Chapter 5

Reforms in the Banking Sector

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This article does not aim to focus on banking in Bosnia and Herzegovina (BiH), although it will provide the reader with a short insight into the country's banking sector. We do not claim that the topics mentioned are complete or all-encompassing, but they are intended to provide the reader with a brief overview of important issues of the economic everyday life in BiH, as well as offer incentives for possible solutions to common issues. This paper focuses on certain burning aspects of the economy of BiH which, of course, tackle the banking sector as well. We mention some of the needed reforms that should be introduced as soon as possible to prepare the Bosnian economy for possible European Union (EU) candidate status, and make it a competitive environment for future investments. There are many ways to approach this topic, from various stand-points—economic, political, or legal. However, the views expressed here stem mainly from the author's work as a banker, and from a general financial point of view. Of course, some of the points are closely linked to the other two standing points, especially those related to tax provisions and the rule of law, as both have an impact on daily banking operations. Nevertheless, banking is one of the most stable industry sectors in BiH, despite experiencing stagnation during the last few years.

Looking briefly into the recently published macroeconomic indicators of BiH, one can get the impression that the country is recovering, albeit slowly, from the crisis and its aftermath in the years 2008–2010. Since 2012, GDP showed a steady growth between 1.5 percent and 3 percent—interrupted only by the huge floods in 2013, where growth in BiH turned negative due to the destructive effects for its people, the economy and the environment. In their outlook for 2016 and the years following, analysts foresee a GDP growth of 3 percent and above for the region.

However, if we take a deeper look, we will recognize very quickly that the economic situation is quite unsustainable. BiH is in the midst of a second-crisis phase. The country has a stable financial environment, international banking groups have been present in the country for years, and many projects in the areas of infrastructure, tourism, and energy exist; yet substantial domestic and foreign investments are still missing.

The Banking Sector in Bosnia and Herzegovina

Bosnia and Herzegovina's banking sector is stable (although less attractive than it used to be before 2008). Foreign funds are flowing into the country, seeking opportunities for quick profits. This is not unreasonable—and would be expected if the economy would boom. Local authorities have very well recognized that a strongly present Central Bank is crucial for the country's survival.

> The economy is underpinned by a convertible currency with fixed parity to the Euro. As a result, the convertible mark is one of the most stable currencies in Southeast Europe. The banking sector in Bosnia and Herzegovina remains reasonably liquid and well capitalized. Foreign banks account for over 90 percent of total assets in the financial system, but the banking sector has not been subject to large credit outflows to parent banks.[1]

A total of 25 banks exist in BiH, where 17 have their headquarters in the Federation of Bosnia and Herzegovina (FBiH), and eight in Republika Srpska (RS). As calculated at the end of June 2016, their total assets amount for around 25 billion BAM, whereas their total capital accounts for around 3.5 billion BAM.[2] We can thus conclude that around 95 percent of their total assets are non-domestic.

The number of banks seems to be in reasonable proportion to the size of the market. However, two foreign capital banking groups dominate with a market share of around 50 percent, i.e. UniCredit Group (Italy) and Raiffeisenbank (Austria). Aside from these two, the biggest groups operating in BiH are Intesa San Paolo (Italy), Sberbank (Russia), Erste Group (Austria), NLB (Slovenia) and Nova Banka (a domestic bank). The American hedge fund *Advent* recently entered the market by purchasing the larger part of former Austrian bank Hypo Alpe Adria International.

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1 "Overseas Business Risk—Bosnia and Herzegovina." Foreign and Commonwealth Office, U.K government. August 21, 2017. https://www.gov.uk/government/publications/overseas-business-risk-bosnia-and-herzegovina/overseas-business-risk-bosnia-and-herzegovina.

2 All data used here are from the Central Bank of Bosnia-Herzegovina (http://www.cbbh.ba) or from the banking agencies of the country, http://www.fba.ba, http://www.abrs.ba.

In the first half of 2016, the total banking sector earned a total of 171 million BAM, which represents a return on equity of roughly five percent. The two largest banking groups showed a profit of above 100 million BAM in the first six months of 2016. The total exposure of Bosnian banks amounted to 16.97 billion BAM, of which households counted for 7.95 billion BAM by the end of August 2016. At the same time, the volume of deposits corresponded to 17.2 billion BAM, of which 10.2 billion BAM stemmed from the retail sector. What is important to mention is the fact that both key loans categories (retail and corporate) registered positive growth rates, but the growth of corporate loans outpaced that of retail loans for the first time since July 2013. Compared to the same period in 2015, corporate loans showed a growth of 3.6 percent, up to 7.97 billion BAM (46.8 percent of total loans) while retail loans saw an increase of 2.2 percent, reaching a value of 7.93 billion BAM, or 46.6 percent of total loans. The level ratio of non-performing loans (NPLs) at the end of June equaled 12.1 percent, and continued a downward trend after it reached its peak in Q3 2014.

All this data mirrors the general economic situation in the country. A country where the average monthly net salary stands at 830 BAM, the GDP per capita is 4,800 dollars, and the trade deficit reaches a level of above 40 percent. In such an environment, it is difficult for banks to achieve returns of 15 percent and above like in other developing regions.

Furthermore, recently, we have seen a record high in banks deposits. This should not be viewed as the result of increased wealth, but it is rather shows the lack of confidence in the country's economic prospects. Following this development and the bankruptcy of two small local banks, the Central Bank responded by increasing the mandatory reserve requirement, which additionally decreased the available amount of money for lending, and increased costs. Two banking agencies exist in BiH, one for each entity, which forces many banking groups to establish two banks in the country. Due to political reasons, it is not possible to merge the banks, which causes inefficiency, additionally increasing the costs of capital and decreasing potential returns. All this might be why at present no serious international banking group is interested in entering the local market.

The risk entry level for lending in the country is very low compared to Western Europe. For cash loans in retail lending it is common that one receives tenures of 12-15 years (sometimes even more), with interest rates between 4.5 percent and 8.5 percent. Households often cannot afford shorter payback periods and prices of goods, especially of those imported, to equal the prices in the West.

Corporate lending refers only to basic instruments; the hedging of Foreign Exchange (FX) risks or interest risks is hardly seen on the market, and even the governments (both at the federal and entity levels) do not use such hedging instruments for their loans from international organizations such as the EBRD, EIB, or the IMF. As most of these government loans are given on a long-term basis (20 years and above), many of them have grace periods. Consequently, the government does not pay back the annuities for few of them, not realizing that it takes over a liability that will burden the next generation. By not hedging these obligations, it seriously jeopardizes its future development.

In general, corporate balance sheets are characterized by very low profit before tax as a result of the existing habit of tax avoidance. Although the government introduced a flat tax rate of 10 percent, the tax behavior of entrepreneurs did not improve significantly. There are several reasons for this, one of them being that the government and state owned companies are the biggest tax evaders. The other reason is based on an inefficient tax authority. We will elaborate on this later.

The attractiveness of doing business in Bosnia and Herzegovina is limited. On the one hand, there is a low domestic demand for goods, and on the other, many of the valid laws in the country were established in the former communist Yugoslavia, which are obstacles in times of free economies and the freedom of moving goods and money. The total number of corporations, and small and medium sized enterprises (SMEs), amount to 24,147, whereas the number of small business totals 46,631.[3] The overall number employed was approx. 489,600. When we look at a country similar in size, Austria has approximately 435,631 SMEs.[4]

A further problem in Bosnia and Herzegovina is the high administrational burden, especially for start-up companies. On the World Bank's ranking for ease of starting a business, BiH stands at 175 in the ranking of 189 economies.[5] The notary system was introduced in 2007, bringing

3 This data is from 2014.

4 Austrian Ministry for Finance (2011): https://www.bmf.gv.at/.../Unternehmen_Anzahl_OE-NACE_4Steller_20121107.xlsx?

5 Worldbank, Doing Business 2016: Bosnia and Herzegovina, http://documents.worldbank.org/curated/en/659921467991987957/pdf/100666-WP-Box393240B-PUBLIC-DB2016-BIH.pdf

a lot of security into the corporate business. However, the country is far away from a "one-stop-shop," where all formalities are handled in one stop. It takes anywhere from two weeks to two months to register a new company and to receive all the necessary approvals. Furthermore, start-ups face difficulties to organize capital—banks generally do not support them with lending due to the high rate of dropouts. Certain municipalities in BiH started programs supporting start-ups (mainly to fight unemployment). These programs either support interest payments, or even provide limited capital to start-ups. However, these initiatives are not centrally coordinated on the state or entity levels (e.g., by the Ministry for Economy and Development), but are actions set by individual cantons or municipalities and are generally very modest in their contributions.

Based on what is stated above, it is not easy for banks to earn money. As mentioned before, the barriers for retail lending are very low compared to other markets in the region. In corporate business, the fierce competition is leading to historical lows in interest lending. Dozens of subsidiaries in the Bosnian market are able borrow money cheaper than their parent companies in other countries. There are cases where parent companies are borrowing money from Bosnian banks through their subsidiaries. The calculation for such low interest rates is simple: banks hope that they can make up for the low margins by getting employees and the side businesses of these companies. Nevertheless, such an approach carries certain risks, especially if rates start to grow with higher traffic. Such a scenario might be difficult to imagine given the current environment, but looking at the rate history—everything is possible.

How Do Banks Earn Money in Bosnia and Herzegovina?

Banks in BiH mainly earn their money through retail banking. And thus, only an extensive number of clients can allow banks to be profitable. Despite the fact that loan amounts are small and payback periods are extremely long for cash loans (the payback period for mortgage loans ranges from 15 to 30 years), the offered products are very simple. Most international banks simply roll-out their simplified product portfolio form their home markets onto the Bosnian market. Therefore, retail business consists largely of lending, savings, simple card business and additional electronic and mobile banking.

The lending business is limited to ordinary repayments. Hedge instruments are not offered because most people taking out a loan cannot afford to buy any derivatives. A couple of years ago a very small number of banks offered loans in Swiss currency (CHF), inviting borrowers to take advantage of the low Swiss LIBOR. However, as none of the loans was hedged against FX risk, this "adventure" ended in a disaster that resulted in extremely high non-performing rates when the Swiss Franc gained to the Euro. It became a political discussion as well, where local politicians accused banks of robbing people. This discussion is still ongoing in BiH, albeit with lower density. A law was passed prohibiting banks to offer loans in other currencies exempt in the Bosnian Mark (BAM) and the Euro.

The savings business consists of various interests given based on the tenor of the deposit. CDs (certificates of deposits) were not implemented in the Bosnian market until recently. As their use requires significant administrational effort to acquire all necessary licenses, they are not commonly used in the market. In general, certificates or bonds are not used as a way of saving in BiH, neither for companies or for households. Interest rates for deposits are extremely low, which further deteriorates the banks' reputation in the eyes of private individuals. Nevertheless, savings have outpaced the growth of loans for several years, and the trend of replacing foreign funding of banks with local deposits continues. The problem of those deposits is their maturity structure. The low interest rates on deposit savings leads to an increase of over-night deposits, consequently leading to a miss-match of banking liquidity maturities. Approximately 25 percent of all deposits are overnight deposits in BiH.

The card business is also mainly focused on extending payback periods as much as possible. Therefore, banks introduced the so-called shopping cards a few years ago, which enjoy great popularity among cardholders. Shopping cards are established through arrangements between banks and retailers, which enabled banks to offer interest free deferred payments to their clients, while the retailer pays the interest directly to the bank. On the other hand, real loyalty programs hardly exist in the local market. One reason is that such programs require high levels of investment by participating partners, which is often not profitable. Another reason is the low purchasing power of clients, so that companies prefer to establish their own loyalty programs—without the involvement of banks.

There is still no law on electronic signatures in BiH, and the paper-based administration causes additional burdens for banks. All public correspondence is printed and signed manually, and those papers are stored for many years. Simple operations such as opening a bank account cannot be performed online but must be done in person. The law does not foresee another way of identifying except the personal show up to the branch. Local authorities, to protect the rights of the clients, have issued many new laws and regulations in the past few years. However, the result is that you get roughly 40 pages of printouts to open an account, which you have to sign. So just an account opening requires in total 80 pages of printouts, one copy for the client and one copy for the bank. It is a similar procedure for all other products. Only the paper work load creates a lot of costs for banks, if only for the required safe storage of all these documents.

Accessibility to online banking in is very low compared to Western European countries, and so branches are the backbone of retail business in Bosnia and Herzegovina. Therefore, banks rely heavily on their branches, and it is thus not a coincidence that the two biggest banks also have the largest branch networks. According to the Bosnian Regulatory Agency for Communication, there were 636,725 online banking users by the end of May 2016, which amounts for 17 percent of the total population.[6] At the same time, the Agency estimates that 2.8 million inhabitants are frequent users of the internet. The Central Bank of Bosnia and Herzegovina reports that at the same time there are 2,013,219 cardholders and 314,777 subjects using some sort of internet or mobile banking. We can thus conclude that only 16 percent of cardholders are active users of online services provided by the local banks. New trends in retail banking to reduce local branches and instead attract people to complete transactions online have not been successful as of yet. Currently, there are attempts for branches to operate with automated machines, but until now it is difficult to predict if this is a sustainable way of doing banking business in BiH in the future.

The two biggest banks on the market serve between 600,000 and 1,000,000 clients today. Smaller banks have between 100,000 and 150,000 clients. Due to their smaller market shares, the costs of enlarging their domestic operations are very high. Additionally, customer readiness to change banks is extremely low, and employer often persuade their employees to open accounts with banks they are already doing business with. It is easier for the employer to complete payroll transactions with banks they have worked with in the past, and sometimes the company receives better

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6 Bosnian Regulatory Agency for Communication.

conditions when many of its employees have their salary account with the same bank.

Aside from the fact that the market is small and salaries are low, the margins in retail banking are better than those in surrounding countries. Through modernizing the law on day-to-day business operations, establishing less interference on the freedom of business, and especially by incentivizing capital injections into the country (primarily FDI—not considering banks), BiH could become a more interesting strategic area.

Drastic Changes are Needed

There is a sense that the general public in BiH has become accustomed to the present economic situation—which is not true. The country has been avoiding desperately needed reforms for a long time, in particular those related to the economy and the rule of law. Such reforms are a prerequisite for creating a business climate that will attract international and domestic investment. Last year, the European Commission summarized the current status of required reforms in BiH:

> The consensus on economic policy essentials has increased. A broad agreement has been reached on economic reforms, but the government now needs to show strong reform commitment by starting to implement the planned reforms. The consensus between the authorities at different levels of government on the economic policy essentials has broadly gained momentum with the adoption of the global framework for fiscal policies and balances 2016–2018 by the Fiscal Council.
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> In February 2015, Bosnia and Herzegovina submitted its Economic Reform Program covering the 2015–2017 periods. The program sets out an overly ambitious fiscal strategy based on reductions in expenditure but lacks initiatives that would stimulate growth. In addition, although some major obstacles for growth were identified, the structural reform strategy is vague on medium-term measures beyond 2015. There is ample room for improvement in terms of policy coordination. Following the adoption of the Reform Agenda in July, Bosnia and Herzegovina is encouraged to take further steps towards its implementation, including with the help of the ERP recommendations set out below, which reflect Reform Agenda priorities

> The IMF Stand-By Arrangement (SBA), agreed in 2012, expired on 30 June 2015 but the last loan tranche disbursement was made in July 2014. The program went off-track due to delays in implementation of previously agreed structural reforms. Negotiations for a new IMF program have been ongoing.[7]

In September 2012, the IMF approved a three-year 405.3 million euros Stand-By Arrangement (SBA) to support the country's structural reforms envisioned in the 2012–2014 economic program, with a focus on reforms aimed at improving national policy coordination, advancing fiscal consolidation and public sector reforms, safeguarding financial sector stability as well as supporting growth and job creation through structural reforms. After this disbursement, BiH did not fulfill the necessary benchmarks, which resulted in delays for the remaining tranches.[8] This year, since additional funding was necessary, a newly extended fund facility in the amount of 500 million euros was agreed on to support these structural reforms.

However, instead of introducing changes, modernizing the financial and fiscal systems, BiH's institutions do not show the courage and resilience to introduce such steps, which would significantly decrease bureaucratic red tape and increase efficiency. As a result, we are faced today with an inefficient tax system, weak legal security, old (originating from Yugoslav communist times) employment laws, and a high current account deficit. Even the movement of people and the mobility of the labor force remain a concern: "the absence of harmonization in employment and labor legislation, of rights based on employment (i.e., health, pension, social and unemployment insurance) and other related taxation issues effectively prevent mobility inside the country."[9]

One of the key topics is the education system. During the times of the former Yugoslavia, the universities were highly respected, with professors who were often internationally educated and enjoyed an excellent reputation. After the Dayton Peace Agreement, the university system became regulated on the Canton level in the Federation of Bosnia and Herzegovina (FBiH). As a result, a lot of new universities have been opened (in both

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[7] European Commission, Commission Staff Working Document, Bosnia and Herzegovina 2015, Brussels, November 10, 2015, p.30

[8] "Overseas Business Risk—Bosnia and Herzegovina." Foreign and Commonwealth Office, U.K government. August 21, 2017.

[9] European Commission, Commission Staff Working Document, Bosnia and Herzegovina 2015, Brussels, November 10, 2015, p.39

Republika Srpska (RS) and FBiH)—sometimes with a questionable standing. Unfortunately, many of them prioritized the business side over the education itself. At the same time, public universities struggle with budget issues as the government cannot afford to spend more on education. The graduates from private universities are often "very far from the economic reality," which results in high unemployment. Therefore, parents who can afford it, often send their children abroad to complete their education. Once they graduate, they rarely return to BiH, as they find high-paying jobs in other countries. Based on this, the European Commission recommended in their Economic Reform Programs (ERPs) to "develop a more strategic approach to tackle the deficiencies in the training and education system by effectively prioritizing measures based on a mapping of the skills gap taking into account the needs of industry, especially SMEs. Harmonize legislation and standards related to education and training at state and entity level, as well as at cantonal level, since the competence on education in the Federation is at cantonal level."[10]

Considering this, the government needs to introduce more changes to the existing labor laws. Labor laws in both entities need to be modernized and harmonized with each other. Despite the fact that FBiH adopted a revised labor law last year in July, which was met with trade union protests, the employers are still put in an inferior position. The fact that employees who have an unlimited contract cannot be laid off, this automatically leads to lower overall employment. Another result of the existing labor laws is that many unprofitable public companies cannot be revitalized as they keep the number of "employed staff" too high. This measure has a social connotation, but many of these companies pay delayed salaries and/or do not pay the social obligations for their staff to the government at all. The employment rate in the country is around 44 percent, and unemployment among young people (15–24 years old) was at 63 percent in 2014. To make matters worse, more than 80 percent remain long-term unemployed (i.e., unemployed for one year or more).[11] Therefore, the European Commission recommended that "labor market rigidities have to be reduced by addressing disincentives to hiring, including taking further steps towards a reduction of the tax wedge while ensuring budget neutrality."[12]

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[10] Ibid., p.35

[11] Ibid., p. 45

[12] Ibid., p. 31

Linked to this topic is the fact that BiH shows a limited private wealth creation. This is partially based on a disproportional large public sector that has only partially been reformed since Yugoslav times. State owned enterprises provided large-scale employment in former communist times, yet most of these companies do not have the same market access they had before the war. Nevertheless, the maintenance of employment in these state-owned enterprises represents the main focus in order to keep social peace in the country. However, the high costs for these companies are eventually paid by taxpayers. In return, this creates a negative spiral and bias against employment.[13]

The development of significant foreign investments could increase the attractiveness of the private sector for young people entering the job market. Still, the majority of young graduates prefer to work for the public sector, which remains the largest employer (32 percent). This inevitably leads to economic ruin over the long term.

A move towards the liberalization of the labor law would cause a social problem in the short-term. Therefore, such changes would need to be accompanied with social solutions for a part of the population. Nevertheless, it is crucial to solve the topic as soon as possible, as postponing would have much larger negative impacts on the economy and social freedom in the future. Generally, the implementation of the legislative framework on social protection remains low. In both entities, due to financial constraints, the government did not implement social benefits prescribed by social protection laws, which include benefits not being paid, or amounts reduced according to available funding.[14]

The Fight for Capital

Bosnia and Herzegovina and its authorities have to recognize that the whole region is competing for capital. In our globalized world, the attractiveness for investments in BiH is low due to low returns. Bureaucracy is creating additional operating costs and reducing opportunities for returns on investment.

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[13] Goldstein, Ellen, Simon Davies, and Wolfgang Fengler. "Three reasons why the economy of Bosnia and Herzegovina is off balance." The Brookings Institution, November 5, 2015. https://www.brookings.edu/blog/future-development/2015/11/05/three-reasons-why-the-economy-of-bosnia-and-herzegovina-is-off-balance/

[14] Ibid.

FDI inflow amounted to 244 million euros in 2014, whereas the investments were mainly in three industry sectors: manufacturing, banking, and telecommunication (74 percent of all FDI stocks by industry from May 1994 until December 2015).[15] Generally, reforms designed to tackle the required reforms could increase the attractiveness of the local market for FDIs significantly. Net FDI inflows have covered just 31 percent of the cumulative current account deficit in 2008–2013, requiring the remaining financial debt to be met through new external indebtedness. Hence, gross external debt remained at around 50 percent of GDP, or 190 percent of export earnings and is forecasted to rise further in the near future.[16]

BiH has much to do not to be outpaced by its neighbors Croatia and Serbia. The fact that both of these economies are victims of the economic crisis supports BiH to not completely lose its connection to these two countries. Nevertheless, the fact that BiH has a smaller market and a much lower purchasing power compared to its neighbors, and an infrastructure that is far behind the requirements of a modern economy, it faces a backward position as soon as the economic crisis comes to an end.

Although Bosnia and Herzegovina is a developing a functioning market economy, and the government took actions to improve the business environment with regard to ease market entry and the granting of construction permits, the labor market remains largely unchanged. The unemployment rate is high, amounting to above 27 percent and rising to 63 percent among the youth population.

As BiH is at an early stage in achieving the capacity to cope with competitive pressure and foreign market forces, and in order to overhaul the business environment, it is imperative that the government reduces market rigidities, and especially that it reduces the tax wedge.

According to a World bank report, "on average, firms in Bosnia and Herzegovina make 45 tax payments a year, spend 420 hours a year filing, preparing and paying taxes and pay total taxes amounting to 23.3 percent of profit."[17] Globally, Bosnia and Herzegovina stands 154th in a ranking of 189 economies on the ease of paying taxes.[18]

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15 Foreign Investment Promotion Agency of Bosnia and Herzegovina, http://www.fipa.gov.ba/informacije/statistike/investicije/default.aspx?id=180&langTag=en-US

16 Country Report Bosnia and Herzegovina, *Euler Hermes Economic Research*, http://www.euler-hermes.com/mediacenter/Lists/mediacenter-documents/Country-Report-Bosnia-Herzegovina.pdf

17 Worldbank, Doing Business 2016: Bosnia and Herzegovina, http://documents.worldbank.org/curated/en/659921467991987957/pdf/100666-WP-Box393240B-PUBLIC-DB2016-BIH.pdf

18 Ibid., p.71

It is not merely about the governance of public finances whose quality and sustainability have deteriorated during the past few years. There needs to be a complete reform of the tax system. BiH significantly reduced the taxes on profits in the past (today it belongs to the lowest in Europe—around 10 percent), simplified its labor tax processes, reduced employer contribution rates for social security, and abolished its payroll tax. Furthermore, it eased the administrative burden of filing and paying social security contributions by implementing electronic filing and payment systems.[19] Nevertheless, the tax on labor is one of the highest in Europe. Approximately, 65 percent of the income is taxed for social contributions and pension costs, thus resulting in a heavy shadow economy and tax avoidance. In my view, a strong decrease in taxing labor accompanied by an efficient monitoring system would lead to a boost in the budget and would increase spending. The high tax burden on labor has been identified as one of the biggest disruptive factors for doing business in BiH, and is not harmonized between the two entities and Brčko district. The taxation even has negative impacts on the mobility of labor force inside the country due to different regulations on health, pension, social and unemployment insurance. Not to mention that the tax administration reports are not used in a proper way to fight corruption (the topic "corruption" is a severe one in BiH seriously damaging the economy and prohibiting attractive investments; we will refrain from discussing it in this chapter).

Another big problem that the new reforms need to tackle, is the fact that the economy is more focused on consumption rather than on production.

> During the post-war economic recovery, Bosnia and Herzegovina did not create new foundations for sustainable economic growth. Financial inflows and particularly aid and remittances—averaging around 20 percent of GDP—fueled consumption-based economic growth. Today, consumption remains at over 100 percent of GDP, with only a handful of countries having higher figures. To sustain high levels of income, create prosperity, and eliminate poverty, Bosnia and Herzegovina will need to shift toward an economic model built on production of goods and services rather than consumption.[20]

In order to overhaul the business environment, aside from reforms in the field of tax and labor governance, it is imperative that the rule of law is

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[19] Ibid., p. 72

[20] Goldstein, Ellen, Simon Davies, and Wolfgang Fengler. "Three reasons why the economy of Bosnia and Herzegovina is off balance." The Brookings Institution, November 5, 2015.

significantly strengthened. The system of commercial law has to be improved and modernized. Property cases cannot wait for years to be resolved. According to a report of the European Commission, the average length of proceedings in 2014 was just over seven years for all courts across the country.[21] Comparing this data with Austria, where on average civil law suits take 4 months, and in Europe 9.5 months[22], one can see that there is significant room for improvement in the Bosnian justice system. Furthermore, there has to be much greater consistency in court rulings. In the present circumstances, rulings are often completely different in cases that are remarkably similar.

Potential FDI is currently predominant in the energy and infrastructure sectors, as the energy sector is one of the strong sides of the local economy. BiH is the only country in the region that exports energy, and currently, many energy projects are still in the planning phase. For instance, RS recently signed a contract with the American company NGP for a feasibility study for hydro power plants with a total capacity of 365 MW aiming to invest up to 1.3 billion euros. Further energy projects foresee investments in the amount of around 4.2 billion euros. These investments include a thermal power plant project (value around 2.32 billion euros), a hydro power plant project (one billion euros), wind farm projects in the total amount of 831.5 million euros and small/mini hydro power plants projects totaling 63.5 million euros.[23]

A positive example of a realized project is the thermal power plant Stanari in RS. The EFT Group—a European company specialized in energy trading and investments, mainly active in Mid and Western Europe, Turkey and the Baltics—won an international tender for private partnership with the coal mine Stanari. Until July 2012, EFT invested 63 million euros in the modernization and enlargement of production of the coal mine. New equipment was bought including trucks, dumpers, bulldozers, diggers, fire department vessels and cars. More than 100 new jobs were created until now, all debts have been repaid, and the company doubled employee salaries. Local banks across the region were included to finance this investment.

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21 European Commission, Commission Staff Working Document, Bosnia and Herzegovina 2015, Brussels, November 10, 2015, p.15.

22 Irma Ibrahimpašić, Master Thesis, "Die Effektivität des Gerichtwesens in Bosnien und Herzegowina im Vergleich mit Österreich", pp. 90-91, http://unipub.uni-graz.at/obvugrhs/download/pdf/232248?originalFilename=true

23 Foreign Investment Promotion Agency of Bosnia and Herzegovina, http://www.fipa.gov.ba/investinbih/index.htm.

Infrastructure projects are the second biggest opportunity to enhance foreign and domestic investments. The FBiH published a tender for the construction of 350 kilometers of highway (the so called "Corridor 5c"), which should connect Budapest (Hungary)—Osijek (Croatia)—Sarajevo (BiH)—Ploče (Croatia). This highway would be the most important transit route in BiH, and the shortest line between Central Europe and the Adriatic Sea. More than 50 percent of the total population and roughly half of all economic activities of the country are situated along this highway route. As of yet, 100 kilometers of this road is already constructed. The government used the financing of international institutions, whereas construction companies mainly use funds through lending from local banks.

However, infrastructure projects do not only include new highways and roads to meet the challenges for a functioning corporate and SME environment. Aside from outdated infrastructure along border crossings, the water and electricity supply needs to be modernized or completely rebuild. To provide funds to these necessary measures, budget spending governance needs to be reviewed and put into a modern fiscal system, which will also guarantee transparency.

Conclusion

Although banking in Bosnia and Herzegovina is a stable industry sector (despite its problems regarding high competition and regulatory affairs representing a burden for new capital injections), its continued attractiveness is highly dependent on the economic-political reforms aiming to improve domestic and FDI in future.

Key challenges for the government will be to increase public spending, attract new investments, and increase domestic demand. To do so, it is necessary to focus on improving its international country rating, leading to the reduction of high interest payments in the future. The basis for a prudent approach is an appropriate education system and a financially trained staff to structure future investments properly. Tax and labor law reforms are imminent. It is vital that improvements are not addressed only by new laws in place, but also by the appropriate bylaws that need to be passed in due time.

All in all, there are huge challenges ahead for local authorities in the near future. The application for EU candidature status is an important step in the right direction. Furthermore, the construction of the highway is of utmost importance for the modernization of the infrastructure and one example of the pillars for further investments into this region. The government's reform agenda needs to be implemented on a daily basis, rather than a "marketing announcement" without any positive impact on the real economy. However, due to BiH's constitution and political reality, these processes cannot be carried out by institutions alone, but need strong support from outside.