



Position of Bosnia and Herzegovina in Respect to the Economic Criteria of EU Membership

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*Sarajevo, November 2007.
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LIST OF ACRONYMS AND ABBREVIATIONS

| | |
|---|------------------|
| CENTRAL BANK OF BH | CBBH |
| CENTRAL EUROPEAN FREE TRADE AREA | CEFTA |
| 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 |
| EUROPEAN UNION | EU |
| EU AFTER THE LARGE ENLARGEMENT | EU27 |
| 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 BANK FOR RECONSTRUCTION AND DEVELOPMENT | IBRD |
| INTERNATIONAL LABOR ORGANISATION | ILO |
| INTERNATIONAL MONETARY FUND | IMF |
| 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-SIZED ENTERPRISES | SMEs |
| STABILISATION AND ASSOCIATION AGREEMENT | SAA |
| UNITED NATIONS DEVELOPMENT PROGRAM | UNDP |
| UNITED NATIONS STATISTICS | UNSTAS |
| WORLD BANK | WB |

INTRODUCTION

Integrating Bosnia and Herzegovina into the European Union represents a strategic aim of this country that no one calls into question. Although full membership of BiH in the European Union requires fulfilling many conditions and criteria, these have not been sufficiently discussed, especially regarding the economic aspects of integration. From that standpoint, the analysis of the economic criteria for EU membership using BiH as an example represents a pressing and significant topic for this country, because the duration of the integration process will to a great extent depend on fulfilment of economic conditions for membership.

The economy of Bosnia and Herzegovina, contrary to the economies in most of the transitional countries, is special for many reasons. It is one of those transitional economies in which initial transitional reforms were stopped because of the war activities. Huge war devastations almost totally ruined the economic capacities of the country, so, by the end of the 20th Century, this country was faced simultaneously with the twin challenges of reconstructions and continuation of the transitional reform process. In a quite complex social and political surrounding, these processes have been carried out for the past decade or so with more or less success in separate areas. The facts generally characterising the BiH economy are the following: the achievement of macroeconomic stability (i.e. stability of prices and public deficits); high official unemployment rate; and huge imbalances in the external sector. In the area of transitional reforms, BiH achieved some positive results, according to transition indices, in the areas of price and foreign trade liberalization, small-scale privatization, whereas it achieved fewer results in the areas of large-scale privatization, enterprise reforms, competition policy, and reforms of non-banking financial institutions. Apparently, the transitional reform processes in BiH have not yet been completed, and it is necessary to make more effort in order that the envisaged reforms achieve some positive results in the country. The BiH decision to follow the path of European integration, hence to follow the direction of fulfilling the economic criteria for membership, gives both a direction and an instrument for accelerating transitional reforms in the country.

The paper is structured as follows. After introduction, the paper begins with the economic criteria and sub-criteria for the EU membership, as well as with the conceptual logic and understanding of these criteria. The third part of the paper analyses the key economic criteria, referring to the example of BiH. In addition, it compares Bosnia and Herzegovina with the candidate countries for membership from the perspective of the economic criteria. In the context of the membership criteria analysis, transition indices and official economic indicators were used in order to examine the specific criteria as profoundly as possible. Because of the limited availability of data, some of the sub-criteria were analyzed less than others. With respect to methodology, the paper was to a great extent prepared according to the *methodology of the Regular Reports of the European Commission*¹, with additional attention to the transition indicators of this country. The last part of the paper encompasses the conclusions, as well as the basic policy recommendations for BiH with the objective of good and fast fulfilling of the economic criteria for EU membership.

¹ For example: Commission of the European Communities, "Bosnia and Herzegovina 2007 Progress Report", Brussels, 2007.



1. ECONOMIC CRITERIA FOR THE EU MEMBERSHIP

1.1. ECONOMIC CRITERIA FOR MEMBERSHIP

The prerequisites and criteria that a country planning to become a full member of presently biggest supra-national integration – European Union has to meet are numerous. One of the unavoidable areas considered during a country's integration into the EU are economic criteria for membership, which were first clearly defined at the Copenhagen EU Summit in 1993. The European Commission then concluded that candidate countries have to meet certain criteria in the area of the economy. The Copenhagen economic criteria imply the "existence of functioning market economy and capacities for the economy to cope with competitive pressures and market forces in the Union".

The economic criteria for membership in the European Union and European Monetary Union are fairly static; they do not speak much of economy quality and they do not have rigorous theoretical underpinning. Besides that, the criteria do not discuss the effect of fulfilment 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 to meet them in accordance with the EU instructions. This research is focused on the degree of BiH readiness to meet the required criteria.

As one can see from the very definition of the criteria, they are not defined very clearly. So it is difficult, in reality, to determine either the meaning of these criteria or the point at which they have been fully met. The European Union decision as to whether the criteria have been met, therefore includes elements of a subjective nature. Still, it is possible to encounter, both in literature and in practice (special European Commission reports) components of the two described Copenhagen criteria that are observed in order to estimate if a country is close to meeting them or not.

With this in mind, it is possible to view the issue of the existence of a functioning market economy through a few sub-criteria¹:

- 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;
- Significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent;
- Equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalized;
- The legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;
- The financial sector is sufficiently well developed to channel savings towards productive investment.

With respect to capacity to cope with competitive pressure and market forces within the Union, the key question is whether domestic companies have strong enough capacities to accept these changes. The second criterion is even more difficult than the first to estimate in the sense of whether it has been met or not. Naturally, these criteria have to be met when a country has become a full member, i.e. when it has integrated into the Common Market in the full sense of the word. Sub-criteria related to this second criterion are the following:

¹ 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.

- 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;
- Sufficient amount, at appropriate costs, of human and physical capital, including infrastructure, education and research, and future developments in this field;
- Extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SMEs, etc.;
- The degree and the pace of trade integration a country achieves with the Union before enlargement. This applies both to the volume and to 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.

The listed elements based on which economic convergence criteria can be analyzed are only a part, or one approach to this issue. By no means must they be viewed as a checklist; and the European Commission also warns about this in its reports. In order to fully determine whether a functioning market economy exists or not, and whether companies are capable of coping with competitive pressures within EU, it is necessary to take into account a series of different macroeconomic and microeconomic variables, including their mutual interaction. Besides, one must not ignore the time dimension in meeting economic criteria.

In reality, it is not possible to perceive all the variables that are directly or indirectly related to these issues and, what is also crucial, the final evaluation of the state of an economy in these terms still contains a degree of subjectivity, which was already noted. Thus, for example, a report dealing with the accession of Croatia to the European Union states that "there is neither a summarized indicator nor a completely satisfactory set of multidimensional indicators of 'market maturity'. There are, however, some approximations based on which such an evaluation can be made with more reliability".² The same report lists the indicators of European Bank of Reconstruction and Development from the Transition Report that can serve for the analysis of these criteria. Due to the fact that the availability of data on the described issues for Bosnia and Herzegovina is poorer in some aspects, we will combine two approaches in our analysis of the Copenhagen economic criteria. First, we will analyze the available data for Bosnia and Herzegovina that are relevant for the analysis of the Copenhagen criteria while having in mind the manner of European Commission reporting on meeting these criteria. Secondly, we will use the indices of the European Bank for Reconstruction

and Development, which will ultimately allow us to perceive problems in this area more clearly and to draw conclusions that are relevant and more reliable than a simple analysis of available data.

And finally, economic criteria and relevant indicators that can be observed for a country overlap in most cases. For that reason, this paper will not observe the criteria as a clear checklist; rather, it will analyze the relevant areas integrally, without analyzing each of the criteria as a separate unit.

1.2. LOGIC OF THE ECONOMIC CRITERIA

It can be said of the economic membership criteria 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 the EU is the achievement of real convergence – i.e. the income per capita and living standard of the country under observation coming closer to the average of the less developed EU countries. Real convergence can be achieved only with long-term sustainable and stable growth under conditions of macroeconomic stability, both of which benefit the national economy. Conversely, non-fulfilment of economic prerequisites for EU membership is both a wasted opportunity for a country on its way towards the EU and suggests a poor environment from the national economy standpoint. This would particularly be the case in for Bosnia and Herzegovina, which has a low starting position in terms of economic performance.

Obviously, economic criteria for the EU membership contain short-term as well as long-term effects and objectives. In the short term, these criteria have been established to create a stable economy, whereas the main purpose in the long term is to create sustainable economies. However, what still has to be kept in mind is that meeting economic criteria for EU membership 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 results of a complete economic system. The choice of priorities and commitment is up to each country, as are a number of existing trade-offs in this process (i.e. between nominal and real convergence).

Finally, there is an issue regarding the nature of the relation between economic criteria for the membership and the transitional reforms that are still being implemented in Bosnia and Herzegovina. The economic criteria for membership are established to be compatible with the process of transition. From that perspective, fulfilling the economic criteria represents a support to the transitional reforms. These criteria can be observed, and used as well, to be an instrument for accelerating the transitional reforms. For that reason, the paper on the analysis of the economic criteria will also encompass the transition indexes as relevant indicators for the research topic.

² Institute of Public Finance; Friedrich Ebert Stiftung, *Croatian Accession to the EU*, Editor: Katarina Ott, Zagreb, December 2003.

2. BOSNIA AND HERZEGOVINA IN THE CONTEXT OF THE EU ECONOMIC CRITERIA

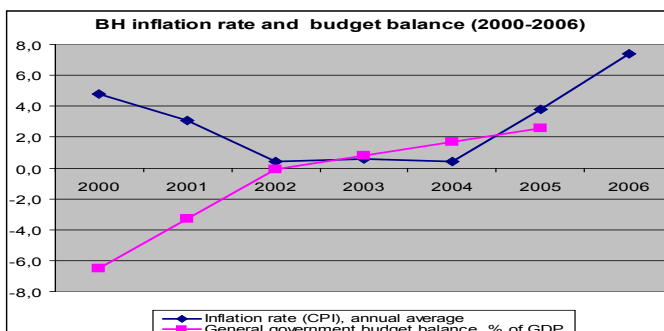
2.1. BOSNIA AND HERZEGOVINA VS. EU ECONOMIC CRITERIA

We will divide the analysis of the economic criteria, on the example of Bosnia and Herzegovina, into two separate sub-units. These overlap in many parts, but they can be observed separately as well. So, we will analyze the criterion 'existence of a functioning market economy' in the first part and 'capacity to cope with competitive pressure and market forces within the Union' in the second part of the Chapter. The European Commission uses this practice in the reporting and evaluation of the Copenhagen criteria for the candidate countries for the membership. We will also take into account the specific features of Bosnia and Herzegovina in this context, focusing on the fact that some of the data relevant for the analysis are still unavailable.

2.1.1. Existence of a Functioning Market Economy

The existence of a functioning market economy requires both prices and trade to be liberalized and an enforceable legal system, including property rights, to be in place. Macroeconomic stability and consensus about economic policy enhance the performance of a market economy. A well-developed financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of market economy.¹

'Macroeconomic stability in Bosnia and Herzegovina is present in its two main aspects, inflation and budget deficit, while external account has huge imbalances from year to year'. Economic growth has been stabilized at the level of about 5 % annually. Real GDP growth was about 5 % from 2000, in spite of adverse external conditions and an increasing trend of official unemployment from year to year.



Graph 1:
BH inflation rate and
general government
budget balance
2000-2006²

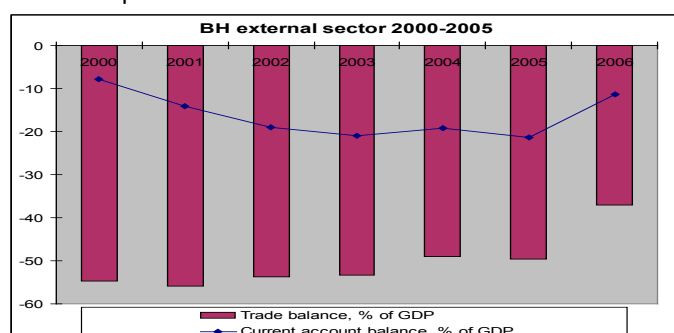
¹ EC, *Progress towards Meeting Economic Criteria for Accession: The Assessment from 2004 Regular Report*, p. 10.

² Source: Central Bank BH, *Annual Report 2006*.

Since 2000, inflation and budget deficits have been showing stable trends, and this is certainly a bright spot in the BiH economic environment. Monetary stability is largely the result of the restrictive monetary regime implemented by the Central Bank of BiH in its arrangement with the Currency Board while, in the area of fiscal policy, a great help in the budget consolidation was given by the International Monetary Fund and the arrangement being carried out with this international institution. As it can be seen from the Graph above, inflation has suddenly increased in 2005 to an annual rate of 3.6 % and in 2006 to 7,4 %. However, such increase may be primarily the result of the Value Added Tax reform. However, at the beginning of 2007, the level of prices is quite stabilized and we can expect a return to price stability.

Public finance stability is viewed through the state of the budget deficit and of the country's total public debt. In spite of the fact that the precise level of the public debt in BiH is still not known, basic statistical sources of the total public debt in Bosnia and Herzegovina registers a falling trend. The level of total public debt viewed in comparison to GDP was around 100% in 1998, and today it is around 50% of GDP³, which is an acceptable level from the perspective of European integration. Besides the decrease in the total public debt, the value of foreign debt also shows a falling trend, which is another important stability indicator. We should mention that BiH has a problem with unregulated internal debt, the level of which is still not quite clear.

Graph 2: External BiH balance 2000-2006⁴



While it can be said that the BiH finances have elements of sustainability, the conditions in the BiH external sector are a source of concern. Both the trade and the current account balance register big deficits, while positive shifts are not visible and present only in relative ratios. However, the decline of trade and current account deficit in 2006, evident on the Graph, is actually a structural break

³ IMF, Bosnia and Herzegovina, Selected Economic Indicators 2002-2006, taken from the official web page: <http://www.imf.org/external/np/sec/pn/2006/pn06117.htm>, October, 2007.

⁴ Source: Central Bank BH, Annual Report 2006.

that can be explained by the VAT reform. Since the VAT was introduced from the January 2006, domestic importing companies imported more in 2005 in order to avoid a higher rate of indirect taxation. Apparently, the huge decline of external deficits in 2006 is not surprising. A further argument is the fact that in the first three quarters of 2007 external deficits are again much higher and will probably return to the level (or above) from 2006. Hence, the external sector still suffers from huge imbalances. Such a state of balance of payment leads to conclusion that BiH economy is still an import-dependent economy.

The uncompleted transitional reforms as well as the inadequate restructuring of the economy are the causes of the high and increasing unemployment in the country. The overall number of the registered unemployed persons in both BiH entities, according to the 2006 statistics, is above half a million; or, in percentages, around 45%⁵. If we consider the data obtained by the LSMS and LFS surveys, it seems that unemployment is much lower and may be below 20 %. However, the official unemployment rate published by the state statistical authorities has an increasing trend over the last 5 years and it is persistently around 40 %. The trend is particularly emphasized in the Federation of BiH where the relative share of employed persons decreases in comparison to those seeking jobs, and this number changed from 1.5 of the employed per one unemployed from 2001 to only 1.1 in 2005⁶. In the other BiH entity, the situation is a bit 'better' in this segment, since the relative number of employed persons in comparison to the unemployed ones did not change considerably, and it is at the level of 1.6 of the employed per one unemployed.

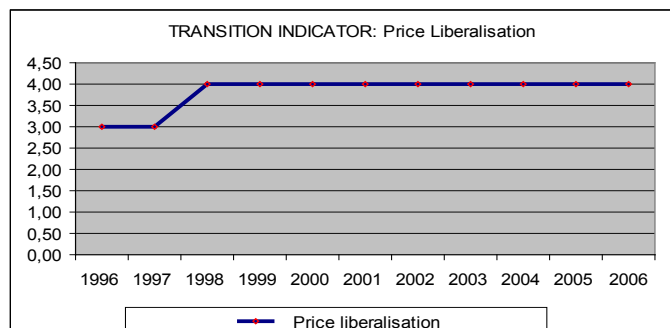
'Equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalized'. Bosnia and Herzegovina fulfills this criterion only in the part relating to price and foreign trade liberalization. The price liberalization has been already achieved in Bosnia and Herzegovina, as an important precondition for a functioning market economy. The transition index of this indicator had the maximal value for the period we observe (2000-2006). Immediately after the war termination, in the framework of transitional reforms, many reforms were implemented regarding price liberalization, and soon regarding trade liberalization. Accordingly, the liberalization index in 1996 had the value of 3, and only years after it reached the maximal value of 4; in this context, BiH can be compared with the developed industrial countries of Europe. The maximal value of this transition index is evident,

⁵ Official unemployment

⁶ Source: Table I in the Annex. (Researcher's assessment)

according to the evaluation of the European Bank for Reconstruction and Development, during the last nine years.

Graph 3: EBRD index, Price liberalization in BiH⁷



In recent years, Bosnia and Herzegovina achieved a considerable level of foreign trade liberalization, primarily through closing the Agreement on Free Trade with the surrounding countries, according to the conclusion of the Stability Pact. By signing the Memorandum of Understanding on Trade Liberalization and Facilitation (MoU) in June 2001, within the framework of the Stability Pact for Southeast Europe, BiH undertook to conclude bilateral free trade agreements with all countries in the region by the end of 2002⁸. Today BiH has fulfilled these obligations - BiH has nine bilateral FTA agreements with the following countries: Albania, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania, Slovenia, Serbia, Montenegro and Turkey. Slovenia is a member of the European Union and has not belonged to this group of countries since 1st May 2004. As part of the foreign trade liberalization, Bosnia and Herzegovina has made progress on the decreasing of tariffs for the free movement of goods and services, primarily through additional alignment of custom tariffs with the system compatible with the one in the European Union. The most important BiH trade partners are the European Union in first place, and then the countries that signed the Agreement on Free Trade; this shall be discussed in more detail below.

Nevertheless, regarding the sub-criteria relating to the 'free interplay of market forces' it is possible to identify numerous problems limiting the free creation of equilibrium in the system of aggregate supply and demand. We will mention the three main limitations to the approach in Bosnia and Herzegovina. First of all, the private sector in Bosnia and Herzegovina still has a relatively small share in GDP in comparison to the public sector.

⁷ Source: EBRD, 2007. 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.

⁸ Source: www.stabilitypact.org

The second problem, appearing in this context that will be more elaborated in the continuation of the paper, is in competition policy. It is the area in which Bosnia and Herzegovina, according to the assessment of the European Bank for Reconstruction and Development, has the worst indicators, and, at the same time, the minimal value of the transition index. It is not only that the value of this index is minimal, but it is constantly at the low level of one since the beginning of the transitional reforms from 1989, with small increase in 2006. According to the EBRD transition index, it seems as if progress in this area has not been achieved at all, whereas it is clear that non-existence of adequate competition policy makes difficult the establishment of a free market and, of course, private sector business activities. This can be confirmed by the results of the business sector research performed by the BiH UNDP, designed for the needs of the Early Warning System⁹. According to this Report, the interviewees from the national companies (Top 150 companies) identified unfair market competition, grey economy, and, at third place, corruption, as the biggest problems in performing business activities. Such results were obtained in all surveys done in 2006 on a quarterly basis, which is a very strong indication. We can see that the business sector in these inquiries clearly emphasizes this area as the biggest obstacles to successful business activities in the market.

And, finally, there can be neither a functioning market economy nor free creation of equilibrium between aggregate supply and aggregate demand if there is no single economic space in the country. Bosnia and Herzegovina still does not have a de facto established single economic space which guarantees completely free movement of goods, services and capital. The establishment of the single economic space is a priority identified in the Feasibility Study, Report on the Process of Stabilization and Association, and the European Partnership as well. The establishment of single economic space in BiH is focused on three areas: competition, consumer protection, and free movement of goods and services, and safety of industrial products. Apparently, the existence of a single economic space in BiH is basically one of the most important economic pre-conditions for getting closer to EU. Taking into consideration the three stated key limitations, beside many others that are possible to analyze, it is clear that Bosnia and Herzegovina has many things to do in order that the sub-criteria are also met.

'Legal system, including the regulation of property rights, laws and contracts can be enforced' is the criterion that poses a huge challenge for BiH regarding the implementation of the reforms nec-

⁹Source: UNDP, Early Warning Systems, The Quarterly Reports (Q1, Q2, Q3, Q4), Annual report for 2006.

essary for improving the current situation in the country.

"Being aware of the fact that an appropriate legislation is a necessary condition for an efficient transition from centrally-planned to market economy, all countries in the region started at the very outset of the transition with a comprehensive reform of their legal and regulatory systems"¹⁰.

With regards to Bosnia and Herzegovina, it is very well known that this country is a very complex one that consists of two entities, the Federation of Bosnia and Herzegovina, and the Republic of Srpska. By the General Framework Agreement for Peace in Bosnia and Herzegovina, initialed on November, 21st 1995 in Dayton, and signed on December, 14th 1995 in Paris, the fundamental principles of the regime of public law of Bosnia and Herzegovina had been agreed. Within the competence of the institutions of Bosnia and Herzegovina are: foreign policy; foreign trade policy; customs policy; monetary policy; as provided in Article 7; finances of the institutions and for the international obligations of Bosnia and Herzegovina; immigration; refugee, and asylum policy and regulation; international and inter-Entity criminal law enforcement including relations with Interpol; establishment and operation of common and international communications facilities; regulation of inter-Entity transportation; and air traffic control¹¹. According to laws in both entities, property transfers must be registered with municipal authorities. Property registers are largely unreliable. In practice, transactions are often not recorded due to high transfer taxes. This leads to inaccurate and unreliable property records that leave property transfers open to dispute. In 2004, BiH adopted a State-level framework law to create a moveable pledge registry. The registry became operational as of January 2005. Regarding Protection of Intel-

lectual Property Rights, the BiH Government does not adequately enforce intellectual property rights (IPR) even though it is enacting and revising laws in preparation for eventual membership in the European Union and WTO. BiH is not a signatory to the Trade-Related Aspects of the IPR (TRIPS) agreement. BiH does not adequately protect intellectual property, patents, copyrights, trademarks, trade secrets or semiconductor chip layout design. In order to meet requirements to begin formal negotiations for eventual membership of the European Union, BiH created a separate Intellectual Property Institute from the BiH Standards, Metrology, and Intellectual Property Institute in 2004. In 2002, the BiH Industrial Property Law replaced all previous legislation from the former Yugoslavia and the entity of Republic of Srpska. Furthermore, BiH does not adequately enforce the key international agreements on IPR of which it is a party. In 1993, BiH became a member of the World Organization for Intellectual Property (WIPO). BiH is a party to five international intellectual property conventions (Paris Convention for the Protection of Industrial Property, Madrid Agreement Concerning the International Registration of Marks, Nice Agreement on the International Classification of Goods and Services for the Purpose of Registering Marks, Locarno Agreement Establishing an International Classification for Industrial Designs, and the Bern Convention for the Protection of Literary and Art Works). In 2005, the International Intellectual Property Alliance gave BiH a special mention because of its lack of effective legislation and enforcement.¹² Considering the registration of property, Bosnia and Herzegovina takes the 144th position in the World Bank Doing Business Report for 2008. Comparing with the Report for 2007, Bosnia and Herzegovina has fallen one position. According to the Report for 2008, registering property in Bosnia and Herzegovina require seven procedures and can be very time and money consuming (table 1.).

Table 1. Registering Property in Bosnia and Herzegovina in 2007

| No. | Procedure | Time to complete: | Cost to complete: |
|-----|--|--|--|
| 1. | Obtain a land registry extract as proof of ownership | 1-7 days (simultaneous with procedure 2) | BAM 2 per page (about 4 pages) |
| 2. | Parties obtain the court extract certifying the person authorized to act on behalf of each company | 10 days (simultaneous with procedure 1) | BAM 8 (each request) + BAM 2 per page (Court Extract, about 4-5 p. each) |
| 3. | Verification of the signatures of both parties at the court | 1 day | BAM 4 per copy of the contract (5 copies) |
| 4. | Submit a request for evaluation of the property regarding tax payments | 1 day | no cost |
| 5. | On-site inspection of the property | 5-15 days | no cost |
| 6. | Payment of the transfer tax at a commercial bank | 1 day | 5% of property value (transfer tax) |
| 7. | Apply for registration at the Land Registry | 250-365 days | BAM 6 (court tax) |

Sources: Doing Business 2008

10 Mrak, M., "Globalization: Trends, Challenges and Opportunities for Countries in Transition", Faculty of Economics, University of Ljubljana, February 2000, pp. 27.

11 Source: Constitution of Bosnia and Herzegovina, Parliament of Bosnia and Herzegovina, www.parlament.ba

12 Source: United states of America, Department of Commerce, A Country Commercial Guide for U.S. Companies, Investment Climate - Bosnia and Herzegovina, www.buyusa.gov

Considering enforcing contracts in Bosnia and Herzegovina, the following is a list of procedural steps necessary to enforce a contract in Bosnia and Herzegovina. The comparison with the region and the OECD countries in enforcing contracts is shown below. The ease or difficulty of enforcing commercial contracts in Bosnia and Herzegovina is measured below. It takes 38 steps and 595 days to enforce contracts in Bosnia and Herzegovina. The average cost of enforcing contracts is 38.4% of income per capita. As we may see from the Table 2, procedures of enforcing contracts have been worsening in 2007 while no improvement is evident with respect to timeliness. In spite of the fact that the institutional framework in Bosnia and Herzegovina is very complicated and costly, also enforcement as an important part of the institutional framework in BH may not be marked as satisfactory. Apparently, the efficiency of domestic institutions is questionable, which may also have adverse economic consequences in line with the New institutional economics hypothesis; namely, that lower efficiency of domestic institutions lead towards worse economic performance¹³.

'Significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent'. New entrants to the market will most likely displace/supplant nearby suppliers, such as Croatia, as well as the dominant EU member country exporters. Establishing a business in Bosnia and Herzegovina can be an extremely burdensome and time-consuming process for investors.¹⁴

tion process should soon be simplified when the new State-level business registration legislation is implemented. Under this new law, there will be one unified business registry for the entire country, which should improve the situation in this 'bad' segment.

The immense structure of state, entity and municipal administrations creates a heavily bureaucratic system that lacks transparency. All three levels of government (municipal, cantonal, and entity) establish laws and regulations affecting businesses, creating redundant and inconsistent procedures encouraging corruption. Often it is impossible to know all of the laws or rules that might apply to certain business activities, given overlapping jurisdictions and the lack of any central source of information. It is therefore critical that foreign investors obtain local assistance and advice. Businesses are subject to inspections from a number of entity and cantonal/municipal agencies. These include the financial police, labor inspectorate, market inspectorate, sanitary inspectorate, health inspectorate, fire-fighting inspectorate, environmental inspectorate, institution for the protection of cultural monuments, tourism and catering inspectorate, construction inspectorate, communal inspectorate, and veterinary inspectorate. Inspection functions may be consolidated into one agency in the future but relevant legislation has not yet been adopted. Corruption remains prevalent throughout political and economic institutions. The business registration and licensing process is par-

Table 2: Enforcing Contracts in BiH 2003-2007

| Indicator | BIH 2003 | BIH 2004 | BIH 2005 | BIH 2006 | BIH 2007 | Region 2007 | OECD 2007 |
|--|----------|----------|----------|----------|----------|-------------|-----------|
| Procedures (number) | 31 | 36 | 36 | 36 | 38 | 35.9 | 31.3 |
| Time (days) | 630 | 330 | 330 | 595 | 595 | 443.0 | 443.3 |
| Cost (% of: claim 2007, 2006; debt 2005, 2004; income per capita 2003) | 51.8 | 19,6 | 19,6 | 19.6 | 38.4 | 22.7 | 17.7 |

Sources: Doing Business 2004; 2005; 2006; 2007; 2008, EBRD/World Bank.

Apparently, transaction costs for domestic companies are higher; hence total costs of production are higher.

Foreign investors must follow the same regulatory procedures when establishing their enterprises. Registration can sometimes be expedited if a local lawyer is retained to follow up each step of the process. The procedure for starting a business is the same in the whole territory of Bosnia and Herzegovina (Federation of Bosnia and Herzegovina, Republic of Srpska, Brčko District).¹⁵ The registra-

tion process is particularly vulnerable to corruption. Businesses must navigate a burdensome and complicated web of regulatory procedures to obtain the necessary licenses to begin operations. With the large number of officials involved, there are multiple opportunities to demand "service fees." Domestic and international entrepreneurs are often forced to pay bribes to obtain the necessary business licenses, or simply to expedite the approval process. Transparency International operates a branch office in Banja Luka. TI's 2005 Corruption Perception Index ranked BiH 88 out of 158, on par with countries such as Armenia and India.

The challenges of launching a business in Bosnia and Herzegovina are shown below. Entrepreneurs can expect to go through 12 steps to launch a business over 54 days on average, at a cost equal to 30% of gross national income (GNI) per cap-

13 North. D. C. "Understanding the Process of Economic Change", Princeton University Press, Princeton, 2005

14 U.S. Commercial Service, A Country Commercial Guide for U.S. Companies, www.buyusa.gov

15 Bosnia and Herzegovina, Foreign Investment Promotion Agency, Information for Investors, www.fipa.gov.ba

ita. They must deposit the equivalent of at least 43% of GNI per capita in a bank to obtain a business registration number. A firm registration costs about \$800. Other administrative procedures are even more time-consuming. For example, obtaining a construction permit can take as long as 6 months to one year. However, BH has not done almost anything to improve the cost of starting business in terms of the number of procedures and time, which are presented in Table 2.

Apart from the problem that costs of starting a business are high, the situation with closing a business is even worse. In Bosnia and Herzegovina, the process of closing a business takes 3.3 years and costs the equivalent of 9% of income per capita. Comparing with the average of Region and especially developed OECD countries, it is quite clear that BH lags behind those countries. The problem that comes out is that entrepreneurs (or even ordinary citizens) may sometimes not be ready to start seasonal or temporary business activities in

Macedonia and Bulgaria - improved their rankings by 17 and 8 places respectively and are also among the top ten most active reformers globally. But other countries in the region have not kept up. In the global ranking BiH slipped from 95th to 105th place. The ranking for Serbia went down by 18, for Albania 16 and for Montenegro 11 places (to 86, 136 and 81, respectively).

'Broad consensus exists about the essentials of economic policy'. In Bosnia and Herzegovina, governmental bodies, and international organizations drafted numerous documents relating to economic policy. Nevertheless, for the successful implementation of any policy, it is necessary to secure some general consensus between the relevant actors. We will single out the key documents securing general consensus related to BiH economic policy. The Poverty Reduction Strategy Paper (PRSP), a document that is in the case of BiH considered as a Mid-term development strategy, represents the

Table 3: Starting Business in BiH

| Indicator | BIH 2003 | BIH 2004 | BIH 2005 | BiH 2006 | BiH 2007 | Region 2007 | OECD 2007 |
|--|----------|----------|----------|----------|----------|-------------|-----------|
| Procedures (number) | 12 | 12 | 12 | 12 | 12 | 8.8 | 6.0 |
| Time (days) | 59 | 54 | 54 | 54 | 54 | 26.1 | 14.9 |
| Cost (% of: GNI p/c 2007; income p/c 2006, 2005, 2005; 2003) | 51.8 | 46.2 | 40.9 | 37.0 | 30,1 | 11.1 | 5.1 |
| Min. capital (% of: GNI p/c 2007; income p/c 2006, 2005, 2005; 2003) | 379.1 | 65.0 | 57.4 | 52.0 | 43.0 | 45.3 | 32.5 |

Sources: Doing Business 2004; 2005; 2006; 2007; 2008, EBRD/World Bank.

the official sector. Apparently, such a situation may support "short-term" business activities in the informal sector rather than facing the overwhelmed costs in terms of money and time for starting and closing businesses.

While some countries in the West Balkans, like

first paper that included several layers of government, private sector, civil society and other concerned groups. Accessing to the European Union is a strategic priority of Bosnia and Herzegovina, and the aspiration of BiH to acquire full EU membership is based on a broad political consensus. There-

Table 4: Closing Business in BiH

| Indicator | BIH 2003 | BIH 2004 | BIH 2005 | BiH 2006 | BiH 2007 | Region 2007 | OECD 2007 |
|--|----------|----------|----------|----------|----------|-------------|-----------|
| Time (years 2007; 2006; 2005; Year of insolvency 2004; 2003) | 1.86 | 3.3 | 3.0 | 3.3 | 3.3 | 3.2 | 1.3 |
| Cost (% of: income p/c 2007; estate 2006; 2005; cost of insolvency % of estate 2004; 2003) | 8 | 8.0 | 9.0 | 9.0 | 9.0 | 13.7 | 7.5 |

Sources: Doing Business 2004; 2005; 2006; 2007; 2008, EBRD/World Bank.

Croatia and Macedonia, proved to be leaders of the reform process in recent years, Bosnia and Herzegovina's pace of reform was slower than that of neighboring countries. Some regional performers have left behind even many Western European economies. Soaring 27 places (WB Doing Business 2008), Croatia is the fastest reforming country in the region this year, and second only to Egypt. Two other countries from Southeast Europe - FYR

fore, BiH prepared a Strategy for integrating BiH into the EU during 2005. We can confidently say that the Mid-term development strategy (MTDS) of BiH presents a single document that secured a broad consensus on economic policy at the level of Bosnia and Herzegovina. One of the three aims of MTDS of BiH is accelerating the EU integration process, so the two documents are complementary. Even at the time when BiH was in the process

of defining the MTDS, it was clear that EU integration was in the political and socio-economic interest of the country¹⁶. These two documents secure a firm framework for the further development of economic policy in Bosnia and Herzegovina on the basis of broad consensus.

In recent years, Bosnia and Herzegovina is very well known by the fact that consensus on the key economic, political and social issues was achieved only with great difficulty by national political subjects. Very often, intervention from the Office of the High Representative was needed as well. Nevertheless, as a promising factor in the series of problems regarding this criterion is the evident existence of consensus on choosing "the European road" for BiH. It seems as if no one any longer doubts that the country will become a full member of the European Union and the European Monetary Union in the future. Although there is verbal support, conditionally speaking, by all the relevant groups in the country, very often there is a lack of the 'real' efforts necessary for accelerating this process in reality. When one feels the "practical" support to this process, we will be able to confirm that consensus is de facto present regarding this issue. Other questions and issues, unfortunately, do not benefit from such a comprehensive consensus as orientation towards the EU. Finally, it is important to underline that the Directorate for Economic Planning (former Economic Policy Planning Unit) has announced plans for new development strategy preparation.

'The financial sector is sufficiently well developed to channel savings toward productive investment'.

"There are at least three reasons why financial sector restructuring has been of strategic importance for transition economies. First, without an active financial market mechanism, their economies, having abandoned planning, there is no alternative allocation mechanism. Secondly, through intermediation of financial institutions, resources can be channeled directly to enterprises and to the real sector in general. Thirdly, efficient financial institutions help imposing a hard budget constraint on the enterprises"¹⁷.

Financial system (FS) of BiH includes: the Central Bank of BiH (Currency Board); the banks (almost totally privatized, with predominantly foreign capital); the insurance companies (the reform has not finished yet); the privatization investments funds

(should be transformed into mutual funds); and the stock exchanges (FBiH and RS – with a very low level of transactions). The Current FS of BiH does not have a fully established money market, mortgage institutions, pension funds and investments funds. The main characteristic of the BiH financial sector is the absolute dominance of the banking sector; and when we speak about the BiH financial system, we practically speak about the banking sector. But, let us take a closer look to the financial institutions in BiH.

The Central Bank of Bosnia and Herzegovina (CB-BiH) is established in accordance with the General Framework Agreement for Peace in Bosnia and Herzegovina in BiH, or the Law on the Central Bank of BiH. The Central Bank cannot emit loans because of the competence of the Currency Board. The Steering Committee is authorized to determine the monetary policy, approve all the reports the Central Bank submits to the Parliamentary Assembly and the Presidency of BiH, and determine the minimal value of the bank notes and coins etc.¹⁸. The Currency Board seemed to be efficient, since prices were quite stable during recent years, while the level of gross foreign currency reserves had a tendency towards continuous growth. Reserve requirements were raised twice in 2005 (to a rate of 15 percent) in an effort to restrain consumer lending. The annual inflation rate rose in 2005 to around 3-4 percent. Some significant price rises were recorded in January 2006 after the introduction of VAT, but the long-term effect on this measure is unlikely to raise inflation significantly. On the fiscal side, the budgets in both territorial Entities have been broadly in balance. Prime ministers in Bosnia and Herzegovina including FBiH, RS and BiH prime ministers recently have promised to establish a Fiscal Council at BiH state level in order to secure better coordination in the future. The 3rd Economic Dialogue between BiH and the European Commission held in Sarajevo has on its agenda the establishment of a Fiscal Council at the BiH level, the adoption of the state law on the fiscal council, the allocation of revenues from the single account and the BiH economic-fiscal program. The 2004 agreement among all parties (state and entities) to restructure and substantially write down the level of domestic debt is on hold. This follows court rulings casting doubt on the legality of the original plan. It raises once again the potential for large liabilities facing governments at all levels in the country¹⁹.

The banking sector in Bosnia and Herzegovina has been almost completely privatized. By the end of 2004, almost 84% of the capital was in private

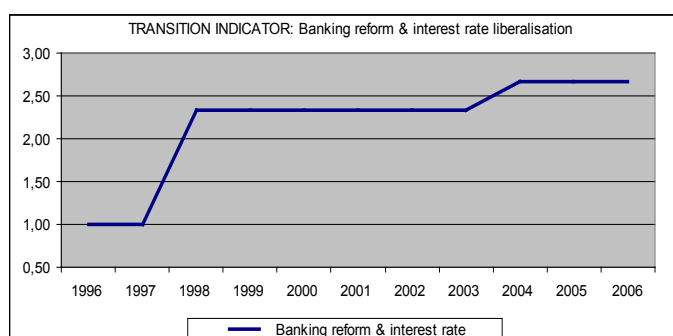
16 Bosnia and Herzegovina, The Council of Ministers, EPPU (PIMU), *Mid-term Development Strategy of BiH* 17 Mrak, M, "Globalization: Trends, Challenges and Opportunities for Countries in Transition", Faculty of Economics, University of Ljubljana, February 2000, Page: 28.

18 Central Bank of Bosnia and Herzegovina, www.cbbh.ba

19 European Bank for Reconstruction and Development, *Transition Report Update*, May 2006

ownership, whereas most of the banks are under the majority foreign ownership. The overall assets of the banking system were 10.99 billion KM by the end of September 2005, 43% more than at the end of 2003, or around 80% of GDP from 2004²⁰. The high return on banks' lending leads to the increased trust, decreased risk, as well as to alleviated conditions banks require for assurance of the loan exposure. In the context of the Central Bank, there has been formed a Working group for drafting the Law on Banks at the state level that should contribute to the creation of the legislation framework for undisturbed movement of capital, improvement of the bank operational activities, competition strengthening, and raising the quality of bank services.

Graph 4: EBRD index, Banking reform & interest rate liberalization²¹



Beside the successfully implemented reforms in the banking sector, significant interest rate liberalization was achieved as well, so the EBRD index for this area constantly grows and its current value is almost 3²². The trust in the banking sector constantly grows, with the trend of decreasing the interest rates for the corporate sector. The corporate interest rates are around 8%; and for the retail sector they are bit higher, around 9.5%. The bank exposures, in the commercial as well as in the consumer sector continuously grow, and in the system of securing deposits, 22 banks are included²³. The successful return of the means placed by banks leads toward the growing trust, decreasing risk, as well as alleviating the conditions that banks require for assuring their loan exposure.

20 Central Bank of Bosnia and Herzegovina, Annual Report 2005.

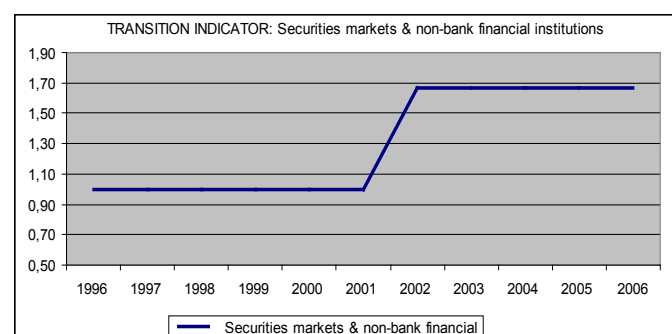
21 Source: EBRD, 2007. Transition indicator scores range from 1 to 4 with 0.3 decimal points added or subtracted for + and - rating. The rank 1 marks the start of market economy while rank 4 means that market economy is at the level of industrialized countries.

22 European Bank for Reconstruction and Development, Transition Report 2005.

23 Central Bank of Bosnia and Herzegovina, Business Activities of Banking Sector, www.cbbh.ba

The institutions for supervision and regulation for the insurance sector are not completely established in accordance with the new legislative solutions. The Laws have been adopted at the state and entity level within the provided deadline, but the very implementation was not carried out with the planned momentum. The insurance companies outside BiH are allowed to have equal treatment in carrying out their business activities through establishing branches, and the establishment of associations and other not-for-profit institutional forms in the insurance sector is also allowed. In the same way, the equal treatment to all insurance companies established in BiH is allowed by these laws. Unfortunately, there is still a lack of coordination in the insurance sector of the different capacities of the entity supervisory agencies. The market of capital is regulated and organized at the entity level and the entity Commissions for Securities monitor the market and issue licenses. The securities trade (i.e. shares and options) is carried out through two stock exchanges (Sarajevo and Banja Luka). The currency business activities are currently regulated by two incoherent entity laws which are implemented inconsistently. Exchange transactions in a country with a unified monetary policy and currency have to be better regulated and it would be optimal if a law on exchange transactions with a strong control mechanism were to be created. The financial markets in BiH are still significantly fragmented and because of that it is impossible to achieve a full financial connection and single market. Almost all the legally binding provisions at the entity level and financial instruments cannot be used throughout the whole country²⁴.

Graph 5: EBRD index, Securities markets & non-bank financial institutions²⁵



24 European Commission, Bosnia and Herzegovina – The Progress Report in 2005.

25 Source: EBRD, 2007. 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.

It is to be noted that the transition index for securities markets and non-bank financial institution marked an increase in 2002, but its value is still below 2. It leads us to the conclusion that this market as well as its institutions, in the context of development, is still way below the level of the highly developed European countries. Apparently, little progress has been made in recent years.

We have to point out that, on the one hand, the BiH financial sector is still insufficiently developed in terms of directing savings towards productive investments. On the other hand, the average population incomes in BiH are still so low that, in most cases, they can only cover basic consumer needs. Although there are some positive indicators in regards to savings, it is still at a very low level. Let us mention the recent research on wages and savings of the BiH population, done by the UNDP Project Early Warning System. According to the results obtained by the interviews carried out in September 2006, more than 45% of the interviewees stated they had insufficient income to cover basic consumer needs. 3.3% of the interviewees from the sample stated they had no incomes, which is not an insignificant percentage. Having in mind the answers of the interviewees on wages and estimations of future incomes, it is no surprise that 82% of the interviewees from the sample stated they would not be able to put away any money for saving from the incomes they had at their disposal.²⁶

2.1.2. Capacity to Cope with Competitive Pressure and Market Forces within the Union

'Bosnia and Herzegovina has already achieved a high degree and pace of trade integration with the Union'. The main foreign trade partners of Bosnia and Herzegovina in recent years have been the

main foreign trade partner became the European Union itself.

The BH external sector is characterized by a huge trade deficit and a low ratio of exports to imports. The small improvement in 2006 that we may see in the Table 5 above is mainly due to the importing companies importing more at the end of 2005 as a „logical“ way to avoid higher taxation in 2006 (anticipating the introduction of VAT from the 1st of January 2006). In spite of the fact that the external sector in BH is in big imbalance, at least a good thing from the EU integration perspective is that the European Union is the most important trade partner (as a group of countries) of BH. However, BH has its highest trade deficit with the EU and the FTA (Free Trade Area) countries. In 2006 the deficit with the FTA countries was 2,507 millions KM, while with the EU the deficit was almost on the same level - 2,505 million KM. EU and FTA countries together share 84 % of the total BH trade deficit. However, the ratio of exports to imports is slightly better in the case of EU countries compared to the FTA countries.²⁷ Apparently, BH has a large degree of trade integration with the European Union but, unfortunately, BH imports much more from the EU than it exports there.

Regarding the import structure from EU, Bosnia and Herzegovina mainly has the biggest import in the group of products that consists of Machinery, Apparatus, Boilers, Vehicles and spare parts, and Metal products and their spare parts. The fact that the biggest portion of import relates to the products that can be used in the process of production is encouraging. On the other side, the biggest exports to the European Union relate to the group of products that consists of Metal products and their spare parts, Machinery, Apparatus, Boilers, and Synthetic fibbers, fabrics, clothes, shoes, and carpets.

Table 5: Total foreign trade BH 2000-2006.

| Year | 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 | 9.371.258 | 12.365.477 | -6.377.039 | 32,00 |
| 2005. | 3.826.489 | 11.081.125 | 14.907.614 | -7.254.636 | 34,50 |
| 2006. | 5.271.043 | 11.234.503 | 16.505.547 | 5.963.460 | 46,90 |

Source: Spoljnotrgovinska/vanjskotrgovinska komora BiH, *Pregled ostvarene vanjskotrgovinske razmjene za BiH za period od 1. do 12. mjeseca 2005/06 godine*, Sarajevo, januar 2007. godine.

countries that signed the Foreign Trade Agreement and, after the last enlargement of EU in 2004, the

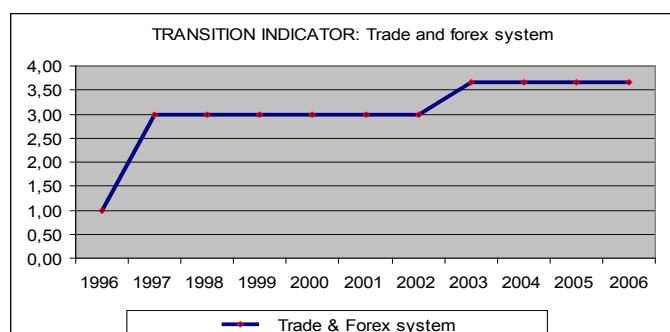
²⁶ Source: UNDP, *Early Warning System*, Quarterly Report Q3, 2006.

²⁷ Izvor: Spoljnotrgovinska/vanjskotrgovinska komora BiH, official web page: <http://www.komorabih.ba/?s=11>, October 2007.

Observed by sector, BiH in 2005 had the biggest imports from the countries of the European Union in the sectors of machines, equipment, mechanical devices, boilers, vehicles, and weapon (1,653 mil. KM); in the agro industrial sector (909 mil. KM); and in the sector of chemical-pharmaceutical products, fertilizers, plastics, caoutchouc and rubber (680 mil. KM). On the other hand, the highest exports were recorded by the sectors of minerals, metals, and other products; then machines, equipment, mechanic devices, boilers, vehicles and weapons; and at the third place we have wood, paper, and furniture.

It is to be noticed that BiH to a great extent imported the products of high technological processing and additional value, and it exported mostly products of the lower processing kind, with a huge share of labour in the final value of the products. The low competitiveness of the BiH economy is an obvious reason for the import of high technological final products, while exports are dominated by raw materials, semi-products, and final products of the low technological processing.

Graph 6: EBRD index, Trade and Forex System²⁸



The transition index for Bosnia and Herzegovina relating to the area of foreign trade indicates very good results, since it has almost reached the highest level. The big turning point in the level of this index was marked at the very beginning of the post-war reconstruction of the country when, at the same time, the price and foreign trade liberalization was implemented. That, of course, resulted in the three-fold rise of the index in just one year. From 1997 till 2003, the value of this index was at the level of 3, and after 2003, this index reached the value of 3.5. This, of course, means that Bosnia and Herzegovina, according to this indicator, is quite close to the highly industrialized countries, and that we can be relatively satisfied by the achieved results, as well as with the evaluation of the European Bank for Reconstruction and

²⁸ Source: EBRD, 2007. 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.

Development. It is to be emphasized that the main foreign trade partner of BiH today is the European Union. It is important to underline that BiH ratified the Central European Free Trade Agreement (CEFTA) in September 2007, which represented a very positive step for the EU approximation. CEFTA has served as a preparation for full European Union membership for all former EU accession countries.

'The extent to which government policy and legislation affect competitiveness through trade policy, competition policy, state aids, support for SMEs'. The Council of Competition in BiH was established in May 1st, 2004 as an independent public body mandated to ensure consistent implementation of the Law on Competition passed in 2001.²⁹ It has exclusive competence to decide on the presence of the prohibited competition activities in the BiH market. For the first time, this Law establishes competition policy as an important instrument and pillar in the creation and strengthening of the single economic space /market in Bosnia and Herzegovina.

The Law on Competition, passed in 2001, comprised the basic rules of competition within the meaning of Article 81 and 82 of the EC Treaty, but it did not apply to practices and resolutions of the modern European legislation - *acquis* in this field. Therefore, a new Law was passed ("Official Gazette BiH", No. 48/05) and it has been in effect since 27th July, 2005. Compatibility of the new Law on Competition, with stipulations and regulations of the European Union legislation in the field of the market competition (i.e. Regulations adopted in 2003 and 2004. - EC Council-No. 1/2003; 139/2004; 773/2004; 802/2004; etc.), ensures effective and transparent application of the law, simple procedures, reduced duration of proceedings and, in general, reduced levels of state intervention in this field. Compared to the previous Law, the new Law legislates the penalty policy for undertakings (Leniency policy), an effective mechanism of market control, and establishes cooperation with the international Agencies in this field. This Law shall apply to all forms of prevention, restriction and distortion of market competition in the whole territory of Bosnia and Herzegovina or out of the territory of Bosnia and Herzegovina having a substantial effect on the market of Bosnia and Herzegovina. Special attention is directed towards agreements on dominant position and abuses of dominant position, and to the rules and procedures concerning competition between undertakings.³⁰

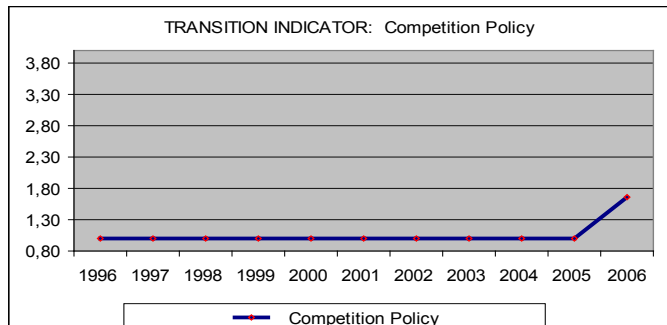
The EBRD index related to competition policy in Bosnia and Herzegovina shows very bad results

²⁹ European Commission, Bosnia and Herzegovina - The Progress Report in 2005, Chapter 3.1.5.

³⁰ Bosnia and Herzegovina, The Council of Competition, www.bihkonk.gov.ba

for the period 1996-2005, and a small improvement in the last year.

Graph 7: EBRD index, Competition policy³¹



As we can see, the value of the transition index for the Competition policy is at the lowest possible level since 1996, except in 2006. According to the assessment of EBRD, Bosnia and Herzegovina has not achieved any positive steps in this area. Let us recall the inquiry of the business sector to which we referred in the previous parts of this paper, and which shows that the biggest obstacle to the business activities of national companies is unfair market competition. Obviously, it is an area where structural reforms are needed in order to remove such obstacles from the BiH market.

Having in mind the fact that Bosnia and Herzegovina prepares itself for WTO membership, and the conclusion of the Stabilization and Association Agreement, there will be additional requirements to take over and implement the regulations on state aid in line with international rules regarding government support to the industrial sector. These requirements shall create new conditions to develop governmental policies in areas like new direct foreign investments, negotiations on bilateral investments or trade agreements, formulation of national industrial policies, privatization, restructuring of companies or industrial branches, development of policy to support small business, regional development, implementation of competition legislation, as well as commercial acceptances of governmental supports, and industrial initiatives by business entities. It is clear that each state (government) grants state aid to certain undertakings. The State Aid Control, that it is necessary to establish, relates to the more extreme cases with big negative effects having the tendency to breach EU state aid law and the WTO Subsidies and Countervailing Measures Agreement. Beside the fact that the establishment of such a system will be needed for regulating and reporting, it will

³¹ Source: EBRD, 2007. 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.

be needed for future trade and international economic relations of BiH, and it will also contribute to future development.

It is clear that in the context of the Stabilization and Association Agreement between the EU and BiH, there will be needed a functioning State Aid Monitoring System. Although the nature, intensity, and the phases of the State Aid Monitoring System considerably differ in relation to the situations and phases in the EU integrations process in different states, the State Aide Monitoring System consists of the following elements:

1. A State Aid Inventory
2. Legislation to create the basis for monitoring changes in the inventory and reporting it annually to the EU (and the WTO).
3. A functioning monitoring mechanism coordinated at State Government level
4. Annual state aid international (possibly also national) reporting
5. Possible national regulatory controls (in the legislation) to provide for
 - approval, non-approval or conditional approval of new state aids or substantial changes to existing aids
 - a process of review and alignment of existing state aid
 - a state aid mapping process to match maximum investment and job creation state aid to real and relative economic disadvantage
 - a right of recovery of illegal state aid.

The State Aid Monitoring System is a general concept that is neutral in relation to the combination and time frame of monitoring and control in the development of the State Aid System. Even before the completion of the Stabilization and Association Agreement, the decision on the European Partnership from November 2005, and the Action Plan of BiH for its implementation refer to the fact that Bosnia and Herzegovina needs to create the necessary legislation and establish the State Aid Inventory by the end of 2007³².

The Project "Support for Competition and State Aid in Bosnia and Herzegovina" financed by the EU will assist the authorities to establish the Preliminary State Aid Inventory for BiH during 2006. The planned coverage of the preliminary state aid inventory for BiH will encompass the state level, Federation of BiH, Republic of Srpska, the Brcko District, 10 cantons in the Federation of BiH, and the main municipalities in both entities. The preparation of the Preliminary State Aid Inventory re-

³² The European Union's CARDS program for BiH, "EU Support for Competition and State Aid in Bosnia and Herzegovina", Progress Report No. 2, 2006.

quires budgetary analysis at all government levels during the period of 2004 – 2006, lists of all state aid schemes and their legal basis, analysis of the schemes and the main sectors they relate to, inclusion of the tax relieves and the analysis of the main economic interventions of the BiH government during the last three years.

In order to improve the situation for small and medium-sized enterprises in Bosnia and Herzegovina, it is necessary to create an environment consistent with the development of this sector.

International projects have had and still have a significant role in training and advisory activities: both indirectly, by strengthening the institutional infrastructure that would support the SMEs and entrepreneurship; and directly, by building SME managerial capacities. GTZ and USAID have done a lot in the field of training and consulting on entrepreneurship infrastructure, while the Italian project GIER paid more attention to the weaknesses of business associations, the system of chambers and the need to initiate new and reform the old associations. The general view in Bosnia and Herzegovina is that there has been a lack of financial assistance in the form of investments for starting and developing concrete business projects. The large share of foreign consulting services in the cost of training and consulting projects, and, at the same time, a significant fall in interest in participating in seminars, indicate that the efficiency of this approach is diminishing.

'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'. Small and medium-sized enterprises are

of the business environment for small-sized enterprises and refer to: reform of laws; approach to finances; business representation; education in entrepreneurship; competitiveness; etc. Bosnia and Herzegovina signed the European charter for small-sized enterprises in June 2003. Together with other countries of the Western Balkans, Bosnia and Herzegovina sends annual reports to the European Commission on the realized goals of the Charter. The implementation of the goals determined in the Charter represents a very important step towards membership in the European Union. There are different definitions of small and medium-sized enterprises. In Great Britain, small-sized enterprises are defined as entities which have up to 200 employees; in France small-sized enterprises employ from 6 to 50, and medium-sized enterprises from 51 to 500 people; while for example in Germany, the basis for definition of small and medium-sized enterprises, apart from the number of employees, is also total annual revenue. According to the EU provisions, small and medium-sized enterprises have less than 250 employees, annual turnover less than 40 million Euros and they are independent in their management. According to the OECD definition, small and medium-sized enterprises have less than 500 employees, although in every country some space is left to decrease or increase this number (in some countries 100 or even 300 employees represent the upper limit). Micro enterprises have 1- 4 employees, very small ones have 5- 19, small ones 20 – 99 and medium-size enterprises 100 – 500 employees.³³ In Bosnia and Herzegovina there is not a single, common definition of the SME. The Ministry of Foreign Trade and Economic Relations of BiH, by the end of 2004, started an initiative for the definition of the concept of small and medium-sized enterprises at

Table 6: Definition of SME concept in BiH

| Criteria | Small-sized enterprises | | Medium-sized enterprises | |
|--|-------------------------|-----------|--------------------------|------------|
| | FBiH | RS | FBiH | RS |
| Max. balance sheet total in million KM | 4.000.000 | 2.000.000 | 30.000.000 | 10.000.000 |
| Max. turnover in million KM | 4.000.000 | 4.000.000 | 40.000.000 | 20.000.000 |
| Max. number of employees | 50 | 50 | 250 | 250 |

Source: Zijad Dzafic, Small and Medium-Sized Enterprises in Function of Transitional Economies Restructuring with the Retrospective View to BiH, Faculty of Economy, Tuzla, 2005.

the main pillar of economic development of the European countries. They are important initiators of innovation, employment, and social and local integration in Europe. The European charter for small-sized enterprises, which is obligatory for all the member countries of the European Union, candidate countries for membership in the European Union and countries of the Western Balkans (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro and Kosovo), points out ten areas which are significant for improvement

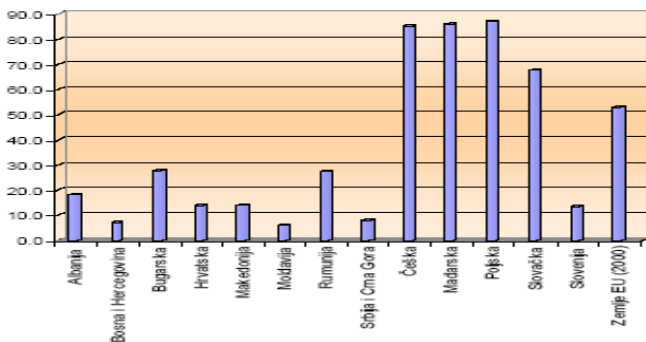
the level of the state, since different definitions are used at the entity level (Table 5).

According to the data of the European Bank for Reconstruction and Development, in the majority of countries of South Eastern Europe's SMEs contribute more than 50% of gross domestic product. Figure 1.1. presents the number of SMEs per

³³ Bosnia and Herzegovina, The Government of the Republic of Srpska, Development Strategy of SMEs in the Republic of Srpska 2006-2010

1000 inhabitants in the countries of South Eastern Europe and the EU member countries in 2002. In 2002 Bosnia and Herzegovina (7), Moldavia (6.1) and Serbia and Montenegro (7.8) had the smallest number of small and medium-sized enterprises per 1000 inhabitants compared with the remaining countries in the region. Poland (87), Hungary (85.9) and Czech Republic (85.1) had the biggest number of SMEs per 1000 inhabitants.³⁴

Graph 8: Number of SME per 1000 inhabitants in the countries of South Eastern Europe



Source: European Bank for Reconstruction and Development, Spotlight on south-eastern Europe, 2004

2.2. BOSNIA AND HERZEGOVINA VS. CANDIDATE COUNTRIES

Croatia and Macedonia are candidate countries for EU membership, after the last enlargement when Bulgaria and Romania became EU members in January 2007. These countries and their way to European integration are undoubtedly interesting for Bosnia and Herzegovina, and the same can be said of comparison of the BiH key indicators to these countries.

Real GDP growth in Bosnia and Herzegovina is higher compare to the candidate countries, but if we have in mind the fact that the level of GDP per capita is only about 18 % of the average level of EU 27, this is not so optimistic. Even if we compare the GDP per capita of BH with that of candidate countries, BH is still far behind. Official unemployment in BH on the level close to 50% is much higher compare to candidate countries and the EU 27 average; indeed, it is questionable to compare this indicator with EU and candidate countries. The increasing trend in unemployment over last few years puts BH at bottom place in the list of transition countries. While inflation during recent years has been very low, in 2006 inflation in BH was higher compare to candidate countries and the EU average. However, it is important to

mention that the structural break in fiscal policy (because of the introduction of value added tax) caused the increase. We expect that monetary stability will be re-established after the process of adjustment to the higher rate of indirect taxation. In spite of the fact that BH is known as the country with a lot of levels of governments and huge public spending, the general government budget balance was in surplus in 2006, which is quite strange. However, this aspect of our comparison does not seem problematic. And finally, current account balance in BH, and generally the external sector, is a problematic part of the story. The deficit in current account is much higher, not only compared to the EU27 but also to the candidate countries as well. Huge external imbalance in BH has been a constant problem during recent years and much should be done in order to improve the external position of this country.

When it comes to the comparison of transition indicators between Bosnia and Herzegovina and average level of candidate countries, it is noted that Bosnia and Herzegovina's best achievements are related to the areas of Price liberalization, Trade and Forex system and Infrastructure reforms. The same situation pertained in 2006 as well. Conversely, the most serious drawbacks as compared to the average levels of the candidate countries have been recorded in the areas of Securities markets & non-bank financial institutions, then enterprise restructuring and, thirdly, small scale privatisation. Compared to the situation from 2006, improvement has been made in the area of large-scale privatisation, which was in the worst position, as well as in Banking reform and interest rate liberalization. Apparently, huge foreign investments in the banking sector have improved the BH position compared to the candidate countries.

Looking only at Bosnia and Herzegovina, it has a very low value of the transition indicator for Competition Policy (1.7). It is worth to mention that in all "transition years" the value of Competition Policy index was 1.0 and for the first time in 2006 this index increased. The situation is also quite bad as regards Securities markets and non-bank financial institutions, with the value of the transition index also at 1.7. Finally, the third place belongs to Enterprise restructuring with an index of 2.0. Such low transition indicators mean that in these areas Bosnia and Herzegovina is far from the average level of the developed economies. The main reasons for that have already been analyzed in the research. Candidate countries also have poor results in this area, which is one more reason that BiH has relatively similar results to these countries. The lowest average transition index for candidate countries is that of Competition policy, being at the level of 2.2, where Macedonia has the lowest value of this index (2.0).

³⁴ European Bank for Reconstruction and Development, Spotlight on south-eastern Europe, 2004

Table 7: BH and EU candidate in 2006 – key economic indicators and Transition indexes

| OFFICIAL INDICATORS (2006) | Croatia | Macedonia | Average Candidate | Average EU 27 | BH |
|---|----------------|------------------|--------------------------|----------------------|---------------------------|
| Real GDP growth rate, % change | 4.8 | 3.2 | 4.0 | 3.0 | 6,2 |
| GDP per capita, EU 27 index 100 | 51.3 | 27.9 | 39,6 | 100 | 18 |
| Unemployment rate, % of labour force | 16.6 | 36.0 | 26.3 | 7,9 | 45 |
| Inflation rate (CPI), annual average | 3.2 | 3.2 | 3.2 | 2.2 | 7.4 |
| General government budget balance, % of GDP | -3.3 | - 0.6 | 1.95 | - 1.6 | 2,6 |
| Current account balance, % of GDP | -7.8 | - 0.4 | - 4.1 | - 0.6* | - 11,4 |
| General government debt, % of GDP in 2005 | 44.2 | 69.9 | 62.7 | 57.1 | - |
| TRANSITION INDICATORS (2006) | Croatia | Macedonia | Average Candidate | BH | BH as % of average |
| Large scale privatization | 3.3 | 3.3 | 3,3 | 2,7 | 81.8 |
| Small scale privatization | 4.3 | 4.0 | 4,2 | 3,0 | 71.4 |
| Enterprise restructuring | 3.0 | 2.7 | 2,9 | 2,0 | 69.0 |
| Price liberalization | 4.0 | 4.3 | 4,2 | 4,0 | 95.2 |
| Trade & Forex system | 4.3 | 4.3 | 4,3 | 3,7 | 86.0 |
| Competition Policy | 2.3 | 2.0 | 2,2 | 1,7 | 77.3 |
| Banking reform & interest rate liberalization | 4.0 | 2.7 | 3,4 | 2,7 | 79.4 |
| Securities markets & non-bank financial inst. | 3.0 | 2.3 | 2,7 | 1,7 | 63.0 |
| Overall infrastructure reform | 3.0 | 2.3 | 2,7 | 2,3 | 86.3 |

Sources: EUROSTAT, October 2007. EBRD, October 2007.
Official data of National banks of: BiH, Croatia and Macedonia, October, 2007.
* Current Account balance of EU 25 in 2005.



3. GENERAL EVALUATION

After analysis of the main economic criteria for EU membership, it is possible to list areas where Bosnia and Herzegovina has good results. However, in most areas, results are still poor and problems still exist. BiH has deficiencies in basic economic indicators compared to candidate countries as an appropriate reference group for Bosnia and Herzegovina. Areas where it has significantly good results are macroeconomic stability seen through the stability of prices (this is in line with a long period of price stability) and public deficits, liberalization of prices and foreign trade. On the other hand, problems exist in competition policy, lack of consensus on economic policy in the country, development of the financial sector and non-banking financial institutions, enormous barriers to market entry and exit, lack of a functional legal framework efficiently regulating property rights, the small share of the SME sector in the market, and a high share of the public sector in GDP. Compared to candidate countries, the most significant deficiencies have been recorded with respect to real economy indicators: namely, GDP p/c and unemployment. Large external imbalances - notably the current account deficit - are also cause for concern.

In most cases BiH has poor performance with respect to the economic criteria for EU membership. Accordingly, BiH is still far behind what was defined in Copenhagen as the '*existence of functional market economy and capacities for the economy to cope with competitive pressures and market forces in the Union*'. We consider that Bosnia and Herzegovina in the short term is unable to meet most of these criteria. Accordingly, it is necessary to take specific strategic steps consistent with achieving the Copenhagen criteria and, thereby, to achieve structural transition reforms in a timely manner.

4. POLICY RECOMMENDATIONS

Following the analysis of the main economic criteria for EU membership in the case of Bosnia and Herzegovina, numerous problems are evident as well as barriers to fulfilment of these criteria in a reasonable time frame. Being aware that it is impossible to rationally identify 'all' necessary policy recommendations, here are the key and priority recommendations aiming at faster fulfilment of economic criteria for EU membership, and recommendations enabling qualitative development of the BiH economy.

- *'Macroeconomic policy should increase external stability and maintain favorable conditions for economic growth and increase in employment'*. Excessively large current account deficit that may prove unsustainable is completely unacceptable and may result in other macroeconomic disturbances in the country. We believe that the reduction of current account deficit is a key macroeconomic challenge for Bosnia and Herzegovina, both in terms of European integration and membership criteria and in terms of improving economic conditions in the country. If the deficit remains so high in the long run, not only will BiH fail to meet economic criteria for accession to EU, but the economy's 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 domestic supply which, in turn, will lead to the substitution of domestic output 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. And, finally, establishing a single economic space in the country, which was defined as an important priority by the EU, may help to restore external balance or, at least, render external deficits sustainable. For example, a single economic space will promote investor confidence, stimulate the development of domestic output and, thereby, promote exports. Of course, in the short to medium run, substantial capital account deficit is likely to persist for reasons favorable to growth; namely, because economic recovery will require investment to exceed domestic savings. In this case, a single economic space and enhanced investor confidence is the key to sustainable financing of the current account deficit during a more or less prolonged phase of rapid capital accumulation. In the long run, therefore, establishing the BiH economy as a single economic space will promote economic growth and decrease in unemployment.
- *'It is necessary, in the short/medium run, to reduce the costs of starting businesses, the duration of establishing and closing businesses, and the time needed for property registration, including other administrative barriers evident in the private sector'*. This recommendation is considered to be fully complementary to the previous statement on creating conditions for increased production and ensuring sustainable external balance. As we can see from the results of our analyses, in 2006 the business environment in BiH was such that an entrepreneur starting a business had to undergo twelve different procedures, which last 54 days on average and cost about 30% of Gross National Income per capita. Such conditions are, naturally, a barrier to domestic business and to foreign investors in BiH. According to the World Bank report¹, the costs of starting a business in BiH are among the

¹ IBRD/World Bank Doing Business 2007 - How to Reform?, Washington, 2006.

highest in the world. Insufficient domestic supply results in a low GDP level, high unemployment and external imbalance. The removal of administrative barriers to the business sector and reduction in the costs of starting and closing businesses would improve the private sector environment and other macroeconomic indicators. Changes in this direction would lead to increased domestic production, decreased unemployment and to relative growth of exports in relation to imports, which in turn would help in correcting external imbalances, which we identified as one of the key challenges on the way towards the EU. We believe that this can be achieved in a relatively short period, and that the Government priority is to study the listed barriers, prepare a program for overcoming them and to adjust laws in directions which will improve the efficiency of the business sector. The ultimate effect would be favourable for the government sector as well, since the reduced public revenues from charges on starting business would be compensated through the increase of private sector activities.

- *'Low competition of domestic products and economy results from, amongst previously mentioned factors, problems of unfair competition, grey economy and corruption'.* The research presented demonstrates that the biggest national companies see unfair competition in the market as the most prominent barrier for successful business operations, as well as the grey economy and corruption in the country. Also, according to the European Bank for Reconstruction and Development, competition policy has been assessed as the worst area in the transition reforms. These are the areas requiring the most serious research focused on removing the above-mentioned barriers in the private sector. It is clear that progress in these three areas, along with elimination of barriers in starting and closing down of businesses, and the setting up of a single economic space, would de facto lead to GDP increase, decrease in external imbalance, increase in employment and improved living standards - i.e. to real convergence, which is the key challenge facing BiH on the road towards the EU. To increase the competitiveness of local enterprises and and of the economy will be impossible without a systematic approach embracing the above-mentioned structural changes, which would eventually result in synergy effects and competitiveness improvement.
- *'It is necessary to create strategy for development of small and medium-sized enterprises and to establish an agency for SMEs at the BiH level'.* Bosnia and Herzegovina signed the European Charter for small and medium-sized enterprises and actively participates in defining

prioritization. Goals for BiH for 2005 in this sense have been partially fulfilled. In the beginning of 2005, the BiH Law on Enterprise Registration and entity laws were adjusted. However, SME development strategy, envisaging the set up of an Agency for SME at the state level, has not been adopted yet. This strategy is extremely important for providing an overall framework for SME development, because SMEs still have a low share in GDP. It should be noted that this is one of the economic criteria for EU membership – namely, a sufficiently developed SME sector that will be able to cope with competitive pressures and market forces in the Union.

- *'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 the EU'.* Although a certain progress is evident in terms of consensus on the key economic issues in the country, Bosnia and Herzegovina does not meet this Copenhagen criterion at the moment. It is necessary to urgently draw the attention of the creators of the country's macroeconomic policy towards finding a common economic policy strategy that would lead BH both towards the EU and towards economic growth and development. In addition, we consider that an extremely important question to be answered by the macroeconomic policy makers of this country will be that of the trade-off between nominal and real convergence, particularly considering that *de facto* continuation of the EU integration process could mainly depend on real convergence.
- *'It is necessary to further strengthen the financial sector'* in Bosnia and Herzegovina, because it is one of the possible 'weakest links' between nominal and real convergence processes in the country. The domestic business sector is facing the lack of liquidity and high interest rates, while at the same time the banking sector is facing the problem of over-liquidity. It is necessary to establish the money market and to develop further the capital market as a way of solving the problem of intermediaries in general, as well as the lack of liquidity and corresponding real economic activities in the business sector. Reforms of the insurance institutions as well as reforms of the pensions system are necessary structural changes in that direction, and these should be the priorities in strengthening the operations and efficiency of the financial system in BiH.

Finally, we reiterate that the 'general' economic challenge for Bosnia and Herzegovina, with respect to the economic aspect of integration, will most likely be real convergence; i.e. achievement of a minimum economic development level and of

living standards approximating those of the least developed member states. We consider that *de facto* continuation of the EU integration process in BiH will depend on BiH's ability to achieve real convergence with the EU, while other areas, not less important, will likely be more easily fulfilled by BiH. In that sense, recommendations leading to real convergence in the short and long run will be priority. Success in real convergence will be possible only as a synergy effect of success in all relevant fields, the main ones being mentioned in our previous recommendations.

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