Bridging to the European Union:

Macroeconomic Challenges for Bosnia and Herzegovina

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LIST OF ACRONYMS AND ABBREVIATIONS

CENTRAL BANK OF BH	**CBBH**
COMMON FOREIGN AND SECURITY POLICY	**CFSP**
CONSULTATIVE TASK FORCE	**CTF**
CONSUMER PRICE INDEX	**CPI**
EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT	**EBRD**
EUROPEAN COMMISSION	**EC**
EUROPEAN FREE TRADE AREA	**EFTA**
FOREIGN DIRECT INVESTMENTS	**FDI**
GROSS DOMESTIC PRODUCT	**GDP**
GROSS DOMESTIC PRODUCT PER CAPITA	**GDP p/c**
GROSS NATIONAL INCOME	**GNI**
GROSS NATIONAL INCOME PER CAPITA	**GNI p/c**
INTERNATIONAL LABOR ORGANISATION	**ILO**
INTERNATIONAL MONETARY FUND	**IMF**
LATVIA+LITHUANIA+POLAND	**EU**
LIVING STANDARD MEASUREMENT SURVEY	**LSMS**
MID-TERM DEVELOPMENT STRATEGY BH	**MTDS/PRSP**
ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT	**OECD**
POLICE AND JUDICIAL CO-OPERATION IN CRIMINAL MATTER	**PJCCM**
SMALL AND MEDIUM ENTERPRISES	**SME’s**
STABILISATION AND ASSOCIATION AGREEMENT	**SAA**
UNITED NATIONS DEVELOPMENT PROGRAM	**UNDP**
UNITED NATIONS STATISTICS	**UNSTAS**
WORLD BANK	**WB**

EXECUTIVE SUMMARY

The paper analyses major macroeconomic challenges in Bosnia and Herzegovina's way towards the membership in the European Union and European Monetary Union. Economic challenges are related to the capability of BH economy to meet economic criteria for membership defined by European Commission in Copenhagen and Maastricht.

Comparative analysis of key economic indicators of Bosnia and Herzegovina with the European Union countries (EU 25), new member states (EU 10), less developed member states (“EU 3”) and candidate countries (Bulgaria, Romania and Croatia) shows that BH lags behind in economic development compared to all the listed country groups, with the lag being the smallest compared to candidate countries. BH has the poorest indicators in comparison with the listed countries in GDP per capita level, unemployment rate and external balance. BH does not lag behind the listed country groups in indicators of general price levels, budget deficit and public debt, with BH public debt being somewhat higher than these countries’ average. BH’s starting position on the way towards European integrations is far worse than that of present candidate countries. As it were, one cannot expect BH, neither in a short nor in medium term, to reach the economic performance of the listed countries that can be taken as a *benchmark* for future BH European integration.

In the context of Copenhagen criteria, BH already has a significant head start in price stability, budget deficit, public debt, liberalization of prices and foreign policy, and trade integration on Union market. However, the major challenge for BH economic policy will include the reduction of deficit in the current account balance, reducing the gap in GDP p/c, reform of small and medium enterprises related to administrative procedures, costs and time needed for

registration, further infrastructure reform, strengthening of competition, strengthening of suitable capacity of physical and human capital in the country and, finally, strengthening of non-bank financial institutions. With all this in mind, one can hardly claim that there is a "functional market economy" in the full sense of the word, and that in an environment such as this BH companies "can cope with competitive pressures and market forces in the Union". The challenges that BH has to solve will certainly result in progress related to market economy functionality and better prerequisites for strengthening private sector competitiveness.

BH can already meet the nominal Maastricht convergence criteria, except for the criterion of long-term interest rate. The level of inflation, budget deficit and public debt, as well as the independence of Central Bank of BH, are sub-criteria that are already within the defined convergence limits. On the other hand, the real convergence in foreign exchange rate stability is satisfactory, while the GDP p/c level is far below the level of the least developed countries and will be possible only with the economic growth rates sustainable in the long term.

Key words:

Bosnia and Herzegovina (BH), economic criteria for membership, European Union, nominal and real convergence criteria, European Monetary Union, economic challenges

INTRODUCTION

The main goal in transition countries' foreign policy after the end of socialism is full membership in the European Union. There are plenty of reasons for such an orientation. In simplest terms – European agreements mean transition countries' hope that they will soon belong to the Union and be able to participate in financial resources and other benefits of integration in this market. Bosnia and Herzegovina's strategic goals also include membership in European Union. It is one of few goals that the entire country agrees upon, both its public and the relevant social subjects. However, the clear goal itself does not suffice; its achievement in the defined time period requires exceptional efforts. It seems that problems for Bosnia and Herzegovina start as early as at this point, primarily due to insufficient efforts directed towards fulfilling prerequisites for membership. This is particularly evident in the field of the economy, an area that will surely be a determining factor influencing the actual duration of this process. As opposed to many others, it is not possible to meet economic criteria for Union membership overnight, nor in a short run. Meeting the set criteria in a defined period requires a long-term engagement. The time has come for relevant government institutions to seriously consider the economic aspect of integration, in order to speed up the process in future. Bosnia and Herzegovina is already lagging far behind in its economic performance, both compared to European Union countries and compared to countries – membership candidates. This makes the economic aspect of European integrations even a greater priority for discussion in Bosnia and Herzegovina.

Integration's economic challenges include meeting the Copenhagen criteria as a prerequisite for European Union membership, and then the Maastricht criteria as a further inevitable step, i.e. membership in the European Monetary Union. Bosnia and Herzegovina is already capable of fully meeting some of the prerequisites listed above, such as price stability, public finance stability, price and trade liberalization. Prices are recently registering a slight growth of up to 1%, budget deficit is at the level of 3% of GDP, while public debt has been reduced to around 60% of GDP value. On the other hand, there are many fields with poor results, and the problems are present starting from the level of GDP p/c, which amounts to only 8% of the EU average, then external imbalance with the current account deficit of over 17% of GDP, competition, large-scale privatization, business sector, etc. All these are challenges facing BH today, challenges that it must accept and find an appropriate response that would allow it to move towards improving the economic aspect, where problems have been registered as soon as possible. It is the intention of this paper to identify economic challenges to EU integration and to offer appropriate recommendations for improvements in this respect.

The first section of the paper offers an overview of BH economic development 2000-2004. After a brief review of BH basic economic performances for the period under review, the second section is focused on the analysis of BH economic indicators in the "European environment". Actually, a comparative analysis of BH and European Union countries (EU 15, EU 25, "EU 3") and candidate countries provides an insight into the position of Bosnia and Herzegovina with respect to these countries. The main goal of this comparison is to objectively determine how far, or how close Bosnia and Herzegovina is to these countries, as well as where the biggest problems or advantages are compared to them. The third part of the paper includes economic criteria for membership in the European Union and European Monetary Union and their meaning, while the next section analyses Bosnia and Herzegovina in terms of these criteria. The last section of the paper contains recommendations for advancing the BH position on its way towards the EU.

The part of the paper including the review of economic indicators for Bosnia and Herzegovina for 2000-2004 period used the analytical method of processing economic indicators. The comparison with other EU countries and candidate countries used the comparative analysis, in order to be able to objectively determine BH position compared to the countries under observation. The section analyzing economic membership criteria used *Transition indices* relevant for the topic, based on which we calculated the index of BH's deviation from transition countries that are now EU members, and transition candidate countries. We also used the projection method for potential fulfilling the criteria in observed areas. Besides the described approach, we used European Commission reports as examples and, naturally, sub-criteria that can be derived for processing economic criteria for membership, and analyzed relevant BH indicators for the past few years. This part of paper includes an analysis of relevant prerequisites for membership in EU and EMU on the example of Bosnia and Herzegovina.

The analysis of such a topic, particularly on the example of BH, is made more difficult for three basic reasons. Firstly, we are faced with insufficiency of all the data relevant for our analysis, primarily due to inadequate domestic statistical support. Secondly, there is no unified or coherent methodology for measuring the fulfillment of economic membership criteria of a country. We therefore had to use the combination of a few methods in order to be able to objectively analyze the research problem, and on that base give relevant recommendations for improvement. Finally, any economic analysis in Bosnia and Herzegovina is difficult due to, as many estimates say, a great participation of informal economy on the market and consequently a potential problem of underestimation of real economic indicators in the country.

Finally, we would like to point out that the paper is focused solely on economic aspects of integration and does not touch upon other areas, including current political problems directly related to Bosnia and Herzegovina's advancement on its way towards EU. All the other problems and areas related to BH "European" road must come to agenda and be resolved in the "right" time; however, this paper did not discuss other areas of European integration.

1. BOSNIA AND HERZEGOVINA – SUMMARY OF ECONOMIC DEVELOPMENT SINCE 2000

Bosnia and Herzegovina is one of the countries in the region that experienced such extensive war destruction in the last decade of the 20th century that has not been seen in the area since the Second World War. Before the war conflicts in former Yugoslavia started, Bosnia and Herzegovina was more developed by its economic performances than some transition countries that are now full EU members. Presently, BH GDP p/c is only 60% of the pre-war level.

The starting economic position of Bosnia and Herzegovina in the environment shifted a few decades back consequent to the war, and the forthcoming processes and phenomena characterizing the present time – transition, liberalization, globalization, trans-nationalization – have taken on a special dimension in such an environment. This is the reality that cannot be ignored. Nevertheless, one thing is certain: the new priority mission in Bosnia and Herzegovina is full membership in European Union.

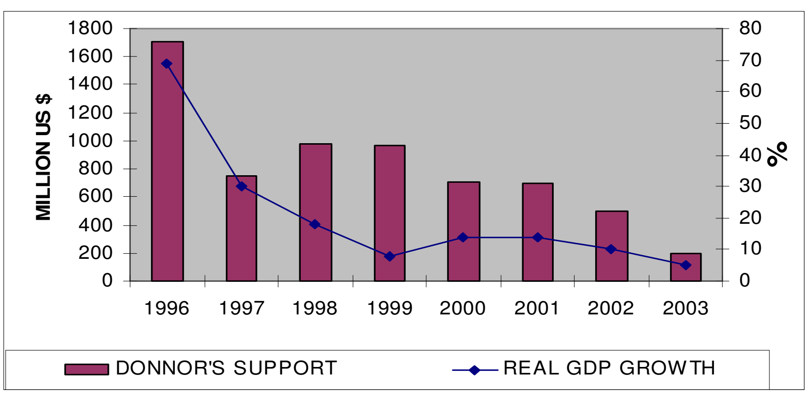
Table 1: Bosnia and Herzegovina, main economic trends 2000-2004

INDICATORS	2000	2001	2002	2003	2004
Real GDP growth rate, % change	5.6	4.5	5.5	3.5	5.7
Inflation rate (CPI), annual average	4.8	3.1	0.4	0.6	0.4
Unemployment rate, official	39.7	40.3	40.9	42.0	43.2
Unemployment rate, grey economy including*	-	22.9	21.1	19.6	-
General government budget balance, % of GDP (before grants)	- 16.5	-10.5	- 7.3	-3.0	- 3.2
General government budget balance, % of GDP (including grants)	- 7.0	- 3.3	- 2.2	0.4	- 0.1
Trade balance, % of GDP	- 36.1	- 36.4	- 37.0	- 35.0	- 35.0
Current account balance, % of GDP, before grants	- 13.8	- 16.7	- 20.3	- 18.2	- 18.7
Current account balance, % of GDP, after grants	- 13.1	- 16.2	- 20.0	- 18.0	- 18.5
External debt, % of GDP	58.8	48.2	42.2	34.0	33.0
Total debt, % of GDP	-	-	-	-	59.7
Debt export ratio, % change	218.5	183.7	171.9	135.8	120.6
FDI inflow, million €	161.1	147.6	219.4	253.4	344.4
FDI inflow, % of GDP	3.2	2.6	4.1	4.5	5.2

* Source: Living in BH – survey, 2003
Source: European Commission, BH statistics

During the first post-war years, Bosnia and Herzegovina registered exceptionally high rates of economic growth (over 80% in 1996). A simple analysis would thus include this economy into the fastest growing ones in the world.[1] However, the economic growth in BH was the result of international community investments into the country reconstruction, primarily into infrastructure, more than the result of investment activity within the country. Another crucial fact that should be kept in mind is that during the war period BH GDP registered an extremely sharp decrease, which by itself shifted the country's starting position to an exceptionally low level. That is why the high growth rate upon the war events is not surprising, even in quantitative terms. However, the high economic growth rates were falling fast and as soon as in 2003 the rate amounted to 3.5%. After the decrease in foreign aid inflow, the GDP growth rate decreased as well, which points to the possibility of positive correlation between the financial aid inflow and the growth of BH Gross Domestic Product.

Graph 1: Real GDP growth and inflow of donors' aid in BH [2]



BH gross domestic product, both the overall and the per-capita one, is still rather low compared to its value before the war[3], as well as to the economy capabilities. As the results of

[1] It was according to the criterion of real GDP growth that London's *The Economist* ranked BH the first in its 2005 report.

[2] Source: *The World Bank's Role in the Development of a Financial Market in Bosnia and Herzegovina*, January 17, 2002, Lecture by Joseph Ingram, Director World Bank Country Office Bosnia and Herzegovina at the Faculty of Economics, Sarajevo

research in business sector show[4], a vast majority of BH companies do not fully utilize their capacities. In the same time, the official unemployment rate is very high; the data show that in 2004 it amounted to 43.2% and was tending upwards. With respect to the labor market one should note that many estimates reveal that the official unemployment in the country has been overestimated. The main reason is the participation of grey economy in overall economic activities in BH, i.e. a great number of officially unemployed people who have some sort of employment in informal sector. World Bank research conducted according to ILO methodology reveals that unemployment in BH in 2003 was below 20%. These data also lead to the conclusion about a significant participation of grey economy in BH, i.e. a great number of officially unregistered persons that have some sort of employment that has not been registered statistically.

Data on the budget deficit presented in the Table 1 indicate positive trends of this macroeconomic indicator, which also shows the readiness of BH economy for future integration into EU and EMU. The high deficit of 7% GDP of 2000 turned into a surplus, and in 2004 the deficit was around 1%. Besides the satisfactory rate of overall budget deficit, the inflation is also pretty stable. The inflation rate measured by CPI index has been below the 1% level since 2002. The exceptional stability of general price level is mostly the result of the restrictive role of Central Bank in BH – Currency Board arrangement - which by definition excludes the inflation due to monetary expansion. The pronounced monetary stability is a crucial determinant of the overall macroeconomic stability in the country. Together with stable inflation, Central Bank of BH registers continuous growth of overall currency reserves.

[3] It is estimated that it reached the value of somewhat over 60% of the pre-war GDP value.

[4] According to the business sector research conducted by UNDP, the degree of capacity utilization in 60% domestic companies is below the level of full use, while only 35% companies fully utilize their capacities. Source: UNDP, Early Warning Systems, Annual report 2004, Sarajevo, 2005, p. 25.

Overall household's savings in Bosnia and Herzegovina are also registering a growing tendency, and were estimated to be at around BAM 2.5 billion level in 2004.

On the other hand, the conditions in foreign economic relations are more than worrying. In 2004, foreign trade deficit surpassed BAM 6 billion or, expressed in relative ratio, it almost reached the level of 50% official GDP[5]. The state of the current account is somewhat better, but still unfavorable for both external and internal BH balance. The current account deficit amounts to the level of 18% GDP, which is high above the average of EU and surrounding countries. The BH economy is obviously still very import-dependant.

> "The review of export structure by customs procedures leads to the conclusion that exports themselves are increasingly dependent on imports. It is concerning that 42% of total BH exports are made up of goods that are imported in order to be processed and finished and then exported, which points to a relative increase of this component in total exports of 16.7% compared to the same period last year."[6]

The total debt expressed in percentage of goods and services exports, has a pronounced decline since it decreased from the level of 218.5% of the total BH exports in 2000 to 120.6% in 2004. Viewed as a GDP percentage, public debt amounted to estimated 60% of BH GDP in 2004. While public debt is registering a falling trend, FDI inflow shows a growing trend. The increase of FDI inflow was particularly prominent in 2004, when total FDI inflow grew by over 35% compared to previous year.[7]

Finally, after the brief review of conditions in BH economy, we deduce that problems are the biggest in real sector (GDP, unemployment, balance of payment). Gross domestic production

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[5] Source: Spoljnotrgovinska/vanjskotrgovinska komora BiH, *Pregled ostvarene vanjskotrgovisnke razmjene za BiH za period I-XII 2003. i 2004. godine*, Sarajevo, February 2005. See the Table 9 in Annexe. Note: According to European Commisssion data, the deficit is smaller and amounts to 35% of GDP of 2004. However, both cases show exceptionally high foreign trade deficit.

[6] Source: Spoljnotrgovinska/vanjskotrgovinska komora BiH, *Pregled ostvarene vanjskotrgovisnke razmjene za BiH za period I-XII 2003. i 2004. godine*, Sarajevo, February 2005, p. 1.

[7] According the data of Ministry of Foreign Trade and Economic Relations BH, 2005, that growth was even higher than 100 % compared to the previous year.

is still low and amounts to about 60% of the pre-war level. The relative growth of real GDP of 5% is insufficient for BH circumstances; unemployment is extremely high and has a growing trend, while there is a big imbalance in external sector, i.e. a high deficit in current and trade account balance. Public expenditure is still high and amount to over 45% GDP, which in turn can lead to further pressure on budgets. On the other hand, bright sides of BH economy include general price levels, minimum budget deficit and falling trend of public debt.

2. POSITION OF BH ECONOMY IN THE "EUROPEAN" ENVIRONMENT

2.1. Bosnia and Herzegovina on its way towards the European Union

Cooperation between Bosnia and Herzegovina and European Union is not recent. The first relations were established as early as with the international recognition of Bosnia and Herzegovina in 1992, although the cooperation was present within former Yugoslavia as well. With the end of the war, the European Union gave a significant support in the processes of signing and implementing the Dayton Peace Accord, which was followed by significant financial aid and other activities in the support to faster country recovery. We will note that Dayton Accord was soon followed by the establishment of CTF – Consultative Task Force, the basic function of which was joint activity on adjusting the overall country legislation to EU requirements through providing technical and professional assistance to local administration in developing the regulatory framework adjusted to EU standards. It was then that a very serious approach to the issues of European integration and assistance started. This was soon followed by the publication of *Road Map* for BH, which included eighteen requirements that were to be met in order for Bosnia and Herzegovina to start preparing the Feasibility Study needed to enter negotiations on the Stabilization and Association Agreement (SAA). By the structure of set requirements, the Road Map was almost identical to

Copenhagen criteria. It included political, economic requirements, and those related to the democratization process, human rights and rule of law. In 2003, after the European Commission report on fulfilling the requirements of 2002 Road Map, the Commission approved the Feasibility Study and identified 16 priority areas of reforms the advancement of which would allow the opening of SAA negotiations. Stating that the Road Map was an "indicator of some hot issues and the measure of political will to solve the issues contained" European Commission declared the start of the Feasibility Study based on which it was to

> "estimate if BH is ready to start negotiations on the Stabilization and Association Agreement (SAA). If BH wants to catch up with neighboring countries, some of which have already entered the transition stage, it has to speed up reforms … and develop truly self-sustainable structures".[8]

Although the Feasibility Study was accepted, it can hardly be claimed that there has recently been any significant progress on the way to European integrations. The basic reason for such a statement is that Bosnia and Herzegovina just entered the negotiations stage on signing the Stabilization and Association Agreement, and it is already quite certain that it lags behind neighbouring countries – Croatia and Serbia and Montenegro.

[8] "Bosnia and Herzegovina – Report on Stabilisation and Association", European Commission, 2003.

2.2. Bosnia and Herzegovina and EU members

The European Union is a supra-national integration that is, by its economic strength, one of the leading economic powers in the world today. Thus, the analyst anticipates likely conclusions of comparing BH economic performances with European Union, which are indeed confirmed objectively. In its economic performances, Bosnia and Herzegovina lags behind the European Union countries, which is particularly prominent in indicators accompanying the real economy.

Table 2: BH and EU (15), EU (25) – key economic indicators in '04

INDICATOR	EU (15)	EU (25)	BH
Real GDP growth rate, % change	2.3	2.4	5.7
GDP per capita, EU 15 = 100, in % of EU 15	100	87.9	7.3
Unemployment rate, % of labor force	9.0	8.0	43.2
Inflation rate (CPI), annual average	2.0	2.1	0.4
General government budget balance, % of GDP	- 2.6	- 2.6	- 0.1
Current account balance, % of GDP	0.4	0.2	- 17.3
Total debt, % of GDP	64.7	63.8	59.7

Source: Eurostat, EC, ECB * Calculations made by the author

If we compare BH data with European Union before its latest enlargement (EU 15), the first thing we observe is an extremely big deviation in the level of GDP per capita. BH GDP per capita is only 7% of the average in the mentioned country group. It is also a good indicator of the level of BH inhabitants' standard of living compared to that in EU 15. Conditions are even worse when one has in mind that the official unemployment in BH is almost five times higher and the deficit in current account balance – unbelievable 43 times higher.

Still, Bosnia and Herzegovina could be equal to this group with respect to macroeconomic indicators: total debt, general government balance and inflation rate. In all the three cases, BH indicators are compatible with the indicators in the 15 EU countries before its latest enlargement.

Finally, we observe that the GDP growth in BH is 2.5 times higher than in EU 15. If these data are approached without a deeper analysis, one could conclude that BH economy is more promising and faster growing than that in EU 15. However, in order to have a true idea of the meaning of these values, two unavoidable facts must be kept in mind. Firstly, BH economic capacities are insufficiently utilized, and secondly, the starting level of GDP after the war was low. In other words, even the registered growth of 5.7% is insufficient for BH, since it is actually approaching EU 15 by the given growth rate minus the growth in EU 15. Having in mind that GDP p/c in BH is only 7% of that in EU 15, it is not difficult to imagine how much BH needs in order to reach the GDP p/c level of the latter countries if the speed of growth remains more or less the same.

If we compare BH economic indicators with the same indicators for European Union, now viewed EU 25, we observe that the position of Bosnia and Herzegovina is somewhat better compared to the results of previous comparative analysis. Thus GDP per capita in Bosnia and Herzegovina is 8.3% of EU 25, which is about 20% better relative ratio than in the previous case. However, the deficit in current account balance is even twice worse than in the previous case, while the other indicators are more or less the same as in comparison to EU 15.

The lag of Bosnia and Herzegovina compared to European Union countries is the most prominent in the real sector, i.e. in the level of GDP per capita, percentage of unemployed labor force, and the state of external balance. On the other hand, BH is fully compatible in the areas of general price level and public finance conditions, i.e. the level of total public debt and budget deficit.

2.3. Bosnia and Herzegovina and less developed member states

Having compared BH economic indicators with European Union countries before and after enlargement, we should pay special attention to the comparison between BH and member states that are the least developed within the Union. We thus compared BH to three countries with the lowest development levels: Latvia, Lithuania and Poland, which we will denote as ''EU 3''.

Table 3: Bosnia and Herzegovina and EU 3 – key economic indicators in '04

INDICATORS	Latvia	Lithuania	Poland	Average of LV, LT, PL	BH
Real GDP growth rate, % change	8.3	6.7	5.3	6.8	5.7
GDP per capita, EU 15 = 100, in % of EU 15	18.8	20.5	20.1	19.8	7.3
Unemployment rate, % of labor force	9.8	10.8	18.8	13.1	43.2
Inflation rate (CPI), annual average	6.2	1.1	3.6	3.6	0.4
General government budget balance, % of GDP	- 0.8	- 2.5	- 4.8	-2.7	- 0.1
Current account balance, % of GDP	- 12.4	- 8.3	- 1.3	-7.3	- 17.3
Total debt, % of GDP	14.4	19.7	43.6	25,9	59.7

Note: Selection of countries and calculations of Average values for Latvia, Lithuania and Poland has been made by the author. A criterion for the selection was GDP p/c in PPP as % of EU 15 GDP p/c in PPP in 2004.
Source: EUROSTAT, EC, ECB.

Compared to average indicators of the three EU countries under observation, Bosnia and Herzegovina is in better position with respect to aggregate indicators of EU 15 and EU 25. GDP per capita in BH is 37% of these countries' average, while it was only 7% compared to EU 15. Deficit in current account is somewhat over twice as high, while in comparison to EU 25 countries the deficit viewed as GDP percentage was over 80 times higher. Unfortunately, the real GDP growth in BH was almost 20% lower from the average of the three countries, where Latvia – as seen in the Table – reached the highest growth rate at the 8.3% level.

BH has an extremely high official unemployment rate, even in comparison to these countries, which themselves have problems with unemployment (13%) compared to the Union average.

It is interesting to note that these countries have the total public debt of only 26% of GDP level; thus BH public debt is twice as high when viewed as a GDP percentage. Conditions in the areas of inflation and budget deficit are stable in both cases, with price growth being far more prominent in EU 3 than in BH.

2.4. Bosnia and Herzegovina and candidate countries

Bulgaria and Romania are candidate countries for EU membership, their accession being expected in 2007. Croatia is also a candidate that expects full membership in 2009-2010. These countries and their success in European integration are undoubtedly extremely interesting for Bosnia and Herzegovina.

Table 4: BH and EU candidate countries – key economic indicators in '04

INDICATORS	Bulgaria	Romania	Croatia	Av. of B+R+C	BH
Real GDP growth rate, % change	5.6	8.3	3.8	5.9	5.7
GDP per capita, EU 15 = 100, in % of EU 15	9.9	10.6	23.7	14.7	7.3
Unemployment rate, % of labor force	11.9	7.1	19.3	12.8	43.2
Inflation rate (CPI), annual average	6.1	11.9	2.2	6.7	0.4
General government budget balance, % of GDP	1.3	- 1.4	- 4.7	-1.6	- 0.1
Current account balance, % of GDP	- 7.4	- 7.5	- 5.7	-6.9	- 17.3
Total debt, % of GDP	38.8	18.5	53.8	37.0	59.7
Source: EUROSTAT, EC, ECB.					

Same as in the EU 3 case, the real GDP growth both in Bulgaria and Romania is higher than in BH, which is certainly an indicator speaking in favor of the assumption that the rate of real GDP growth of about 5% is insufficient for BH economy. GDP per capita in Bosnia and Herzegovina is about 50% of the average of the three countries under observation, which is relatively good with respect, particularly having in mind many estimates pointing to the underestimated GDP level in BH due to a high participation of grey economy in the country. Conditions on the labor market and current account balance in the candidate countries are also significantly worse than in the European Union; with this in mind, the BH deviations compared to these countries are far smaller than compared to previously observed groups of EU countries. Thus the average unemployment in the three countries amounts to about 13% while the deficit in current account balance is about 8%. We observe that Croatia registers the highest unemployment rate. Also, the total public debt is fairly low having in mind the fact that the average public debt of candidate countries is below 37% of GDP.

The general price level rate is the only indicator where Bosnia and Herzegovina has a distinctive advantage compared to candidate countries, owing to the fact that the average inflation rate in candidate countries is 6.7%. General price increase was the biggest in Romania, where it amounted to 12% in 2004. Romania has somewhat better economic indicators compared to Bulgaria, since GDP p/c is higher, economic growth in 2004 was by almost 2 % higher, unemployment is almost 4% lower, while the total public debt amounted to 18.5%. Only the budget deficit is higher in Romania than in Bulgaria, although it is also within permitted limits.

BH’s neighbour Croatia has a significantly higher GDP per capita level than BH, and only half of the unemployment and deficit in payment balance current account. In terms of other indicators, these two countries are more or less equal, with BH having a greater price stability and lower budget deficit, while Croatian total public debt is somewhat lower than that in Bosnia and Herzegovina.

2.5. BH Comparative matrix

After the individual comparative analysis of BH macroeconomic indicators with target groups of countries relevant for the research topic, we made a matrix including the analysis results. Besides the previously reached conclusions, the matrix includes potential dynamics with which Bosnia and Herzegovina can reach the level of individual indicators. In estimating the dynamics, we started from the present economic conditions and assumption of starting actual activities in order to improve conditions in individual economy segment related to observed indicators in the Table 5.

The degree to which it is possible to compare key BH indicators to countries included in the comparative analysis in terms of their worth and indicators quality is rated on a I-IV scale. The rating of dynamics of reaching indicators of the countries included in the comparison is also given on a 1-4 scale. The scale legend can be seen in the Table 5 enclosure.

Table 5: BH comparative matrix

INDICATOR	BH/ EU 15	BH/ EU 25	BH/ EU 3	BH/ CANDIDATES
Real GDP growth rate, % change	III 4	III 4	III 3	III 3
GDP per capita, EU 15 = 100, in % of EU 15	IV 4	IV 4	III 4	II 3
Unemployment rate, % of labor force	IV 4	IV 4	IV 4	IV 3
Inflation rate (CPI), annual average	I 1	I 1	I 1	I 1
General government budget balance, % of GDP	I 1	I 1	I 1	I 1
Current account balance, % of GDP	IV 4	IV 4	III 3	III 3
Total debt, % of GDP	I 1	I 1	II 2	II 2

INDICATORS: I – very successful; II – successful; III - poor; IV – very poor
DINAMYCS: 1 – immediate; 2 – short-run; 3 – mid-term; 4 – long-term

We rated the real GDP growth in BH with "poor" in all cases for the simple reason that economic growth in BH is smaller than in candidate countries and EU 3. On the other hand, BH GDP per capita has the lowest value in all the comparisons we made, and the BH economic growth is therefore insufficient in the sense that the approach to the living standard of EU countries could be anticipated in at least the next 20-30 years.

GDP viewed per capita was rated as "very poor" for EU 15 and EU 25, for a reason that GDP p/c in BH is only 8% of its value in these countries. Conditions related to this indicator are "poor" for EU 3 having in mind the fact that GDP per capita in BH has approached the level of 40% in this case. In comparison with candidate countries, we believe that rating "successful" is satisfactory, since the relative ratio is such that the GDP per capita is at about 50% level without considering grey economy.

The official unemployment in Bosnia and Herzegovina is "very poor" in any case, having in mind the fact that the unemployment rate is already at over 43% level and has had a growing trend in recent years. Indicators – inflation rate and budget deficit – got the highest rating for the simple reason that BH is comparable to any country group in terms of these indicators. Besides these, total debt has also received a fairly good rating owing to the fact that BH total public debt is about 60% of GDP level, which is relatively good, compared to other countries.

Finally, the level of deficit in current account is "very poor" compared to EU 15 and EU 25, while it is somewhat better when compared to EU 3 and candidate countries is thus rated "poor". The deficit in payment balance current account at about 18% level is more than poor indicator and the rating of this indicator is naturally warning for Bosnia and Herzegovina.

In terms of dynamics, i.e. the time period in which Bosnia and Herzegovina can reach the observed countries with special efforts, the conditions are similar to previous ratings.

It is only in the long run that Bosnia and Herzegovina should count on growth rates of EU 15 and EU 25, which are, indeed, lower than in BH but exist in an entirely different economic environment: capacity utilization is far higher. It is difficult to compare these indicators using the static approach, since these are completely different "qualities" of economy. When an economy reaches the level of high capacity utilization, small growth rates can be expected, both according to economic theory and practice. On the other hand, Bosnia and Herzegovina has somewhat lower growth rates than EU 3 and candidate countries, which can hardly be reached before 2007 unless significant changes come about in BH environment. Such an opinion is consequent to the fact that the optimistic scenario of BH development strategy (PRSP) 2004-2007 provided for the economic growth rate of 5.5%.

Bosnia and Herzegovina will not manage to reach GDP per capita of EU 15, EU 25 or EU 3, except in a long run, but we would say in a "very long run". On the other hand, BH could approach the GDP p/c of candidate countries with certain efforts in a medium run, particularly since we constantly keep in mind the fact that a high participation of grey economy results in BH economic indicators being underestimated and that it is always possible to get a clearer statistical picture of it once, which will certainly be in favour of BH.

It is not possible to decrease unemployment to the level of observed country groups, at least in terms of official rate, except in a long run. On the other hand, the inflation rate and budget deficit are at such a level that BH could be compared to EU countries and candidate countries at any time and, certainly, meet Maastricht criteria in this area. Finally, with respect to total public debt, BH is comparable to EU 15 and EU 25 countries in a given moment, while EU 3 and candidate countries register 50% lower public debt.

3. ECONOMIC CRITERIA FOR MEMBERSHIP IN EU AND EMU

3.1. European Union: from Maastricht to current

The European Union was established by Maastricht agreement, which was signed on February 7th, 1992 and came into force on November 1st, 1993. This is also the formal beginning of this supra-national integration existence. The Union is grounded on three pillars. The first pillar includes communities developed after the Second World War, including: European community for coal and steel, EUROATOM and European Community. The second support includes the cooperation of member states in the area of common foreign and security policy (*CFSP – Common Foreign and Security Policy*). Finally, the third pillar implies the cooperation of member states in the area of justice and policing (*PJCCM - Police and Judicial Co-operation in Criminal Matter*). At the time of its establishment, Union was made up of twelve full members – France, Germany, Italy, Belgium, Netherlands, Luxemburg, Great Britain, Ireland, Denmark, Greece, Spain, and Portugal.

The main requirements for EU enlargement were already defined in Article 0. of Rome Agreement of 1957, amended by Amsterdam agreement in 1997,

> "Any European country that respects principles of freedom, democracy, human rights, fundamental freedoms and the rule of law can submit the request for membership in the Union"[9]

At the Council session of 1993, EU made the decision according to which

[9] Source: European Commission, 2001, p. 7

"associated states in central and eastern Europe can become EU members if they want to"[10]

Union openness to other European countries for membership, naturally conditioned with acceptance of European achievements and standards, soon resulted in the first enlargement of 1995, when then neutral states – Austria, Sweden and Finland, otherwise members of EFTA (European Free Trade Area) became full Union members. The first enlargement was followed by preparations for the greatest enlargement in this integration history, which took place in the spring of 2004, when ten new countries were granted the full member status – Malta, Cyprus, Latvia, Lithuania, Slovakia, Hungary, Estonia, Slovenia, Czech Republic, and Poland.

Thus, European Union presently numbers 25 countries, covers a total area of almost 4 million square kilometres, has over 450 million inhabitants, and the total value of GDP amounts to almost $ 11 billion. These impressive indicators will keep changing owing to the recent enlargement with Bulgaria and Romania, and tendencies of other countries to become full members of this world economic "giant".

3.2. Economic criteria for membership

The European Commission concluded that candidate countries have to meet certain criteria in the area of economy. *The Copenhagen economic criteria* imply the "existence of functional market economy and capacities for the economy to cope with competitive pressures and market forces in the Union". When a country has become a full EU member, it has to meet the second set of economic criteria for accession to the European Monetary Union, defined by Maastricht agreement; one should note that this is the obligation of all future EU members,

[10] Source: European Commission, 2001, p. 8

which was not the case before.[11] As opposed to Copenhagen criteria, *Maastricht nominal and real convergence criteria* are far more clearly defined and more accurately determined. With this fact in mind, the literature frequently includes the statement that Maastricht criteria have become "synonym for candidate countries' readiness for EU accession"[12].

Economic criteria for membership in the European Union and European Monetary Union are static; they do not speak much of economy quality and there is a lack academic explanation. Besides, the criteria do not discuss the effect of fulfillment on different countries, having in mind the fact that no country has the same economic environment. Still, it is necessary for every country to re-examine its position with respect to these criteria and meet them in accordance with EU instructions.

Economic criteria defined in Copenhagen can be viewed through a few sub-criteria[13]:

- *Equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalized;*
- *Significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent;*
- *The legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;*
- *Macroeconomic stability has been achieved including adequate price stability and sustainable public finances and external accounts;*
- *Broad consensus exists about the essentials of economic policy;*

[11] It is well known that Denmark, Sweden and Great Britain have not acceded to EMU; this is no longer possible, neither for the ten new member states from the latest enlargement nor for future member states.
[12] See: Institute of Public Finance, Zagreb, *Pridruživanje Hrvatske Europskoj uniji – Izazovi institucionalnih prilagodbi,* Mihaljek, D., Chapter: *Makroekonomski aspekti pridruživanja Hrvatske Europskoj uniji*, p. 30
[13] European Commission, European economy, Enlargement papers, Directorate General for Economic and Financial Affairs**,** *Progress towards meeting economic criteria for accession: the assessment from the 2004 regular reports***,** November 2004, p. 6-7.

- *The financial sector is sufficiently well developed to channel savings towards productive investment.*
- *The existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability;*
- *A sufficient amount, at appropriate costs, of human and physical capital, including infrastructure, education and research, and future developments in this field;*
- *The extent to which government policy and legislation affect competitiveness through trade policy, competition policy, state aids, support for SMEs;*
- *The degree and the pace of trade integration a country achieved with the Union before enlargement. This applies both to the volume and the nature of goods already traded with Member States;*
- *The proportion of small firms, partly because small firms tend to benefit more from improved market access, and partly because a dominance of large firms could indicate a greater reluctance to adjust.*

All the countries - future EU candidates have to accede to European Monetary Union in the second stage and adopt the common currency – Euro (€) – nominal and real convergence. Nominal convergence criteria are the following:

- *Inflation rate during a given year must not surpass 1.5% of average inflation rate in three countries with the most stable prices*
- *Long-term interest rate must not be higher than 2% than the interest rate average in three countries with the most stable prices*
- *Deficit in state budget, regional budget, and local budgets must not surpass 3% of GDP value*

- *The ratio between public debt and GDP must not be higher than 60%*
- *National Central Bank must have full political independence*

On the other hand, real convergence means the decrease in the existing gap in indicators of country's economic development compared to the Union average, including *income per capita and its structure, then wages and prices convergence, foreign exchange rate equilibrium*.[14]

3.3. Understanding of economic criteria

Accession of Bosnia and Herzegovina to European Union has been marked by fulfilling a series of prerequisites – political, economic, social, administrative, institutional, … - that are in daily practice frequently named the "obligations" of a country. The present transition countries indeed have far stricter criteria that have to be met than former membership prerequisites, but the key question that crops up is: are the membership criteria useful for national economies as well, or are they a wasted opportunity to implement their own national strategies?

What can be said of economic membership criteria is that they are set in such a way that they can only be useful for the country, especially in a long run. The essence of the entire process and prerequisites that need to be fulfilled by certain countries on their way towards EU is the achievement of real convergence – i.e. income per capita and living standard of the country under observation coming closer to the average of less developed EU countries. Real convergence can be achieved only with the long-term sustainable and stable growth in the

[14] Gaspar, P., *Real and Nominal Convergence of Pre-Accession Economies and the Choice of Exchange Rate Regime*, International Center of Economic Growth and Budapest University of Economics, p.3.

conditions of macroeconomic stability, which is in both cases a benefit for national economy. On the other hand, non-fulfillment of economic prerequisites for EU membership is both a wasted opportunity for a country on its way towards EU and is a sign of poor results in economic environment from the national economy standpoint – which would particularly be the case in the context of Bosnia and Herzegovina, which has a low starting position in terms of economic performances. However, what still has to be kept in mind is that meeting economic criteria for membership in EU and EMU is a necessary, rather than an absolutely sufficient prerequisite for long-term economic growth and development, particularly due to the fact that these are dynamic categories and reflect the result of activities of complete economic system. The choice of priorities and commitment is up to each country, but the "win-win" combination is clear, as well as a long-term sustainable economic growth and development compatible with economic criteria for membership using the "allowed" dose of flexibility on the way.[15]

[15] For example, Poland has negotiated the 12-year-long transition period for full liberalization of agricultural produce market although the European Commission proposed a seven-year long term. This is a typical example that still shows that European Union also has a dose of flexibility in special circumstances, which of course depends on the country, and on future candidate's capability to manage to achieve national interests in negotiations with EU.

4. BOSNIA AND HERZEGOVINA AND ECONOMIC CRITERIA FOR MEMBERSHIP

4.1. Analysis of economic criteria in the case of BH

In the analysis of Bosnia and Herzegovina readiness to meet the given criteria we will use EBRD indicators on the one hand, as well as other indicators relevant for rating these criteria.

Table 6: EBRD Indices, 2003[16]

EBRD INDEX (1,0 – 4,0)	BH	BH compare to the new EU members* - index	BH compare to the candidate countries** - index
Price liberalization	4.0	94.0	95.2
Forex and trade liberalization	3.7	86.0	88.1
Small-scale privatization	3.0	69.8	76.9
Large-scale privatization	2.3	63.6	67.0
Enterprise reform	2.0	63.9	81.1
Competition policy	1.0	34.3	43.5
Infrastructure reform	2.3	77.8	82.1
Banking sector reform	2.3	66.3	71.1
Non-bank financial institutions	1.7	54.6	72.9
AVERAGE	**2.5**	**67.8**	**75.3**

* Check, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia *** Bulgaria, Romania, Croatia

According to transition indices, Bosnia and Herzegovina shows the best results in terms of price liberalization, where the index for BH is extremely high (4.0). High index is given to the field of foreign trade liberalization (3.7), which is certainly the result of Bosnia and Herzegovina opening in the trade area, which has been achieved through establishing a free trade zone in the region in accordance with the Stability Pact. BH registers a relatively good index in the area of small-scale privatization, while conditions in large-scale privatization are far worse. We observe that the biggest problems are encountered in the area of competition policy, where the index is minimal and amounts to 1.0, and in non-bank financial institutions – 1.7. Finally, it should be added that the average value of analyzed indices is 2.5, which of

[16] Calculations made by the author. Data used for the calculations are available in the Annexe, Table 10.

course is not a good indicator of the functionality of BH market economy, partly including the economy capacity to cope with competitive pressures upon accession to European Union.

However, it is important for this analysis to have the value of these indices for the transition countries that have become full members and for candidate countries and, of course, to compare them with Bosnia and Herzegovina.

- The average value of Bosnia and Herzegovina's index compared to the seven transition countries that are today Union members is 67.8 or, in other words, the indicators we monitored are about 32% worse in Bosnia and Herzegovina. With respect to candidate countries, the lag of Bosnia and Herzegovina is smaller and amounts to a total of 25%.
- In comparison with the listed groups, Bosnia and Herzegovina has the best results in the area of price liberalization (average deviation not greater than about 10%), and in foreign trade liberalization (average deviation somewhat smaller than 10%).
- Bosnia and Herzegovina shows the poorest results in the area of competition policy, where its index value is 1.0 compared to the two categories of countries under observation with indices of 34.3 and 43.5 respectively. In other words, Bosnia and Herzegovina is more than twice as weak in competition policy compared to the countries under observation. It is certainly the result of still existing differences between the entities in this area on the one hand, and the lack of suitable macroeconomic policy at state level on the other.
- Bosnia and Herzegovina also has poor results in the area of privatization, particularly privatization of large companies. The slow privatization of big economic systems is certainly the result of such mark.

- The value of index measuring the reform in banking sector is surprisingly low, both for BH and in comparison to other countries. The banking sector is almost entirely privatized and owned by foreign capital; banking sector efficiency is thus rated exceptionally high, even at the regional level. However, we believe that BH has good results in this area despite the low mark.
- The company reform index also shows a fairly low value. One can list many reasons, but the issue of unfinished privatization is in the forefront, and is followed by a great participation of public sector in total GDP, complicated administrative procedure, high costs of starting business, etc. Besides, the number of small and medium-sized enterprises per capita is still far below the average of developed countries and countries in the region.

The key economic indicators pertaining to the country's willingness to meet the membership economic criteria were analyzed previously, and will not be dealt with extensively at this point. This primarily applies to the economic growth, which has been holding at about 5% annually over the past couple of years, and is likely to remain at the same level in the medium term.

The full self-sustainability of BH economic system is still a dilemma being discussed, due to the still present economy dependence on foreign aid and the import-dependent economic system.

Macroeconomic stability in BH is now present in two areas: inflation and budget deficit. Since 2000, these two indicators have been stable and this is certainly a bright spot of BH economic environment.[17] Public debt in Bosnia and Herzegovina registers a falling trend. The

[17] See the Annexe, Graph 2.

level of total public debt viewed in comparison to GDP was around 100% in 1998, and today it is around 60% of GDP, which is an acceptable level from the European integrations aspect.[18] Besides the decrease in total public debt, the value of foreign debt also shows a falling trend, which is another important stability indicator. With respect to the economy's foreign sector, we have already stated that BH economy is still an imports-dependent economy, and the small amount of BH exports is greatly (over 40%) based on imports.

Speaking of the political consensus on key macroeconomic policies in the country as a sub-criterion, one can hardly say that it existed until recently, except in some areas. A significant progress in this direction was made with the preparation of BH Development Strategy, which was *de jure* adopted by governments at all levels, who took upon themselves the obligation to implement this strategic document. This may be the only example where, though with the help of international community, a general consensus was reached on the five-year economic policy. Another example of consensus is a broad support to the orientation of Bosnia and Herzegovina towards membership in European Union, ignoring the daily-politics problems that can indeed hinder the entire process on this way.

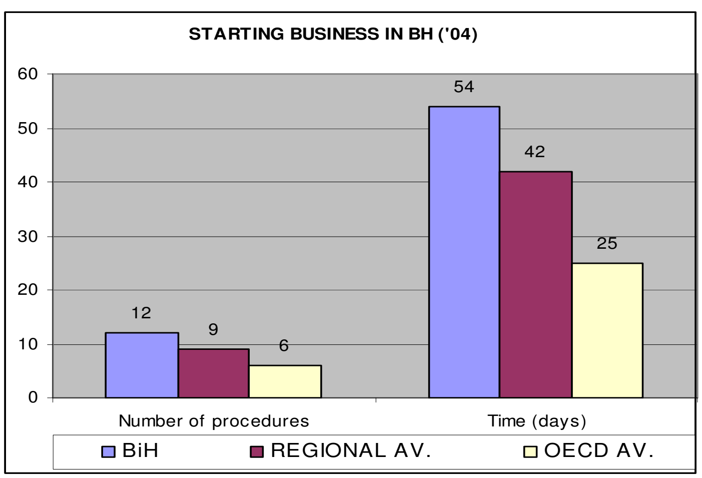
Country integration in the area of foreign trade is another Copenhagen criterion that was not discussed in a great detail in the previous sections of the paper. With respect to Bosnia and Herzegovina, European Union is its main foreign trade partner. Over 50% of total trade exchange pertains to EU. Thus, in 2005, the overall BH imports from EU amounted to 53%, and overall exports to 54%[19]. Bosnia and Herzegovina already has strong trade ties with European Union countries, which will definitely be further developed in future.

[18] See the Annexe, Graph 3.
[19] Source: Foreign trade chamber BH, period I-VIII 2005

Problems related to the internal and external imbalance in BH are related to domestic supply, which is not able to produce and offer suitable products and services, neither within BH nor those competitive to foreign ones. Such a state results in poor capacity utilization on the one hand, and extremely high official unemployment rate on the other. According to data on the number of small and medium-size enterprises per 1000 inhabitants, there are only seven SME's in Bosnia and Herzegovina. The number in Croatia is twice as great and amounts to 14; this is followed by Albania with 18, Bulgaria with 28, while in Hungary there are 88 SME's per 1000 inhabitants[20].

Problems on the domestic supply side include both those with the subjects themselves and those within the system, which is not appropriately prepared for the new circumstances in which BH economy functions.

Graph 4: Number of procedures in starting business in BH in 2004



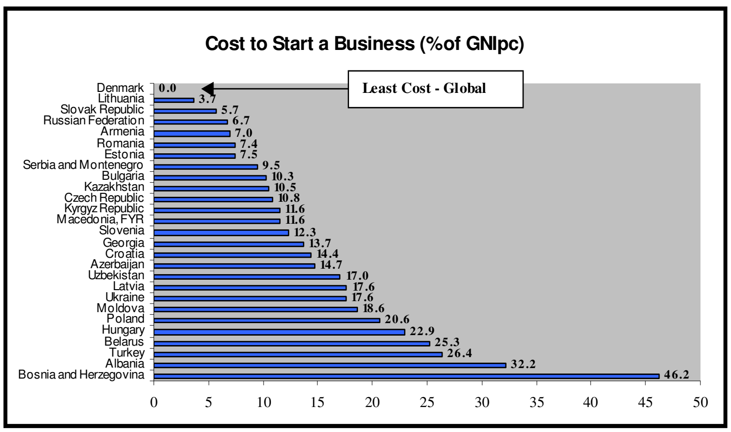
Thus, according to the results of World Bank research, it is far more difficult, expensive and uncertain to start business in BH than in the region or OECD countries. Entrepreneurs can expect to go through 12 steps to launch a business over 54 days on average, at a cost equal to

[20] Source: Spotlight on south-eastern Europe 2004, EBRD. See Annex, Graph 7.

46.2% of gross national income (GNI) per capita. They must deposit at least 65.0% of GNI per capita in a bank to obtain a business registration number, compared with the regional average of 51.8% of GNI and OECD average of 44.1% of GNI.[21]

According to the Doing business data base, costs of starting business in BH are the highest of all countries. The next Graph clearly illustrates the position of BH regarding the costs of starting a Business in 2004.

Graph 5: Cost to Start a Business in BH (% of GNI p/c)[22]



Important issue here is that in Bosnia and Herzegovina it takes 331 days to register property, compared with the regional average of 133 and OECD average of 34 days. Additional difficulty in this area is that the costs of property registration as percentage of the property values in BH are twice higher (6, 1%) compared to the Regional Average (3, 1%).[23]

Finally, we will mention that Copenhagen criteria also include the existence of suitable level of physical and human capital in the country. Although this criterion is rather vague, the key problem on BH example is non-existence of suitable indicators. Although it is possible to find

[21] Source: Doing Business Database, World Bank, 2005.
[22] Source: Doing Business Database, World Bank, 2005.
[23] Source: See the Annex, Graph 6.

estimates of the state of physical and human capital, it is still not known what the conditions in BH are in this area, particularly in comparison to other countries. It is thus hard to say whether Bosnia and Herzegovina meets the criteria in this area or not, and we will therefore leave this question open. Still, we believe that the state of human capital is better than that of physical capital in the country.

Comparative indicators of nominal convergence for BH and ten new member states are shown in the following table.

Table 7: Indicators of BH and EU(10) in relation to convergence

	Inflation			*Government budgetary position* Deficit (% of GDP)			Debt (% of GDP) (2004 – forecast)			Long term interest rate
	2002	2003	2004	2002	2003	2004	2002	2003	2004	2004
Refer. value	**2.4 %**			**3 %**			**60 %**			**6.4 %**
CZ	1.4	- 0.1	2.6	- 6.8	12.6	- 5.0	28.8	37.8	37.9	4.7
EE	3.6	1.4	3.0	1.4	3.1	0.3	5.3	5.3	4.8	4.6
CY	2.8	4.0	1.9	- 4.6	- 6.4	- 5.2	67.4	70.9	72.6	5.2
LV	2.0	2.9	6.2	- 2.7	- 1.5	- 2.0	14.1	14.4	14.7	5.0
LT	0.4	- 1.1	1.1	- 1.5	- 1.9	- 2.6	22.4	21.4	21.4	4.7
HU	5.2	4.7	6.8	- 9.2	- 6.2	- 5.5	57.2	59.1	59.9	8.1
MT	2.6	1.9	2.7	- 5.9	- 9.7	- 5.2	62.7	71.1	73.8	4.7
PL	1.9	0.7	3.6	- 3.6	- 3.9	- 5.6	41.1	45.4	47.2	6.9
SI	7.5	5.7	3.6	- 2.4	- 2.0	- 2.3	29.5	29.4	30.8	5.2
SK	3.5	8.5	7.4	- 5.7	- 3.7	- 3.9	43.3	42.6	44.5	5.1
EU-12	2.3	2.1	2.1	- 2.4	- 2.7	- 2.9	69.4	70.7	71.2	4.3
EU-25	-	-	-	- 2.3	- 2.8	- 2.8	61.6	63.3	62.7	4.6
BH	**0.3**	**0.6**	**0.4**	**- 3.7**	**- 1.3**	**- 1.1**	**-**	**-**	**59.7**	-

Source: EUROSTAT, EC, ECB

The reference value of inflation has been calculated as the simple arithmetic average of the average inflation rates in the three best performing Member states plus 1.5 percentage points. With respect to this convergence criterion, it is clear that Bosnia and Herzegovina has been fully meeting the inflation criterion, its average value being 0.4 %, in all the three years under observation. Besides the stable price level, which is in accordance with Maastricht criteria, the Central Bank independence is guaranteed and is being practically implemented. BH government cannot borrow money from Central Bank; also, Central Bank of BH is not allowed to issue money that is not 100% covered by Euro or another foreign currency.

Maastricht convergence criteria pertaining to the area of state budget cover two sub-criteria: total budget deficit must not surpass the level of 3% of GDP and the total state public debt must be lower than 60% GDP. Maastricht criteria covering the area of public finance are also already at the permitted levels in Bosnia and Herzegovina. Budget deficit was higher (by 0.7%) than the permitted limit only in 2002, while in other years the deficit remains below the permitted value. With respect to public debt, we are facing insufficient quality data on this indicator; most estimates say that it is now at about 60% level and registering a falling trend, which is within the set oscillations a limit. In other words, Bosnia and Herzegovina is capable to fully meet convergence criteria pertaining to state budget and public debt, if not at a given moment then certainly in a relatively short time period.

Finally, convergence criteria include the level of long-term interest rates. The criterion on the durability of convergence as reflected in long-term interest rates is based on the assessment of interest rates on 10-years government benchmark bonds, using an average rate over the latest 12 months. Analysis of long-term interest rate as convergence criteria in Bosnia and Herzegovina is difficult because there are still no government benchmark bonds, based on which one could determine the level of long-term interest rate. In the given situation, we can analyze only average long-term interest rates in the banking sector, as an illustration or alternative to this indicator. If we take into account the level of long-term interest rate in the banking sector, we observe that this interest rate in BH is by some 30% higher than the permitted convergence threshold. This is certainly one of criteria that Bosnia and Herzegovina cannot meet in a short run particularly when we have in mind the fact that issuing government bonds remains to be seen, as well as formation of interest rates on these securities.

Finally, real convergence criteria for European Union membership require income per capita to be close to the average of less developed Union countries. Real convergence is one of long-term challenges for Bosnia and Herzegovina, since BH GDP per capita is only 37% of GDP p/c in the three countries with the lowest value of this indicator.

4.2. Conclusions

Economic aspects of Copenhagen criteria for EU membership

- Macroeconomic stability viewed through indicators inflation and deficit in fiscal policy is at a satisfactory level in Bosnia and Herzegovina. Inflation is below 1% a year, a rate that is lower than the average in EU 15, EU 25 and candidate countries. On the other hand, the budget deficit is minimum, although one should note that this calculation includes grants to the budget. However, even if the grants are excluded from budget calculations, the state is still satisfactory, having in mind the fact that over the past two years budget without grants was at about 3% level, which can be considered ratheradequate. Public debt is also within permitted tolerance limits. Total public debt at some 60% GDP is at a level that does not threaten the sustainability of BH public finance and it has registered a falling trend in recent years.
- Price liberalization and foreign trade liberalization has fairly high transition indices and in these areas Bosnia and Herzegovina is comparable to transition countries from its immediate surroundings, including the transition countries that are now EU members.

- Country integration in the field of foreign policy is another criterion where Bosnia and Herzegovina has a fairly good ranking. The main BH foreign trade partner is the European Union, which accounts for over 50% total foreign trade, both of BH imports and exports. There is not yet a full consensus of government(s) on key economic policies, which in turn is one of prerequisites for meeting Copenhagen criteria.
- Costs of starting business in Bosnia and Herzegovina are the highest compared to transition, EU and candidate countries. The estimated cost of starting business is 46.2% of GNI p/c, while in other surrounding countries this cost is by at least 20% lower. Not only the costs of starting business are extremely high; the number of procedures and their duration are also extremely unfavorable for business founders. To start business in BH, one needs to go through 12 different procedures that last about 54 on average, the regional average being 9 procedures and 42 days. The time period needed to register property and procedure costs are also exceptionally high compared to other surrounding countries. The property registration procedure is 331-day long on average, the average for Region being 133 and for OECD countries – only 34 days. Property registration costs are also extremely high and amount to 6.1% of the value of property being registered, which is twice as high as regional average.
- According to transition indices, Bosnia and Herzegovina has extremely poor results in the area of competition. It is not surprising that the rating for this area is so low, since there is no full harmonization between entities.
- Large-scale privatization has not yet been finished. It is certainly the main reason for bad marks of this area.
- Non-bank finance institutions in BH are still in infancy, and consequently cannot be compared to other countries, which in turn results in poor rating for this area.

- Adequate infrastructure is a criterion that Bosnia and Herzegovina cannot meet, although it must be noted that there has been a significant progress in this area.
- The state of physical and human capital in the country is a subject of evaluation and it is difficult to determine the ranking of Bosnia and Herzegovina with respect to these indicators. Still, we presume that physical capital is more worrisome than human capital in the country.
- Finally, it can hardly be claimed that with all the listed problems there is a "functional market economy" in the full sense of the word and that in such environment BH companies can "cope with competitive pressure and forces within the Union".

Maastricht criteria for EMU membership

- General price level is an indicator and nominal convergence criterion that Bosnia and Herzegovina can fulfill in a short run.
- Budget deficit is the second Maastricht criterion where conditions are fairly satisfactory, i.e. within the permitted nominal convergence limits.
- In 2004, total public debt was at about 60% level, which already meets Maastricht criterion.
- Independence of Central Bank in Bosnia and Herzegovina is guaranteed and is *de facto* carried out in practice.
- One of nominal convergence criteria is that long-term interest rate on state bonds with 10 year maturity must not surpass the level of 2% of three best countries' average. It is clear that Bosnia and Herzegovina cannot meet this criterion, except in a long run. The basic reason for this is that no state securities are being issued in Bosnia and Herzegovina and it is therefore not possible to calculate the value of interest rate on state bonds. Having in mind such circumstances, we can monitor the long-term interest rate in BH banking sector

as an alternative criterion. However, the long-term interest rate in BH banking sector is higher (by around 30%) than the nominal convergence criterion, which certainly illustrates the level of long-term interest rate on state bonds.

- Real convergence is one of the biggest problems for future integration into the European Monetary Union. The increase in real GDP per capita certainly requires long-term strategy and special commitment in order to achieve real convergence in BH. Fortunately, real convergence is a criterion that has to be met only upon the accession to Union market, which is certainly an encouraging fact for less developed countries. They will then attempt to reach the development level of other members during the integration process itself. Still, real convergence can be achieved only with economic growth rates sustainable in a long term, which is a great challenge for country’s macroeconomic policy.
- Finally, Bosnia and Herzegovina can meet Maastricht nominal convergence criteria in the short run, except for the criterion of long-term interest rate level. On the other hand, real convergence that implies living standard close to the average of less developed Union countries is possible only in a long term and with long-term sustainable rates of economic growth. The other part of real convergence, foreign exchange rate stability, is already present owing to the stability of BH currency.

5. **POLICY RECOMMENDATIONS**

- *It is necessary to maintain macroeconomic stability in the areas of prices and public finance, particularly in the short term.* Bosnia and Herzegovina has an advantage, even in comparison to European Union countries, in the criterion of general price level stability. In recent years, the inflation has been up to 1% a year. The survival of Currency Board arrangement is an essential support to price stability, which is a good short-run solution for BH. BH does not significantly lag behind EU countries in the area of public finance and can meet Maastricht and Copenhagen criteria without major problems. Budget deficit has stabilized at the level of 3% GDP (without grants), and public debt – at about 60% GDP. We are aware of the fact that there is a possibility for fiscal policy to use public expenditures for expansive purposes, by increasing debt and stimulating economy in this way. However, one must not ignore an alarmingly high deficit in current account balance, which is a constant threat to BH macroeconomic stability. It is necessary to ensure the stability of public finance at the mentioned level, particularly in the short term, as a support in case of disturbances in external deficit financing. Besides, the preservation of public finance stability is a priority due to the fact that national savings are still extremely low and is not able to cover the current account deficit. However, once the progress in external imbalance in payment balance has been achieved, we believe that fiscal policy will also gain a new dimension and could take the direction of financing economic growth in the country. This option should not be counted on in the short run.
- *Macroeconomic policy should increase external stability and maintain favorable conditions for economic growth.* Deficit in payment balance current account of 18% GDP is completely unacceptable and results in the external imbalance of payment balance, and many other macroeconomic disturbances in the country by extension. We believe that the

reduction of deficit in current account is a key macroeconomic challenge for Bosnia and Herzegovina, both in terms of European integrations and membership criteria and in terms of improving economic conditions in the country. The credibility of a country's economic policy is reflected in the current account, which is also an indicator of excessive expenditures. The deficit in BH current account is far higher than that in EU countries and candidate countries we analyzed. As an illustration, we will mention that the deficit in current account is dozens times higher that the deficit in European Union countries. If the deficit remains so high in the long run, not only will BH fail to meet economic criteria for accession to EU, but the economy liquidity could also become questionable. The solution for reducing the current account deficit should not be sought in "traditional" protectionist measures, but rather in stimulating measures within economy that will result in the increase in domestic supply which, in turn, will lead to the substitution for import consumption and, naturally, to increased exports. The first step in increasing exports from Bosnia and Herzegovina is removing internal barriers to export, strengthening institutions that support exchange, developing standards and norms and, of course, development of export infrastructure.

- *It is necessary, in the short run, to reduce costs of starting business, duration of establishing and closing business, and time needed for property registration, including other administrative barriers evident in private sector.* In 2004, business environment in BH was such that the person starting business had to undergo twelve different procedures, which last 54 days on average and cost about 46% of Gross National Income per capita. Such conditions are, naturally, a barrier to domestic business and to foreign investors in BH. According to the World Bank report, costs of starting business in BH are among the highest in the world. Insufficient domestic supply results in a low GDP level, high unemployment and external imbalance. The removal of administrative barriers to business sector and reduction in costs of starting and closing business only would improve the private sector environment and other macroeconomic indicators. Changes in this direction would lead to the increase in domestic production, decreased unemployment and, to relative growth of exports and decrease in imports, which in turn would help in correcting external imbalance we identified as one of key challenges on the way towards EU. We believe that this can be achieved in a relatively short time period, and that the Government priority is to study the listed barriers, prepare a program for overcoming them and adjust laws in the direction which will improve the efficiency of business sector. The ultimate effect would be favorable for government sector as well, since the reduced public revenues from costs of starting business would be compensated through the increase of economic activities in private sector.

- *Government(s) in Bosnia and Herzegovina must reach general consensus on key macroeconomic policies that will serve to improve the country's position on its way towards EU.* Although a certain progress is evident in terms of consensus on key economic issues in the country, Bosnia and Herzegovina does not meet this Copenhagen criterion in the given moment. It is necessary to urgently draw the attention of creators of country's macroeconomic policy towards finding a common economic policy strategy that would lead BH both towards EU and towards economic growth and development.
- *It is necessary to further strengthen capital market in Bosnia and Herzegovina.* Capital market in Bosnia and Herzegovina is poorly developed and lags behind EU countries and surrounding countries. At the moment, Bosnia and Herzegovina does not meet the Copenhagen criterion on this market functionality, and has poor performances compared to other countries. It is not possible to achieve a functional capital market in the short time period, but the goal should be meeting this criterion in the medium term, which is naturally in Bosnia and Herzegovina's interest.

- *Keep developing infrastructure in BH as a long*-term priority. Bosnia and Herzegovina registers a significant progress in the infrastructure area, but its level still does not meet "European criteria" defined by European Commission in Copenhagen. Advancement of infrastructure must be a short-term, medium-term and long-term goal for Bosnia and Herzegovina. It is not possible to support infrastructure development without capital investments. We believe that it is necessary to increase public capital expenditures in the country directed toward infrastructure improvement, and reduce the current public expenditures in the same time. In recent years, the country's capital expenditures have been falling constantly, viewed as GDP percentage, and it naturally has be to changed.
- *One of essential priorities in the country includes strengthening of statistic capacities in order to provide relevant and reliable economic indicators.* It happens, in Bosnia and Herzegovina, that key economic indicators are not reliable enough; some indicators are not available yet, while others are incomplete or methodologically questionable. Examples are numerous; we will only say that the basic macroeconomic indicators such as GDP, GDP p/c, and unemployment rate must be considered with a great caution. Such circumstances beg the question as to how to develop a suitable economic strategy for the country's accession to European Union, if key indicators are questionable. As a short-term priority in the statistics field, we believe that it is necessary to establish statistic capacities for GDP recording according to the *expenditure approach*, which would in turn allow the calculation of more accurate GDP value. On the other hand, such an approach would cover part of informal economy, which is extremely important in BH case.
- *Decrease informal sector in favor of the formal one using stimulating measures for business legalization.* Estimates of grey economy in Bosnia and Herzegovina show that the informal sector of BH is over 30% of the official GDP. Such a state is certainly not good and results in the official indicators being neither real nor reliable, which in turn leads to numerous

problems In this respect, it is necessary to develop a separate strategy for decreasing informal sector, the main mission of which would be to redirect the informal sector into formal economy, through stimulating measures. This step would improve the country image at the international level and result in the improvement of economic performances, both in the short and long term.

- *Real convergence in Bosnia and Herzegovina is another true priority.* Without an adequate, sustainable economic growth, Bosnia and Herzegovina will not get closer to the European Union. The economic growth about 5 % is not sufficient for BH. Let us mention that EU membership candidates had a stronger grown of real GDP than BH in 2004. A stronger economic growth is a synergetic effect of the success in all the areas discussed. In this respect, economic growth in a country has to be the consequence of good results of macroeconomic policy, In other words, it is not possible to achieve prosperity of a country by partial solutions. It requires the overall commitment of all relevant institutions, subjects and individuals in order to allow Bosnia and Herzegovina to move closer to EU at a faster pace.

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ANNEX

Table 8: GDP and FDI in Bosnia and Herzegovina 2000-2004

	2000	2001	2002	2003	2004
GDP in mil of KM	10,500	10,960	11.650	12,303	12,980
GDP in mil of Euro	5,368.6	5,603,8	5,956.6	6,290.4	6,636.6
FDI in mil of Euro	158.6	140.2	308,9	169,1	383,3
FDI % GDP	3.0	2.5	5.2	2.7	5.8

1 Euro = 1.95583 KM

Source: Central Bank BH, 2005.

Table 9: Total foreign trade BH, 2000-2004

Total foreign trade of BH for the period 2000-2004					
	EXPORT	IMPORT	TOTAL	BALANCE	EXPORT/IMPORT
2000	1,969,682	7,114,154	9,083,836	-5,144,472	27.69
2001	1,806,725	6,563,599	8,370,324	-4,756,874	27.53
2002	1,888,321	6,881,311	8,769,632	-4,992,990	27.44
2003	2,313,211	8,274,741	10,587,952	-5,961,530	27.96
2004	2,994,219	9,367,484	12,361,703	-6,373,265	31.96

Source: Spoljnotrgovinska/vanjskotrgovinska komora BiH, *Pregled ostvarene vanjskotrgovisnke razmjene za BiH za period I-XII 2003. i 2004. godine*, Sarajevo, februar 2005

Table 10: EBRD indicators and indices for selected transition countries

EBRD INDEX	BIH	BU	CRO	CZK	HU	LA	LT	PL	RO	SL	SI	Av. new EU mem.	Av. Can .
Price liberalisation	4.0	4.3	4.0	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.0	**4.3**	**4.3**
Forex and trade liberalisation	3.7	4.3	4.3	4.3	4.3	4.3	4.3	4.3	4.0	4.3	4.3	**4.3**	**4.2**
Small-scale privatisation	3.0	3.7	4.3	4.3	4.3	4.3	4.3	4.3	3.7	4.3	4.3	**4.3**	**3.7**
Large-scale privatisation	2.3	3.7	3.3	4.0	4.0	3.3	3.7	3.3	3.3	4.0	3.0	**3.6**	**3.5**
Enterprise reform	2.0	2.7	2.7	3.3	3.3	3.0	3.0	3.3	2.0	3.0	3.0	**3.1**	**2.4**
Competition policy	1.0	2.3	2.3	3.0	3.0	2.7	3.0	3.0	2.3	3.0	2.7	**2.0**	**2.3**
Infrastructure reform	2.3	2.7	2.7	3.0	3.7	2.7	2.7	3.3	3.0	2.3	3.0	**3.0**	**2.9**
Banking sector reform	2.3	3.3	3.7	3.7	4.0	3.7	3.0	3.3	2.7	3.3	3.3	**3.5**	**3.0**
Non-bank financial institutions	1.7	2.3	2.7	3.0	3.7	3.0	3.0	3.7	2.0	2.7	2.7	**3.1**	**2.2**
AVERAGE	**2.5**	**3.3**	**3.0**	**3.7**	**3.8**	**3.5**	**35**	**3.6**	**3.0**	**3.5**	**3.4**	**3.6**	**3.1**

Transition indicator scores range from 1 to 4 with 0.3 decimal points added or subtracted for + and – rating. The rank 1 marks the start of market economy while rank 4 means that market economy is at the level of industrialized countries.

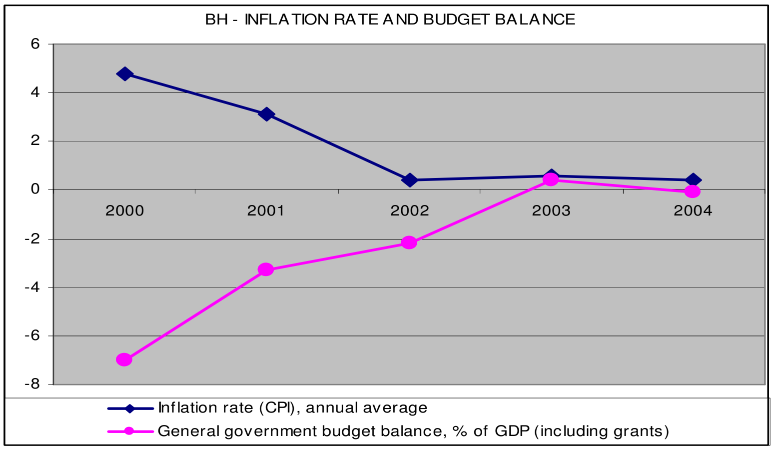
Source: *Transition report 2003*, EBRD, London

Table 11: Number of procedures to start a business – BH, OECD, Region

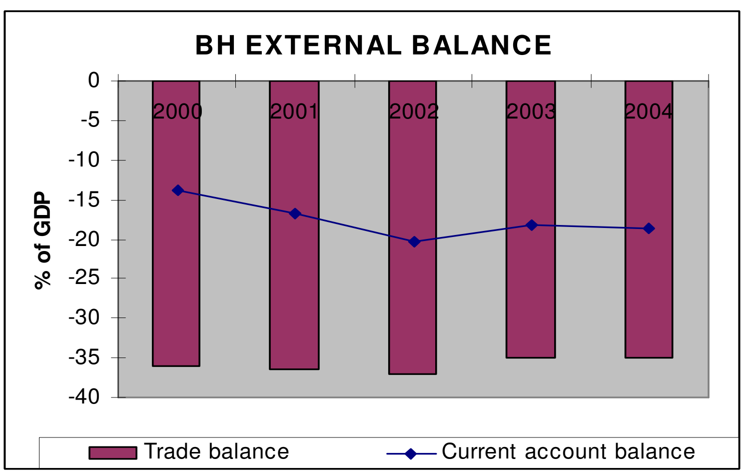
Indicator	Bosnia and Herzegovina	Regional Average	OECD Average
Number of procedures	12	9	6
Time (days)	54	42	25
Cost (% of income per capita)	46.2	15.5	8.0
Min. capital (% of income per capita)	65.0	51.8	44.1

Source: Doing Business Database, World Bank, 2005

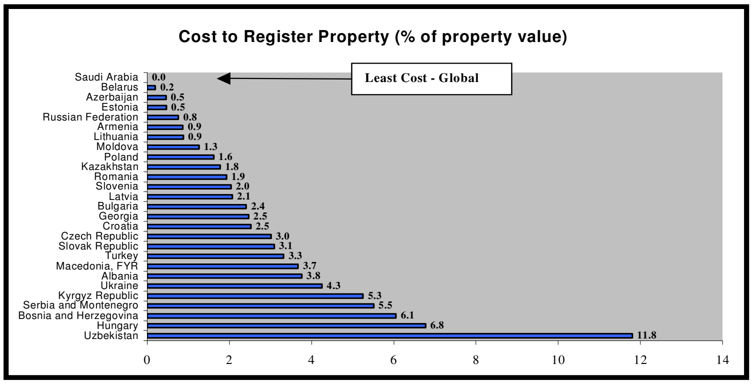
Graph 2: BH inflation rate and general government budget balance



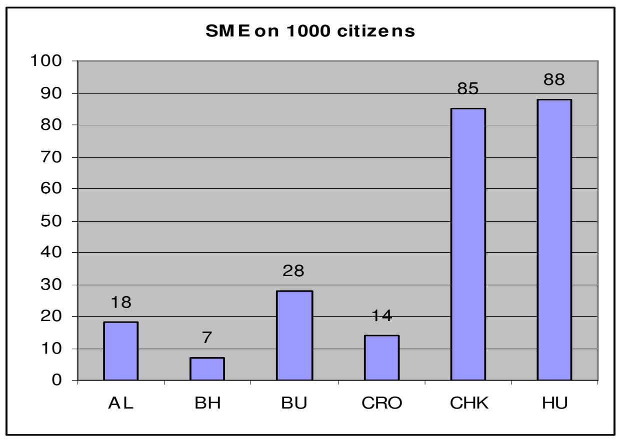
Graph 3: External BH balance 2000-2004



Graph 6: Cost to Register Property in BH (% of property value)



Graph 7: Number of SME's per 1.000 citizens[24]



[24] Source: Spotlight on south-eastern Europe 2004, EBRD