEF) projects, SME credit lines, microfinance, and Small Business Support (Business Advisory Services and Enterprise Growth Programme, including support for implementation of the EU Small Business Act for SMEs).

The Bank will selectively engage in the restructuring of viable private companies to bolster their competitiveness with both debt and equity, and will support privatisation of eligible large companies, if the authorities show willingness to restart the process and adhere to high standards of transparency and good practice in organising competitive tenders.

Private sector operations will focus on sectors where the country has competitive advantages and where the private sector has the greatest scope for expansion, including agribusiness

producers, food retailing, real estate, and manufacturing companies. Foreign investors will be encouraged and supported where possible.

The Bank will also support financial sector reform, including microfinance institutions reform, to ensure stability of the financial sector, improve access to finance by the local private companies, and deepen local capital markets through the introduction of new financial products, potentially including risk sharing products to support women's entrepreneurship. The Bank is currently looking at structuring a First Loss Lending Programme for the Western Balkans, including services to be provided to the potential end users of the SBS programmes. SBS services to women entrepreneurs will also be expanded under the first loss programme.

Policy Dialogue

Policy dialogue on the business environment will include participation in the supervisory boards of Foreign Investors Council and Foreign Investment Promotion Agency and will focus on simplification and strengthening of relevant laws and legislation, emphasising the need to take decisive action against corruption. In addition the Bank will continue supporting judicial training in the business related areas.

The Bank will exploit and draw lessons from the new round of the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), the results of which are expected to be available in late-2013.

Building on its successful track record, the Bank will strengthen its policy dialogue in the area of microfinance to allow progress with commercialisation and transformation of microfinance institutions.

3.1.2 Forging closer linkages with wider regional markets

Transition Challenges

- Key transport networks are still inadequate to allow private companies to benefit from the strategic location of the country. Given the lack of fiscal space there is an urgent need to start financing infrastructure improvements using public private partnerships.
- Many local companies are unable to benefit from the proximity to larger regional markets due to the need to improve their competitiveness and raise quality standards.

Operational Response

The Bank will consider financing upgrades of key infrastructure networks, including Corridor Vc and other parts of strategic transport networks in line with the indicative network definition set up for this region in the new EU TEN-T regulation, in parallel with the reform of relevant institutions and infrastructure companies, including procurement reform and greater involvement of the private sector in infrastructure improvements.

The Bank will provide financing to private companies for improvements in their quality standards to the level needed to reach major international markets. The Bank will also provide financing for private companies supporting deeper regional integration via investment and trade flows. This will be complemented by relevant Small Business Support projects.

Policy Dialogue

The Bank will be ready to provide technical assistance to implement procurement reform, support restructuring of transport sector companies, and enable greater use of public private partnerships in the country. The Bank will be also ready to provide technical assistance for public procurement and concession legislation and support procurement capacity building, including through targeted trainings and workshops.

3.1.3 Promoting a more efficient and sustainable use of resources

Transition Challenges

- Energy and other natural resources (including forests) are used inefficiently in both the public and private sector and significant investments in energy efficiency in power generation, industrial, public and residential sectors as well as legal and regulatory changes are long overdue.
- Municipal utilities are still mostly unreformed, resulting in poor operational and financial performance and low level of services for customers. Tariff reform, financial and operational improvements with better defined relationships between the owners and the service providers, and investments into dilapidated infrastructure are key challenges in this area.
- B&H has large unfulfilled potential in the area of renewable energy investments (hydro power, biomass, wind farms, solar energy production), full utilisation of which would require legal and regulatory improvements, including on feed-in tariffs and concessions policy, and a greater role for the private sector.

Operational Response

The Bank will provide financing for sustainable energy investments both directly and using dedicated financial facilities: the Western Balkans Sustainable Energy Financing Facility via local private financial institutions and Western Balkans Sustainable Energy Direct Financing Facility for direct financing of smaller projects.

The Bank will finance restructuring and commercialisation of municipal utilities in the area of water and wastewater as well as district heating, and will aim to support restructuring of waste disposal and urban transport, should the authorities decide to start implementing reforms in these sectors.

The Bank will target investments in the energy sector that contribute to the efficient use of resources and reduction of pollution levels; for example, renewable energy and rehabilitation or replacement of old and inefficient generation facilities, in line with the Bank's Energy Strategy.

Policy Dialogue

A comprehensive policy dialogue on sustainable energy will be undertaken, in close cooperation with EU and other donors, including technical assignments in legal and regulatory areas focusing on the development of market for energy service companies (ESCOs), introduction of energy performance contracting (EPC), transposition of the EU

Energy Performance of Buildings Directive (EPBD), forestry management / more efficient use of biomass, and district heating sector reform.

The Bank will promote and focus on commercialisation of public utilities and energy companies, including tariff reform, improvements in regulation, and adoption of public service contracts, based on technical assistance projects attached to individual operations.

Concession policy improvements and a greater role for the private sector in ensuring better use of resources will be promoted to enable investments in the sector, by a concerted and closely coordinated effort of all relevant departments.

3.2 Environmental and Social Implications of Bank Proposed Activities

All EBRD projects are subject to the 2008 Environmental and Social Policy and Performance Requirements⁵. The Bank will work with clients to assess each project's environmental and social impacts, risks and opportunities, and will assist them in implementing the Performance Requirements, including good international practice and relevant EU standards. During the construction and operating phases EBRD will monitor projects against agreed commitments and standards, and the nature and frequency of monitoring will be determined by the environmental and social risks associated with the investment.

Environmental management in Bosnia and Herzegovina continues to be hampered by sub-optimal institutional, policy and legal frameworks. However, the process of harmonisation with EU standards is resulting in environmental reforms and the EU pre-accession period has created opportunities for the country to start systematically adapting its laws and accessing additional resources and technical assistance. Some environmental laws have been harmonized in line with EU directives (including laws on Waste Management, Air Protection, Nature Protection and Environmental Protection Fund). The projects should comply with the EU environmental requirements and acquis. In the event that projects are not fully compliant with EU environmental requirements, this will be made clear in the Bank's information for the Board of Directors, with appropriate justification for any derogation, and also in the public Project Summary Document. EBRD will ensure that the necessary action is taken such that the projects that do not meet EU environmental criteria are brought fully into line with the EU acquis.

For projects involving local SMEs, the Bank will assess their ability to implement the projects in line with the Bank's environmental and social requirements. This may involve capacity building in areas such as environmental management, occupational health and safety, transparency and public consultation. Similarly, for projects involving financial intermediaries the capacity in the partner bank to assess and manage environmental and social risks and opportunities is crucial to achieving sustainable outcomes. Where necessary EBRD will provide training for these FIs.

In the transport sector, EBRD will aim to finance projects that enhance sustainable transport. Infrastructure and public transport should be accessible, efficient, environment friendly, and safe. For highway and urban transport projects, the Bank is working to promote road safety

⁵ The 2008 Environmental and Social Policy and Performance Requirements will be reviewed and revised during 2013. Any new Policy will apply to projects that proceed to Concept Review on or after the date on which it goes into force.

for drivers, pedestrians and other road users. Construction safety is another important consideration for the transport sector and where projects require land acquisition, EBRD requirements for resettlement and livelihood restoration will apply.

The efficient and sustainable use of resources will be another important objective of many of EBRD's projects. Greenhouse gas (GHG) emissions in Bosnia and Herzegovina are estimated to grow by almost 30 per cent between 2005 and 2030 and currently, 73 per cent of GHG emissions originate from the energy sector⁶. The Bank's investments in energy efficiency, renewable energy and resource efficiency will help to reduce Bosnia and Herzegovina's carbon intensity and pollution loading, as well as producing cost and efficiency savings. For renewable energy projects, and particularly wind turbines, siting decisions should take account of biodiversity and habitat considerations, including avoiding or minimising impacts on protected areas and bird migratory routes. For biomass projects, EBRD will work with clients to help them understand their supply chains and promote the use of legal and sustainable fuel sources.

Water stress will have implications water-intensive industries including agribusiness. It will affect agricultural production adversely, and increase the demand for irrigation. Hydropower investments may also have to take into account climate-driven changes in hydrology. The need for investment in more efficient and better-managed water supply systems will increase in the face of greater water stress caused by climate change. Action will be needed in climate-sensitive sectors such as water supplies, power and energy (especially hydropower) and water-intensive industries such as mining, agribusiness and manufacturing.

4. ACCESS TO CAPITAL: PRIVATE AND PUBLIC SOURCES OF FINANCE

4.1 Private sources of capital

Most of Bosnia and Herzegovina's public debt is financed externally from official sources including the IMF, EU and the World Bank. The rest of the public debt is financed through borrowing on domestic capital markets. B&H has not yet tapped international capital markets to finance public debt. The country's low sovereign credit rating (S&P rates B&H at B, two notches below investment grade; Moody's at B3, the bottom of the speculative and high risk band) has made such borrowing prohibitively expensive so far.

The banking sector in B&H is largely in foreign hands. Foreign-owned banks account for over 90 per cent of all banking assets in the country. Their entry in B&H has led to a significant increase in access to credit for both households and corporates. In 2007 and 2008, just before the global financial crisis hit the region, credit was growing on average at nearly 30 per cent year-on-year. However, since then credit growth has weakened considerably. At the end of 2012, it was growing by a mere 2 per cent year-on-year.

Households account for around 45 per cent of total loans to the private sector while corporates account for the remaining 55 per cent. Most of the loans are either denominated or indexed to a foreign currency. Access to finance for MSMEs has been particularly affected by the limited liquidity and increased risk aversion in the financial system due to the crisis.

⁶ UNECE, 2011

Domestic capital markets are still underdeveloped. Both government bond markets and money markets remain at the very early levels of development. Government bond markets lack liquidity and transparency through quoting on official sites. An OTC market has not been developed either. Money markets remain shallow and they lack benchmark indices and liquidity. Corporate bond markets remain nascent with no issuances seen over the last five years.

4.2 MDB finance and collaboration with other IFIs, EU and multilateral donors

The Bank will continue to closely cooperate with other donors in Bosnia and Herzegovina, including on coordination of donor activities related to the EU integration process. The main areas of co-operation between the EBRD and other donors will include:

Policy dialogue cooperation: The EBRD will continue to be an active participant in semi-annual donor coordination meetings with the government. The donor coordination on policy dialogue will include regular meetings between respective agencies on specific sectors (e.g., regular meetings on municipal and environmental infrastructure related policy dialogue issues), bilateral meetings of donors to discuss specific projects (Corridor Vc, energy, municipal utilities), and ad-hoc meetings as and when necessary. In the private sector, cooperation among IFIs and donors is expected to remain less formal, except for the microfinance sector where the lenders / donors have joint policy dialogue with the regulator and coordinate activities closely. All IFIs will cooperate on enforcing the same high standards of corporate governance and transparency, with the EBRD taking the lead in this area in the microfinance sector.

Project co-financing: Several infrastructure projects undertaken or prepared by the EBRD during the current strategy period involve co-financing by the EIB (Corridor Vc, Dobo-Banja Luka motorway, EPB&H) and bilateral donors (Corridor Vc, all MEI projects). This cooperation is expected to continue during the strategy period under consideration. Although EBRD loans are not subject to any IMF concessionality requirement under the current IMF programme, affordability constraints will require significant grant co-financing, particularly for municipal projects in the regions outside the capital.

Technical assistance: The Bank will continue to actively use significant technical assistance from the EU, bilateral donors and the EBRD Shareholder Fund, mainly for project preparation and implementation in the key strategic sectors (infrastructure, sustainable energy, SME financing and microfinance, as well as small business support). The Bank will also pursue donor financed legal and regulatory technical cooperation in key areas, including energy sector, sustainable energy, and the financial sector. Additional areas where more active involvement with donor financed technical cooperation assignments is expected include further support for microfinance sector transformation, investment climate improvements and fight against corruption, and private concessions.

Western Balkans Investment Framework: Established in December 2009, the WBIF provides a joint grant facility and a joint lending facility for priority investments in the region. The objective is to simplify access to credit by pooling and coordinating different sources of finance and technical assistance. In Bosnia and Herzegovina, an initial focus on infrastructure sectors, including social infrastructure, will continue, subject to developments of the EU integration process, and be expanded in the strategy period to include support for

small businesses within the framework of the Enterprise Development and Innovation Facility.

Cooperation between the EBRD and EU:

Bosnia and Herzegovina was recognised as a potential candidate country for EU accession in 2003 and signed a Stabilisation and Association Agreement (SAA) in 2008, agreeing to the EU's conditions for membership. The Stabilisation and Association Agreement has been ratified but has not yet entered into force.

Bosnia and Herzegovina has received financial assistance under the Instrument for Pre-accession Assistance (IPA) since 2007. The EU Delegation to Bosnia and Herzegovina is responsible for the implementation of financial assistance in the country. In October 2013 the EC launched procedures for reducing the initially foreseen Instrument for Pre-Accession Assistance (IPA) 2013 programme for B&H by 54 per cent and to postpone discussions on IPA II until the country is back on track in the EU integration process. The Council of the European Union at its last meeting on 17 December 2013 noted the inability of the B&H leaders to meet EU requirements that led to "a loss in IPA funds for 2013" and to "postponement of further discussions on IPA II", and expressed "serious concern that the EU integration process has stalled due to a lack of political will on the part of the B&H political leadership". Until the EU integration process stalemate is resolved, no new EU and WBIF funds are expected to be available. The Bank will however continue implementing projects with already approved EU co-financing, and considering new projects on the basis of already approved EU technical assistance funds, in close cooperation with the EU. The EU will also continue financing SBS activities in BiH under IPA 2013 programme.

In November 2009, the Council of the European Union adopted a decision to make available to Bosnia and Herzegovina an EU macro-financial assistance of up to €100 million in the form of a loan in two equal instalments of €50 million. The Memorandum of Understanding defines the conditions for the disbursement of the assistance, namely a satisfactory track record in the implementation of the Stand-By Arrangement with the International Monetary Fund and the fulfilment of specific conditions related to each tranche. The disbursement of the first instalment of €50 million was conditioned on the approval of the Global Framework of Fiscal Policies by the Fiscal Council and the tendering of the common Government Budget Management Information System. BiH has complied with these conditions and the first instalment was disbursed in February 2013. The disbursement of the second instalment of €50 million was conditioned by eight further structural reform criteria and took place in September 2013.

The cooperation between the EBRD and EU in Bosnia and Herzegovina is threefold: i) close cooperation in the policy dialog in all sectors where the EBRD is active (strong focus on transport, in particular transnational Corridor Vc), ii) financing of technical assistance for specific projects, with the EU providing about one quarter of total TC commitments to date, and iii) investment co-financing using the Instrument for Pre-accession Assistance (IPA) and Western Balkan Investment Framework (WBIF).

Joint IFI Action Plan for Growth. The EBRD, the EIB and the World Bank are working closely under this plan to revive growth in the CESEE region, including potential joint projects.

ANNEX 1 – POLITICAL ASSESSMENT

Bosnia and Herzegovina (B&H) is committed to and applying the principles of multiparty democracy, pluralism, and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank.

The constitutional and legislative framework for a pluralistic parliamentary democracy, the separation of powers and checks and balances in the political system, the guarantees for fundamental rights and for the meaningful role of civil society are in place in B&H and are largely in line with international and European standards.

However, the functioning of the state in general, and of its democratically elected institutions in particular, is affected by the specifics of the country's constitutional set up. The 1995 Dayton Accords, which ended the war in B&H and paved the way to the country's stability, created a uniquely complex institutional structure and a fragmented policy-making apparatus. At the central level, decision-making is based on a complex system of checks and balances, which were designed to protect the interests of the three 'constituent' peoples and which *de-facto* encourage their representatives to demonstrate their commitment to their ethnic constituency rather than to the State. While there is no consensus in sight between the country's ethnic leaders regarding the optimal internal organisation of B&H, without comprehensive constitutional reform further progress towards a more efficient state, implementation of a meaningful reform agenda and EU approximation will be difficult to achieve. There has been no meaningful progress since the adoption of the previous Strategy regarding possible constitutional reform.

Many of weaknesses common to other Western Balkan countries – such as overall institutional weakness, relatively low capacity of public administration, excessive politicisation and lack of meritocracy in the civil service, weak judiciary, and difficult business environment – have been multiplied in B&H. This is one of the main reasons the country often ranks among the worst in the region in various ranking tables related to the business environment.

The specifics of the constitutional set up also affect human rights. Some parts of the existing B&H legislation are not in compliance with international standards, including the European Convention of Human Rights. In 2009, the European Court of Human Rights (ECHR) issued a verdict to stop discrimination against ethnic minorities in B&H, whose representatives are prevented by law from running for the highest public offices. This verdict of the ECHR has not been implemented yet. The failure to implement the verdict of the ECHR is currently one of the key obstacles for submitting a formal application for EU membership. B&H remains the only Western Balkans country (apart from Kosovo) that has not yet applied for EU membership.

The latest Resolution of the Parliamentary Assembly of the Council of Europe (PACE) on B&H noted that there has been “very little progress achieved in the implementation of key outstanding commitments to the Council of Europe” and the current situation “hampers the completion of much needed reforms in key sectors, such as democratic institutions, the rule of law and human rights (...)”.⁷ The lack of progress in democratic reforms has affected the country's progress in EU approximation. The European Commission (EC) concluded in its

⁷ Parliamentary Assembly of the Council of Europe (PACE), Resolution 1855 on “The functioning of democratic institutions in Bosnia and Herzegovina” (adopted in Plenary on 9 January 2012)

latest progress report on B&H that the country “is at a standstill in the European integration process”.⁸ The Council of the European Union at its last meeting on 17 December 2013 noted the inability of the B&H leaders to meet EU requirements that led to a “loss in IPA funds for 2013” and a “postponement of further decisions on IPA II”, and expressed “serious concern that the EU integration process has stalled due to a lack of political will on the part of the B&H political leadership”.⁹

Representative and Accountable Government

Free, fair and competitive elections

The existing legal framework, even if complex and suffering from the lack of harmonisation between the Entities, enables democratic elections. Elections are generally conducted in line with OSCE and Council of Europe commitments, as assessed by these two institutions. The 2001 Election Law forms the basis of the electoral legal framework, which has undergone substantive and positive changes over the years.

However, there is one area where the legal framework fails in terms of both active and passive suffrage rights: existing ethnically-based and residence limitations to the right to run in elections do not comply with the European Convention on Human Rights and run counter to the OSCE Copenhagen document and other international standards. PACE has repeatedly requested B&H authorities to amend its Constitution and electoral legislation in order to end discrimination against ethnic minorities.¹⁰ On 22 December 2009, the ECHR issued a legally binding verdict providing that ethnicity-based ineligibility is incompatible with the general principles of the European Convention. In 2011, an Interim Joint Parliamentary Committee was set up in order to draft amendments to the Constitution and electoral law in order to comply with the ECHR verdict, but no changes have been agreed so far by the key stakeholders. The EC has noted that continuing failure by the authorities to implement the verdict of the ECHR could “seriously undermine the legitimacy and credibility” of the next general elections due in 2014.¹¹

In practice, elections broadly allow for competition between different political parties and free choice for voters. Candidates are able to campaign freely and without hindrance from the authorities. The Central Election Commission (CEC) is an independent permanent body appointed by a special Commission for Selection and Nomination. Representatives of the OSCE and of the Office of the High Representative (OHR) used to be members of CEC until 2005, and continue to have one advisory seat each in CEC, without voting rights. Municipal election commissions are permanent bodies appointed by the municipal authorities and approved by the CEC.

The media provide voters with diverse and extensive coverage of the electoral campaign. The Electoral Code provides for domestic and international election observation at all levels of election administration. However, the number of domestic observers from civil society has

⁸ European Commission, Enlargement Strategy and Main Challenges 2013-2014, Communication from the Commission to the European Parliament and the Council, 16 October 2013, p19.

⁹ Conclusions of the General Affairs Council, Council of the European Union, 17 December 2013, p.20.

¹⁰ Parliamentary Assembly of the Council of Europe (PACE), Resolution 1701 (2010), Resolution 1725 (2010), and Resolution 1855 (2012)

¹¹ European Commission, Memo on the outcome of the 3rd Round of High Level Dialogue on Accession Process, 10 October 2013.

been declining, largely due to the lack of funding. Specifics of the country's constitutional set up and remaining ethnic divisions lead to the political parties reaching out mostly to their own ethnic constituencies, although there are a few parties that pursue a more multi-ethnic approach.

B&H has held regular democratic and competitive elections at both central and municipal levels since the end of the war (1992-1995). In the past, elections had effectively been organised by the OSCE. The last two general elections (2006 and 2010) and municipal elections (2008 and 2012) were fully administered by the B&H authorities. The last general elections were assessed by the OSCE/ODIHR Election Observation Mission as administrated broadly efficiently and in line with OSCE commitments.¹² A total of 3,900 candidates contested in the general elections, offering a wide choice to voters. The electoral campaign was competitive and largely clam, orderly, and peaceful, even if occasionally marked by the nationalist rhetoric of some contestants. Among recurring procedural irregularities is the so-called 'proxy' (family) voting, especially in rural areas.

Separation of powers and effective checks and balances

The constitutional and legislative framework for a parliamentary democracy, underpinned by the separation of powers and checks and balances in the political system, independent legislature and procedures of legislative oversight in prescribed domains of decision-making, is in place in B&H. The uniquely complex governance architecture of B&H stems from the provisions of the Dayton Peace Accords, and has an elaborate system of checks and balances. They were largely designed to protect the interests of the three 'constituent' peoples. In reality, they encourage political representatives to demonstrate their commitment to their Entity and their ethnic constituency rather than to the State. The functionality and efficiency of the central government is limited, as is the coordination of policy-making. The Constitution grants limited powers to the state-level institutions, while vesting most of them in two Entities: Federation of B&H (FB&H) and Republika Srpska (RS).

The efficiency of the Parliamentary Assembly of B&H is limited, although there has been recently some progress in the reorganisation of its Secretariat. At the Entity level, the overall functioning of the Parliamentary Assemblies is more efficient.

Effective power to govern of elected officials

B&H has established institutional, legal, and financial arrangements for elected officials to exercise their power to govern and they are not constrained by internal non-democratic veto powers or other undue influences. As in many other transition countries, there has long been a close relationship between business and political elites. However, this does not compromise the powers of elected officials to govern the country.

International presence in B&H remains significant, even though its role and numbers have been reduced. The Dayton Accords established the Office of the High Representative (OHR) under the United Nations auspices. The High Representative (HR), who reports to the Peace Implementation Council (PIC), a group of 55 countries and international organisations that "sponsor and direct the peace implementation process", can issue decisions that have legislative power, including overruling domestic legislation. In 1997, PIC provided the HR

¹² The OSCE Office for Democratic Institutions and Human Rights (ODIHR), General Elections of 3 October 2010, Election Observation Mission, Final Report (17 December 2010)

with additional powers (the Bonn powers) to remove any officials, including elected officials, who obstruct the Dayton peace process. Although the use of the Bonn powers in practice has decreased over the years, the HR continues to use them occasionally. PIC has reached an understanding that the OHR will have to be closed in the future, provided certain “conditions” and “objectives” have been met.

In the past, the HR served also as the European Union Special Representative in B&H (EUSR). Since the recent decoupling of these two mandates, the EU has reinforced its role in B&H, including the combined presence of the EUSR and the EU Delegation. The EU has deployed considerable resources in B&H under the Common Foreign and Security Policy and is a key international stakeholder.

The EU Police Mission (EUPM), which monitored the implementation of the police reform and assisted in fighting corruption and organised crime, was closed in 2012.

B&H has an EU-led foreign military presence – EUFOR Althea which, in accordance with a UNSCR resolution, has a mandate to support a safe and secure environment in the country. In 2012, EUFOR was reconfigured and reduced to 600 troops. It currently focuses largely on capacity-building and training.

Civil Society, Media and Participation

Scale and independence of civil society

There is a satisfactory legal framework for civil society organisations. A national Civil Society Development Strategy is under preparation. An institutional mechanism for cooperation with civil society has been established in the two Entities, but is not fully operational yet. It has not been established yet at the State level.

While there are many registered NGOs in B&H, few of them are well established and functioning. Many NGOs are project-based, and relatively narrowly specialised.

Civil society is involved in legislative activities. However, the consultation process with civil society is not sufficiently robust. In general, public participation in decision-making in B&H needs further improvement.

The right to form trade unions is enshrined in the law. However, trade unions in general lack stable finances and labour rights and social dialogue need further strengthening. No steps have been taken so far to establish a state-level Economic and Social Council.

Independent pluralistic media that operates without censorship

Pluralism in the media, which operate broadly freely and without censorship in B&H, has increased overall in recent years. The legal framework is largely in place and in line with international standards. The Press Council, which is a self-regulatory body for the print media, helps to promote freedom of speech and the respect of journalistic ethics.

At the same time, more needs to be done to ensure that freedom of expression and media freedom, which are guaranteed by the Constitution, are respected in practice, since there is a widespread perception among citizens that the media are over-politicised and are under

pressure from political parties. The high level of polarisation of the media along both political and ethnic lines remains a source of concern. The existing legislation provides legal safeguards to ensure the independence of the Communications Regulatory Authority, but attempts to undermine the latter persist. The OSCE Representative on Freedom of the Media has repeatedly raised concerns against instances of threats and intimidation against journalists.¹³

The media landscape is diverse and complex and includes some 200 licensed broadcast media and 100 print media outlets. The public broadcasting system consists of three broadcasters – one operating at the State and two at the Entity levels – which cover 70 per cent of the country’s territory. There are over 60 public and 16 public TV channels operating locally.

Multiple channels of civic and political participation

Multiple channels of civic and political participation are in place. However the public participation in decision making needs improvement.

Freedom to form political parties and existence of organised opposition

The freedom to form political parties is both guaranteed by the Constitution and implemented in practice, as highlighted by the existence of considerable number of parties and a significant opposition able to campaign freely and oppose government initiatives. 39 political parties contested in the last general elections. More than 18 different political parties are represented in the national Parliament. The representatives of the opposition political parties are in majority in a number of municipal assemblies.

Rule of Law and Access to Justice

Supremacy of the law

Necessary legislative and institutional safeguards for the supremacy of the law are in place. Citizens have the right to a free and fair trial, and are free from arbitrary arrest or detention.

Independence of the judiciary

The independence of the judiciary is guaranteed by the Constitution and key safeguards are in place to ensure its impartiality, although enforcement is uneven. The independence of the system is further supported by the functioning of the independent Constitutional Court, the Court of B&H, and the High Judicial and Prosecutorial Council. The main challenges stem from the specifics of B&H’s constitutional set up. Independence is affected by the lack of coordination and harmonisation between the State level and Entity levels, and budgetary fragmentation.

Strengthening the independence and efficiency of the judiciary has been one of the main objectives of the EU’s on-going Structured Dialogue on Justice. The EU provides assistance to B&H in this area. The Dialogue contributed to the revision of the Law on the High Judicial and Prosecutorial Council and other measures designed to reform the State-level judiciary

13 The OSCE Representative on Freedom of the Media, press statements dated 16 April 2013 and 20 July 2012

system in accordance with European standards of independence, impartiality and professionalism.

Government and citizens equally subject to the law

The authorities have stepped up measures to increase accountability and prevent abuse of authority by public office-holders. The Office of the Disciplinary Council has managed to reduce the number of unresolved cases and increase the number of disciplinary actions against public office-holders.

Effective policies and institutions to prevent corruption

According to the 2013 Transparency International Corruption Perceptions Index (CPI), B&H had a score of 42, which places it 72nd out of 177 countries¹⁴. This is unchanged from the previous year. Corruption remains a serious problem and is perceived by citizens as a widespread phenomenon.

According to the latest reports by the Council of Europe's Group of States against Corruption (GRECO), the main challenge in fighting corruption in B&H – leaving aside the deficiencies stemming from its peculiar constitutional set up and lack of coordination and harmonisation between the State and Entity levels – lies within the “effective application of legislation”. GRECO noted that statistics showed alarming data on prosecution and adjudication: “most cases end up in acquittals or suspended sentences”.¹⁵ In its 2011 Report, GRECO issued a number of concrete recommendations. The authorities of B&H presented their report on the implementation of these recommendations at the end of 2012, and the Compliance Report by GRECO is currently being prepared.

Anti-corruption strategies are in place in the two Entities. Although the regulation establishing the Agency for the prevention of corruption and coordination of the fight against corruption was adopted in 2012, the Agency is still not fully operational.

The Law on Conflict of Interest is in place, but the harmonisation of conflict of interest legislation across the country is pending. Very few high-level corruption cases lead to prosecution. Nepotism continues to hamper professional performance throughout the public sector.

Civil and Political Rights

Freedom of speech, information, religion, conscience, movement, association, assembly and private property

B&H has a legal and institutional basis for the protection of fundamental rights and freedoms, which are enshrined in its Constitution. B&H has ratified all major UN human rights conventions. The Constitution lists 15 international human rights instruments and explicitly stipulates that the European Convention for the Protection of Human Rights and Fundamental Freedoms and its Protocols apply directly and supersede national law.

¹⁴ Transparency International, 2013 Corruption Perceptions Index (CPI) rankings

¹⁵ Council of Europe, Group of States against Corruption (GRECO), Third Evaluation Round, Evaluation Report on Bosnia and Herzegovina (Adopted in Plenary on 27 May 2011)

While the necessary framework is in place, the implementation of human rights standards remains uneven. The last assessment of the track record of Bosnia and Herzegovina in the area of human rights in the framework of the United Nations Universal Periodic Review (UPR) was conducted in February 2010 and adopted in Plenary in June 2010. The next review of Bosnia and Herzegovina, as part of UPR's second cycle, is due in October 2014. The top three recommendations for Bosnia and Herzegovina included women's rights (16.67 per cent of 126 recommendations); the rights of the child (14.29 per cent); and minorities (11.9 per cent). Bosnia and Herzegovina accepted more than two-thirds of the recommendations made through the review process.¹⁶

The constitutional guarantees for freedom of assembly and association, speech, thought, conscience, and religion are broadly respected. At the same time, the Council of Europe and EU reports pointed to remaining weaknesses in the area of the freedom of expression (protection against, and prosecution of, physical attacks against journalists and human rights advocates). Discrimination against LGBT people remains widespread. The anti-discrimination law does not include age and disability as categories for discrimination and allows for a broad range of exceptions. In general, public awareness of the legal remedies provided by the anti-discrimination law remains low.

Property rights are respected, and the vast majority of cases of property repossession requests have been resolved. However, since the dissolution of the Commission for Property Claims of Displaced Persons and Refugees in 2009 over 100 unresolved cases remained. There is still no reliable database on outstanding claims. There are still more than 100,000 internally displaced persons in B&H, 7,000 refugees, and more than 13,000 missing people. Despite steps taken to implement the revised Strategy for the Implementation of Annex 7 to the Dayton Accords, mainly regarding housing, B&H still lacks a coordinated mechanism to address legislative gaps hampering sustainable returns and local integration.

The Constitution provides citizens with the right to refer violations of their rights and freedoms guaranteed by the Constitution to the Constitutional Court. When its decisions are not enforced citizens can lodge cases before the European Court of Human Rights (ECHR). The total number of pending applications before ECHR was 1433 in 2012. There is also the institution of the Ombudsperson in place, which has issued several reports and recommendations to the Parliament.

Political inclusiveness for women, ethnic and other minorities

Due to a history of armed inter-ethnic conflict, the issues related to the rights of ethnic communities in B&H are particularly sensitive. There was no census of the population in B&H from 1991 to 2013, when the first post-war census was conducted and included questions on ethnic affiliation. The results of the 2013 census are expected to be released in 2014. The Constitution established the category of "constituent peoples", which includes Bosniaks, Croats, and Serbs. The next category is "minorities". According to the Law on the Protection of the Rights of National Minorities, there are 17 national minorities in B&H (Albanians, Montenegrins, Czechs, Italians, Jews, Hungarians, Macedonians, Germans, Poles, Roma, Romanians, Russians, Rusins, Slovaks, Slovenians, Turks, and Ukrainians). Those who do not declare their ethnicity are defined as "others".

¹⁶ Universal Periodic Review (UPR), 2010 review of Bosnia and Herzegovina, 17 February 2010 – adopted in Plenary in June 2010. Statistics: UPR Info's statistics of UPR recommendations

Although the legal and institutional framework for the protection of minorities, including the above-mentioned law, the Anti-Discrimination Law, and the National Minority Councils, are largely in place, implementation remains uneven. The most severe, and unique problem as regards inclusiveness of ethnic minorities, however, is related to the specifics of the constitutional set up. In B&H citizens who do not identify themselves as part of one of the three “constituent peoples” are legally barred from running for the B&H Presidency and in the House of Peoples chamber of the national parliament. Furthermore, there are discriminatory restrictions based on residency: a citizen registered in the “wrong” Entity (a Bosniak or Croat in RS or a Serb in FB&H) cannot run for the B&H presidency either; RS voters can only vote for a Serb candidate, while voters in FB&H may only vote for a Bosniak or Croat candidates. All these discriminatory provisions are not in compliance with ECHR rules, and run counter to the OSCE Copenhagen document and other international standards.

On 22 December 2009, the ECHR issued a legally binding decision providing that the ethnicity-based ineligibility rule is “incompatible with the general principles of the European Convention”.¹⁷ In a PACE Resolution adopted on 9 January 2012, the authorities of B&H were reminded that the above-mentioned ECHR verdict was legally binding and urged B&H to implement it without any further delay, warning that failure to adopt necessary constitutional amendments would put at stake the continued membership of B&H in the Council of Europe.¹⁸ Nevertheless so far the key stakeholders in B&H have failed to reach an agreement on the implementation of the ruling of ECHR.

The Roma minority continues to be the most vulnerable in B&H. According to the 1991 census, this community comprises 9,000 people, but the estimates put this number in the range of 30,000 to 100,000. Some progress was made to provide the Roma with personal documents, as well as improve their housing conditions. B&H participates in the Roma Decade of Inclusion, and four Action Plans under the Roma Strategy are in place. However, little progress has been made in improving the situation of Roma women and children, who continue to suffer from discrimination and domestic violence.

The key legislative elements for gender equality are in place in B&H. The country has committed itself to respecting gender equality through several international instruments that are listed in the Constitution, including the UN Convention on Elimination of All Forms of Discrimination against Women. The Gender Equality Law provides for the participation of women at all levels of public life. B&H has continued to implement the Action Plan on UNSCR 1325 regarding Women, Peace, and Security. The Gender Action Plan for B&H, adopted in 2006, identified the increase in the participation of women in political life and decision-making as one of key priorities.

Nevertheless, the participation of women in political life remains low. The Law on Gender Equality, as amended in 2009, envisaged at least a 40 per cent representation in public administration. This quota has not been reached. While legal requirements regarding gender balance on party lists during the elections were respected during the last general elections, and 37.7 per cent of candidates were women, only 43 women were elected to the three parliaments (the State, and two Entities). Women MPs represent 19.28 in the current elective bodies, which is only a slight increase from 2006 (17.21 per cent). In 2013, the first female

17 European Court of Human Rights (ECHR), Complaint lodged by two applicants of respectively Roma and Jewish origins: “Sejdić and Finci versus Bosnia and Herzegovina”, 22 December 2009

18 Parliamentary Assembly of the Council of Europe (PACE), Resolution 1855 on “The functioning of democratic institutions in Bosnia and Herzegovina” (adopted in Plenary on 9 January 2012)

prime minister was appointed in the RS. Women represent an impressive 24 per cent of the Government of RS. At the same time, there is only one female minister in the Government of the other Entity (FB&H), and no women at all are members in the State-level government.

Some progress was made in combatting violence against women, particularly in the RS, where the implementation of the Strategy against Domestic Violence is gaining momentum and police training has been launched. In FB&H the Law on Domestic Violence remains to be amended to enhance victim protection. Discriminatory customs and stereotypes are still present in the rural areas, undermining women's basic rights.

Freedom from harassment, intimidation and torture

Constitutional guarantees against harassment, intimidation, and torture are in place and are largely upheld in practice. However, in contrast to the previous findings, the last report of the Council of Europe's European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT) noted "a considerable number of credible allegations of serious physical ill-treatment by the police and other law enforcement officials".¹⁹

¹⁹ Council of Europe, European Committee for the Prevention of Torture and Inhuman or Degrading Treatment or Punishment (CPT), Report to the Government of Bosnia and Herzegovina on the visit to Bosnia and Herzegovina carried out by the European Committee for the CPT from 5 to 14 April 2011 (Adopted in Plenary on 26 April 2012)

ANNEX 2 – ASSESSMENT OF TRANSITION CHALLENGES

Sectors	Market Structure	Market-Supporting Institutions
Corporate sectors		
Agribusiness	Medium	Medium
General industry	Large	Medium
Real estate	Large	Large
Telecommunications	Medium	Medium
Energy		
Natural resources	Large	Large
Power	Large	Large
Sustainable energy	Large	Large
Infrastructure		
Urban Transport	Medium	Large
Water and Wastewater	Large	Large
Roads	Medium	Medium
Railways	Medium	Small
Financial Institutions		
Banking	Medium	Medium
MSME	Medium	Medium
Insurance and financial services	Medium	Medium
Private Equity	Large	Large
Capital Markets	Large	Large

INDUSTRY, COMMERCE AND AGRIBUSINESS

Agribusiness

Market structure: *Medium*

Market institutions: *Medium*

Bosnia and Herzegovina made notable improvements since 2005 in the structure and extent of markets on the back of both regional trade negotiations and direct investment. Bosnia signed an SAA agreement with the EU in 2008 and negotiations to become a WTO member are ongoing. Agricultural markets now generally operate freely and trade restrictions as well as government support to the sector are low. However, the sector suffers from the very small size of average land holdings and the lack of clear land ownership rights, partly as a result of the war but also due to high bureaucratic burdens of registering or leasing land. The process for building a warehouse is equally bureaucratic and the sector suffers from a lack of storage facilities. The sector mostly consists of small-scale farms producing for home consumption, while larger scale state farms are mostly not operating or in difficulties due to the protracted privatisation process. In addition, displacement of land owners during the war as well as land contaminated by landmines limits the use of agricultural land. This results in an important potential of bringing fallow land back into production as according to FAO data, more than 40 per cent of arable land is currently uncultivated. The food processing industry is recovering after a long period of under-investment. Around 80% of the industry is now privatised and it has been managing to attract a sizeable amount of FDI up to 2008. This has also led to improvements in ISO certification and quality standards, but there is still

significant potential for upgrades in order to access export markets, such as the EU. Agribusiness processing, logistics and retail distribution activities remain underdeveloped.

Manufacturing and Services

Market structure: *Large*

Market institutions: *Medium*

Bosnia and Herzegovina has typically come last among SEE countries in cross-country assessments of Manufacturing and Services reform, especially in the areas of starting a business, dealing with construction permits, contract enforcement and getting access to electricity. This situation has not changed in the last year. The country's complicated political and constitutional structure continues to be a major hindrance to reform and good governance in line with EU standards. The country also lags behind other EU candidates or potential candidates in the region in terms of EU approximation. There has been virtually no progress over recent years in the remaining large scale privatisation due to lack of political will to sell-off economically sensitive enterprises, i.e. those that are providing direct and indirect employment to a large number of workers. The privatisations of large-scale M&S enterprises, such as the aluminium maker Aluminji d.d. Mostar, the engineering company Energoinvest and the construction company Hidrogradnja, remain stalled. Nevertheless, a number of large industrial facilities that were privatized to strategic sponsors in the mid-2000's have shown resilience to the recent crisis

Real estate

Market structure: *Large*

Market institutions: *Large*

The property market is at early stages of development, including the introduction of new products and financing methods. Real estate lending and real estate transactions in Bosnia and Herzegovina are constrained by a number of factors, including delays and other problems in enforcement of legal contracts and excessive taxes, fees, and permitting requirements. As a result, market penetration of modern property-related commercial services (retail, office, accommodation, and tourism facilities) is low. On the positive side, administrative improvements made it easier to obtain cadastre excerpts, required for building permits, and to register new buildings in the cadastre and land book registry. The land registry and cadastre have been fully digitised. Gaps in terms of the development of modern primary and secondary legislation supporting the sustainability of real estate (energy efficiency, impact on environment) are still large.

Telecommunication

Market structure: *Medium*

Market institutions: *Medium*

The telecommunications sector is regulated by the Communications Regulatory Agency (RAK). Implementation of modern regulation is lagging behind, especially in areas such as the authorisation regime, universal access provisions or market access. The market has been fully liberalized in January 2006. There has been progress in setting up the necessary infrastructure for number portability, both mobile and fixed, but only the fixed one has been implemented so far. The process of digitalisation of national broadcasting networks is nascent, with the country's present broadcasting infrastructure owned by three separate companies operating in different provinces of B&H.

The telecommunications market continues to be dominated by the three ethnically-based fixed line operators (all of them state-controlled, two of them by Bosnia and Herzegovina, one by Serbia), which also operate mobile networks – all of the latter offer near-national coverage. Republika Srpska sold the incumbent to Telekom Srbije, but plans for the privatisation of HT Mostar and BH Telecom have been delayed further. In February 2011, the authorities indefinitely postponed the privatisation of the latter. In the mobile segment, the three major operators are affiliated with the fixed-line incumbents. They have been designated as possessing significant market power and the first set of reference unbundling offers (RUO) was introduced in 2010. In 2009 all three mobile operators received a 3G license. Internet services are available through both the incumbents and alternative (cable) operators. Broadband internet penetration is still low, well below the EU average, but growing strongly, also thanks to a strong uptake of mobile broadband. There have been significant consolidation efforts in the cable TV segment which has started investing in the provision of advanced services such as broadband internet and telephony, thus putting strong competitive pressure on the fixed line incumbent operators.

ENERGY

Natural Resources

Market structure: *Large*

Market institutions: *Large*

The main natural resources are coal, iron ore, bauxite, manganese, lead, zinc and copper. Mines have been corporatized and are largely privately-owned. The mining sector remains small compared to other industries, yet, there is still scope for improvement in terms of transparency and EHS&S standards. The country is heavily reliant on other countries for its energy supplies, as it imports all of its natural gas and oil supplies. The fuels market is open to private distribution companies, albeit dominated by Russia's Zarubezhneft - which also controls the country's refining facility at Brod.

Unlike in the power sector, the gas transport and distribution activities are still prerogatives of the two entities, Republika Srpska (RS) and the Federation of Bosnia and Herzegovina (FBH). BH Gas is the only operator of the gas transmission network in the FBH and *de facto* the single importer and the main wholesale supplier of the country. Of the two transmission companies in RS, Gaspromet has been 40 per cent privatized to Srbijagas, thereby enabling Bosnia-Herzegovina to participate in the South Stream project. The company's commercial and legal unbundling, in line with the EU Directive 2003/55, remains one of the key challenges in the sector.

A large gap also remains in creating market enabling institutions that operate at a Federal level. The RS parliament approved an "Energy Development Strategy until 2030" in December 2010. The country is a signatory of the Energy Community Treaty, which aims at establishing an Integrated Energy Market Organisation in South-East Europe. Unlike in the electricity sector, there is currently no regulator for natural gas transmission and distribution functions in the FBH, nor at common federal level. In light of the lack of competition and unbundling in the gas sector, as well as the very weak market supporting institutions and policies, the transition gaps in B&H have both been assessed as *large*.

Sustainable Energy

Market structure: *Large*

Market institutions: *Large*

The legal and institutional framework for sustainable energy remains weak. There is no specific energy policy or strategy at the state level, no energy law, or Energy Agency. There are no official policies for promotion of RES and energy efficiency. The only legal act in place is the Electricity Act for Transmission, Independent System Operator (ISO) and Regulator. Currently, B&H is in the process of adopting basic laws on federal level regarding the feed-in tariffs and RE support in order to stimulate possible investments. A new Law on RES and Efficient Cogeneration in FB&H is currently in its final procedures for adoption. Fixed feed-in tariffs for electricity produced by RES and power purchase obligation for electricity suppliers or grid operators were introduced in 2002 (for plant capacity below 5 MWh). The residential collection rate is close to 100 per cent, but electricity tariffs are still not costs reflective and do not include environmental costs. Significant cross-subsidisation persists. Transmission/distribution losses remain high at 21 per cent in 2008, although have been reduced from 24 per cent in 2006. Efficiency of thermal power plants is extremely low (about 22 per cent according to Enerdata). B&H ratified the UNFCCC and Kyoto protocol where it holds the status of the Non-Annex 1 Party. No GHG emission targets or policies have been adopted.

Power

Market structure: *Large*

Market institutions: *Large*

The power sector is currently organised in three vertically integrated state-owned regional monopolies which provide power generation and distribution in their respective territories. There is little state level policy direction or development strategies. Some progress has been made in improving the market structure with the start of the unbundling process, and in Republika Srpska distribution has been functionally unbundled within a loose holding company structure (EPRS). However, this work is still to be completed. In 2006, the legal unbundling of the transmission activities, with the creation of the Electricity Transmission Company (Transco) and an Independent System Operator (ISO), was successfully concluded. So far private sector participation in the sector has been limited and the liberalisation of the market is at an early stage. The quality of institutions needs to be improved both at the entity and the state level. State and Entities-level Regulatory Agency is in place but their independence is limited. Furthermore, electricity tariffs are not yet cost reflective and significant cross-subsidies exist. Transmission/distribution losses remain high at 17 per cent in 2010, although they have been reduced from 24 per cent in 2006. Efficiency of thermal power plants is extremely low (about 22 per cent according to Enerdata).

INFRASTRUCTURE

Water and wastewater

Market structure: *Large*

Market institutions: *Large*

Full decentralisation of local infrastructure is now in place in FBH and in RS, as all utility companies are either wholly or majority owned by the municipalities. At the same time almost all of the utility companies are fully corporatised. The financial performance of some

of the utilities is acceptable due to grant and budgetary transfers as the tariffs, cost control and the collection rates are often poor. The infrastructure sector in general relies on grants as revenue based investments are not the norm. There is lack of commercial financing due to untested legal framework for sovereign guarantees and commercial limitations for local utilities. This is subject to change as the new legislation has been adopted to foster commercial lending in the sector. Operational performances are often weak, characterized by high water losses, and utilities are lacking clear performance targets. The provision of services is often supply driven and there is no meaningful competitive pressure or significant private sector participation in the municipal sector.

All major aspects of the operation of a utility company (tariff setting, capital investments, human resources, etc.) are directly controlled by the municipal councils. Tariffs are set without a clear price formula or the approval of an independent regulator assessing the tariffs or business plans. In the absence of adequate contractual frameworks between municipal utilities and local authorities, the tariff setting and operational planning is often politicised and lacks transparency.

Urban Transport

Market structure: *Medium*

Market institutions: *Large*

The majority of the transport providers are corporatised, but lack modern practices such as business planning, management information systems and service quality controls. Hence, operational performances are often weak and transport companies are lacking clear performance targets. The provision of services is often supply driven and there is no meaningful competitive pressure or significant private sector participation in the municipal sector. In Sarajevo, the municipal public transport operator maintains a monopoly position. The financial performance of some of the transport companies is acceptable due to grant and budgetary transfers however the fare box ratios and the ticket control is often poor. The infrastructure investments in urban transport sector are majority grant driven. There is a lack of commercial financing - with or without sovereign guarantee - due to legal and commercial limitations for municipal companies. This is subject to change as the new legislation has been adopted to foster commercial lending in the sector. As elsewhere in the Western Balkans, traffic congestion is a growing problem; the need for investment in key missing link road segments and traffic management is also clear in Sarajevo, due to the reshaping of the city's urban growth pattern over the past 15 years. In the absence of adequate contractual frameworks between urban transport providers and local authorities, the tariff setting and operational planning is often politicised and lacks transparency.

Roads

Market structure: *Medium*

Market institutions: *Medium*

The road agencies in both political entities have been corporatised. Cost recovery of road maintenance through user charges has been achieved. Open tendering became a practice in construction and large maintenance contracts. Similarly the motorway agencies have been established as separate corporate entities with fuel levy for motorways as the main direct revenue source. The authorities seem to be keen to develop a PPP scheme for motorways construction, especially in Republika Srpska (RS), which has published a tender for a PPP to develop the section of Corridor Vc in RS.

Railways

Market structure: *Medium*

Market institutions: *Small*

In railways, operating and policy setting functions have been separated and core railway businesses have been partly unbundled and ancillary services have been divested. An independent railway regulator was established but its capacity is inadequate and scope for third party access is limited by the lack of commercial appetite. The reform process was politicised and faced with strong political oppositions.

FINANCIAL INSTITUTIONS

Banking

Market structure: *Medium*

Market institutions: *Medium*

29 banks compete in Bosnia and Herzegovina. These include 19 banks which are majority foreign-owned, of which eight are located in Republika Srpska and 11 are located in FB&H. However, the importance of foreign-owned banks in the Bosnia and Herzegovina banking sector is even more pronounced when one looks at assets, since they hold 92.1% of the total assets as of end 2011. The sector is not particularly concentrated since the top 5 banks hold just over 40% of total assets. With assets/GDP of 84% and deposits/GDP of 59% as of end 2011, there is room for deeper financial intermediation. The substantial strengthening of the deposit insurance scheme in early 2010, thanks to a € 50 Million EBRD loan, has so far not resulted in an increase in deposits. Deposits denominated in or indexed to foreign currency decreased marginally and accounted for 53% of total deposits at the end of last year, versus 56.6% in 2010. Private credit to GDP amounts to around 60% of GDP at end 2011. The share of NPLs rose further to 11.85% in 2011 (compared with 7.1% in October 2010 and 5.87% in 2009). The Capital Adequacy Ratio stood at a solid 17.7% as of end 2011.

The banking agencies in the two entities comprising the country still operate independently of each other. In addition to banks, they supervise micro-credit and leasing companies. Both have signed a Memorandum of Understanding establishing a framework for coordination with the central bank. There is some degree of cooperation and data sharing between the two agencies, through a Standing Committee on Financial Stability (established in 2009), but standards of supervision as well as the degree of harmonization of supervisory practices and regulations require further progress.

Insurance and other financial services

Market structure: *Medium*

Market institutions: *Medium*

The insurance sector in Bosnia and Herzegovina is not particularly concentrated, with the largest three insurers holding 35% of the market. Private companies account for nearly 70% of the market. Insurance penetration stands at 1.88% premiums/GDP, of which 16% is in life insurance and 84% in non-life. Insurance legislation and regulation are in place, with clear guidelines with respect to reserve requirements. There are separate licensing regimes for each of B&H's two political entities, and high licensing fees combine with this dual requirement to result in a shortage of agents. However, for about four years now, companies have been

working across entities. Companies from FB&H with branches in RS increased their total earned premia by 88% (in 2010). More striking, however, companies headquartered in RS but operating their branches in FB&H, have seen premia increase 6-fold. This suggests that activity across entities is to be encouraged going forward, as it increases competition and ultimately should result in better quality and development of Bosnia's insurance sector. Regulators are perceived to be operationally independent. At the same time, implementation of legislation needs to be strengthened further and a number of technical regulations need to be upgraded. Availability of products and skills in the markets remains limited. Eight leasing companies together form the Association of leasing Companies of Bosnia and Herzegovina. The majority (59%) of leasing activity is in the vehicle segment. Bosnia's pension system has Pillar I and Pillar III funds.

Micro, Small and Medium-sized enterprises

Market structure: *Medium*

Market institutions: *Medium*

Despite significant improvement in access to finance, lending to MSMEs accounted for about 25 per cent of total bank lending in 2011. Domestic credit to private sector is estimated at about 55 per cent of GDP. Important progress was made with the Microfinance Law (MF), which was implemented in 2007. Consolidated information on the overall volume of micro finance operations in the country does not exist. The Entity banking agencies have also begun to supervise micro credit and leasing companies, which have significantly expanded their activities in recent years. Microfinance institutions are now targeting transformation into banks, though this has been held back by regulatory requirements. Progresses have been made in the efficiency of cadastre and the registration system for movable assets with the establishment of a unified collateral registry in 2009. However, the legal framework remains quite complex due to two different government systems. The definition of collateral is flexible and micro-loans can be extended in the absence of collateral. USAID sponsored a project to set up a state-wide registry for movable assets, which became operational four years ago. In this registry, anyone who is in Bosnia Herzegovina can enter information about pledged movable assets. A private credit registry exists since 2001 with a good coverage across Bosnia and Herzegovina even though its coverage has decreased since 2010 from 69 per cent of adults to 39.6 per cent of adults which was compensated by an increased in the public registry coverage. Although changed recently, micro-finance institution did not actively use the credit information from the credit bureau, which led to excessive lending and over-indebtedness in the past.

Contract enforcement remains lengthy and expensive processes.

Private equity

Market structure: *Large*

Market institutions: *Large*

A commercial private equity sector is yet to develop to any significant degree in this challenging business environment. No country-dedicated fund managers have successfully entered the market yet, and less than five regional fund managers have been identified to include Bosnia and Herzegovina in their target region. Investment strategies are focused on growth opportunities. Active capital remains at low levels, at 0.3 per cent of GDP in 2011 and there is no capital available for investment in the Bosnian private equity market. The

local institutional investor base remains non-existent. Corporate governance frameworks conform reasonably well to OECD Principles of Corporate Governance

Capital markets

Market structure: *Large*

Market institutions: *Large*

In 2011, the Sarajevo Stock Exchange capitalisation was 2,119 EUR million, and that of the Banja Luka Stock Exchange 1,764 EUR million. Total market capitalisation in Bosnia and Herzegovina stood at 29.6% of GDP at the end of 2011 (down from 44% in 2010). The total volume of stocks traded on the two markets was USD 60 Mill. Both government bond markets and money markets remain at very early levels of development. The former still lacks progress in the secondary segment in particular, such as the development of an OTC market, increased transparency through quoting on official sites, and liquidity. Money markets remain shallow with benchmark indices non-existent and liquidity lacking. Corporate bond markets remain nascent with no issuances seen over the last five years.

ANNEX 3 – LEGAL TRANSITION

This annex presents an analysis of selected legal topics directly relevant to the Bank’s investment strategy for the new period. In the case of Bosnia and Herzegovina, the legal framework for secured transactions, corporate governance, insolvency and capital markets will be relevant to the Bank’s plans on restructuring and expanding the local private sector. Legislation on public-private partnerships will be crucial to the development of infrastructure needed for linkages with wider regional markets. Finally, energy efficiency and renewable energy legislation will play a significant role in the promotion of a more efficient and sustainable use of resources.

Secured transactions

Bosnia and Herzegovina is equipped with a modern and unified legal framework for secured transactions based on a national Framework Pledge Law. It adopts a so-called “functional” approach to security, providing the same regime for possessory pledges (when the debtor must transfer the collateral to the creditor or a third party), non-possessory pledges, liens, leases and other security rights. A pledge can encompass tangible property, bank accounts, account receivables, or shares in a company with limited liability. The law leaves the parties with great freedom to define both the object of the security (specifically or generally, including as a pool of fluctuating assets) and also the secured debt (including revolving loans and credit lines).

In practice, enforcement may be the weakest link of the regime because the judicial system has difficulty coping with the regime’s demands, in particular in terms of speed. Debtors are thus often able to obstruct enforcement process.

Corporate Governance

Each Entity regulates its own corporate governance regime and has its own Securities Commission. The EBRD’s 2007 Corporate Governance Sector Assessment ranked both entities as in “*medium compliance*” with the OECD Principles of Corporate Governance, and the regulatory framework does not appear to have changed significantly since that assessment. The EBRD’s 2005 Legal Indicator Survey revealed that judicial procedures in both entities can be complex and lengthy, and that enforcement can be problematic.

The practice of separate audit boards including "outsiders" instead of audit committees made of (independent and qualified supervisory board members remains an issue in B&H company law. Best practice suggests that the audit board should include only board members if the functions delegated to the audit board are typical board functions. Secondly, it is essential that those members sitting in the audit board and recommending specific actions to the supervisory board, then follow up and vote the recommendations at the supervisory board, therefore reinforcing the “objective judgement” that independent directors should provide. Finally, presence of outsiders can create problems with confidentiality and accountability. While it is legitimate that the committee might need external advice or expertise on specific issues, it should be able to request such advice, but it should not allow the advisor(s) to replace the committee in its determinations and recommendations.

The key concern about the corporate governance framework in Bosnia is its effectiveness. Authorities should identify the major weaknesses affecting corporate governance practices of

companies and banks and tackle them with targeted and effective legislation. Further, they should ensure that the legislation is duly implemented. Corporate governance codes can be a very useful tool to promote the dialogue between companies and authorities, however proper resources should be assigned to ensure the effectiveness of this dialogue.

Insolvency

The Insolvency Law of 2005 (as amended in 2010) consolidates the law for the two entities. The EBRD's Insolvency Sector Assessment completed in late 2009 concluded that the Insolvency Law provisions were of high quality and contained many of the elements that international insolvency standards and best practices recognise as critical to a well-functioning insolvency legal regime.

The law provides for entry into bankruptcy, leading either to the 'liquidation' of the debtor or reorganisation, one of the main objectives of which is preservation of the activities of the debtor's business. There is no separate or fast-track reorganisation procedure; ordinary bankruptcy proceedings may be converted into reorganisation proceedings, as the debtor may file a reorganisation plan together with its proposal to open bankruptcy proceedings. Where time is of the essence, the absence of a separate reorganisation procedure may give rise to undue delays. The World Bank 'Doing Business Report' 2013 suggests that efficiency of court proceedings is an issue and cites bankruptcy cases lasting on average 3.3 years.

Whilst the EBRD assessment praised provisions regarding commencement of proceedings, treatment of creditors and avoidance of pre-bankruptcy transactions, it identified reorganisation as an area where the law could benefit from reform, to include amongst other matters provisions for independent analysis of a proposed reorganisation plan, to restrict voting by connected parties and to contain provisions to allow post-approval modification of a plan. The reorganisation plan requires the support of a simple majority of creditors in each class representing an aggregate amount of claims that is greater than the total claims of any dissenting creditors.

Furthermore the EBRD assessment also revealed that the legislative framework relating to insolvency administrators is weak and should be improved. There is at present no dedicated regulatory body for insolvency practitioners and no provisions for professional standards or ethical codes of conduct.

Capital Markets

In the FB&H, the securities markets regulator is the Securities Commission, while the Banking Agency of the FB&H oversees the banking sector. The basic legislation on the securities market is the Law on Securities Markets, enacted in December 2008. The law regulates trading and issuance of securities and aims at aligning national legislation with the *Acquis Communautaire*. Other relevant laws include the Law on Companies, the Law on Takeovers and the Law on Investment Funds. The only stock exchange in the FB&H is the Sarajevo Stock Exchange. The securities markets legislation lacks comprehensive provisions governing issuance and trading of bonds. There is also uncertainty in terms of enforceability of derivatives transactions and close-out netting. Moreover, initial public offerings are not common in the FB&H and the required content of the prospectus does not provide sufficient information to investors in terms of risks associated with a potential investment. In terms of

markets itself, primary government debt issuances only began in 2011, mostly limited to short term T-bills.

In the RS, the securities market regulator is the Securities Commission of Republic of Srpska, while the banking regulator is the Republic of Srpska's Banking Agency. The basic legislation on the securities markets is the Securities Market Law, redrafted in 2006 and then amended in 2009. This Law regulates the issuance and trading of securities, the conduct of participants on the securities market, the functions of the stock exchange and the central registry of securities and details rules for transparency of the market and protection of investors. Other relevant laws include the Law on Companies, the Law on Takeovers and the Investment Funds Act. In 2011 the RS adopted a law governing the primary market of treasury bills. There is only one stock exchange in the Republic of Srpska, the Banja Luka Stock Exchange. Similarly to the FB&H, the major flaws are the lack of comprehensive legislation on bonds and provisions providing for enforceability of derivatives. Similarly, primary government debt issuances in the RS also began in 2011.

It is advisable that both regulators consider improving the required content of the prospectus to the level that would allow potential investors to take an informed investment decision when purchasing securities. This would, for example, entail to include higher disclosure standards required from prospective issuers. The legal framework governing enforceability of derivatives and close-out netting could be considered to be developed in the longer term.

Public-private partnerships (PPPs)

PPPs/concessions in Bosnia and Herzegovina are regulated by a composite set of laws, reflecting the country's complex federative structure. The Concession Law of Bosnia and Herzegovina of 2002 is the central piece of legislation at the federal level, co-existing along several acts at the entity and regional levels. Overall, the laws of Bosnia and Herzegovina in the PPP/concessions sector are a step forward in the development of a modern legal system and demonstrate the intention to create a reliable legal basis for granting a concession that could attract foreign investment. Benefiting from expertise of international advisors who participated in their drafting, these laws relatively clearly define the scope of application, regulate the procedure for selection of a private partner and set up quite flexible framework for project agreements. Moreover, these laws clearly refer to the principles of transparency, non-discrimination, proportionality and refer to consumers' rights.

However, market cooperation in Bosnia and Herzegovina is still in the early stages of development and the PPP/concessions are relatively new models for the country. The Policy Paper on Granting Concessions in Bosnia and Herzegovina of 2006 adopted by the Concession Commission of Bosnia and Herzegovina Commission on Concessions and adopted by the Council of Ministers of Bosnia and Herzegovina and the House of Peoples of the Parliamentary Assembly of Bosnia and Herzegovina in 2006 has identified a general policy framework for improving the legal environment and promoting PPP. The paper states that there are still many issues to be resolved in order to improve the business climate in Bosnia and Herzegovina. In the recent EBRD PPP/Concessions Laws Assessment throughout the EBRD countries of operation, the quality of laws of Bosnia and Herzegovina was rated as "in medium compliance with the international best standards", and their workability in practice was ranked "medium effectiveness," largely due to somewhat unclear PPP policy, inconsistent legal framework as well as underdeveloped institutional capacity.

One of the issues faced by the country is the co-existence of several legislative acts regulating similar issues at various levels. For instance, it is not entirely clear whether the Law on Public Procurement of Bosnia and Herzegovina of 2004 applies to concession awards, particularly given the existence of separate concessions legislation. Moreover, the definition of a concession in the concessions laws in Bosnia and Herzegovina includes also other forms of agreements on public-private partnership. Thus, harmonisation of sectoral laws remains necessary in order to avoid overlaps, inconsistencies and loopholes. With the EU accession having been put as a priority for the country by the state authorities, aligning national legislation with the *acquis* is one of fundamental goals of the government, including in the PPP/concession sector.

Energy Efficiency and Renewable Energy

The government places sustainable energy development high on the policy agenda but further efforts need to be made to establish coherent and comprehensive energy efficiency and renewable energy policy, legal and regulatory framework as well as adequate institutional capacity, along with aligned incentives for project implementation.

In energy efficiency, the government should focus on improving the formulation, implementation and on-going review of country-tailored energy efficiency policy and objectives, which should serve as a basis for developing a specialised legal and regulatory framework aligned with the EU Directives. The state and entity governments have to ensure that the proper institutional capacity is in place for implementation of the policy objectives. Campaigns focused on raising awareness of the benefits of energy efficiency improvements in various industries and households will be a crucial factor for achieving these objectives.

For renewable energy, the country should enhance its efforts on aligning the policy and legal framework with its international commitments and the EU *acquis*. Particular attention should be given to setting appropriate financial incentives for project implementation and attracting relevant funding, including from local banks. Institutional arrangements need to be in place to ensure aligned efforts on both policy and regulatory framework formulation and implementation. Appropriate capacity building for market players and raising awareness campaign would benefit the establishment of a well-functioning renewable energy sector.

ANNEX 4 – SMALL BUSINESS SUPPORT

The EBRD promotes economic transition by assisting enterprise change in viable micro, small and medium enterprises and contributing to the development of a sustainable MSME support infrastructure through the mechanisms of Small Business Support (SBS): The Enterprise Growth Programme (EGP) and Business Advisory Services (BAS).

Previous SBS experience in Bosnia and Herzegovina

The EBRD initiated SBS activities in Bosnia and Herzegovina in 1997 with the EGP, followed by the launch of BAS in 2001. To date, SBS has raised more than €7.7 million in donor funding from the EU, the EBRD Shareholders' Special Fund, Luxembourg, the Netherlands, Japan and other. This has been further matched by almost €3 million in client contributions.

To date, the EGP has carried out 47 projects, mainly in the manufacturing industries. Most projects aim at improving sales and marketing practices as well as organisational and management structures. At completion, 65 per cent of managers rated the EGP project as successful or highlight successful. Assisted enterprises increased turnover by 14 per cent and exports by 38 per cent on average. In addition, 18 per cent of EGP beneficiaries received financing in excess of €1.3 million. The EGP has further organised a number of sector development activities (SDA) and business matching trips.

BAS has implemented more than 600 projects, mainly in the area of implementation of international standards, market analysis and computerised financial systems across a wide number of industries. 508 projects have been evaluated to date, of which more than 74.5 per cent were rated successful or highly successful. 70 per cent of BAS assisted enterprises have reported an increase in turnover, and 64 per cent an increase in their workforce. BAS thereby contributed to the creation of more than 1,500 jobs. In addition, 27 per cent have received financing in an average amount of more than €600,000. BAS has also undertaken 28 market development activities (MDAs) to help develop an adequate MSME support infrastructure.

In terms of cross-cutting issues, BAS has supported gender equality through a dedicated Women in Business (WiB) Programme. Conclusions from this and previous WiB programmes include that women in particular have limited knowledge and resources for development of their businesses. They mostly lack confidence and/or knowledge in basic business functions, such as marketing and sales strategies, management skills and business planning. In addition, it has become clear that women-supporting programmes should be linked with financial institutions in order to maximise their impact.

Lastly, SBS puts strong focus on rural development outside of the main cities.

MSME and Consulting sector in Bosnia and Herzegovina

The MSME sector

MSMEs play an important role in the domestic economy, though official statistics on the sector in Bosnia and Herzegovina remain scarce. According to the latest SME strategy, which expired in 2011, micro enterprises account for more than 93.6 per cent of total enterprises. Most SMEs are in the trade sector. Exported products are usually of low value added and

some industries are facing increasing difficulties in light of Croatia's accession to the EU and the subsequent loss of a major trading partner within the CEFTA region. Most enterprises are family-run with little delegation and division of labour, and enterprise performance is constrained by the lack of adequate management processes, efficient production and comprehensive distributions and marketing channels.

The consultancy market

The country's consultancy sector faces medium transition challenge with regard to local consultant services. The spectrum of services is adequate but the sector lacks any expertise in more sophisticated and advanced consulting services and any formalisation. Consultants qualified for implementation of quality management systems are widely available and the quality of ICT and engineering services is gradually improving. Conversely, general- and human resource management consulting is almost non-existent. Further areas lacking expertise include the implementation of feasibility studies and partner search, as well as advanced marketing services. Demand amongst MSMEs for consulting services in the field of introduction of European standards, in particular in the food and beverage and wood processing industry, remains strong but many entrepreneurs have not yet recognized the need to seek external advice for more sophisticated business aspects, such as strategic planning, branding and marketing. Female participation in the sector is adequate and many consultancy services are available outside of the capital, mainly attributed to the specific structure of the country. Lastly, a local consultant association exists but with minimal membership, in particular from Republika Srpska, and very limited activities.

Infrastructure of MSME support

Due to the complex political structure of Bosnia and Herzegovina, institutional support for the development of the MSME sector remains scattered and uncoordinated. At state-level, the Ministry for Foreign Trade and Economic Relations coordinates SME-related policies and the implementation of the Small Business Act (SBA). There is no SME agency at state-level, though an SME Council with a coordinative function amongst entities has formally been created but in practice has not yet started to work. Individual policies and strategies are implemented at entity-level. Both entities have an SME strategy in place, but only Republika Srpska has an agency to effectively support the implementation of SME policies. In addition, SMEs representation at both state- and entity level remains highly limited and as a result, public-private dialogue on SME development is almost non-existent. A recently launched Association of business women aims at assisting female entrepreneurs to position themselves in the market has not yet become self-sustainable.

The international donor community continues to play an important role in assisting the development of the private sector in Bosnia and Herzegovina. A number of bilateral and multilateral donors are still active in the country, supporting SME and consultancy activities through a large variety of instruments and programmes.

Continuation of SBS in Bosnia and Herzegovina

The EBRD will continue supporting the country's MSME sector through direct enterprise support and systemic market development interventions through SBS, thereby contributing to the development of a competitive and sustainable private sector and supporting the implementation of the SBA. In close cooperation with other donors and national authorities,

SBS will in particular focus on increasing export activity, product development and marketing as well as on fostering innovation in the domestic MSME sector, and will work with enterprises in priority sectors such as agribusiness, wood and metal processing and ICT. Particular focus will be placed on facilitating client access to finance through the Bank and its partner financial institutions in Bosnia and Herzegovina, and the EBRD will continue to implement the BAS/LEF accounting improvement programme (AIP) as a pre- and post-investment tool to raise enterprise financial management practices and standards. Cross-cutting issues such as environmental improvement, rural development, gender equality and young entrepreneurship will continue to be addressed in SBS's activities. In particular, BAS will seek to continue its Woman in Business programme in cooperation with the Financial Institutions team to further facilitate access to finance.

Through the EGP, the Bank will further support the transfer of management skills and specific industry knowledge, and will work with mid-sized corporates that have good export- and high growth potential. It will assist them in internationalising their products by enhancing enterprises exposure to international best practises and creating linkages with other companies in the region and the EU markets. Furthermore, EGP assistance will focus on types of services such as business planning, financial management and sales and marketing strategies.

The Bank will further enable MSMEs to access consulting services by facilitating projects with local consultants through the BAS instrument. A flexible grant scheme will be applied through annual updates of the Grant Guideline Matrix to prioritise intervention and avoid duplication of efforts with international donors and governmental organisations. Typically, higher grants will be allocated for smaller enterprises located outside of Sarajevo and for projects involving consultancy services where market demand is less mature. These include in particular Energy Efficiency and Environmental Management, but also sophisticated services related to marketing and branding, and ICT systems.

BAS will focus on developing a sustainable and commercially viable local business advisory services market. It will also build further existing partnerships with relevant local institutions to strengthen institutional support in order to sustain assistance to the industry in the long-term. BAS assistance at market level will include:

- (i) *visibility and dissemination* to promote the use of business advisory services, especially in less developed areas, and to stimulate demand for more sophisticated consultancy services;
- (ii) *consultancy capacity building* focused on trainings in sales and marketing of consultancy services as well as energy efficiency and environmental management and
- (iii) *MSME trainings*, which will mainly focus on addressing cross-cutting issues such as women in business, rural development, energy efficiency and environment protection.

ANNEX 5 – TECHNICAL COOPERATION

TC COMMITMENTS BY DONOR THROUGH EBRD, 2010-2012

Donor	TC Commitments (€)
Austria	451,400
Central European Initiative	45,000
Czech Republic	298,400
EBRD Shareholder Special Fund	1,457,141
EU	3,612,400
European Western Balkans Joint Fund	1,167,593
Italy	50,000
Luxembourg	250,000
Netherlands	746,929
Spain	206,000
Sweden	566,000
Grand Total	8,850,863

TC COMMITMENTS BY SECTOR THROUGH EBRD, 2010-2012

Sector/Team	TC Commitments (€)	
SME Development *	EGP/BAS	3,151,579
Financial Institutions	Financial Institutions	980,000
LTT	LTT	68,550
Infrastructure	MEI	4,310,734
Other	Other	340,000
Grand Total		8,850,863

Note: Commitment values based on year end or period end data for each year.

* This sector category encompasses direct assistance to SMEs and indirect assistance through policy dialogue between the EBRD, the authorities and commercial/business associations (e.g. Investment Councils)

ANNEX 6 – SELECTED ECONOMIC INDICATORS

BiH	2007	2008	2009	2010	2011	2012	2013
						<i>Estimate</i>	<i>Projection</i>
Output and expenditure	<i>(Percentage change in real terms)</i>						
GDP	6.2	5.7	-2.9	14	13	-0.5	0.1
Private consumption	0.9	-0.1	-3.5	-12	3.5	-12	n.a.
Public consumption	7.0	9.2	3.9	12	3.6	-18	n.a.
Gross fixed capital formation	37.8	13.2	-21.4	-8.0	-6.4	2.3	n.a.
Exports of goods and services	11.6	8.2	-5.8	8.0	2.7	-7.5	n.a.
Imports of goods and services	12.3	3.9	-11.0	-0.6	3.3	-4.8	n.a.
Labour Market¹	<i>(Percentage change)</i>						
Gross average monthly earnings in economy (annual average)	9.8	7.0	17.9	11	4.4	n.a.	n.a.
Real LCU wage growth (approx)	8.6	9.2	5.4	-11	-14	-0.5	n.a.
	<i>(In per cent of labour force)</i>						
Unemployment rate (end-year)	29.0	23.4	24.1	27.2	27.6	27.6	n.a.
Prices	<i>(Percentage change)</i>						
Consumer prices (annual average)	15	7.4	-0.4	2.1	3.7	19	17
Consumer prices (end-year)	4.9	3.8	0.0	3.1	2.7	18	18
Fiscal Indicators	<i>(in per cent of GDP)</i>						
General government balance	0.2	-3.7	-5.9	-3.9	-3.1	-2.8	n.a.
General government revenues	46.9	45.9	45.0	46.7	46.5	45.7	n.a.
General government expenditure	46.7	49.6	50.9	50.6	49.5	41.9	n.a.
General government debt	32.8	31.1	36.0	39.4	40.3	44.3	n.a.
Monetary and financial sectors	<i>(Percentage change)</i>						
Broad money (M2, end-year)	20.7	4.1	2.2	7.2	5.8	3.4	n.a.
Credit to the private sector (end-year)	28.8	22.4	-3.2	3.5	5.3	2.9	n.a.
	<i>(In per cent of total loans)</i>						
Non-performing loans ratio	3.4	3.0	4.5	9.1	12.0	13.5	n.a.
Interest and exchange rates	<i>(In per cent per annum)</i>						
Local currency deposit rate	2.0	1.9	2.0	1.6	1.4	1.5	n.a.
Foreign currency deposit rate	2.0	2.1	2.4	2.0	1.6	1.7	n.a.
Local currency lending rate	8.3	8.2	8.5	8.7	8.2	8.1	n.a.
Foreign currency lending rate	8.4	8.8	9.0	8.5	8.2	7.8	n.a.
Money market rate	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	<i>(KM per US dollar)</i>						
Exchange rate (end-year)	1.3	1.4	1.4	1.5	1.5	1.5	n.a.
Exchange rate (annual average)	1.4	1.3	1.4	1.5	1.4	1.5	n.a.
External sector	<i>(In per cent of GDP)</i>						
Current account	-10.7	-14.1	-6.6	-5.6	-9.6	-9.7	n.a.
Trade balance	-37.2	-38.3	-27.8	-25.8	-27.9	-28.1	n.a.
Merchandise exports	39.6	37.3	33.5	44.3	47.0	53.9	n.a.
Merchandise imports	-64.9	-66.2	-51.6	-55.7	-61.3	-63.0	n.a.
Foreign direct investment	13.6	5.4	1.4	1.5	2.1	1.5	n.a.
Gross reserves, excluding gold (end-year)	30.5	25.3	18.6	19.1	17.5	19.2	n.a.
External debt stock	51.4	46.7	55.8	52.3	46.5	51.8	n.a.
Public external debt	18.2	17.2	21.8	25.6	26.1	28.5	n.a.
Private external debt	33.3	29.6	34.0	26.7	20.4	23.3	n.a.
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	4.3	6.0	5.9	5.4	5.4	5.1	n.a.
Memorandum items	<i>(Denominatio as indicated)</i>						
Population (end-year, million)	3,842	3,774	3,768	3,760	3,752	3,752	n.a.
GDP (in billions of Marks)	218	24.8	24.1	24.6	25.5	26.4	n.a.
GDP per capita (in US dollars)	3,901.6	4,741.4	4,375.5	4,271.9	4,654.4	4,461.2	n.a.
FDI (in million of US dollars)	2,083.1	1,006.4	251.4	230.5	380.2	256.5	n.a.
External debt/exports of goods and services (in per cent)	138.1	126.5	173.4	138.4	117.6	129.9	n.a.
Broad money (M2, end-year in per cent of GDP)	54.7	50.2	52.8	55.4	56.6	56.6	n.a.

¹ Figures do not include emigrant workers abroad.

ANNEX 7 – GENDER EQUALITY

Gender Inequality and Human Development

According to the UNDP 2012 Human Development Index (HDI)²⁰, Bosnia and Herzegovina is among those countries with high human development index. It is ranked 81st out of 187 countries, which is slightly below the regional average for Europe and Central Asia. The HDI is comprised of three dimensions: health, education and decent standard of living.

Labour force participation and gender pay gap

According to the Labour Force Survey (LFS) done by the Agency of Statistics of Bosnia and Herzegovina, in 2012 32.6 per cent women aged 15 years or older participated in the labour force as compared to 56.4 per cent of men in the same age group. Employment rate of women for the same year was almost one half lower than male employment rate (22.6 per cent of females and 41.5 per cent of males were employed). The unemployment rate for women was 30.7 per cent compared to 26.4 per cent for men. Occupational segregation shows similar patterns with women mostly clustered in low prestige low paid jobs. 60.6 per cent of working women are employed in the service sector, 22.7 per cent works in agriculture and 16.7 per cent work in industry, while 42.3 per cent of working men are engaged in the service sector, 38.3 per cent works in industry and 19.3 agriculture. In 2012, 25.1 per cent of employed men were registered as self-employed compared to 18.6 per cent of women. According to a 2012 Eurofund study, women earned an average of 20 per cent less (estimation) compared to men.

According to UNESCO statistics, in 2011 there were no major differences in the gross enrolment ratios of girls and boys in primary and secondary schools. As far as tertiary education is concerned, in 2011 the gross enrolment ratio for men was 33 per cent and for women it was 43 per cent. According to UNESCO statistics, in 2011 women enrolled in tertiary education outnumbered men in health and welfare, education and humanities and arts, while men were mostly enrolled in services, engineering, manufacturing, construction and agriculture.

Entrepreneurship, access to finance

According to the 2009 Business Environment and Enterprise Performance survey (BEEPS) 38 per cent of the 361 surveyed firms had female participation in the ownership compared to 36 per cent for Eastern Europe and Central Asia. 14 per cent of firms had a female top manager compared to 18.9 per cent for Eastern Europe and Central Asia. The proportion of permanent full time workers that are women was 32.2 per cent in 2009 compared to 38.2 per cent, the average for Eastern Europe and Central Asia.

According to BEEPS 2009 58 per cent of female owned firms applied for loans compared to 56 per cent of male owned firms and 51 per cent of the female managed firms applied for a loan compared to 57 per cent of male managed firms. 11.5 per cent of loan applications submitted by female owned firms were rejected compared to 17.4 per cent of applications submitted by male owned firms. The gap is bigger when looking at firms with women top

²⁰ According to the HDI, countries fall into four broad human development categories: Very High Human Development, High Human Development, Medium Human Development and Low Human Development

managers: 24 per cent of applications by women managed firms were rejected compared to 14 per cent of application submitted by men managed firms.

		Owner of firm	
		Female (38%)	Male (60.9%)
Applied for loans		58%	56%
	Loan application rejected	11.5%	17.4%
		Top manager of firm	
		Female (14%)	Male (86%)
Applied for loans		51%	57%
	Loan application rejected	24%	14%

Source: BEEPS 2009