EXECUTIVE SUMMARY

1. This Country Economic Memorandum (CEM) has three main objectives. First, it takes stock of economic developments in Bosnia and Herzegovina (BH) since the end of the war in 1995, with a particular focus on the most recent period. Second, the report discusses potential sources of high and sustained growth that BH could exploit, as European Union integration is advanced. Finally, the report formulates policy recommendations that would help maximize the potential of BH economy to achieve higher real GDP growth and generate more jobs. In doing so, the CEM focuses on four priority policy areas: macroeconomic management, international trade policy, business environment and enterprise reform, as well as labor market policies. The latter includes an assessment of BH's education policies.

2. The report conveys three key messages. **First, ten years after the end of the war, BH still suffers from the legacy of a conflict that destroyed a significant part of the country's physical productive capacity, depleted human resources and shattered institutions and social capital.** Time lost during the war, combined with subsequent difficulties in coping with the double challenge of post-conflict reconstruction and the transition to a market economy have left BH far behind the most successful countries of central and eastern Europe (CEE). While post-conflict reconstruction has been successful, mainly because of large aid flows, the analysis in the report shows that BH lags on many of the structural reforms that have accompanied economic transition in the region. These include strategic privatization, product and labor market liberalization and enterprise restructuring.

3. As the recent decline in aid flows is likely to continue, delays in advancing structural reforms constrain BH's self-proclaimed goal of emerging as a vibrant, productive economy integrated in global markets. The outstanding challenges are many. Strong and sustainable economic growth is yet to be established after the post-conflict recovery. The job market is anemic and unemployment is high, and the informal economy appears to be gaining further ground. The country's external imbalances remain large and need to be corrected to limit long-term risks. Many companies, especially those that are state-owned or mass-privatized, continue to operate under soft budget constraints, leaving space for inadequate managerial behavior that can range from a weak profit motivation to asset stripping. BH's most precious resource, its people and especially its young population, is still longing to leave the country. The uncertainties surrounding the country's economic future and the related apparent lack of opportunities are an important cause of continuing brain drain. However, the mindset in decision - making, be it at the political level, within the public administration or inside many companies, is still geared towards preserving short-term privileges over establishing grounds for sustained output expansion.

4. As an important caveat, the political and administrative structure which emerged from the **Dayton Peace Accords (DPA)** makes the task of catching up more complex. Although it is

outside the purview of this report or the mandate and expertise of the World Bank to make any assessment of the political and institutional relevance of the DPAs, which the report takes as given, it should be noted that these arrangements carry a significant cost. The level of complexity underlying administrative arrangements throughout the country brings direct fiscal costs. It also results in less tangible economic costs because major reforms have to be sanctioned by a mandatory consensus among BH's constituent peoples. Reforms which may appear to put one or another group at a disadvantage often cloud the policy debate and crowd out the reform's likely larger, longer-term development impact. This problem is compounded by weak technical capacity and policy coordination failures across the various levels of government. The recent vacillations over higher education reforms provide a telling case of the complexities of BH's political economy. Not anticipating or suggesting any profound modification to the DPA, this reports signals that the political commitment for achieving reforms in a reasonable time frame needs to be even stronger in BH than elsewhere in the region in order to overcome the system's inherent inertia.

5. **The report's second key message is that BH can indeed catch up with the more advanced economies in central and Eastern Europe.** Opportunities for growth exist and the authorities have in several instances demonstrated the political will and persistence to engage in difficult reforms. Some very important institutional reforms been achieved with a measurable initial impact, even if not on the scale and at the pace that would be desirable. BH firms can export, foreign investors see business prospects in BH, and new jobs are being created. In order to scale up these initial results, however, a number of critical challenges need to be addressed. These mainly relate to the business environment, enterprise reform and labor market reform. The authorities' Medium-Term Development Strategy (MTDS) identifies most of these challenges and provides a vision consistent with that of this CEM: the objectives are not necessarily higher growth and investment than the fast pace in the aftermath of the war, but a different type of growth and investment, where the private sector is in the driver's seat. To achieve this objective, the MTDS recommends a wide array of policy measures. Unfortunately, the MTDS fails to prioritize policy actions in terms of their likely impact for boosting real GDP growth. The CEM attempts to fill in this gap by singling out the most pressing issues requiring an urgent policy response in these areas.

6. **The third key message relates to the optimal characteristics of the policy response: selectivity in the choice of priority actions, and flexibility of the policy stance, ranging from holding firm in some policy areas to intervening smartly in others.** As noted, BH authorities have not waited for this CEM to identify pressing policy issues and have even made plans in several areas requiring action. Often, however, the envisaged policy response is biased towards active and wide-ranging intervention by government. Moreover, envisaged actions are too numerous to be credible and to serve a signaling function, including those prescribed in the MTDS. The CEM, by contrast, takes a more nuanced view. The underlying policy objective to stimulate the "new" type of growth is primarily to set the right incentives for efficiency and effectiveness. In some areas, such as the trade regime or exchange rate policy, this translates into staying the course. In many other cases, setting the right incentives requires governments to minimize their presence or even get out of the way. Finally, there are opportunities for active policy intervention, in particular with respect to reorganizing public expenditure in order to reform the education system or provide more adequate safety nets for those who need them the

most now and in the future as the economy transforms. Within this framework, the remainder of this summary reviews the most salient conclusions of the report.

INITIAL ACHIEVEMENTS AND OPPORTUNITIES

7. Bosnia and Herzegovina has been successful in **achieving macroeconomic stability**. Inflation has been brought down to industrial country levels. Fiscal accounts have improved and the consolidated fiscal deficit has narrowed markedly. The confidence in the currency is strong, as evidenced by steadily rising KM-denominated deposits. Successful rescheduling agreements, aided by lack of access to capital markets, have helped reduce external debt to sustainable levels. Despite a large and persistent current account deficit, foreign reserves have increased. Inflows of foreign direct investment (FDI) more than doubled than since 2000 to 6 percent of GDP in 2004. Total FDI since the end of the war is estimated to have surpassed US$1.6 billion.

8. **The track record in structural policies is uneven and the agenda largely unfinished, as described above.** Still, BH has managed to develop a competitive banking market, including regulatory and supervisory functions that appear to be enforced. The successes in the financial sector do not come without challenges, however, with credit to households growing at a rapid pace and spilling into imports. Similarly, while the divestiture of the state from many small- and medium-sized enterprises is completed, the use of the mass privatization method has had an adverse effect on corporate governance.

9. **In the area of foreign trade, BH has adopted the most liberal trade regime in South Eastern Europe (SEE) and has concluded bilateral free trade agreements with all its main trading partners in the sub-region.** These agreements generally meet the standards of coverage recommended by the Stability Pact. Policymakers and other observers, however, have generally expressed disappointment with the lack of supply response to this favorable trade regime. As noted earlier, the data presented in this report confirms that export performance has been lackluster. However, these concerns are not entirely justified. Despite the extremely difficult initial conditions of the war's immediate aftermath, BH merchandise exports have increased by 10 percent percent a year in euro terms, while the export coverage of imports has risen from less than one-tenth to one-third. More importantly, BH seems to have achieved some success in redirecting its trade towards the market which bears the most promise for its future, namely the EU. BH was also able to gain trade shares with its second trading partner, Croatia. Participation in retail-driven commodity chains, such as in the furniture sector, shows that BH firms can be present in a very competitive market place. Also encouraging is the progress achieved with curbing corruption at border posts, an important dimension for facilitating trade.

10. While the overall performance of the **corporate sector** remains lackluster, the subset of small and medium-sized enterprises (SMEs) appears to show promise. Business practices of small, *de novo* firms are geared towards profit seeking and they have adopted a business culture where contracts are honored, and where suppliers and workers are paid. This contrasts starkly with large enterprises, especially state-owned firms, which still operate on the principles of the pre-war self-management economy: over-employment, soft budgets, and poor governance. Many crucial reforms are underway, although some are implemented very slowly. In some instances, the government has shown the resolve needed to advance the reform agenda. The submission of the bankruptcy legislation in both entities – the Federation of Bosnia and Herzegovina (FBH)

and the Republika Srpska (the RS) – and the subsequent successful campaign by the FBH government to convince Parliament to retract the amendments that it had introduced and that would have undermined the implementation of the law, demonstrated that difficult reforms can be achieved in BH.

11. This duality is also reflected in the **labor market**. Even if BH displays low participation and employment rates overall, the SME sector shows that there is potential for a dynamic labor market. Initial reforms of the labor market institutions, including of the labor code and the employment institutes, have gone in the right direction, but the labor market remains the area where challenges are perhaps the most significant.

CHALLENGES

12. As the outstanding challenges are daunting, their analysis should lead to some prioritization in order to guide policy. **The single most important macroeconomic imbalance is the persistent current account deficit.** At close to 17 percent of GDP, it is not sustainable in the long run. The analysis presented in this report suggests that it is the result of low domestic savings rates rather than high investment. The rate of investment is not above the average for transition economies, but the share of domestic savings that can finance it is particularly low. In a context where external savings in the form of aid flows are declining and where investment levels need to remain high to accompany the economic transformation, macroeconomic and structural policies should be geared to stimulating domestic savings and attracting foreign capital of a new kind.

13. **The need for higher domestic savings raises the question of the adequacy of BH's current fiscal policy stance to serve economic growth: can BH reduce the share of public expenditure, while increasing the efficiency of public services? The challenge may at first seem insurmountable but this report argues that it can be tackled.** Despite the gradual reduction in public expenditures, the weight of government in the economy, while considerably reduced in the last couple of years, is still too large at almost 50 percent percent of GDP. Further consolidation is called for, and will have to depart from recent efforts focused on investment spending. Curtailing recurrent spending, despite all of the inertia which affects such spending, is a top priority. Given the unmet funding needs for maintenance and operations, the public sector wage bill and some transfer programs are the prime candidates for rationalization. Increasing expenditure efficiency is also key to establishing a growth-enabling environment and providing better safety nets for those who will not be able to redeploy to new activities.

14. **In the medium term, however, fiscal adjustment alone will not generate the required increase in domestic savings. A substantial contribution will also need to come from higher domestic private savings.** In the household sector, the recent period has been marked by high access to credit to finance construction and consumption. In the framework of the currency board arrangement that governs exchange and monetary policy, this is believed to have been accommodated by sizeable inflows of private savings from nationals abroad, including worker remittances. While a drying up of these resources would automatically restrain credit, the short-term imperative is to rein in credit growth to households by resorting to the limited monetary policy tools that are available under the currency board regime. These include hiking reserve requirements and tightening prudential regulation and banking supervision. In the longer run,

however, the real challenge is to boost domestic savings in the corporate sector, i.e., the profitability of companies operating in BH. This will require a series of actions to strengthen the business environment and corporate governance, stimulate enterprise restructuring and increase the flexibility of the labor market. Only then will BH firms, whether locally or foreign owned, be able to capture large shares in European and world markets, and contribute to an improvement of the country's external position.

15. **In the area of trade, the recent sluggish performance can hardly be attributed to a policy stance that has pursued liberalization and integration. The real constraints to a more dynamic export performance lie in the business environment and investment climate**. In fact, BH's trade environment offers many opportunities that remain untapped. For example, merchandise exports are much too low, representing a little over 10 percent percent of GDP. Exports are dominated by raw materials and products intensive in unskilled labor. Opportunities for participating in international supply chains, especially with the EU, are insufficiently taken advantage of. In sectors where BH firms are present, such as textiles and leather products, the long-run sustainability of their participation is threatened by tough competitive pressures, calling for an upgrading of production to higher rungs on the value ladder. This type of investment will be best promoted if the business environment becomes more attractive to foreign investors. Also, opportunities on the growing neighboring market of Serbia and Montenegro (SAM) are not sufficiently exploited. BH has demonstrated that it can successfully export products from the agro-food sector to Croatia. It has however failed to capture the immense EU market for such products, not the least because it lacks an adequate institutional infrastructure for product certification. BH's own domestic market further needs developing into a single economic space that will also stimulate cross-border trade.

16. Despite the destruction of production capacity during the war, and in spite of the pre-war industrial structure that is not easy to reconvert, some sectors appear to have potential for future growth, such as forestry and manufacturing of wood products, textiles and leather, other small-scale manufacturing, some agriculture sub-sectors or the electricity sector. However, this report makes the case that policies should focus on ensuring maximum flexibility by removing barriers to investment or doing business and enhancing human capital. Through broad-based incentives, BH can further develop into a multi-sector economy. In contrast, "picking winners" through targeted industrial policy is unlikely to produce any better results in BH than it has in other countries.

17. **The challenges of broad-based enterprise reforms essentially center around two main issues** (i) removal of structural barriers to the creation and functioning of competitive markets; and (ii) establishment of robust rules, procedures and related institutions that create *incentives* to facilitate day-to-day business transactions.

18. **Removing barriers to entry is essential to stimulating further enterprise creation as well as to the growth of recently created *de novo* firms** as this segment of the enterprise population offers the best opportunities for growth and employment generation. Several bottlenecks should be removed as a priority.

19. First, the report finds that economic policy uncertainty and corruption are among the most powerful obstacles to foreign investment, business creation and development. Second, the

cost and access to finance, tax rates and administration, anti-competitive practices, and the functioning of the legal system in protecting property rights and contracts place a significant burden on business development and investment. The lack of strong and competitive enterprise sector in BH makes financial institutions unwilling to lend to companies. As a result, firms rely on informal sources for working capital and investment needs. Difficulties in accessing capital as well as the limited security of contract rights makes businesses transact in primitive ways by resorting to on-the-spot deals. Third, administrative obstacles such as land-titling, access to land, labor regulations, permits, and licensing requirements are seen as a persistent challenge to entry and market competitiveness. It still takes too long and costs too much to open a business in BH. Business registration reform is ongoing, but the pace of the reform is slowed not so much by the technical difficulties related to the establishment of an integrated system, but also by protracted debates of a political nature. Administrative and bureaucratic hassles also increase the costs of running a business. The commercial court system suffers from a heavy backlog of pending cases. In addition, despite recent progress, the country still cannot be described as offering a nation-wide level playing field with respect to taxation levels and collection.

20. **There is a compelling case for offering opportunities for longer-established firms to restructure and reorganize.** The widespread practice of accumulation of arrears and reliance on subsidies hampers such restructuring and needs to cease. The accumulation of arrears indicates a willingness of governments at all levels to tolerate and protect loss-makers from market exit as well as to accept a practice of delayed payments among the firms. For state-owned enterprises, the options are clear: privatize strategically or liquidate. The report demonstrates, however, that the reliance on insiders and the state in most of the completed voucher-privatization deals has left fragmented ownership structures, poor incentives for restructuring and development and weak corporate governance structures. This has limited inflows of new capital and know-how in the newly privatized firms and has caused investors to be hesitant in bringing in greenfield foreign investment. The government will need to address the challenge of streamlining and accelerating privatization so that the business prospect of the tendered company is the main factor in the investment decision. In mass privatized companies, frequently minority-owned by Privatization Investment Funds (PIFs), profit-seeking is constrained by the firm having to maintain excess labor. Because of wage and contribution arrears, total severance costs exceed cash flow possibilities so that firms are constrained to maintain surplus workers even if this limits their investment and growth strategies. However, for most such enterprises, the main weakness lies in the dilution of ownership and the lack of corporate discipline imposed by owners.

21. **Finally, market exit has been largely nonexistent**. BH is a country where the concept of bankruptcy is virtually untested, and where modern bankruptcy laws have only recently been adopted. An effective bankruptcy regime is crucial for providing the institutional tools for corporate restructuring to restore a firm's economic viability, or to facilitate its exit. It provides an opportunity to release assets that could eventually lead to new business activities and jobs, even if liquidation and job losses happen in the short term. In many cases, jobs in unviable SOEs and other companies were only virtual, not related to any productive activity or not giving rise to any wages or contributions being paid, but only accruing fictitious arrears in the company's books. Such companies being kept on life support at the expense of their workers, suppliers or the taxpayers need to be fundamentally restructured or liquidated, both of which the new bankruptcy laws can achieve. However, the use of the bankruptcy process in BH is still hindered

by: (i) political reluctance, especially on the part of the tax authorities, which have only very recently considered initiating a bankruptcy in either entity; and (ii) social pressure combined with a very negative perception of bankruptcy. In such an environment, the effective implementation of the new bankruptcy frameworks is entirely dependent on the political will to close down unviable companies.

22. **Challenges in the labor market are numerous. Unemployment is high and rising, particularly for women and the young. New jobs being created are too few, and mainly in the informal sector.** Participation rates remain low, even if labor supply seems more responsive to job opportunities than previously assumed. The causes of the lack of flexibility in the (formal) labor market are difficult to pin down with accuracy. Despite relatively flexible labor legislation, separation and remuneration practices show persisting signs of rigidity, and wage increases appear to consistently outpace productivity. The relative weakness of employers' associations in collective bargaining may explain apparently unsustainable employment practices. The problem is compounded at the firm level by weak market discipline and corporate governance as highlighted above. Workers are often not ready to enforce their claims on firms by initiating bankruptcy, even when it is long overdue. Firms rarely take difficult decisions related to rightsizing the labor force and resisting automatic wage increases, even when their survival is at stake. The governments themselves appear to fail in many aspects related to labor market reform. They prove to be a weak bargaining partner in labor negotiations, underestimating the signaling and spill-over effects of public sector agreements. Instead of focusing on core labor market intermediation, employment institutes have channeled their surplus funds into direct economic intervention. Education policies, especially for upper secondary and tertiary, are delinked from the needs of the market.

OPTIONS FOR THE WAY AHEAD

23. The BH authorities have recognized most of the challenges outlined above, as reflected in the MTDS. The authorities have also taken numerous initiatives to meet these challenges. Action plans for economic revitalization are discussed, social programs are prepared and solutions are sought to ease the financial plight of troubled companies. Too often, however, the policies envisaged seek to increase government intervention or to achieve short-term relief by offering unsustainable subsidization of some sort, including write-offs. In other instances, as in any country, governments are being pressured by interest groups to change policies that work or to delay reforms that could bring needed change. Repeated calls for increased protectionism are a case in point. As the trade chapter of the report concludes, there is nothing fundamentally broken with the trade regime that requires fixing. The real bottlenecks are elsewhere.

24. To achieve the overall policy objective of an improved incentive environment for economic growth, this report therefore argues that policy needs to focus on the priorities identified above while the nature of the policy stance may vary form case to case. First, in some areas, such as international trade or monetary and exchange rate policy, the policy choices have been adequate. In such cases, the best policy option is to stay the course. This means keeping the same policy direction, in some cases even accelerating the pace, while constantly monitoring the policy's impact. Maintaining the currency board for instance, does not mean that the authorities should not keep a close watch on the evolution of the real exchange rate or credit growth, and

weigh the options again in due course. At the present moment, the priority appears to be to rein in growth of credit to households.

25. The second type of policy priorities should focus on improving the environment for the private sector to perform. It generally translates into streamlining the administrative framework surrounding private sector activity, or just freeing up space and resources for it to grow.

26. Finally, in a few cases, active intervention is needed. Clearly, this applies to all core areas of the public domain, including reallocation and rationalization of government spending.. Sometimes even a market intervention is advocated, such as a strict incomes policy for public sector companies. The remainder of this section summarizes the report's key policy recommendations.

Bank on Recent Successes

27. A key policy ingredient to support further growth will be to maintain the macroeconomic stance adopted over the past few years: rely on the currency board arrangement as the anchor for macroeconomic policy and support it through continued fiscal consolidation. The main vehicle for achieving this latter objective is reinforced control of the government sector wage bill. Until the country establishes its creditworthiness, the authorities should maintain prudent external borrowing strategies.

28. With respect to trade policies, the report finds that all in all the current trade regime is favorable and is not the weak link of exports. Reverting to protectionist policies would backfire, as it has in many other countries. On the contrary, if BH is to amend its tariff schedule, it should liberalize tariffs further, and especially lower rates which remain unusually high, such as for some investment goods. Resorting to Tariff Quota Rates (TQRs), is not likely to achieve productivity gains, even in the agro-food sector. Given the administrative complications they entail, this report recommends completely foregoing TQRs. If they are implemented for some goods, the tariff rates should be kept as low and the licensing procedure as transparent as possible.

Promote the Right Incentives and Free up Space for Growth

29. One of the most fundamental reforms on the authorities' agenda is the introduction of a Value-Added Tax (VAT). This reform will have far-reaching implications for public finance, the business environment, the strengthening of domestic competition and the promotion of better governance. The institutional arrangements for the adoption of VAT have been put in place, starting with the establishment of the State-level Indirect Tax Authority and fundamental pieces of legislation regarding rates, structure, exemptions. Legislation regarding revenue allocation and other issues needs to be adopted urgently so that the subsequent efforts can concentrate solely on building the capacity of the tax administration and raising the awareness of taxpayers.

30. Improved incentives for trade are linked to the implementation of key institutional reforms and the rapid establishment of a regulatory framework. Priority policy measures should focus first and foremost on meeting the conditions for engaging in negotiations for a Stabilization and Association Agreement (SAA) as soon as possible. Advancing negotiations on the SAA will need to be accompanied by legal harmonization that will entail consolidation of

BH's single economic space. The SAA will also pave the way for BH to participate to the "Pan-European Cumulation of Origin." This would in turn raise BH's attractiveness as a participant in producer-driven commodity chains and to foreign direct investment more generally. Efforts should also focus on further pursuing trade facilitation policies; including streamlining of procedures at border crossings and continuing the fight against border post corruption.

31. To provide the right incentives for new businesses to be created and to grow, the authorities will need to accelerate the implementation of long-agreed reforms. The new business registration system must be implemented completely to ensure its smooth functioning. Plans to streamline business inspection, moreover, should also be implemented, to limit the regulatory burden on companies. Vigorous enforcement of competition policy is also needed to safeguard vibrant and contestable markets.

32. Fundamental change in corporate ownership rules, as well as the rules for privatization investment funds (PIFs) is an important area of reforms to improve incentives. The new rules should encourage PIFs to make a strategic choice: become a mutual fund or a management company.

33. Changes in privatization regulations in both entities are necessary, to allow for unbundling and financial restructuring of SOEs outside of the bankruptcy regime. In both state-owned and privatized firms, a proper ownership structure should be in place for the effective restructuring of the enterprise sector. For already privatized firms, the key issue is encouraging the formation of concentrated owners with incentives to operate in a business environment following strong corporate governance principles and profit motivation. In addition, the governance structure of all firms needs to engender incentives for managers and owners to maximize efficiency gains. Reforms that will promote such objectives include: the clear separation of functions between management and supervisory boards; elimination of political appointments to ensure the independence of first-tier boards from management, employees and large shareholders; simplification of the corporate boards system through abolishing the third tier of boards in BH, namely, the "audit board" in FBH and the "supervisory board" in the RS; harmonization of company laws in both Entities to establish equal rights for all shareholders; and the public disclosure of firms' financial statements. Furthermore, adoption of the accounting regulation standards compliant with international standards and independent external audits can be powerful tools for improving corporate performance, and building investor confidence.

34. Increased labor market flexibility will be achieved, *inter alia,* by the government seeking to gradually reduce the tax wedge on labor, starting perhaps with a reduction in the employment insurance contribution in the FBH. Such reduction should be facilitated by broadening of the social security contribution base, including through reducing the number of workers exempt from making contributions. The government should actively pursue the abolition of the automatic feedback loop between minimum and average wage in the FBH. With respect to labor relations, the authorities should free space and play a facilitating role only for employers to become a more active partner in the social dialogue.

Intervene Smartly

35. While reducing overall public expenditure as a share of GDP, the authorities should also continue to alter the composition of spending, such as reallocating savings from the wage bill and social transfers to operations and maintenance and investment. This will require decisive action. Wage bill caps determined within medium-term fiscal targets need to be adhered to in annual budgets while salary determination rules should be overhauled and brought in line with standard European practice.

36. Within core public sector services, such as education or social protection, expenditure allocation should be driven by efficiency and equity considerations. In particular, vocational and higher education financing are in urgent need of reform, as are welfare transfers to households. Also, the planned policies to contain fiscal risk through the settlement of the large overhang of domestic claims should be implemented as foreseen.

37. Accelerated privatization requires more active but concerted government action. Streamlining the processes by introducing a simplified and transparent auctions procedure is recommended. Similarly, the institutional and technical leadership for the privatization process should be clarified and strengthened. The Privatization Agencies could play a key role, if given more independence and protection from political interference either in the transactions themselves or in the agencies' budgets.

38. For restructuring efforts to succeed, however, exit should be facilitated through the reduction of subsidies and arrears, unsound firms should be liquidated, labor rigidities should be drastically reduced, and corporate governance and ownership structures should be significantly improved. These policy actions would lead to hardening of budget constraints and result in more effective restructuring. While bankruptcy is largely an issue related to incentives and the business climate, the government could show the way by initiating bankruptcies for unviable companies with large tax and contribution arrears.

39. With respect to labor relations, and in line with the above mentioned reform of the wage determination system for government workers, the government should exclude these workers from general collective agreements as it moves to a statutory regime of employment. A strict incomes policy should be applied to key SOEs. Finally, the government should reconsider the mechanism governing the determination of the minimum wage, especially in the FBH, and introduce a low minimum wage that would not jeopardize the competitiveness of the country or hamper the employment of youth and low-skilled workers.

CONCLUSION

40. BH faces all of the political economy challenges that other countries in transition have typically grappled with, in addition to its own. This calls for adequate sequencing of reforms and improved governance. The sequencing and pace of reforms is essential for policies to reach their desired objectives. As in other transition economies, some of the needed reforms will encounter resistance from various interest groups such as SOE managers, local government officials, or affected workers. In addition, given BH's recent history and its complex political structure, fundamental reforms often require difficult and protracted consensus building among the

country's constituent peoples. There are also important external imperatives that drive the reform agenda, most importantly the prospect of entering a SAA with the European Union. All these factors will require the authorities to distinguish the urgent from the important and refrain from adding new tasks to an unfinished agenda. The Medium-Term Development Strategy provides a useful framework for such sequencing, but further focus is still required. More importantly, improved governance and more effective anti-corruption policies constitute a necessary condition for gaining the support of the broader population for reforms. In addition to helping build a broad constituency for reforms, improved governance is a fundamental determinant of enhanced economic growth, as research by the World Bank and others demonstrates.