

## **FOREIGN DIRECT INVESTMENTS IN BOSNIA AND HERZEGOVINA: BANKING SECTOR EXAMPLE**

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### **ABSTRACT**

Among transition economies in the South East Europe (SEE) Bosnia and Herzegovina (BIH) is one of the countries that has lagged behind the relatively developed republics of Former Yugoslavia and other economies in the region. Convergence reforms in BIH are continuing to help strengthen macroeconomic vulnerabilities. To enhance the prospects of the country as a destination for foreign direct investment (FDI) further steps were taken, especially by the establishment of the Promotion Agency, privatization and investment incentives. Indeed, a renewed privatization drive in 2007 pushed foreign direct investments to record levels. Banking sector was the second biggest sector that attracted the highest amount of FDI in BIH. In this study, first we give a literature review of the foreign direct investments in South and Central Eastern European countries and especially in the banking sector. Then we overview the FDI into BIH and analyze the factors affecting the FDI inflows. Finally, we focus in particular on the FDI in Bosnia and Herzegovinian banking sector.

**Keywords:** Bosnia and Herzegovina, Foreign Direct Investment, FDI, Banking.

### **INTRODUCTION**

With the dissolution of the communist regime in the late 1980s, opinions diverge widely about a common future among the national leaders in the new countries Macedonia, Bosnia and Herzegovina, Croatia, Serbia and Slovenia. Finally, this situation entailed to the collapse of the former Yugoslav Federation. Croatia and Slovenia declared independence in 1991 while paramilitary origins from Serbia occupied several Bosnia and Herzegovina towns killing civil Bosniaks<sup>1</sup> and Croats. In this clash of ethnic groups, BIH was confronted with serious humanitarian and social problems in which thousands of people died and a considerable part of the population seeks for refugees. The conflict lasted (1992-1995) until the Dayton Peace Agreement<sup>2</sup> was signed in Paris in December 1995 between the counterparts (Malcolm 2002). Post-war endeavors began to overcome the existing problems in the financial and economic structure, legislation and administration as well. The prime point in the Dayton Agreement is that a multiethnic society had to live in a divided country with two entities but jointly guided by a central government. With one confederation, two entities, ten cantons in the Federation, five administrative areas in the Serb Republic, a special Brcko district, plus municipalities and local government unit presents a very complex political system in the world which conceals meaningful barriers and bureaucratic hurdles that will need to overcome to succeed (Petricevic and Danis 2007: 424). For mobilizing international support for the Agreement,

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<sup>1</sup>Bosniak refers to Muslims live in Bosnia and Herzegovina.

<sup>2</sup>The Dayton Peace Agreement in 1995 sets the bases for the establishing of modern Bosnia and Herzegovina and its economic recovery.

BIH is governed by the international community under tutorship of the Office of High Representative (OHR), though it is accepted as a parliamentary democracy.<sup>3</sup>

After the political failure, BIH has also started a wide-reaching process of reconstruction and development of its political, economic, social and legal systems of the country. The integration to the world economy took place under extremely complicating circumstances. In 2008, Heritage Foundation assessed Bosnia and Herzegovina's economy to be 53.7 percent free (The Heritage Foundation 2009). To build the capacity for sustainable development the main part of beginning was to liberalize the economy and to force market-oriented reforms. Pegging the convertible mark to the euro has increased the confidence in the currency system, financial institutions and financial services. To enhance the prospects of the country as a destination for foreign investment further steps were taken, especially by establishing the Promotion Agency (FIPA), privatization and incentives for foreign investors.

## **2. FOREIGN DIRECT INVESTMENTS IN TRANSITIONAL ECONOMIES**

Foreign direct investment (FDI) plays an extraordinary and growing role in global business. The role of FDI in economic growth and development is now widely acknowledged, and all countries are actively seeking to attract it. Moreover FDI is generally considered as a driving force in the integration of developing countries into the globalization process that characterizes the world economy.

Foreign direct investment can be described as a company from one country making a physical investment in another country. It is an investment abroad, usually where the company being invested in is controlled by the foreign corporation and be stayed in contrast with making a portfolio investment, which is considered an indirect investment. Several forms can be used for capital investing abroad: investment in a joint venture with a local firm, acquisition of a foreign firm (mergers & acquisitions) or construction of a facility (wholly owned).

There are several researches conducted on the FDI inflows to the South East European (SEE) and Central Eastern European (CEE) countries. There is a large diversity among the SEE countries in the progress made in implementing the various institutional and economical reforms. Today's investment climate in the SEE region has improved in comparison with the climate in the late 1990s. Serin et al. (2009) indicated that there is a great foreign investors' interest in the EU member SEE countries because of the fewer barriers and better market access. Also SEE countries which are on the membership way to the EU attract foreign investors. Kaminski (2001) analyzed the effects of the CEE countries EU accession on the FDI and international trade in these countries. He also found that the access to EU markets have attracted FDI to these countries. Resmini (2000) analyzed the determinants of FDI from EU to the CEE countries at sectoral level. The study concluded that FDI in service sector may affect the development and reconstruction of the host country. Škuflić and Botrić (2006) studied the question that is how SEE countries can attract higher levels of FDI. They analyzed the FDI determinants in the SEE countries and found out that market-seeking and resource-seeking determinants of FDI are significant. Bevan and Estrin (2004) investigated the determinants of FDI from EU countries to CEE and SEE countries. They found that the most important influences are unit labor costs, gravity factors, market size, and

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<sup>3</sup>OHR is in the main charged with observing the implementation of the Dayton agreement and coordination of the activities of international organization and intervenes in situations of unwillingness of the main parties to cooperate (e.g. the new flag design) or to take economic reform seriously. (OHR 2009)

proximity. Furthermore they indicated that EU accession process increased the FDI into the future member countries.

Claessens et al. (2001) investigated the extent and effect of presence of the foreign investors in the banking markets. They found out that foreign banks in developing countries generate more profits, have higher interest rates and tax payments than domestic banks. Uiboupin (2005) analyzed the short-term impact of foreign bank entry on bank performance in CEE countries. He indicated that foreign bank presence enhances the competition in the market and may increase the costs of domestic banks. The study shows that foreign bank entry is less associated with decreasing incomes and loan loss provisions in more developed countries than in less developed countries. Staikouras et al. (2008) analyzed the cost efficiency in the banking sector of SEE countries. They found out that medium-sized banks with some type of foreign ownership were the most cost efficient credit institutions. In general, they concluded that foreign banks are associated with lower inefficiency. They suggest encouraging the entry of foreign banks to improve the banking sector. Weill (2003) analyzed the effects of foreign ownership on the performance of the banking sector in Czech Republic and Poland. He found out that foreign banks are more efficient in terms of costs than domestic banks. The results of his study indicate that the degree of openness of the banking sector to foreign capital has a positive influence on the macroeconomic performance of the countries. As a result of his research Murphy (2006) claims that recapitalization and rehabilitation of the banking systems in Croatia, BIH and Serbia were required. He said that in Croatia and BIH rehabilitation was done by entrance of foreign banks. On the other hand as a result of this the banking systems of these countries are now dominated by foreign banking groups. Clarke et al. (2006) investigated the relation between the degree of foreign bank presence and the accessibility of external financing for enterprises in the developing countries. They found that in countries where is a higher level of foreign bank participation it is easier for firms to access to credit. Increased foreign bank presence reduced the interest margins and overhead costs, and it may cause domestic banks to improve their processes

Ćosić (2006) investigated whether the foreign banks in transition countries are more efficient than the domestic banks in the example of BIH. Based on the reserve management practices of the banks in BIH he found out that foreign banks are more efficient than the domestic banks. As a result of his study foreign banks also operate more efficiently in BIH than the domestic ones. Weyerstrass (2008) investigated the potential macroeconomic and fiscal effects of EU membership of BIH. The result of the study shows that EU accession of BIH will increase the amount of the FDI to the country with removed barriers and confidence of foreign investors in the stabile economy. FDI will result a knowledge transfer as well as the capital transfer from European countries. Rovcanin et al. (2008) analyzed the effect of FDI policy of BIH and increase in the national competitiveness. They suggested the BIH government to integrate its FDI policy with the development strategy of the country by building local capabilities and infrastructure and by improving the investment promotion system to attract FDI. Babić-Hodović and Burić (2005) analyzed the FDI flows and structure in CEE and SEE and evaluated the perception of banking services quality. They presented changes of the BIH banking sector resulting from the FDI inflow. They found that the foreign banks in the banking sector of BIH increased competition level in the financial services supply, as a result of this quality of services provided by the banks were improved. In the study they also mentioned as a result of foreign capital participation in the banking sector, domestic banks lost their competitive power and the ownership of them was transferred to foreign groups. Pugh (2005) claimed that BIH has limited ability to attract FDI and lack of FDI inflows results an increase in the fiscal deficit of the BIH and the borrowing requirement from abroad. He also claimed that FDI in Bosnia made not enough impact on growth but it leads the instability in production and consumption.

Babić-Hodović and Tesche (2006) analyzed the level, structure and effects of FDI on the banking sector in BIH. They concluded that the effects of increasing FDI in the banking sector in BIH have been positive. Since

the foreign owned banks brought confidence in the banking system the amounts of the deposits and assets in the banks were increased. On the other hand they mentioned that there is a systemic risk with a concentration in the sector and potential anti-competitive monopolistic behavior. Tamás (2005) analyzed the development of the banking sector of BIH and investigated the development of capital adequacy and profitability. He found that entrance of foreign banks in BIH market supported the reform process in the banking sector. Doing business in BIH is burdensome for out coming investors with respect to non-transparent business regulations, obstacles in administrative procedures as well as weak judicial structures (Petricevic and Danis 2007: 430-431)

### 3. FOREIGN DIRECT INVESTMENTS (FDI) IN BOSNIA AND HERZEGOVINA

#### 3.1. Economic Developments in Bosnia and Herzegovina during the Last Decade

The existence of a market economy requires that equilibrium between supply and demand is established by the free interplay of market forces. In particular, the existence of a functioning market economy requires that prices, as well as trade, are liberalized and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and consensus on 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 the economy. (Antczak et al., 2007: 13) Selected economic indicators for BIH between 2000 and 2008 presented in Table 1 reveals a strong post-war recovery. Continued growth in industrial production over the past years can be seen. Inflation rate stabilized at EU level. In 2008, average real GDP growth rate was around 7.0%. GDP per capita reached EUR 3,648 in 2008. However, uncompleted transition reforms and inadequate restructuring of the economy bring about increasing unemployment in the country. International trade has been a major source of economic growth for BIH. One of the key imbalances in the economy of BIH is its high trade deficit which is ultimately leading to a significant current account deficit in the balance of payments. But large and widening current account deficits are not surprising for transition economies. The significant increase in FDI could be the most important instrument in financing of the overall balance of payments. Efforts to attract foreign investment lead to the development of the State Foreign Investment Policy and the successful reform of the banking system as well as the customs reform.

Table 1. General Economic Indicators of Bosnia and Herzegovina

INDICATORS	2000	2001	2002	2003	2004	2005	2006	2007	2008
Nominal GDP (billion EUR)	5.5	5.9	6.6	7.4	8.1	8.7	9.8	11.1	12.5
GDP per capita (EUR)	1,660	1,786	1,958	2,214	2,388	2,561	2,873	3,254	3,648

Real GDP growth rate (%)	5.5	4.5	5.5	3.0	6.3	3.9	6.7	6.8	7.1
Industrial production growth rate (%)	8.8	12.2	9.2	4.8	9.0	10.0	11.0	10.0	9.2
Average net wages (EUR)	190	209	228	247	258	275	300	322	385
Annual inflation rate (%)	4.8	3.1	0.4	0.6	0.4	3.7	6.1	1.5	6.5
Annual unemployment rate (%)	39.7	40.3	40.9	42.0	43.2	43.0	31.0	29.0	23.4
Currency reserves (million EUR)	522	1,379	1,270	1,428	1,779	2,160	2,787	3,425	3,219
Trade balance (billion EUR)	-3.00	-3.31	-3.52	-3.67	-3.68	-4.01	-3.41	-4.14	-4.89
Deposits of households in Commercial Banks (million EUR)	267	740	829	985	1,273	1,629	2,097	2,641	2,662
Total FDI (million EUR)	159	133	282	338	567	478	564	1,628	701
FDI contribution to GDP (%)	2.9	2.2	4.3	4.6	7.0	5.5	5.8	14.7	5.6
Population (in million)	3.30	3.32	3.35	3.35	3.38	3.38	3.40	3.40	3.44

Source: FIPA – Foreign Investment Promotion Agency of Bosnia and Herzegovina (2009), Investment Opportunities in Bosnia and Herzegovina, Sixth Edition, February 2009, Sarajevo, p.10 (\*FIPA estimation)

BIH is still an importing country. Main importing items are such as chemicals, information technology products and machines, whereas exported goods and services can be regarded such as metals, wood products and clothing. The primarily trading partners of BIH are Croatia, Slovenia, Italy and Germany, followed by Austria, Turkey and Hungary<sup>4</sup>. BIH became a full member of the Central European Free Trade (imports and exports) Agreement in September 2007. But so far, BIH also has free trade agreements with Turkey, as well as preferential export regimes with e.g. the European Union, USA, Japan, Norway, New Zealand, and Russia. In 2007 trade amounted totally 10,141,783 (in thousand Euro) and in 2008 11,758,560 (in thousand Euro). Private sector is still expanding through consumer borrowing and growth in real wages. The “golden age” of BIH was achieved during the 1970-1980 period, which culminated in the Sarajevo Winter Olympic Games in 1984 (Petricevic and Danis 2007: 425). According to the World Bank BIH is a middle-income country with 67% of GDP in the service sector, 22 % in industry, and 10 % in agriculture (World Bank, 2009). In 2008 BIH reached GDP per capita amounted by 3,648 Euro. Supports were made first regarding privatization under the leadership of the U.S. Agency for International Development in 1997. The Framework Law for Privatization of Companies and Banks was enacted in 1998. As in most fields the Federation and the Serb Republic had also their own privatization laws, which complicate the ongoing process of development. (Petricevic and Danis 2007: 428) In spite of encountering obstacles, in both post-communist and postwar periods, BIH has rendered an enormous development in post-conflict reconstruction transform its economic structure. It has the willingness to be more integrated in international environment. Having in mind those inmost cases BIH has had significantly good results, but it is the fact that it is still far behind what was defined in Copenhagen. The economic criteria for EU

<sup>4</sup>Slovenia and Germany has been the major import partners.

membership were established in 1993 and they indicate the existence of a functional market economy and the capacity for the economy to cope with competitive pressures and market forces in the Union.

BIH has indeed negative deviations in basic economic indicators compared to candidate countries and new members like Croatia, Bulgaria and as a reference group of countries. For further support by the EU reforms in the judicial system is one of the primary preconditions. In several areas it still has enormous barriers to market entry and exit, lack of functional legal framework as well as regulating property rights. The complexity of BIH government and its legal system undoubtedly contribute to an unsatisfactory fulfillment of transition reforms. The Stabilization and Association Process (SAP) is the EU's framework for the Western Balkan countries regarding pre-accession issues for supporting a stable and fast transition path with liberalized economy, approach to an eventual EU accession as well as stress of regional cooperation. The first step towards to assist them in adopting and implementing EU standards a membership with the EU for BIH represents the Stabilization and Association Agreement (SAA), initialed in the end of 2007, after approving by the Council of the European Union and signed in 2008. Moreover, the EU assists the country under the 2007 IPA (Instrument for Pre-Accession Assistance). The first step in the EU integration process started with establishing the Consultative Task Force in 1998 which was redefined in 2006 to "Reform Process Monitoring". (Weyerstrass 2008: 395) In fulfilling economic criteria for being a Member of the EU, BIH is virtually capable to do it (Efendic and Medjedovic 2006).

### **3.2 Factors that Influence Investors' Decision to Invest in BIH**

In transitional economies, the imperfection of a gradually established market mechanism is a common feature (Wen 2007). As a formerly central planned economy BIH transforms to market-oriented one with an increasingly open trade regime and a gradually improving environment for FDI. But, according to the data in Table 2, BIH did not benefit as much from FDI inflows as other countries with a more liberal trading regime. As part of various reform programs the trade policy fundamentally changed. Consequently, the trading volume, measured as imports plus exports as a share of GDP, has increased enormously. Measured by this indicator, BIH now has arguably a more open trading regime. A major assumption in the literature on transitional economies is that privatization should induce the increased investment. Bennett, et al. (2007) come to the result that privatization plays an important role in economic growth. In BIH, the total amount of FDI inflows is relatively quite low comparing to other SEE countries. With the increasing inflow of foreign capital into the banking sector, quality of services provided increase, overall sector's efficiency continue to increase. (Babić-Hodović and Burić, 2005: 1429) The tertiary sector has been the most preferred sector for investment in the nineties, especially as regard to export-oriented Greenfield investment. The most important factor that influences the choice of BIH as an investment destination is the macroeconomic and political environment. Among the macroeconomic and political environment factors it is the political stability as the most important variable that influences investment decision. Furthermore in the case of the institutional environment, protection of investors is one of the important variables. Those can be the tax systems, lack of corruption, the ease of starting up a company, law of contract, transparency, safeguarding of property rights and efficiency of justice (Škuflić and Botrić 2006: 82-83). Furthermore the time and cost of acquiring and registering property can be estimated as yet another factor. According to the Index of Economic Freedom, the overall country rating for Bosnia in 2009 is 53.1 out of 100, or ranked 134th out of 179 countries included. Bosnia and Herzegovina is ranked 40th freest among the 43 countries in the Europe region, and its overall score is well below the regional average. (The Heritage Foundation 2009) The Bosnian government is trying to work on these issues. Reforming the business environment in BIH is also high on the World Bank's agenda. The IMF also pursues assistance for BIH.

The cumulative volume of FDI attracted to BIH had experienced a considerable amount, extensively in the banking sector after 1995. Net FDI inflows recorded in the balance of payments during last 13 years for selected SEE and CEE Countries are given in Table 2. As the government is committed to meet the EU set of criteria strengthen the business environment for foreign investors in Table 2 it is shown evolving of FDI inflows. While several neighboring countries are making substantial progress towards a functioning market economy compared to the most developed Eastern European countries, BIH is lagging behind in the context of attracting foreign investors. However, volume of the FDI inflows has been considerably increased in BIH during the past years. Additional boost to FDI inflows comes from EU candidature. With this assertiveness Bulgaria and Romania and some other Central and South Eastern Countries commended a phase of significant privatization in the last few years (Table 2).

Table 2. Foreign direct investments (net inflows recorded in the balance of payments) -in USD million

<b>Selected SEE and CEE Countries</b>	<b>1996</b>	<b>1998</b>	<b>2000</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008 (Est.)</b>
Albania	97	45	143	135	178	344	283	325	651	880
Bosnia and Herzegovina	0	100	146	266	382	708	579	710	2.023	1.200
Bulgaria	138	537	998	876	2.070	2.879	4.005	7.583	11.433	8.472
Croatia	466	842	1.105	552	1.927	732	1.551	3.212	4.644	4.098
Czech Republic	1.280	3.575	4.942	8.282	1.814	3.941	11.630	4.598	7.930	5.500
FYR Macedonia	11	128	175	105	117	322	94	424	700	612
Hungary	3.335	3.070	2.151	2.722	479	3.405	5.586	3.640	2.197	4.763
Moldova	23	75	127	132	71	146	199	223	481	679
Montenegro	na	na	na	84	44	63	482	585	717	783
Poland	4.445	6.049	9.327	3.901	4.284	11.761	6.951	10.727	17.976	12.951
Romania	415	2.079	1.051	1.080	2.156	6.368	6.587	10.957	9.818	11.000
Russia	1656	1.492	-463	-72	-1.769	1.662	119	10.753	6.800	20.000
Serbia	0	113	50	475	1.365	966	1.550	4.264	2.195	2.487
Slovak Republic	199	374	1.897	4.130	1.913	3.052	2.279	4.178	2.881	3.156
Slovenia	167	221	71	1.508	-174	281	-67	-215	-353	280
Turkey	612	573	112	957	1.252	2.005	8.967	19.065	19.940	15.400

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Source: EBRD (2006) Transition report 2006: Finance in transition, <http://www.ebrd.com/pubs/econo/6813.htm>, accessed 15.04.2009.

As a part of the efforts aimed at attracting foreign investors, the Bosnia and Herzegovina Parliamentary Assembly adopted the Law on Foreign Direct Investments, which established political directions for favorable treatment of foreign investors and protection of their interests. Foreign investors enjoy the following benefits (APF 2009; FIPA 2009):

- 1) Exemption from customs duties on investments;
- 2) Unlimited right to open and keep an account in all commercial banks in the entire territory of Bosnia and Herzegovina, in domestic or any other foreign convertible currency;
- 3) The right of free and undisturbed foreign transfer of all income realized by investments in Bosnia and Herzegovina in all convertible currencies;
- 4) Equal property rights with all citizens of Bosnia and Herzegovina;
- 5) Protection from nationalization, expropriation, requisition, or measures with similar consequences;
- 6) The right to employ foreign citizens in accordance with Bosnia and Herzegovina laws on labor and immigration. International Development Agency (IDA) and Investment Guarantee Agency (IGA) provide guarantees for protection from political risks for short term and medium term commercial transactions between Bosnia and Herzegovina companies and foreign companies, suppliers and banks.

When the FDI in BIH divided by sectors between May 1994 and December 2008, the largest FDI flow was in manufacturing with the 35% of the total FDI inflows (Table 3). Banking follows it by 22%, and then telecommunication comes with 14%, and trade with 11%. Investments in telecommunication, transportation and tourism record constant growth. (FIPA, 2009: 16) In many emerging markets, banking sector is the corner stone of every financial system. In BIH there is a cumulative considerable volume of FDI attracted to BIH, extensively in the banking sector after 1995. With the increasing inflow of foreign capital into the banking sector, quality of services provided increase, overall sector's efficiency continue to increase. (Babić-Hodović and Burić, 2005: 1429). The banking sector after privatizations has now a better regulation. Today, a number of key reforms and the entry of foreign financial institutions, with access to capital and better lending conditions, are helping to restore trust in the system. That leads to an increased confidence in banking system followed by borrowing costs have declined sharply. Alfaro et al. (2003) show by using cross-country data that FDI has a crucial role in contributing to economic growth, in which countries with lack of development of local financial markets can adversely restrict the opportunities of potential spillovers from investments abroad. Conversely, well-developed financial markets gain significantly from FDI.

Table 3: Foreign Direct Investment in BIH by sectors (1994 – 2008)

	<b>Sectors</b>	<b>Percentage</b>
1	Manufacturing	35 %
2	Banking	22 %



3	Telecommunication	14 %
4	Trade	11 %
5	Other Financial Services	7 %
6	Services	7 %
7	Real Estate	2 %
8	Tourism	1 %
9	Transport	1 %
	Total	100 %

Source: FIPA – Foreign Investment Promotion Agency of Bosnia and Herzegovina (2009), Investment Opportunities in Bosnia and Herzegovina, Sixth Edition, February 2009, Sarajevo, p.16.

In spite of laying the bases for promoting FDI they have not been as successful as countries like Croatia, Romania and Bulgaria which were the main attractors of FDI in the last years in the region of Southeastern Europe. The biggest amount of investments in BIH was made by companies from Austria (27.1 %) and Serbia (15.6%). Croatia (11.7%), Slovenia (11.4%), Switzerland (6.8%), Germany (5.5%), Russia (5%), The Netherlands (2.5%), Italy (2.1%), USA (1.9%), Turkey (1.3%), and other countries (9.1%) follow them (Table 4).

Table 4: Top investor countries in BIH (1994 – 2008)

	<b>Country</b>	<b>Amount (million Euro)</b>	<b>Percent</b>
1	Austria	1,446	27.10 %
2	Serbia	832	15.60 %
3	Croatia	626	11.70 %
4	Slovenia	610	11.40 %
5	Switzerland	364	6.80 %
6	Germany	294	5.50 %
7	Russia	268	5.00 %
8	The Netherlands	134	2.50 %
9	Italy	114	2.10 %

10	USA	99	1.90 %
11	Turkey	68	1.30 %
12	Other Countries	487	9.10 %
	TOTAL	5,300	100.00 %

Source: FIPA – Foreign Investment Promotion Agency of Bosnia and Herzegovina (2009), Investment Opportunities in Bosnia and Herzegovina, Sixth Edition, February 2009, Sarajevo, p.15

Leading multinational corporations, among others Coca-Cola, IBM, Microsoft, Procter & Gamble can be quoted, seek investments opportunities in BIH in the last years. With the actively operation in BIH of international companies, domestic companies could benefit on this way from knowledge spillovers especially in management as well as profits from technology transfers. On the other side there may be a more tightly integration of local firms in the world market. So the role of FDI, in this context, is straightforward.

#### 4. FOREIGN DIRECT INVESTMENT IN BANKING SECTOR OF BOSNIA AND HERZEGOVINA

##### 4.1. Banking System in Bosnia and Herzegovina

The developing banking system in BIH laid the base for tremendous change and improvement compared to other sectors. By promoting the institutional development of the bank regulatory authorities in both entities over the past few years most inefficient and problematic banks closed and helped to change, respectively. After privatization process of state owned banks entrance of strong foreign banks in the country led to the result of enhancing of the level of confidence through a sharp increase in citizens deposits as well as a total deposits increasing can be concluded. Deposit growth raised significantly during the currency conversion to the Euro in late 2001. The banking system in Bosnia-Herzegovina will continue to evolve and consolidate.

The Central Bank of Bosnia and Herzegovina (CBBH) was founded under the Dayton Peace Agreement and started its work as a federal-level institution on August 11, 1997. It is headed by the Governing Council of the Central Bank acting, by law, as an independent central financial institution. CBBH is the only monetary authority in the country. Formulating, adopting as well as controlling the monetary policy of BIH are the main objectives of the CBBH and operates some kind of a Currency Board Arrangement as designated in the CBBH law and in the Dayton Peace Agreement. Both “fixed exchange rate” and “rule-based approach to monetary policy” (CEFBH 2005; Kovačević 2003: 59-60) Thus the CBBH cannot use monetary policy to lean against rising demand<sup>5</sup>. It has few monetary policy tools at its disposal.

The Country-wide currency Convertible Mark (Konvertibilna Marka, KM) was introduced in June 1998 and replaces the three different currencies in use in the different parts of BIH. It was formerly pegged to the German

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<sup>5</sup>Instead BIH must use fiscal and income policies.

Mark. In 2001 the peg was changed to the Euro at a rate of 1 KM = € 0.51129. Inflation has been relatively low in the federation after the introduction of the KM, as would be expected in a currency board system (Kovačević 2003: 60). An institution, the Fiscal Council, has been established is responsible for coordination of fiscal policy.

From the end 1990s on new modern banking laws were issued. Within an institutional-based guidance of the banking sector, the regulation and supervising is distinguished from the systematic as in the European countries, in which, in BIH, the monitoring and observing authority is assigned to the Banking Agency of the Federation of BIH (FBA BIH), the Banking Agency of the Republic Srpska (BARS) and partly, the Deposit Insurance Agency of Bosnia and Herzegovina (DIA). The Federation Banking Agency started functioning in 1997. The Federation Banking Agency is responsible for bank licensing and supervision. The National Bank of Republic Srpska has been converted to the Banking Agency of the RS in mid-1998 after enabling legislation was passed in March 1998 (Teseche 2000: 319-321). In 1998 two laws were passed to set up bank privatization: the “Law on the Privatization of Banks” and the “Law on Opening Balance Sheets for Enterprises and Banks”. Supervisory agencies both in the FBA BIH and the BARS conducting banking supervision in Bosnia and Herzegovina, which are each governed by individual entity-level legislation. Both are authorized to grant and revoke licenses and measures banks. The CBBH coordinates the activities of the two entity agencies. Basically the FBA BIH and the BARS, among both, and also between these and the DIA exists a cooperate agreement. To effectively implement the Basel principles the banking supervision agencies got a great deal of technical assistance (IMF 2006: 28).

Deposit Insurance Agency of Bosnia and Herzegovina (DIA) is established by the “Law on Deposit Insurance in Banks of Bosnia and Herzegovina” in 2002. DIA is an independent, non-profit, legal entity with full authority under the Law of the State. Head Office of the DIA is located in Banja Luka, and there is one Branch Office in Sarajevo and Banja Luka. In 2009 there are 25 banks which are signed the Contract on Deposit Insurance (DIA 2009)

According to the Law on Banks the commercial banks in BIH are enabled for banking activities and operations. Overall, the main share of assets in BIH is today privately owned. Foreign-owned banks have been the main drivers of credit growth. The list of the commercial banks operating in the Bosnia and Herzegovina in 2009 is given in Table 5. Center offices of the 19 banks in the list are in Federation of Bosnia and Herzegovina, while center offices of the 10 of them are in RS.

Table 5. Commercial Banks in Bosnia and Herzegovina in 2009

	<i>NAME OF THE BANK</i>	<i>CENTER OFFICE</i>	<i>OFFICIAL WEBSITE</i>
1	<b>ABS BANKA D.D. SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.absbanka.ba">HTTP://WWW.ABSBANKA.BA</a>
2	<b>BOR BANKA SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.borbanka.ba">HTTP://WWW.BORBANKA.BA</a>
3	<b>BOSNA BANK INTERNATIONAL D.D. SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.bbi.ba">HTTP://WWW.BBI.BA</a>
4	<b>FIMA BANKA DD SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.fimabanka.ba">HTTP://WWW.FIMABANKA.BA</a>
5	<b>HYPO HYPO ALPE-ADRIA-BANK D.D. MOSTAR</b>	<b>MOSTAR</b>	<a href="http://www.hypo-alpe-adria.ba">HTTP://WWW.HYPO-ALPE-ADRIA.BA</a>
6	<b>INTESA SANPAOLO BANKA D.D. BOSNA I HERCEGOVINA</b>	<b>SARAJEVO</b>	<a href="http://www.intesasanpaolobank.ba">HTTP://WWW.INTESASANPAOLOBANK A.BA</a>

7	<b>INVESTICIONO-KOMERCIJALNA BANKA DD ZENICA</b>	<b>ZENICA</b>	<a href="http://www.ikbze.com.ba">HTTP://WWW.IKBZE.COM.BA</a>
8	<b>KOMERCIJALNO-INVESTICIONA BANKA DD V.KLADUŠA</b>	<b>VELIKA KLADUŠA</b>	<a href="http://www.kib-banka.com.ba">HTTP://WWW.KIB-BANKA.COM.BA</a>
9	<b>NLB TUZLANSKA BANKA DD, TUZLA</b>	<b>TUZLA</b>	<a href="http://www.nlbuzlanskabanka.ba">HTTP://WWW.NLB TUZLANSKABANKA.BA</a>
10	<b>POSTBANK BH D.D. SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.postbankbh.ba">HTTP://WWW.POSTBANKBH.BA</a>
11	<b>PRIVREDNA BANKA SARAJEVO D.D. SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.pbs.ba">HTTP://WWW.PBS.BA</a>
12	<b>PROCREDIT BANK SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.procreditbank.ba">http://www.procreditbank.ba</a>
13	<b>RAIFFEISEN BANK DD BIH</b>	<b>SARAJEVO</b>	<a href="http://www.raiffeisenbank.ba">http://www.raiffeisenbank.ba</a>
14	<b>RAZVOJNA BANKA FEDERACIJE BIH</b>	<b>SARAJEVO</b>	<a href="http://www.ibf-bih.ba">http://www.ibf-bih.ba</a>
15	<b>TURKISH ZIRAAT BANK BOSNIA DD SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.ziraatbosnia.com">http://www.ziraatbosnia.com</a>
16	<b>UNICREDIT BANK D.D.</b>	<b>MOSTAR</b>	<a href="http://www.unicreditbank.ba">http://www.unicreditbank.ba</a>
17	<b>UNION BANKA D.D. SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.unionbank.ba">http://www.unionbank.ba</a>
18	<b>VAKUFСКА BANKA D.D. SARAJEVO</b>	<b>SARAJEVO</b>	<a href="http://www.vakuba.ba">http://www.vakuba.ba</a>
19	<b>VOLKSBANK BH DD</b>	<b>SARAJEVO</b>	<a href="http://www.volksbank.ba">http://www.volksbank.ba</a>
20	<b>BALKAN INVESTMENT BANK AD BANJA LUKA</b>	<b>BANJA LUKA</b>	<a href="http://www.bib.ba">http://www.bib.ba</a>
21	<b>BOBAR BANKA AD BIJELJINA</b>	<b>BIJELJINA</b>	<a href="http://www.bobarbanka.com">http://www.bobarbanka.com</a>
22	<b>EEFC BANK, A.D. BANJA LUKA</b>	<b>BANJA LUKA</b>	<a href="http://www.iefkbanka.com">http://www.iefkbanka.com</a>
23	<b>HYP0 ALPE-ADRIA-BANK A.D. BANJA LUKA</b>	<b>BANJA LUKA</b>	<a href="http://www.hypo-alpe-adria.ba">http://www.hypo-alpe-adria.ba</a>
24	<b>KOMERCIJALNA BANKA AD BANJA LUKA</b>	<b>BANJA LUKA</b>	<a href="http://www.kombank-bl.com">http://www.kombank-bl.com</a>
25	<b>NLB RAZVOJNA BANKA</b>	<b>BANJA LUKA</b>	<a href="http://www.nlbrazvojnabanka.com">http://www.nlbrazvojnabanka.com</a>
26	<b>NOVA BANKA AD BANJA LUKA</b>	<b>BANJA LUKA</b>	<a href="http://www.novabanka.com">http://www.novabanka.com</a>
27	<b>PAVLOVIĆ INTERNATIONAL BANK A.D.</b>	<b>SLOBOMIR BIJELJINA</b>	<a href="http://www.pavlovic-banka.com">http://www.pavlovic-banka.com</a>
28	<b>UNICREDIT BANK A.D. BANJA LUKA</b>	<b>BANJA LUKA</b>	<a href="http://www.novablbanka.com">http://www.novablbanka.com</a>
29	<b>VOLKSBANK A.D. BANJA LUKA</b>	<b>BANJA LUKA</b>	<a href="http://www.volksbank-bl.ba">http://www.volksbank-bl.ba</a>

Commercial banks in Bosnia and Herzegovina provide more than 10.000 jobs for residents of BIH. Number of employees of the BIH banks is increasing nearly 10 percent each year. Number of Employees of the Banks in Bosnia and Herzegovina both in Federation of Bosnia and Herzegovina and RS are given in Table 4.

#### 4.2. Developments in the Banking Sector

The reform program about banking system was also of increasingly interest in the former Social Federal Republic of Yugoslavia which aimed implementing of necessities for development. But with the beginning of the ethnical conflict in former Yugoslavia many reforms couldn't never implemented. In the former Yugoslavia the banking system was pretty centralized. Additionally it was dominated by a number of socially-state-owned banks apart from small private banks. (Tesche 2000)

After war damage and highly influences through policies set forth by international (financial) organizations, (e.g. IMF, EBRD, The World Bank, EU, etc.) the banking sector in BIH gains the opportunity to restructure themselves in order to render regular banking services in accordance with free market conditions since 1997 with the building up the Central Bank in BIH. In compliance with the institutional framework it is aimed to reach a long-term political, security and economic stability. Decisions were made to a bank-based financial system, which underlines the predominance of banks in financial intermediation. (Sevic 2000a; Sevic 2000b). Reforms in the banking sector have so far produced best results. It has realized a sizable progress due to accelerated privatization and liberalization of the banking sector among all the sectors in BIH, with significant confidence in banks, improvements in terms of extending credits to businesses and households and presented one of the fundamentals of economic development of the country (World Bank 2004: 92-93). Besides, it is wide-range accepted that state ownership is in comparison to private ownership less efficient and foreign-originated banks are most efficient of all (Bonin et al. 2008; Fries and Taci 2005; Weill 2003). Investments from famous banks especially from Austria, Italy, Turkey, Germany and Slovenia BIH have one of the most advanced financial sectors in the region. In the framework of the institutions-building process and the restructuring of the State Banks, foreign investors allowed entering the banking sector by buying important shares in the state-owned banks when these were "ready" for privatization and often not meeting the minimum requirements of financial soundness (Babić-Hodović and Tesche 2006). Main foreign investors in the banking sector of BIH are shown in Table 5.

In last 12 years there is a significant increase in both deposits and loans of the commercial banks in BIH. Total amount of the deposits in commercial banks' accounts was only 1,382 million KM in 1997, while it reached 12,013 million KM in 2008 which is 769 % more than the amount in 1997. This shows the increasing confidence in the BIH financial sector. Total amount of the loans given by the commercial banks was only 2,439 million KM in 1997, while it increased to 14,561 million KM in 2008 which is 497 % more than the amount in 1997. This shows the financial support of the financial sector to the development of the BIH economy and households (Table 6).

Table 6. Total Deposits and Loans of Commercial banks (of million KM)

Year / month	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008

	/ 12	/ 12	/ 12	/ 12	/ 12	/ 12	/ 12	/ 12	/ 12	/ 12	/ 12	/ 12
<b>Total deposits</b>	1.382	1.663	1.820	1.954	3.271	3.724	4.366	5.579	6.876	8.839	12.139	12.013
<b>Total loans</b>	2.440	2.921	2.781	3.017	3.339	4.281	5.122	5.927	7.544	9.308	11.964	14.561

Source: Central Bank of Bosnia and Herzegovina (2008)

The balance sheet volume of the commercial banks in BIH is also has been continually increased during last decade. Analytical Accounts of Commercial Banks in Bosnia and Herzegovina in 1997 and 2008 are given in Table 7. The amount of the total assets of the commercial banks increased to 21,040 million KM in 2008 which is 531 % more than the amount in 1997.

Table 7. Analytical Accounts of Commercial Banks in BIH (in million KM)

#### ASSETS

Y	M	Reserves	Foreign Assets	Claims on General Government	Claims on Non-Financial Enterprises	Claims on Private Sector	Total
1997	12	239.5	657.8	133.8	2,171.0	134.8	3,336.9
2008	12	3,392.9	3,086.9	264.3	7,440.4	6,856.3	21,040.9
Increase %		1,317 %	369%	98%	243%	4,986%	531%

#### LIABILITIES

Y	M	Deposits of Central Government	Other Demand Deposits in Domestic Currency	Other Demand Deposits in Foreign Currency	Time and Saving Deposits in Domestic Currency	Time and Saving Deposits in Foreign Currency	Bonds	Foreign Liabilities	Capital Accounts	Other	Total
1997	12	233.6	139.2	448.5	9.6	363.3	14.2	1,513.8	1,043.4	-428.5	3,336.9
2008	12	1,546.7	3,684.9	1,511.6	1,799.5	3,470.6	12.9	6,307.8	3,004.5	-297.5	21,040.9
Increase %		562%	2,547%	237%	1,8645%	855%	-9%	317%	188%	-31%	531%

Source: Central Bank of Bosnia and Herzegovina (2008)

Beside all these developments, an ever increasing number of newly created private banks could be seen over the years. It is a fact, that a lot of foreign investors perceive the Balkan region as a surrounding with high risks for investment. Not only due to fragile political situation, but also from weaken law enforcement agencies. With increasing political stability it can be given good signals to foreign investors. Furthermore the privatization process can be regarded as the main important institutional possible course of action that can happen to the

transitional banking sector in BIH to improve the performance within this branch. It is noteworthy that international reserves have been boosted substantially in the banking sector. But overall the banking system in BIH are not internationally competitive: *“Despite constantly increasing participation of foreign banks and other financial institutions in the national banking systems, it is still necessary to persuade foreign investors that the current, constantly improving overall social situation will most likely be sustained in the future, and that they have to opt for long-term operation in the country.”* (Sevic, 2000b: 279) Today the banks are significant players in the Bosnian financial system. Several empirical studies proved the positive relationship between financial sector developments and economic growth (e.g. Alfaro et al., 2003; Babić-Hodović et al., 2008; Babić-Hodović et al., 2009)

### 4.3. Foreign Investors in Banking Sector

In general, the financial system in BIH is dominated by the banking sector while the nonbank financial sector is not so much developed. Rapidly increasing of internet banking in developed countries has not the same insight in BIH due to various factors. Progress in e-banking required to be done in this country. (Basheska-Gjorgjieska et al., 2006) The consolidation process of the banking sector came mainly on the back of FDI through the acquisition of private or privatized banks. Privatization of the banking sector in BIH is almost completed. 90% is private capital, of which 77% is foreign private capital, while 13% is local private capital. There are 29 commercial banks operating in BIH in 2009. A strong concentration of capital among several large banks is noticeable so a few banks holds a large amount of the total capital. Out of the total number of commercial banks, 25 are included in the state deposit insurance scheme. Investment in banking sector in period 1994-2008 amounts 1.2 billion Euros and represents 22% of total investment in BIH. BIH has been given “B2” credit rating with the stable outlook by Moody’s Agency (May 17, 2006) Standard & Poor’s Rating Services assigned ‘B+’ credit rating with stable outlook to Bosnia and Herzegovina. (December 22, 2008) (FIPA 2009: 22)

Structural changes in the banking system, adoption of modern principles of evolving the banking industry leads to a bank-based financial system in BIH (Željko 2008: 28). The banking system is dominated by large foreign banks, which have been the main source of credit growth in BIH, and has improved the soundness of the financial system. As a consequence these altered the nature of risks of financial stability. This means that no longer a traditional risk in banking slovenly crisis is assumed but rather the risk to the sustainability of foreign exchange reserves increasing from the potential for capital flow volatility. (IMF, 2006: 11-12, 28) The information in Table 7 is taken from the Ministry of Foreign Trade and Economic Relation BIH, for the period May 1994-December 2008. It shows the foreign Investors in the Banking sector which registered investment in amounts higher than 20 million KM.

Table 7. Main Foreign Investors in the Banking Sector

BH Bank	Country	Investor	Amount	Total Amount (000 KM)
Hypo Alpe-Adria-Bank d.d. Mostar	Austria	Hypo Alpe-Adria-Bank AG	183,000	183,000
Raiffeisen BANK d.d. Bosna i Hercegovina	Austria	Raiffeisen International Bank Hold., AG	163,854	168,922
	Austria	Millenia Beteiligungsverwaltungs	5,068	

		GmbH		
Hypo Alpe-Adria-Bank AD Banja Luka	Austria	Hypo Alpe-Adria-Bank AG	120,837	120,837
UniCredit Bank d.d. Mostar	Croatia	Zagrebačka Banka d.d.	78,228	118,174
	Austria	Bank Austria Cred.	29,079	
	USA	Internat. Fin.Corp.	6,831	
	Italy	Unicredito It. S.p.a.	3,900	
	Spain	Transmadrid	136	
Bosna Bank International d.d. Sarajevo	UAE	Dubai Islamic Bank	25,920	47,520
	Saudi Arabia	Islamic Development Bank	21,600	
Volksbank BH d.d. Sarajevo	Austria	Ostereichiche Volksbank.	47,000	47,000
AD Volksbank Banja Luka	Austria	Volksbank Int. AG	42,471	42,471
BBI Leasing Real Estate d.o.o. Sarajevo	Saudi Arabia	Islamic Development Bank	21,531	39,905
	UAE	Abu Dhabi Islamic Bank.	18,374	
NLB Razvojna banka a.d. Banja Luka	Slovenia	Nova Ljubljanska Banka	21,245	36,028
	Germany	LHB Inter. H. Bank	12,171	
	Serbia	Vojvođanska banka	2,611	
CBS Bank d.d. Sarajevo	Germany	LHB Inter. Hand. AG Frankfurt	11,789	26,993
	Slovenia	Banka Domžale	15,114	
Turkish Ziraat Bank Bosnia d.d. Sarajevo	Turkey	T.C. Ziraat Bankasi	25,000	25,000
IEFK Banka A.D. Banja Luka	Russia	Istočno Evropska Fin. Korporacija i drugi	<b>20,000</b>	20,000

Source: Coskun A. and Ilgun E. (2009), "Reconstruction and Developments in the Banking Sector of Bosnia and Herzegovina", Proceedings of 1. International Symposium on Sustainable Development Vol 1: Economy and Management Proceedings, June 9-10, 2009, Sarajevo–Bosnia and Herzegovina: 52-63 (The lists were kindly provided by Dušanka Brkić from FIPA)

## CONCLUSION

Besides some lagging periods the Bosnia's private sector continued to grow year by year. Financial institutions and financial services reform accelerated in 2001. Most of the banks and other financial institutions in financial services sector in BIH were influenced by the foreign investors, especially from the European countries. Inadequate coordination between the state and entities, gray market activity, a sizeable national current account balance deficit and high unemployment figures remain the most major economic problems. Red tape occurs with respect to independent administrative areas which are Federation of Bosnia and Herzegovina, Republika Srpska and Brčko. Different rules within the country exist (Klamert 2008: 4-7). In the Federation, where there is a political division between ethnically-based political parties, making agreement on economic policies is more difficult.

<sup>6</sup>The entities are to a large extent independent as for legislation and there is no real deferral legal system.



FDI plays a rigorous role in the economy of BIH as it does not only provide opportunities to host countries to enhance their economic development but also opens new vistas to optimize their earnings by employing their ideal resources. The main advantage of FDI is its contribution to economic growth in host countries. The extent of such growth-enhancing responses depends on country-specific characteristics such as liberal trade regimes, accumulation of human and physical capital and macroeconomic stability. On the other side, multinational companies have the opportunity to catch first-mover advantages that guide their international business, where for example skilled labor force exist only for a fraction of cost of that in Western Europe. MNCs are interested especially in maximizing global profits contrary to states which have comprehensive political, social and economical objectives like GNP growth, full employment, etc. as well as non-economic aims like environmental protection, distribution of income etc.). In short, they are interested in maximizing the welfare of their own citizens.

BIH is a small country but strategically located in the European region. It has free market access to a very large European market. The laws of the Federal Government and entities are often not properly implemented or executed, and corruption remains pervasive. We concerned that divergences in policy between its key members could lead to further political wrangling, delaying the convergence process. Different regulations between the cantons and the entities must be harmonized at the entity level, creating a single economic space. BIH has a strong Central Bank and a banking system that is now playing a major economic role. On the economical part one of the increasingly favorable economic conditions is the minimizing of the current account deficit. More political effort is needed to push forward reforms. It is necessary for attracting higher levels of FDI to accelerate convergence. The banking system has improved significantly in BIH and this has brought down the cost of capital. The banking sector has gone further and faster than reform in any other sector of the economy. We can say that the balance between risk and opportunity now favors opportunity for investors. Convergence reforms in both entities in BIH will continue to help strengthen macroeconomic vulnerabilities. Moreover an enhanced educational level of the working population could be beneficial to attract additional FDI inflows.

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