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**Bosnia and  
Herzegovina after  
Five Years of  
Reconstruction**

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## **Abstract**

Even under favourable conditions economic recovery in Bosnia-Herzegovina (BiH) will take time. In economic terms, the country will probably remain on the track it is already running down. A miracle in terms of GDP, income and employment growth is unlikely, given that no change in the handling of economic matters is in sight. It would be misguided to hope that recent developments such as the abolition of the former accounting system and the ongoing deregulation of companies will yield swift gains. On the contrary, both programmes will lead to disruptions in the short term, the achievement of positive results will take a number of years.

The issue of kick-starting economic recovery in the Balkans remains very much an item on the agenda. Over the next few years, the experience gained in Bosnia and Herzegovina should benefit the region as a whole.

**Keywords:** Bosnia, BiH, economy, reconstruction, aid, Balkan, business, investment, banking

**JEL classification:** O52, K42, P30

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## **Bosnia and Herzegovina after five years of reconstruction**

Update October 2001\*

### **A brief overview**

#### **Fundamental improvements based on foreign support and guidance**

By the end of 1995, with the cessation of hostilities in Bosnia-Herzegovina (BiH), several hundred thousand people had perished. The greater majority of those who had lived in BiH before the war no longer resided in their pre-war homes. They had abandoned their houses or flats for a variety of reasons: direct violence, massive threats or intolerable living conditions. About one million people had fled the country – some left for other parts of Former Yugoslavia and the more fortunate headed for countries in the West. A similar number had gone into emigration within the country itself: so-called displaced persons. Many of those that remained in the country barely subsisted at best. Most were left without any means of survival and were close to starvation. They relied on external humanitarian aid, relatives living abroad and international organizations. The economy was in a disastrous state. Enormous damage, if not complete destruction had been inflicted on residential buildings, workshops, factories, railways, roads, bridges, telephone and electricity lines, water mains and means of transport. The country had split into small bailiwicks under the tutelage of different ethnic groups. The borders between these areas were almost completely closed – at least to the local population. The all-important divisive element was a person's ethnic background, something that before the war had been of only minor importance to many people or at least had not hindered interaction in any great measure. To a far greater degree than the destruction of infrastructure and physical assets, this radical isolation of minor territories was a stranglehold on production activities. In most areas production had shut down entirely or was merely kept at subsistence level.

Today, five years on, the picture has changed. The (violent) crime rate is low by international standards. Part of the population is re-engaged in economic activities. Many houses have undergone at least partial repair. Contact between people of different ethnic backgrounds is becoming more frequent. These ties include mutual trading and joint production projects. Throughout the country people use the local currency; they even fly the country's flag and their cars bear BiH number plates. They can travel all over the country. Traffic jams have become a common feature in larger towns and on main roads. For the most part, the infrastructure has been rebuilt and public utilities are in supply once

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\* There were several reasons for revising the original version of this study: new data, new literature, e.g. from the EBRD and the International Crisis Group, and last but not least critical comments I received from a number of experts. For an author, there is nothing better than finding such attentive readers and commentators.

more. All this has become reality thanks to the support and guidance provided by international organizations and foreign powers.<sup>1</sup>

### **Discomfort persists**

Admittedly, recent developments in Croatia and Serbia have drastically changed the political environment in BiH. None the less, the situation in the country remains fragile. Both its economy and political system continue to be fully dependent on foreign support. For years to come foreign support and involvement will remain the pre-requisites for further progress. In all probability, all the achievements to date would disappear in one fell swoop, were the foreign powers and institutions to leave the country. With BiH having become aid-dependent, donor organizations and countries are confronted with a continuous need for additional funds; this fact, however, allows them to exercise control and exert influence. BiH society – if we resort to a simplifying singular – has adjusted to this fact, as have the economic and political players. For many voters the question as to which parties might guarantee or block future aid is a decisive criterion. Those politicians and managers who have learnt to adjust their attitudes to the expectations of the donor community representatives are forming a new elite. Aid money lessens the pressure to make the country attractive to private investors. Certain aspects of the economic development in post-war BiH bear a distinct similarity to the situation in the former German Democratic Republic: the imposition of a foreign currency; the inability of local companies to face up to Western competition; and the entanglement in a dependence on massive external transfers as a substitute for domestic growth generation.

BiH still has a long way to go to normality. A large proportion of the inhabitants still face sub-standard conditions in terms of their dwellings, legal standing, social relations and opportunities for economic activity. Undoubtedly, the change in the political climate in the Balkans as a whole will have a major medium- and long-term impact on Bosnia-Herzegovina. The odds are shortening: a multi-ethnic state could become reality. That notwithstanding, the project could falter, not so much because of an internal boycott, as has been the case hitherto, but rather on account of the Western governments' annoyance at the prospect of the country's never-ending need for financial support.

At present, BiH itself creates a mixed impression. It remains formally – and substantially – divided into the Serb-dominated Republika Srpska (RS) and the Federation of Bosnia-Herzegovina (FBiH), the latter being de facto split into Croat and 'Bosniac' (Moslem) controlled cantons.

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<sup>1</sup> The reconstruction plan established by Dayton scheduled expenditures of USD 5.1 billion for subsequent years. Of this sum, USD 3.1 billion has been distributed to date. Up to 2000 the EU, one of the major donors, had allocated close on EUR 2.2 billion to BiH.

Some of the major problems still await a solution, whereas in other respects it has become easier to achieve progress – an initial outcome of the international organizations' endeavours over the past few years. Their experts' country-specific knowledge has improved. It has become easier to determine the next important steps to be taken and the extent of intervention needed. Most of the achievements over the past few years have been the outcome of interventions on the part of the Office of the High Representative (OHR). The Dayton agreement, co-signed by the local powers, entitles the High Representative to intervene if domestic state bodies are unable to provide adequate solutions of their own in time.

Progress in BiH has been slower than expected by the donors' community: a major source of dismay. It is an open and crucial question as to what or who might be the main culprit responsible for the country being mired in sub-standard structures and its continuing to be dependent on all kinds of external support. One possible answer is that expectations were exaggerated; it is quite probable that in the wake of massive physical and social destruction, achieving a state of normality takes much longer and requires appreciably more funding than the engineers of the recovery programme had initially expected. This explanation appears quite plausible.

Other observers stress that of the total of USD 5.1 billion pledged by the donor community, the USD 3.1 billion made available to date would have offered an opportunity to achieve economic self-reliance within five or six years. Politicians both within BiH and the region as a whole, so the argument, spoiled things by boycotting the programme, openly or tacitly.<sup>2</sup> Reports<sup>3</sup> point to massive corruption<sup>4</sup> and misappropriation of foreign aid in BiH as a main obstacle to social, political and economic progress. Of course, this view makes pumping funds into the country a most unattractive proposition.

No matter how massive corruption and obstructionism on the BiH side might be, a third question arises: Did the foreign experts approach their task in the most appropriate manner? Was the allocation of the USD 5.1 billion adequate to the task on hand? Those responsible for the design of the economic strategy were faced with a completely new brief: kick-starting the economy of a completely fragmented country, whose physical assets and social relations had been ruptured beyond imagination. Most probably, there is no clear and simple answer to this last question. Nevertheless it is interesting – not so much in the sense of economic history; the issue of kick-starting economic recovery in the Balkans

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<sup>2</sup> In May 2000 at a two-day conference in Brussels to review the Dayton peace agreement, western representatives demanded that an end be put to what they termed 'obstructionism'. The EU foreign policy representative, Javier Solana, warned that international financial support for Bosnia could not continue at its current level, but might be reduced to USD 0.3 billion per year for the two remaining years.

<sup>3</sup> For example a *New York Times* article from 17 August 1999 that, unfortunately, transpired to have been ill-researched.

<sup>4</sup> For a comprehensive discussion of corruption see *Anticorruption in Transition – A contribution to the Policy Debate*. The World Bank, September 2000.



remains very much an item on the agenda. Over the next few years, the experience gained in BiH should benefit the region as a whole.

### **Statistical data – a reflection of reality**

#### **A warning concerning the reliability of BiH statistical data**

The de facto split of the country into three areas almost independent of each other makes it extremely difficult to monitor ongoing economic activities comprehensively. Some of the local administrations try hard to lie low where mutual links between the three areas were concerned: this explains why five years of technical advice from abroad has failed to set up a national accounting system.

Inflation and production data are the most reliable components in BiH data. Both the Federation Institute for Statistics and the RS Statistical Institute compile prices and production indices following sound methodological procedures, although the underlying weights for the indices are seriously outdated. Both institutes are weakest on labour statistics; the data on employment, unemployment and wage rates are based on deficient methodologies.

GDP figures are derived from an extremely weak basis. For want of reliable data only some of the standard methods can be used. Production and income aggregates at constant prices and compilation of GDP by final demand are still unavailable (BiH country report 01/08, IMF 2001, p. 59<sup>5</sup>).

A glimpse at sub-aggregates highlights some of the problems facing GDP statisticians. Government expenditure data are deficient on three counts: timing, recording difficulties and the exclusion of expenditures financed from external sources (BiH country report 01/08, IMF 2001, p. 60). In addition, the exclusion of arrears from expenditures understates actual government commitments and the overall deficit. For lower administrative levels in the Federation (cantons and municipalities) that account for a major share of general government operations, the classification system is not harmonized with that of the Federation and excessive reporting lags are prevalent.

The information required for country-wide balance of payment statements is only assembled at the time of EU missions; ad hoc basic data are drawn from donors or relevant entity agencies (BiH country report 01/08, IMF 2001, p. 59). As stressed in a USAID study (BiH Economic Update, 31 October 2000, p. 17), accurate measurement of BiH trade flows has been one of the most difficult areas. For 1999 import estimates vary

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<sup>5</sup> Bosnia and Herzegovina: Fourth and Fifth Reviews Under the Stand-by Agreement and Requests for Extension and Reshaping of the Agreement, Country report 01/08, IMF 2001.

between KM 4 billion (as a result of subtotals reported by the FBiH and the RS statistical offices) and KM 5.3 billion according to CAFAO and RS customs data. Even the latter figure may be an underestimate. Informal sector activities, to use a euphemism, are alleged to be particularly widespread in all kinds of trade. The discrepancy between the Balkan's official borders and unofficial ethnically defined borders is one reason. Another reason is that from times past the population is already adept at circumventing harassment by the authorities. In order to improve control, the international forces have set up a state border service; by the end of 2002 it should have units attached to each of the 44 international crossing points.<sup>6</sup>

### **Demographic situation**

Empirical facts hint at the problems that still persist and the progress achieved to date. Demographic data highlight the problems and reveal that progress has been modest.

Excepting refugees living abroad, the population of BiH ranges between 3.5 and 4.0 million, the official figure being 3.75 million. At the beginning of the nineties, i.e. before the war, the territory boasted 4.4 million inhabitants<sup>7</sup>. By the end of the war, in December 1995, 1.2 million had fled the country, but emigration did not stop at that juncture<sup>8</sup>. Some of the refugees have since returned to BiH; by the end of July 2000 some 333,000 had returned to the FBiH and 26,000 to Republika Srpska<sup>9</sup>. Their return was not always a voluntary matter; invariably they did not go back to their former homes, but to areas controlled by their own ethnic groups. Of those abroad 0.6 million still await a lasting solution; they can thus be counted as potential returnees. According to estimates, slightly more than 0.7 million have since found permanent solutions abroad. Parallel to this massive emigration, Serb refugees from Croatia and later from Kosovo fled to Serb-dominated regions of BiH, and a number of Moslems – now referred to as 'Bosniacs' – emigrated to the Federation from Yugoslavia.

Both during and after the war, highly qualified people frequently managed to arrange their emigration,; in many cases, they did not count as refugees at all. Less qualified people were more likely to join the group of displaced persons – émigrés inside the country. The number of displaced persons peaked in 1995 at close to 1.3 million; while at the end of 1998 it had dropped back to 0.8 million<sup>10</sup>. In the period January 1996-July 2000, 219,000

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<sup>6</sup> <http://www.nato.int/docu/facts/2000/bih-fnf.htm>.

<sup>7</sup> 1991: 4.377,033 persons. Workshop on Reconstruction, Reform and Economic Management in BiH, UNDP, UNDD SMS and WIIW, October 1996, p. 21.

<sup>8</sup> According to survey results published in the UNDP Human Development Report 2000 almost two thirds of the young people in BiH would leave the country, given the opportunity.

<sup>9</sup> The majority, about 310,000 persons, had already returned in the period 1996-1998.

<sup>10</sup> UNDP Human Development Report – Bosnia and Herzegovina 1998, p. 18.

displaced persons returned to their homes in the FBiH and 97,000 to Republika Srpska. The largest number of returnees was observed in 1996.

A most important indicator is the number of minority returns. It shows how many people have returned to their homes and properties despite their being in a area now controlled by a different ethnic group. This shows the degree to which the rule of law is gaining ground. In most areas progress has only proved feasible, if international bodies impose massive sanctions, positive and negative. Minority returns in Bosnia and Herzegovina were on a far larger scale in 1999 than in 1998. For 1999, the Office of the High Representative estimates that the actual number of such returns ranged between 80,000 and 90,000 persons, compared to 35,000 to 40,000 for 1998<sup>11</sup>. Many of those returns were spontaneous and in defiance of political obstruction. UNHCR statistics only reflect registered minority returns; the minority returns reported by UNHCR for the period January-July 2000 amounted to 23,352 persons. In July 2000, the number was 3,601, more than double the figure for the corresponding month a year previous.

### **Economic data**

At least in certain parts of the country, living standards have improved appreciably since the end of the war, and the supply of goods and services has increased correspondingly. The country absorbs more goods and services than the GDP or GDP per capita (see Appendix Table A/1) would seem to indicate. This is borne out by the high import surplus.<sup>12</sup>

IMF data record quite impressive GDP growth rates, which should be regarded as rough estimates: 50% for 1995, 86% for 1996, 40% for 1997, 13% for 1998 and 9% for 1999. This is less of a success than would appear at first sight. During the war, the GDP dropped to a *quantité négligeable*. Comparing 1999 to 1995, that negligible quantity has more than trebled; yet the country produces much less than before the war. In other words, many pre-war production capacities have not been repaired or replaced, and/or their utilization factor is low. The creation of new capacity has also been marginal. Employment is correspondingly low.<sup>13</sup>

It is difficult to measure employment and unemployment accurately, as some economic activities remain unregistered. At the same time quite frequently many people enjoy

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<sup>11</sup> For detailed information on the topic see e.g. the Annual Report 2000 of Amnesty International, <http://www.web.amnesty.org> or the homepage of the U.S. Committee for Refugees <http://www.refugees.org/>

<sup>12</sup> Depending on the source used, the estimates for the GDP per capita differ considerably. The population numbers of the CBBiH are 4.2 million for 1997, 4.23 million for 1998 and 4.28 million for 1999. Due to the broader population concept, in statistics of the CBBiH the GDP per capita is, compared to IMF data, by 10% to 13% lower.

<sup>13</sup> UNIS, Volkswagen's Bosnian partner, may serve as an example. Allotted to the machinery and transport equipment industry, UNIS ran 84 plants before the war and employed about 50,000 people. 61 plants have survived, and the official employment figure stands at 5,000.

employee status frequently in companies that are effectively bankrupt, yet they have no work to do and do not even receive a regular basic wage. Therefore, employment figures are problematic, as are data concerning the rate of unemployment.<sup>14</sup>

GDP per capita, calculated in USD at current prices and current exchange rates, has almost tripled since 1995; in 1999, it was close to 1,200. No data are available for calculating purchasing power parities. Probably, the result for 1999 would be slightly, but not fundamentally higher. Compared to Europe or the United States, some USD 1,200 in BiH would buy a somewhat, but not dramatically larger basket of goods and services of a given composition. BiH thus belongs to the very poor countries of the world.

As Table 1 shows, aggregate domestic absorption<sup>15</sup> of goods and services exceeded domestic production (GDP) by 59% in 1996 and by 35% in 1999. In other words, in 1996 the country produced about two thirds of what it absorbed. In 1999, the proportion was already 80%. However, the reality may be far worse. BiH GDP figures should be taken as very rough estimates; they vary widely depending on their source.<sup>16</sup> A basis for reliable calculations is still being built up.

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**Table 1: BiH: absorption of domestic and foreign products**

USD million, current prices, current exchange rates

	1994	1995	1996	1997	1998	1999
GDP	1964	2157	2741	3423	4134	4394
Foreign trade deficit, USD million	803	930	1546	1758	1959	1852
Deficit in factor services	88	23	74	-154	-378	-324
Resulting domestic absorption	2855	3110	4361	5027	5715	5922
Domestic absorption in % of GDP	145	144	159	147	138	135

Source: IMF.

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<sup>14</sup> ICG Balkans Report No 115, 7 August 2001.

<sup>15</sup> The GDP measures the gross value-added produced by domestic units - imports are excluded. As imports were high in recent years, much higher than exports, BiH absorbed many more commodities than it produced.

$GDP + Imports = Private Consumption + Private Investment + State consumption and investment + exports.$

The left-hand column is the sum of products available; the right-hand column indicates their absorption. If we shift export to the left, the resulting sum of GDP and trade deficit equals the sum of domestically absorbed products.

<sup>16</sup> According to the International Crisis Group, the foreign trade deficit in 2000 amounted to 64% of GDP. A USAID Study (BiH Economic Update 2000 – Third Quarter, 31 October 2000, p 17) comments on the balance of payment figures as follows: Assuming that the official estimates (CBBH) on the Balance of Trade in Services are accurate, the Current Account deficit excluding transfers would have been, in 1999, between KM 4,064 million and KM 4,271 million. Considering the nominal GDP amounted to KM 8,014 million, in 1999, the estimate for the deficit is in the range of 50.7%-53.3%.

It is easy to explain why domestic absorption could far exceed domestic production. Thanks to foreign aid, imports of goods and services were much higher than exports: 5.6 times higher in 1996 and still 3.9 times higher in 1999. As Table 2 shows, the deficit in the balance of trade of goods amounted to 56% of GDP in 1996 and to 42% of GDP in 1999. Another source, the ICG Balkan Report No 115, reports a marked increase in imports in 2000 (for the most part consumer goods) and a trade deficit totalling KM 4.3 billion.

Compared to the foreign trade deficit, the current account deficit was significantly lower: 27% of GDP in 1996 and 22% in 1999. There were two reasons for this. First, in 1999 the balance of services was in surplus, owing to revenue from incomes that foreigners, mainly employees of foreign agencies and organizations, spent in BiH. Secondly, the inflow of transfers was very high, such as support to BiH households from relatives living abroad or various kinds of support lent by international organizations and foreign governments.

**Table 2: BiH: current account components in % of GDP**

GDP = 100

	1994	1995	1996	1997	1998	1999
<b>I. Current account</b>	-14	-10	-27	-31	-19	-22
<b>A. Goods and services, net</b>	-71	-51	-59	-47	-38	-35
<b>a. Trade balance, net</b>	-64	-50	-56	-51	-47	-42
Commodity exports, fob	7	8	12	17	17	15
Commodity imports, fob	71	58	69	68	64	57
<b>b. Services, net</b>	-7	-1	-3	4	9	7
Credit	8	12	12	12	14	13
Debit	15	13	14	8	4	5
<b>B. Income, net</b>	-13	-13	-8	-7	8	6
<b>C. Current transfers, net</b>	70	54	40	23	11	6
Credit	71	57	46	25	11	7
1. General government	25	20	20	12	5	2
2. Other sectors	46	37	25	13	7	5
Debit	-1	-4	-6	-2	0	0

GDP USD million,

current prices, current exchange rates

	1964	2157	2741	3423	4134	4394
	1964	2157	2741	3423	4134	4394

Source: IMF.

An important aspect is the demand driving the domestic absorption of goods and services. External influences have been decisive and they have had an impact, direct or indirect, on all categories of domestic demand. As mentioned above, transfers to BiH households from relatives living abroad or humanitarian organizations have led to a rise in private consumption. The money that foreign organizations and their employees spend in BiH, which are probably registered as service exports, has had a snowball effect on private

consumption by the local population. According to estimates<sup>17</sup> some fifteen thousand foreigners resident in Sarajevo spend about DEM 720 million per year in the area. This adds up to over DEM 2 billion over the period 1996-1998 for Sarajevo alone; furthermore, the figure does not include expenditures by military personnel attached to IFOR and later SFOR<sup>18</sup>. By expanding the demand for both services and consumer goods, expenditures by foreign individuals and organizations have also boosted imports. Especially in the earlier years, domestic producers were not in a position to benefit to any extent from increasing aggregate demand. A large proportion of the money was spent on purchasing imported vehicles.

In areas with a high concentration of foreign organizations, foreign personnel spent considerable amounts of money..Local people were thus able to accrue income which they often started to invest in the construction or reconstruction of dwellings or business premises. However, for the most part, donor money boosted investment in another, more direct manner.<sup>19</sup> It helped to repair and update technologically most of the heavily damaged infrastructure, such as roads, railways, bridges, telecommunication lines, water, gas and electricity lines. This created the physical preconditions for the expansion of economic activities within a matter of years. Reconstruction was rapid as all investment relied predominantly on imports. Once again, domestic producers supplied only a small fraction of the enormous amount of capital goods and material required.<sup>20</sup> This investment boosted the volume of goods absorbed within the country, but did not lead to a parallel increase in domestic production. In other words, it did not provoke a corresponding creation of value-added. A large portion of the donor money helped to set up the prerequisites for a future increase in production; however, it did not contribute much to the actual increase in domestic gross value-added (GDP).

Over the period 1996-1998, BiH produced a total gross domestic product (GDP) of USD 10.3 billion, while the final use of goods and services totalled USD 15.1 billion. Over the same period, expenditures in the context of the Priority Reconstruction and Recovery Plan (PRP) amounted to USD 2.7 billion.<sup>21 22</sup> This massive international involvement, however, only partially stimulated actual GDP growth in BiH. Reconstruction itself had a

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<sup>17</sup> Why Will No One Invest in Bosnia and Herzegovina?, International Crisis Group, 21 April 1999, p. 6

<sup>18</sup> NATO-led military intervention from abroad was of crucial importance to the implementation and later stabilization of the Dayton Agreement and to the correspondingly labelled Implementation Force (IFOR) in the initial phase and Stabilization Force (SFOR) in the later.

<sup>19</sup> According to the International Crisis Group, in 1997-98 private sector investment in BiH totalled USD 160 million, which to 80% (129 million) was financed by foreign investors. It is not clear which proportion of this sum was investment in the GDP sense. Part of it have been merger and acquisition, a frequent form of 'foreign direct investment', which constitutes a shift in the ownership of existing assets, not a creation of new value.

<sup>20</sup> It is remarkable that only in 2000 did a major foreign investor (Heidelberg Zement) start producing building materials.

<sup>21</sup> By the end of 1998, donor nations had committed about USD 4 billion, of which USD 2.7 billion had been spent.

<sup>22</sup> PRP expenditures concentrated on construction activities. Only a small fraction, 2.3%, was invested in the manufacturing sector.

considerable impact on actual domestic absorption of goods, but less so on GDP. For the most part, this type of expenditures increased the revenues of EU and US companies. At least, the expenditures effected by international organizations and individuals *in situ* as well as transfers from abroad entered the domestic market in the form of demand where it was met by either domestic products or imports. In the early post-war years in particular, imports were dominant. Even today BiH imports a large proportion of its food requirements on account of domestic food production and processing not having recovered after the war.

As can be seen in Table 3, the sectoral composition of GDP confirms the impression that the comprehensive reconstruction programme failed to stimulate the creation of value-added in the construction sector to any large extent. That sector's contribution to GDP was 3.1% in 1995 and 5.7% in 1998<sup>23</sup>, which is still low for a country with enormous reconstruction requirements. Obviously, the programme did not boost the value-added of industry either. Its share declined from 23.8% of GDP in 1995 to 22.4% in 1998. Admittedly, in 1999 industrial production in the FBiH was 3.5 times above the 1995 level and in the Republika Srpska 2.2 times. However, this does not say too much, since by the end of the war industrial production had become a *quantité négligeable*. In most industries it was only a fraction of what it had been before the war. Many products have disappeared completely from the market, making it impossible to construct an index for the decade as a whole.

On the other hand, in 1995 the contribution of services accounted for 48% of GDP: a high level given that BiH is not a developed market economy. In the following years it even increased, rising to about 56% in 1998. Remarkable in the composition of services is the position of trade, which may have something to do with the large revenues generated by the import business. The position of the public sector is also remarkable given that the general government is not only represented in public administration, but is also dominant in other service categories such as education and research, health care and public utilities. The share of tourism and catering is relatively low and may signify that some of the money spent by foreigners is not reflected in the statistics.

Hitherto most capital goods installed in BiH have come from abroad; imports also meet a considerable part of the demand for consumer goods, including food. Only in the case of public sector demand – the third category of domestic demand besides private consumption and investment – can coverage by domestic supply be assumed to be high. In GDP statistics, the contribution of the public sector to GDP is equal to the sector's

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<sup>23</sup> According to the Deutsche Bank Research, Sonderbericht of 31 May 1999, in 1997 the GDP contribution of the construction sector was 4.9% in the Federation and 5% in the Republika Srpska. The contribution of industry in both entities ranged between 21% and 22%,

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**Table 3: Sectoral composition of GDP**

	1995	1996	1997	1998
<b>GDP, %</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Agriculture, fisheries and forestry	24.6	20.5	17.5	16.0
Industry	23.8	21.3	22.4	22.4
Water management	0.1	0.1	0.2	0.1
Construction	3.1	4.3	5.2	5.7
Services	48.4	53.8	54.7	55.8
Transportation and communications	6.1	6.5	7.3	7.9
Trade	20.4	16.7	16.2	14.8
Catering and tourism	2.2	2.6	2.7	2.3
Crafts	1.5	2.4	1.9	1.7
Housing and public utilities	0.7	1.6	1.7	2.1
Education and research	2.5	4.9	5.8	6.0
Health care	1.5	3.4	3.7	4.8
Banking and insurance	3.0	3.9	4.6	5.6
Government administration	7.4	8.2	8.7	8.6
Other services	2.9	3.7	2.1	2.0
Private sector, % of GDP	.	.	.	35.0

Source: IMF, June 2000 (GDP composition), World Bank (Private sector share).

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remuneration of its employees and its consumption of materials, since it cannot be evaluated at market prices. The accounting scheme assumes that the public sector consumes its own production and that both supply and demand are domestic. As can be seen from Table 1, in 1999 GDP covered 80% of the domestic absorption. This has to be regarded as an average. As domestic supply covers close to 100% of the demand for public services<sup>24</sup>, we know that less than 80% of the demand for private sector products was met from domestic supplies<sup>25</sup>.

Fiscal and other government revenues were extremely low after the war, and donor money had to step in to fund crucial activities in the public sector. In this sense, foreign funds backed the generation of the state's contribution to GDP. Public households had to rely on international financial institutions, as the Dayton Agreement does not permit government borrowing from domestic sources. In the WIIW country table (see Appendix, Table A/1), the budget data do not reflect this fact: government revenues also include grants.

In other words, donor aid fuelled private as well as public demand. In the absence of this support, BiH would face, according to USAID calculations, negative GDP growth:

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<sup>24</sup> A fraction of the government's material consumption could be imported.

<sup>25</sup> The gap increases with the extent of the state contribution to the GDP.



approximately –1% annually. However, were foreign aid to cease abruptly, the economy might well collapse.

The deficit in the trade balance reflects the weakness of the BiH economy. This weakness, however, bears another severe consequence. The government should fulfil a number of very important tasks, but is restricted by the fact that within the country there is no source from which it can draw the financial means required. In the FBiH with its agglomeration of state bodies, total public revenues amounted to 49%<sup>26</sup> of GDP in 1999 – which because of the weakness of the private sector was far from sufficient to fund public sector activities to the degree desired.

Pursuant to the Dayton agreement the Central Bank of BiH (CBBiH) has to observe rules that are even stricter than those applicable to other currency board regimes. BiH statistics show that the CBBiH was highly successful in achieving its goal of stabilizing the internal and external value of the country's currency. The konvertibilni marka (KM) has replaced local currencies; its exchange rate vis-à-vis the DEM has been fixed at a ratio of 1:1, and inflation is not a major problem. Compared to 1995, the price index in 1999 was 10% lower in the FBiH and 27% higher in the Republika Srpska.<sup>27</sup>

Unfortunately, the high current account deficit cannot be covered by a market-induced inflow of capital. Willy-nilly, the international financial institutions have had to take care of the problem. Otherwise the system would collapse. Thus, the significance of foreign involvement is obvious in terms of stabilizing both the monetary and real sectors.

### **Income and impoverishment**

In 1998, 58% of the population in the Federation and 64% in the Republika Srpska were in an impoverished state.<sup>28</sup> In October 1998 in the Federation the consumer basket of basic needs for a family of four cost KM 477 per month. Those with an income amounting to less than two thirds of that basket are considered impoverished. This applied to about 60% of the population, among them a high proportion (about one quarter) of employed people. The average net salary was KM 352 per month: KM 323 in the so-called 'economic sector' and KM 415 in the so-called 'non-economic fields'<sup>29</sup>. Only the average net incomes of those employed by financial institutions and working in public administration (KM 527 and 475, respectively) covered the cost of the consumer basket. In the Republika Srpska, the

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<sup>26</sup> In RS the ratio was only 29%.

<sup>27</sup> In 1999-2000 the population of the RS switched from using the Yugoslav dinar to the konvertibilni marka, and the meaningfulness of a price index from 1995 to 1999 is questionable.

<sup>28</sup> UNDP 1998, p. 43. These data are only rough estimates, especially for Republika Srpska

<sup>29</sup> This distinction is a legacy of the former system, which regarded only part of the economic activities as productive.

average net wage in August 1998 was KM 139, but a consumer basket of basic needs has yet to put together and priced. In the meantime, poverty has increased considerably, especially in those areas where the consumption of public utilities is no longer free of charge.

The pension system relies on current contributions; in 1998, in the Federation these made up 24% of gross salary. The resulting total was not enough to meet obligations. In October 1998, the minimum secured pension was KM 134, yet a number of pensioners received less. The State did not fulfil its mandate to close the gap. Furthermore, payments were usually delayed for several months at a time. The situation is even worse where unemployment benefits are concerned, despite legislation excluding the greater majority of jobless from unemployment benefits.<sup>30</sup> Benefits have to be funded from contributions amounting to 3% of gross salary.

On average, in 1998 the impoverished had a daily income of KM 0.6; they survived thanks to solidarity among relatives in BiH, financial support from relatives and friends living abroad, international humanitarian assistance and activities in the 'survival economy'.

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**Table 4: Impoverishment indicators**

Number of persons in thousands

	Total		Impoverished	
	Federation	Rep. Srpska	Federation	Rep. Srpska
Population.	2,250	1,391	1,299	890
Employed.	407	202	102	60
Unemployed	249	143	249	143
Waiting workers <sup>1)</sup>	70	45	70	45
Pensioners	255	159	113	111
Soc. prot. benef.	135	61	135	
Displaced persons	450	416	450	416
Returned refugees	150	17	150	17
Invalids	30	37	30	37

*Note:* 1) 'Workers for whose work there is temporarily no need' (Law of labour regulation, 1992), with monthly compensation ranging from KM 30 to 100.

*Source:* UNDP Human Development Report – Bosnia and Herzegovina 1998, p. 43; October 1998 data for the Federation, 1997 data for Republika Srpska.

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The situation has not changed substantially since 1998. In December 2000 the number of pensioners in the Federation was 281.000 and in Republika Srpska 172.000. They lived of an average pension of KM 171 in the FBiH and KM 80 the RS. In November 2000, the

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<sup>30</sup> UNDP, p. 44.

High Representative changed the pension system, tying current pension payments to the resources available. The dual purpose was to avoid the accumulation of further arrears and protect the recipients of minimum pensions. Thus, the pension system is the first segment within BiH society to have been subjected to rigorous financial discipline. The poor are now confronted with rising public utility prices and tough treatment of those unable to pay.

## **Reasons for industry's failure to recover**

### **Rupture of links on the input side**

The start of the post-war period in BiH was marked by high imports and almost no exports. Domestic factories re-launched operations only partially or – in many cases – not at all. This state of affairs might appear surprising as wages were (and still are) very low and unemployed labour has always been in plentiful supply both within enterprises and without. The public authorities have ruled that companies are obliged to retain a certain proportion of their idle workforce on a ‘waiting list’ and to pay them some remuneration. The OHR's amendment to the labour code has done away with these waiting lists; However, for a number of reasons many companies still keep employees they do not need on their payroll, paying them a symbolic wage or in some instances no wage at all.

Wage levels can hardly be held responsible for production volumes remaining far below pre-war levels. In 2000, average net wages were DEM 413 in the FBiH and DEM 277 in the RS: a very low level if we take into account the fact that shops sell most commodities at prices not much below those in Western Europe. Average gross wages were DEM 606 in the FBiH and DGM 386 in the RS. Employers' social security contributions amounted to about 20% of gross wages in the FBiH and less than 15% in the RS. By European standards, these ratios are quite normal.

The reasons for post-war production not bouncing back to pre-war levels are manifold. One reason was that individual firms lacked access to the material inputs they required. Inactivity on the part of one firm could bring things to a standstill elsewhere, if it was the sole supplier of the material that others required. The war-damage inflicted on traffic routes and communication links was not the sole reason for restricted access to material inputs. Equally adverse was the country's being split into isolated, ethnically homogenized zones. Those controlling the individual zones blocked all kinds of traffic with neighbouring ‘hostile’ zones. A similar state of affairs prevailed where links to the outside world were concerned. People from Serb-controlled sectors could not enter Croatia, Croats were barred from entering Serbia. Bosniacs (Bosnian Moslems) were denied access to Yugoslavia and had, at least in the early post-war phase, difficulties entering Croatia. Bosnian Serbs were able to travel to the rest of Europe via Serbia, Bosnian Croats via Croatia. For Bosniacs

destined for Europe, things were especially troublesome as scheduled flights started only a few years after the end of the war. For producers or potential producers, access to markets supplying material inputs and capital goods was extremely difficult; even today access to those markets is more difficult than in Central Europe, for example.

In the informal economy, trade between ethnic groups and ethnically separated zones flourished even during the war and went on to boom thereafter. These black markets, however, traded in consumer goods. They were – and still are – an inadequate basis for supplying companies with production material.

### **Restricted market access on the output side**

Where output was concerned, firms came up against the same problem. Tightly controlled ethnic borders restricted their access to potential sales markets. In the first few years after the war, even communication with potential business partners was difficult. Whereas it was possible to communicate with partners in Europe or the United States, it was impossible to establish ties with potential partners in those areas of BiH controlled by a different ethnic group or a hostile neighbouring country.<sup>31</sup> The rupture in communications lines was not the result of technical shortcomings; it was a political act designed to undermine the aims and objectives of the Dayton Agreement. It took the representatives of the international community years to dismantle that particular barrier.

The international community was able to overcome the technical damage inflicted upon the pre-war infrastructure and even improve it in some instances. The main problem, however, was that the ethnic groups controlling different parts of BiH and the neighbouring countries restricted the use of part of the infrastructure once it had been repaired. An illustrative example, one of many, is the railway line running from Sarajevo to the Dalmatian coast. After Germany had financed and organized its reconstruction, political obstructionism long blocked its use completely; even today utilization remains low (one passenger train a day).

The three ethnic groups were reluctant to co-operate with each other; numerous regulatory barriers were erected discouraging inter-entity trade, ranging from bureaucratic hurdles to illegal levies. Almost all inter-entity trade was carried out on an illegal basis. A major achievement of the past few years has been that people from all regions can travel throughout the country once again. The situation has relaxed somewhat, yet obstacles still impede business activities across the country as a whole.<sup>32</sup> For example, until recently a

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<sup>31</sup> Croatia in the case of Republika Srpska, Yugoslavia in the case of the FBiH.

<sup>32</sup> According to USAID estimates, in the first three quarters of 2000 BiH foreign trade has been almost forty times greater than inter-entity trade. For the third quarter of 2000 official data report a KM 32.2 million of inter-entity trade compared to KM 44.4 million in the fourth quarter of 1999. However, as inter-entity trade is not monitored on a regular basis, these figures are not reliable.

company wishing to secure full coverage for its products throughout the country had to set up branches in both entities. In all parts of the country, people now mainly use the KM, thus facilitating the conduct of business between different parts of the country.

Restricted access to both input and output markets was – and to some degree still is – the main reason for slow economic progress. Most of the restrictions are man-made. The existence of both official and highly efficient unofficial barriers makes for a bad combination of segmented sales markets and major companies inherited from the previous regime. Attempts to put the latter on a sound track, for example via privatization, are bound to fail as long as such barriers remain in force.

### **A distorted financial sector**

A further reason for the depressed state of the manufacturing sector lies in the financial sphere. If faced with lucrative orders, many companies would have found it difficult to meet demand, mainly for want of financial means to purchase the requisite inputs. After the war, most companies were in a parlous financial state and have remained so. A financial sector able to assess the creditworthiness of companies or projects was lacking, and the banking sector was not up to providing loans to production companies. At least, they were unable to offer loans on terms that would have made production projects profitable. Under the conditions prevailing in BiH, banks run a greater risk when granting long-term loans than when investing in financial markets abroad. In BiH, interest rates differ from bank to bank, from region to region and from client to client. On a weighted average, they run to two digits. Given the low rate of inflation, this has proved prohibitive for most companies planning to enter production. Only wholesale traders with short-term loan requirements can afford the high interest rates.

### **Tax in excess of the tax base**

Observers frequently argue that in BiH the tax system imposes a discouraging burden of disincentives. This qualification may be justified from the viewpoint of US fiscal standards; however, by West European standards it is much less so. In the FBiH, the corporate tax rate is 30%; in the RS it varies, between 10% and 30% depending on the amount of profit generated. Similarly, depending on the type of good, the tax rate on the sale of goods ranges between 24% and 12% in the FBiH and 18% and 8% in the RS. The sales tax on services is 12% in the FBiH and 10% in the RS. Customs duty stands at 1% in the FBiH and varies between zero and 15% in the RS. Surcharge and excise taxes are levied on a specific per unit basis<sup>33</sup>. Labour is taxed at a rate equivalent to about 70% of net wages – a ratio that is not outrageous by European standards.

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<sup>33</sup> ICG Balkans Report No 115, 7 August 2001

The problem is not so much the heavy tax burden, but a political environment which discriminates between two groups of businesses. One group is expected to meet all its tax obligations, the other has close ties with the establishment and can thus secure tax exemptions or it can count little or no penalties for tax evasion. In the trade sector, the establishment of fictitious companies has become a highly efficient method of evading tax, especially when linked to corruption. If investing in BiH, foreign companies are expected to observe tax laws and customs regulations. If operating in manufacturing, they have to face competition from illegally imported products that are effectively tax-free. Companies such as Coca Cola and Volkswagen have experienced this type of thing.

It is up to the local elites to decide who pays tax and who does not. Likewise they determine who gets penalized for failing to pay tax and those who get off scot-free. Yet again in 2000, actual budget revenues were only a fraction of that projected. Having accepted responsibility for BiH's post-war recovery, the international community cannot run the risk of the state collapsing and having to finance the resulting deficit. In 2000, donors allocated about KM 800 million to bridging the budgetary gaps in the budgets in both entities<sup>34</sup>.

Drawing inspiration from the Laffer curve, many experts hope that lower tax rates will ultimately reduce tax evasion. Most probably, they are suffering an illusion. Under the conditions prevailing in BiH, lowering tax rates will hardly change the local elites' attitude towards the state. Given the low degree of sanctions, tax evasion will remain the cheapest option for those on the inside track

### **Bureaucratic hurdles**

In BiH investment in production activities is too risky a proposition and not profitable enough. Insiders have every opportunity to profit from the interaction between trade and politics; they are thus not interested in the troublesome sphere of production. Others who try to engage in production fall victim to all kinds of bureaucratic parasitism.

An inordinate body of inherited and recently added administrative regulations is still in force. It serves the bureaucracy as a means of exerting power – often in a parasitic manner. Those engaged in business activities are confronted with excessive reporting requirements; they have to accept intrusion by all kinds of inspectors who are entitled to shut down a company on the spot and/or impound goods.<sup>35</sup>

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<sup>34</sup> ICG Balkans Report No 115, 7 August 2001

<sup>35</sup> Why Will No One Invest in Bosnia and Herzegovina?, International Crisis Group, 21 April 1999, p. 13.

## **Institutional obstacles to economic growth**

After 1995 import growth was much greater than that of domestic production. This was not primarily attributable to the inflexibility typical of non-privatized companies. The reasons are manifold. As recent analysis shows, social relations within the country are distorted. During the war, some oligarchies acquired enough power to control political life and public administration. They now use that power to protect their own monopoly positions in the economic sphere and to 'fleece' outsiders wishing to enter the markets. Given these structures, outsiders cannot hope to be granted protection by the judiciary or administrative system. Even junior civil servants exploit their position, many of them earning more from bribes than from their meagre salaries. This parasitic approach has a dampening effect on entrepreneurial activities.

For the oligarchs, however, legal and administrative regulations have no binding force. On the contrary, they are used as tools to prevent the entry of newcomers, including foreign investors, or to extort 'licence fees' permitting them to stay in the market. Consequently, external investors are embroiled in an avalanche of cumbersome regulations, penalties, fees, taxes and customs duties, as well as bribery and corruption. There is no legal respite from such practices. The ruling oligarchies adopt a flexible attitude towards international organizations, but the implementation of agreed contracts is slow or fragmentary.<sup>36</sup>

As interviews with over 50 BiH companies have shown<sup>37</sup>, officials in the Payment Bureau, inspectors (customs, market, sanitary and communal) and minor government officials are corrupt. The ethnocentric political parties, so the outcome of the study, act as a closely knit and highly organized clan. Non-compliance with the law is widespread at all levels. Those in power award lucrative contracts to their cronies and families; they do not pay customs duties and taxes; they launder money, acquire prime commercial sites and real estate, as well as disrupt the business activities of outsiders, especially those not willed to pay bribes. Due legal process and an effective appeals system are absent. Widespread corruption increases the costs of doing business to an often untenable degree.

The law courts have proved completely ineffective. Contract law cannot be enforced. In the judicial system, corruption is rampant. Judges are subservient to the political party in power; party officials often dictate judgements. As a result, cheating and fraud are the rule rather than the exception in BiH.

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<sup>36</sup> An example is oil and gas imports from Croatia. In accordance with international recommendations, in 1998 the Federation parliament passed a law stressing the right of the government to tax the oil and gas trucked in from Croatia, with revenue expectations amounting to hundreds of millions of dollars. When the law appeared in the official gazette, the articles stipulating the taxation were inexplicably missing, and the oil and gas importers continued to pay no taxes. Sarajevo court judges, fearing retribution, were afraid to try the case. Only international pressure was able to reinforce the taxation.

<sup>37</sup> Why Will No One Invest in Bosnia and Herzegovina? International Crisis Group, 21 April 1999

Hitherto, even in the worst cases of corruption, bank fraud, tax and customs evasion seizure or sequestration of company and personal assets have proved impossible. For large-scale economic crime, the risk of being sentenced and serving a long term in gaol is minimal.

### **Discouraging conditions for foreign investors**

In the early days of reconstruction, a number of foreign companies displayed interest in investing in BiH<sup>38</sup>. Most of them either abandoned their plans after studying the situation more closely or their experience within the country was so bad that they simply capitulated.

The most severe problems they had to face were: the impossibility of collecting accounts receivable: problems with directors of BiH partner firms who often tried to increase their influence and incomes beyond the level initially negotiated; blackmailing by landlords and officials; exaggerated bureaucratic requirements; failure to comply with contracts; unreliable transport links and very small sales markets. The most ambitious project, the Volkswagen re-launch of car production, is still running at extremely low capacity. The demand within BiH is very low and exports are impossible. The government failed to keep its promise to buy only domestically produced motorcars. Thus, in 2000, 1200 employees assembled altogether a total of 4000 VW-Skoda cars.

Foreign companies active in manufacturing have had to face inordinate difficulties – definitely far in excess of those involved in marketing imported goods.

### **Insufficient output quality**

It is frequently argued that pre-war industrial goods were rubbish by international standards, and post-war companies were unable to produce anything better. After 1995, when borders were wide open to imported goods, domestic low-quality products were crowded out. One could argue that it would be better to let new green-field companies grow and have private investors decide which of the existing production sites should be revitalized. However, under the quite exceptional conditions prevailing in post-war BiH to date, the problem is that hardly any private investor has shown interest in running a production plant. The prescription was thus equivalent to suggesting extensive de-industrialization.

The rupture of the links on the input side and restricted market access on the output side were the factors primarily responsible for limited recovery in industrial production. Had this

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<sup>38</sup> For example CitiBank, McDonalds, ABN AMRO, Pilkington, AES, Tebodin, Guardian, Coca-Cola, VW, DHL, Metal Glas, IMSA, Siemens, Ericsson, Gluck



been otherwise, the low wage-levels in the initial post-war years would have permitted at least some of the existing companies to produce and sell cheap low-quality products – adequate to the needs of the poorer segments of the population.

## **Political roadblocks to economic progress**

### **Dayton 1995: a common starting point in different directions**

The events that occurred in the first half of the nineties have determined the economic situation and political attitudes ever since. The process of dissolution in Former Yugoslavia led to inordinate acts of violence and cruelty. Across the country, some of the political and military leaders tried to combat dissolution – at least at the outset. As the process continued, defending the integrity of the state degenerated and simply served as a pretext for Belgrade to acquire control over as much of Former Yugoslav as possible. Leading Serb politicians aspired openly to creating a ‘Larger Serbia’. They sought to secure or extend their control over those regions beyond Serbia where at least part of the population was Serb. Their grand designs clashed with those of Croat nationalists eager to wrest control over Croatia’s territory regardless of the population’s ethnic background. Both sides rode roughshod over the rights of minorities. The tension culminated in a first wave of hostilities on Croat territory. The second wave, the war in BiH, broke in 1992 in the wake of a referendum. People in Bosnia-Herzegovina had been asked whether they wanted their country to become an independent state. The Serb side argued that a referendum on the subject was illegal. Two thirds of the registered voters, for the most part Bosniacs (Bosnian Moslems) and Croats, participated in the referendum and opted almost unanimously for an independent state. The remainder, for the most part Serbs, boycotted the referendum. Very soon afterwards, a struggle for control over BiH erupted. Squeezed on two sides by Serb and Croat expansionism, the Bosniacs in BiH endeavoured to control those territories where Moslems constituted a significant share of the population. On all sides armed forces, often merely paramilitary in nature, fought to consolidate their hold over individual territories by expelling or even killing people belonging to ethnic groups other than their own. The world was compelled to stand by and watch how spiralling violence in BiH gradually destroyed the symbiosis between the different ethnic groups who had lived alongside each other for centuries. The war led to the complete erosion of the demographic mix that hitherto had been typical of all townships throughout BiH. Previously each municipality had boasted communities comprising different proportions of Croats, Bosniacs, and Serbs, as well as members of smaller minorities and last, but not least people who of their own will defied ethnic categorization.<sup>39</sup>

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<sup>39</sup> In some of the urban areas, this latter group made up between 20% and 30% of the population

Even during the war, humanitarian aid started pouring in from many sides. At the same time, international organizations as well as many governments tried to broker peace agreements. In 1994 it proved possible, by virtue of the Washington Agreement, to put an end to violence and fighting between the Bosniacs and Croats. For the nationalist Croat leadership, the agreement represented a major step towards a 'Larger Croatia'. The treaty was designed to bring about a merger of BiH territories under Bosniac or Croat control into a federation that was ultimately planned to become a Croat satellite state – formally independent, but economically integrated into Croatia. In the months following the Washington Agreement, Croat and Bosniac forces sought to expand the territory under their control to the detriment of the Serbs. Furthermore, US-led and UN-supported military intervention got under way. The Bosnian Serb forces faced an utterly hopeless military situation that compelled them to devise an exit strategy. Towards the end of 1995 an agreement negotiated in Dayton<sup>40</sup> and signed in Paris finally brought the armed conflict in BiH to a halt<sup>41</sup>. Faced with the population's overwhelming desire for peace and massive international pressure, the Croat leaders agreed to be co-signatories, even though they regarded the whole thing as a retrograde step: the integration of the Bosniac-Croat federation into a larger state threatened their claims to hegemony.

In the Dayton Agreement, all parties agreed that the continued presence of NATO-led armed forces would be necessary to avoid the eruption of renewed violence. The representatives of international organizations and Western governments alike were well aware that a comprehensive improvement in living standards over time was essential before the foreign troops could be withdrawn and humanitarian aid cut back. Raising living standards would offer hopes of a more prosperous future, and economic aspects were thus accorded particular significance from the very outset.

The Dayton Agreement was fully in line with the goals of the international community. It opened the door to the creation of a sovereign, democratic and economically prosperous BiH that would respect human rights and in turn re-establish and safeguard ethnic diversity. However, this was the point where the intentions of the international and local players differed fundamentally. The agreement corresponded in no way to the designs of the leaders in Belgrade and Zagreb. Both camps hoped that sooner or later the time would come when they could enlarge their countries by engulfing stretches of BiH territory that were already controlled by their allies in the region. In this way they ultimately hoped to stand to gain from the war.<sup>42</sup> For them, signing the agreement merely meant pursuing their objectives in new guise rather than renouncing them. Permanently open or tacit

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<sup>40</sup> For the full text of the Agreement, see the home page of the Office of the High Representative <http://www.ohr.int/> or University of Minnesota, Human Rights Library: <http://www1.umn.edu/humanrts/icty/dayton/daytonaccord.html>

<sup>41</sup> By signing the Dayton agreement, Belgrade implicitly recognized the outcome of the referendum of spring 1992.

<sup>42</sup> According to stenographic notes published in May 2000 Croatia's president Tudjman still voiced this intention in 1999.

obstruction, so they hoped, would ultimately stifle the prospects of an independent multi-ethnic BiH and pave the way for their expansionary aspirations.

### **A post-war game with arcane rules ...**

The 'peace agreements' – the Dayton Agreement (1995) in tandem with the Washington Agreement (1994) – have become the legal and constitutional basis for post-war developments. The Washington Agreement is the legal basis for the Federation of BiH, i.e. the Bosniac- and Croat-controlled part of the state. The peace agreements lay down the rules of the game, which the local players, however, only observe under duress. The constitutional structure emanating from the agreements is rather complicated, reflecting the complex situation in 1995 when the political leaders of each ethnic group sought protection against potential domination by one of the other groups. According to the constitution, BiH comprises two entities: the Federation of BiH and Republika Srpska. The Federation is divided into ten cantons. For ethnic reasons, the cantons are in a relatively strong position vis-à-vis the Federation authorities.<sup>43</sup> Some cantons are predominantly Bosniac, others Croat or split into two sub-territories. Ties between cantons of the same ethnicity are more informal, yet more effective compared to the constitutional structures. The Bosniac-dominated cantons co-operate with each other and share common institutions, such as financial administration or banking institutes, as do the Croat-dominated cantons.<sup>44</sup> Contact between the two camps ensues mostly at the insistence of the international community; BiH territory is thus de facto divided into three segments. The RS territory is Serb-dominated throughout, thus no cantons have had to be established there. The municipalities enjoy a relatively weak position. The weakest role in BiH as a whole, however, is accorded to the 'central state'. It is burdened with the task of servicing the foreign debt, yet it derives no direct revenues other than administrative fees. It has to rely on funds transferred by the Federation and the Republika Srpska.<sup>45</sup> By virtue of the constitution, the smaller entities, not the state, assume responsibility for the most important matters such as defence and internal security, as well as tax and customs administration.

Examples of the complicated constitutional settings are easily cited. Sarajevo, for example, hosts: (a) the triumvirate that constitutes the BiH Presidency; (b) the 'BiH Council of Ministers' and the government of the Federation; (c) the two chambers of the BiH

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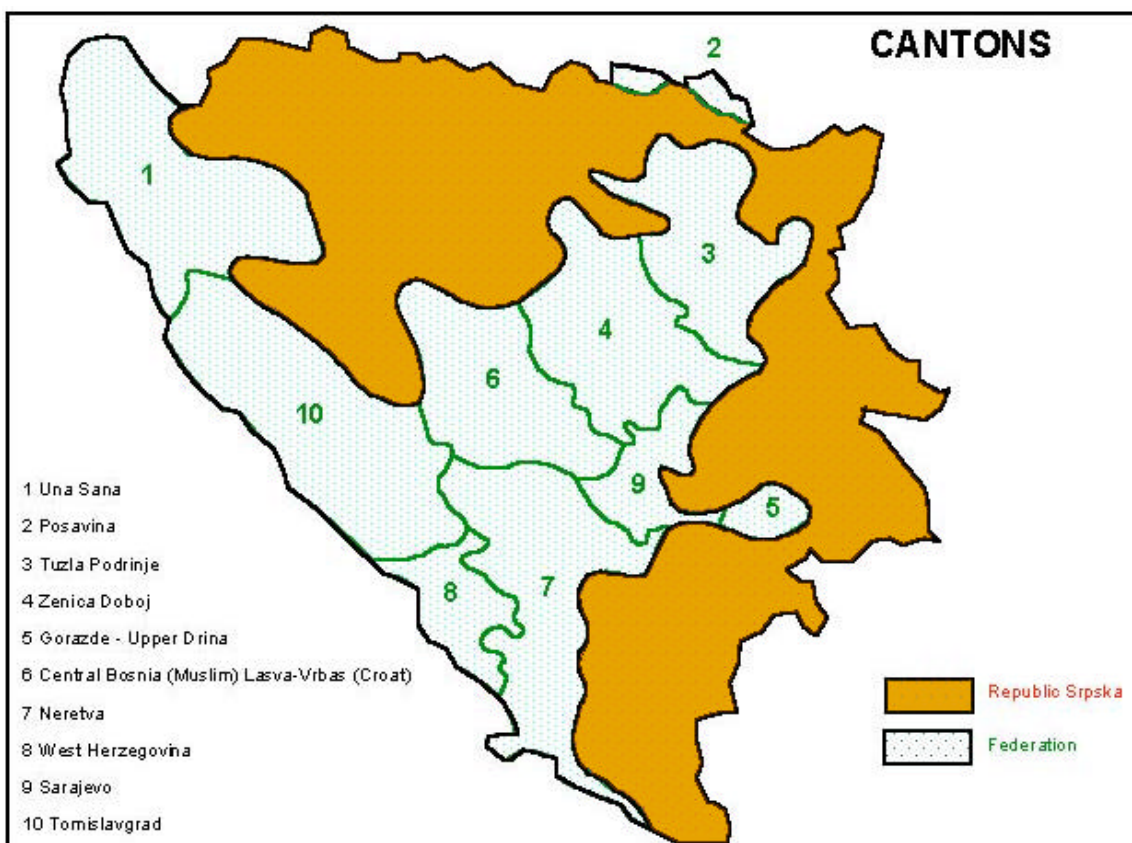
<sup>43</sup> Budget figures reflect this fact. According to data from the EU-funded Customs and Fiscal Assistance Office (CAFAO), the total FBiH tax revenues amounting to KM 1,339.1 million in the first three quarters of 2000 were allocated as follows: canton authorities 51%, federation authorities, predominantly customs tariff duties and import excises, 41%, and municipalities 9%.

<sup>44</sup> The armed forces of both sides have not been integrated either.

<sup>45</sup> In June 1998 an abortive attempt was made to establish an 'automatic' payment transfer from the two entities to the State.

parliament; and (d) those of the Federation parliament. Furthermore, the city is the seat of the institutions serving both the canton and municipality of Sarajevo.

BiH budget figures reflect the highly exceptional configuration of the public sector. In 2000, the central state budget amounted to KM 281 million, most of which (KM 198 million) went to servicing the foreign debt. The FBiH had a budget of KM 954 million; the RS KM 678 million. In the FBiH, a high proportion of the overall state budget was administered by the cantons: KM 386 million by the Canton of Sarajevo alone.<sup>46</sup>



Source: Internet, A page of links specific to OSCE and ODIHR (<http://www.bramley.demon.co.uk/observers/bosnia/osce.html>).

### ... and unwilling players

Initially, the representatives of the international community had hoped that after a while the local players would adopt a constructive approach and start negotiating solutions among themselves. This has never yielded viable results; local obstructionism has never let up. Under these circumstances, the Office of the High Representative, representing the will of the 'international community', has had to implement all the steps needed to create the BiH

<sup>46</sup> ICG Balkans Report 115, 7 August 2001.

state. Throughout the post-war period, it was mainly the High Representative who took important and urgent decisions. The Dayton agreement, co-signed by the local powers in late 1995, grants him this authority if local institutions are derelict in proposing solutions of their own or if he regards their solutions to be contrary to the spirit of the peace agreements. The rules laid down in the Dayton Agreement provide the elected representatives of the people of BiH with an opportunity to run their institutions themselves. Insofar as they prove unable or unwilling to do so, the country will degenerate into a protectorate run by the international community.

Quite soon after the war it became obvious that without edicts from 'outside' the situation would remain stuck in a rut of immobility. However, several years were to elapse before the institution of the High Representative began to intervene with any effect. In the initial years the fear was that blatant interference would grant local players a pretext to break off co-operation of any kind. By the end of 1998 a declaration of the Peace Implementation Council<sup>47</sup> entitled the High Representative to assume a much more active role. From then on the High Representatives, Carlos Westendorp and later Wolfgang Petritsch, adopted a more straightforward approach. It soon transpired that local politicians did not want to run the risk of a complete break. In some cases, their protest was fierce, but was mainly nothing more than a gesture made for the benefit of their constituents. In a sense, the situation provided the local politicians with a considerable degree of licence and consolation: the foreigners did what had to be done and they could get on with their ethnocentric posturing, an important factor given that their power derived from the ethnocentric allegiance of their constituents.

### **The elections in November 2000: disappointing results?**

For Croatia and Serbia, 2000 was a year of change. In early 2000 non-nationalist parties won the presidential and parliamentary elections in Croatia; in October 2000 Kostunica replaced Milosevic as president of Serbia. This meant a radical change in the political environment of BiH. Within the country itself, the Social Democrats won the municipal elections in Bosniac areas, especially in the Canton of Sarajevo, in April. This remarkable new development fuelled hopes of a comprehensive change to come in the much more important general elections scheduled for 11 November 2000.<sup>48</sup>

The outcome of the parliamentary elections in November saw the electorate split almost equally between nationalists and non-nationalists. For the first time since the early nineties,

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<sup>47</sup> Meeting of the Peace Implementation Council on 15 and 16 December 1998 in Madrid.

<sup>48</sup> On 11 November 2000 voters elected nation-wide the House of Representatives of the BiH Parliamentary Assembly. In the Federation of BiH they also elected the House of Representatives of the Parliament of the Federation of BiH and the Cantonal Assemblies. In Republika Srpska voters also elected the Republika Srpska National Assembly and the President and Vice President of the Republika Srpska. In Srebrenica municipal elections were held on the same day.

the three dominant nationalist parties – the Serb Democratic Party (SDS), the Croatian Democratic Union (HDZ) and the Bosniac Party for Democratic Action (SDA) – attracted less than 50% of the votes cast. This, however, fell short of the international community's expectations of a much more devastating defeat.

The hopes that people had cherished of the nationalist parties suffering a swingeing blow had disregarded the experience that many other regions had made across the globe. After an episode of violent ethnic conflict, people are afraid to abandon loyalties and allegiance towards their ethnic representatives; ethnocentric parties simply build on such fears. Only some seven or eight years previously ethnic identity had been the most decisive criterion for most people as it had determined their survival or death. A wide range of parties secured seats in the new parliament. This split of the votes seemed to indicate that the people in general distrusted rather than trusted politicians and parties. Analysts have identified a number of factors contributing to the relatively strong performance of the three ethnocentric parties. Quite successfully, these parties appealed to the people's dissatisfaction with the reform steps being urged by the international authorities or at least proposed by international experts. Some of the reforms put forward are indispensable to the establishment of a state that respects human rights: for instance, the pressure in favour of people returning to their pre-war homes and property and ensuring acceptable living conditions once they have returned. Another example is the pressure in favour of establishing ethnically mixed schools: a target of frenetic protest by the nationalist parties in the period immediately prior to the election. In the months leading up to the election, foreign experts and authorities alike urged the parliament to adjust pension expenditures to the system's revenues and to amend the labour law: for example, companies should no longer be obliged to retain on their payrolls people who were de facto unemployed. The leading parties objected to these – undoubtedly economically reasonable – proposals or managed to foil their being implemented, thus earning the gratitude of many poorer people. The poorer segment of society may also have honoured the leading parties' hesitant attitude towards rapid privatization and their reluctance to condone the use of vouchers or certificates as a means of compensating people for their long overdue claims. Other proposals from domestic or international sources merely served to bolster the nationalist parties still further; for example, the proposal to disband the entities or merge the country's three armies into one military formation. Both proposals raised anxiety levels, fuelling the Serbs' fears in particular.

In a sense, there is every good reason for the general mood of disappointment and malaise. The post-election situation is most disconcerting. With more or less equal power having been given to the nationalists and the pro-Dayton block, it is difficult to secure political stability and establish viable working conditions in legislative bodies. The non-nationalist camp is not homogeneous, and mutual animosities make working together

difficult. This is bad news indeed, as authorities urgently need to acquire enough strength to reshape the country in the spirit of the Dayton Agreement.

The three major nationalist parties, which share the principle of ethnocentrism, want to regain full power and are thus ready to co-operate to that end. However, wherever they achieve majorities, they will probably continue their obstructionist policies. Nationalist candidates – the Serb chairman Zivko Radisic, the Croat Ante Jelavic and the Bosniac Halid Genjac – managed to get themselves elected to the joint presidency of BiH. In February 2001 the High Representative dismissed Ante Jelavic because of his promotion of a third Croat entity. Halid Genjac, who had replaced Alija Izetbegovic on an interim basis, stepped down, so that at the end of March 2001 the BiH parliament had to vote for new Bosniac and Croat representatives in the tripartite presidency. The Alliance for Change nominated Jozo Križanovic and Beriz Belkic, both of them regarded as moderates.

At the state level<sup>49</sup>, voters gave the opposition Social Democratic Party (SDP) a lead position; it is now the largest party in Bosnia<sup>50</sup>. The SDP attracted 22% of votes. Ten parties, grouped around the SDP, formed the Alliance for Change, which now holds 17 seats in the 42-seat House of Representatives.<sup>51</sup> The SDP has outstripped the nationalist Bosniac Party of Democratic Action<sup>52</sup> (SDA) that secured 20% of votes. The nationalist Serb Democratic Party<sup>53</sup> (SDS) won 15% of votes and the Croatian Democratic Union<sup>54</sup> (HDZ) 12%. Together, the three traditional nationalist parties – HDZ, SDA and SDS – gained about 47% of the votes cast and now hold 19 seats: less than half the total. In order to form a government, they would need to secure the support of three other MPs. A post-electoral alliance of the non-nationalist parties excluded the three nationalist parties from the central government. An alliance of this kind does not necessarily stand on firm ground. The Sarajevo-based parties – the SDP and the Party for Bosnia and Herzegovina<sup>55</sup> (SBH)

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<sup>49</sup> Source: Helsinki Committee for Human Rights, recent faxletters available on the Internet <http://www.bh-hchr.org/faxlett/faxlett.htm>

<sup>50</sup> The SDP is the largest opposition party, headed by Zlatko Lagumdžija; it appeals to professionals among all three Bosnian ethnic groups, promising to tackle economic issues and fight corruption.

<sup>51</sup> The voters elect the members of the House of Representatives directly, 28 of them in the F BiH, 14 in the RS. The 15 members of the second chamber of the BiH parliament, the House of Peoples, are elected by the parliaments of the two entities.

<sup>52</sup> The SDA is the main Moslem party, headed by Alija Izetbegovic, who up to October 2000 was also chairman of the three-member presidency. The SDA appeals exclusively to Bosnian Moslems, pledging to protect their cultural and religious identity.

<sup>53</sup> It was Radovan Karadzic, the Bosnian Serb wartime leader and indicted war criminal, who founded the SDS in 1990. The party is now headed by Dragan Kalinic. Over the past two years, in its role as opposition party it has backed away from hard-line nationalist rhetoric. The strongest support comes from the less developed eastern areas of the RS.

<sup>54</sup> The HDZ is the ethnocentric party of Bosnian Croats, the smallest ethnic group in the Balkan country. The HDZ leader, Ante Jelavic, who previously was the Croat member of the BiH presidency, pleads in favour of the division of the state into three entities and tried to link the election to a referendum on this matter.

<sup>55</sup> A mainly Moslem party headed by former Prime Minister Haris Silajdzic. The SBiH's central policy is a call for the abolition of the entity borders in Bosnia and an insistence on a single multi-ethnic Bosnia. The election result grants the party a key role in the formation of governments at all levels.

with 15% of votes – have to co-operate with the Banja Luka-based parties: the Party of Democratic Progress<sup>56</sup> (PDP) with 5% of the votes led by the former RS prime minister Dodik and the Party of Independent Social Democrats (SNSD) headed by the present RS prime minister Ivanic<sup>57</sup>. They also depend on the support of a number of smaller parties such as the new Croatian Initiative (NHI)<sup>58</sup>. The international authorities had been pressing for such an alliance. In December 2000, first signs of co-operation along those lines became visible: the PDP helped to elect the SDP vice-president Sead Avdic to the office of speaker in the new state-level parliament. Furthermore, both parties joined forces and voted together in the election of several other office holders. Then, on 22 February 2001 Bosnia's central parliament elected the first so-called Council of Ministers: the first government without nationalist parties since the Dayton agreement of 1995.<sup>59</sup> Responsible solely for foreign affairs, defence and trade, the government was made up of Bozidar Matic, the rotational chairman for the next eight months, and five ministers and their deputies from ten parties and all three ethnic groups – Bosniacs, Croats and Serbs.<sup>60</sup>

At the level of the two entities, the outcome was mixed.<sup>61</sup> In the 140-seat Federation parliament<sup>62</sup> the SDP-led Alliance for Change holds 69 seats, while the two nationalist parties – the Bosnian Party for Democratic Action (SDA) and the Croatian Democratic Union (HDZ) – hold 63 seats<sup>63</sup>. In order to gain a majority, the non-nationalist camp had to overcome their animosities and gain the support of the smaller parties. In fact, at its first session the new parliament elected candidates from the Alliance as its speaker and deputy-speaker, respectively. On 2 March 2001, the president of the FBiH, Karlo Filipovic, and the vice-president, Safet Halilovic, nominated Alija Behman as the entity's new prime minister. Behman is a moderate member of the multi-ethnic Social Democratic party; his nomination had to be approved by both chambers of the Federation's parliament.

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<sup>56</sup> The Party of Independent Social Democrats (SNSD) is led by the former moderate Bosnian Serb Prime Minister Milorad Dodik.

<sup>57</sup> Mladen Ivanic, professor of economics at the University of Banja Luka founded the party in 1999. His government enjoys the support of SDS, a fact that does not facilitate cooperation with pro-Dayton forces on the BiH level.

<sup>58</sup> The New Croat Initiative (NHI), a moderate party, portrays itself as a pro-Bosnian alternative for Croats. Kresimir Zubak, the former HDZ leader and Bosnian presidency member, founded it in 1998 after losing the battle for party presidency to Jelavic.

<sup>59</sup> Twenty-two of the 35 deputies present at the session of the 42-seat house voted for the new government (Agence France Press).

<sup>60</sup> Matic, 63, is a member of the Social Democratic Party (SDP). Previously, he was a manager in the erstwhile giant engineering conglomerate Energoinvest. He is professor at Sarajevo University and the head of the Bosnian Academy of Arts and Sciences.

<sup>61</sup> The same is, of course, true for the cantons, which constitute a tertiary level in the FBiH.

<sup>62</sup> Federation voters elect the members of the 140-seat Federation House of Representatives, whereas the Cantonal Assemblies elect the members of the Federation House of Peoples.

<sup>63</sup> With 27% of the votes the nationalist-Bosniac SDA has remained the strongest party in the FBiH. The Croat-nationalist HDZ won 18%. The SPD won 26% of votes, the SBH 15%. The remaining votes went to a number of smaller parties.



In the RS the election results at the entity level made it impossible to exclude the nationalist SDS from government.<sup>64</sup> In the RS National Assembly<sup>65</sup> the party won 31% of the votes, while a number of smaller nationalist parties, which will most probably stand by the SDS, secured an appreciable number of votes. The PDP and SNSD won 13% each; a coalition with the SDP and SBH, each of which won 5% of the votes in that entity, would not have sufficed to secure a majority in the entity government. On 12 January, the RS parliament voted in a new government headed by Mladen Ivanic, chairman of the PDP. It is a government of experts; it has a Bosniac member; and it enjoys the support of the SDS. Sweden's ambassador to Bosnia, whose country held the EU presidency at the time, expressed the hope that ties between the European Union and the Bosnian Serb government would improve. US ambassador Miller announced that Washington did not want to condemn Ivanic's government a priori. This means that the government will have to undertake a major effort to gain the trust and confidence of the international community.

Mirko Sarovic, the newly elected RS president, has heightened Western concerns by announcing a referendum for the secession of Republika Srpska in the event of such an option being envisaged for Kosovo (the region in the Federal Republic of Yugoslavia). This announcement runs counter to both the Dayton Agreement and the Constitution of BiH; it would thus have entitled the High Representative to remove Mirko Sarovic from office. Such a move, however, would not have overcome the fundamental dilemma of it being impossible to rule the entity without SDS participation. The dilemma allows for two conflicting interpretations. Some would say that the US authorities were right to plead in favour of excluding the SDS from the elections. Others argue that such a strategy might have provoked a boycott of the elections in RS, hence it was wise to ignore it. Claims of that kind, they argue, merely lent support to the SDS.<sup>66</sup> Whether it was a good strategy to base post-war development on elections is a major issue of debate. This, so the argument, gave the war criminals' parties an opportunity to run for parliamentary office, thus legitimizing them as part of the political system. The counter-argument is that it would have been difficult to exclude all three nationalist parties from the elections, while administering the country as an international protectorate would have risked provoking passive resistance among the population.<sup>67</sup>

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<sup>64</sup> The strength of the SDS within the entity is also apparent from the fact that the SDS candidate for the RS presidency, Mirko Sarovic, won a convincing victory in the first round.

<sup>65</sup> The RS has a single-chamber parliament with 83 members.

<sup>66</sup> Helsinki Committee for Human Rights, Faxletter No 25 A - 11/2000, Press Release: The International Community Helped Nationalists

<sup>67</sup> For opposing views on this matter see Bosnia's November Elections: Dayton Stumbles, ICG Balkans Report No 104, Sarajevo/Brussels, 18 December 2000, and publications of the Helsinki Committee.

## **The problem of legality – another roadblock to economic progress**

### **The law in limbo: an in-built feature**

The peace agreements accept the split of the BiH territory into ethnically dominated subdivisions – entities and cantons. Possibly this has been the only way to check violence. This understandable piece of *Realpolitik*, however, is out of keeping with the passages in the agreements that grant every citizen the right of return to his/her pre-war home and restitution of all property lost or due compensation for such losses. The architects of the peace agreements may have hoped that comparatively soon after the war ethnic tolerance would re-emerge, thus opening up the way back home for most people. This hope has not materialized.

According to the UN Human Development Report on BiH<sup>68</sup>, 'the population in most municipalities has changed considerably. In some of them, only 10% of the pre-war residents are still there. The vast majority of newcomers have still not settled in their new environment... The alienation from the local environment is present among newcomers as well as the domicile population.' Building a new identity in the local community poses a major problem.

Although the war in BiH is over, a large percentage of the population have legal claims they cannot lodge. Seen from the opposite angle, across the country a large proportion of the population are occupying houses and flats or availing themselves of other assets that in the legal sense belong to somebody else who, one way or the other, was forced to leave the area. The majority now seem to be opposed to a new mass reshuffling of people and assets for a number of reasons. They know that some of the new realities are irreversible; even those who yearn for the pre-war atmosphere harbour no real hopes of it ever coming back. Hundreds of thousands of displaced persons, émigrés in their own country, have fallen victim to this adherence to the status quo. The current situation differs markedly from what the peace agreements envisaged as the new legal order. The result is a legal conundrum: an inconsistency between the written law and the status quo. It hampers both political and economic progress. Many business people might be reluctant to invest in a country where a large proportion of the assets are not in the hands of their legal owners and nobody knows what the final outcome will be. To calm such fears, the High Representative amended the law by introducing a restitution clause. If deemed justified, restitution claims will be compensated from government funds, not by the new owners of the companies concerned.

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<sup>68</sup> UNDP Human Development Report – Bosnia and Herzegovina 1998, p. 27

## **A key issue: reinforcement of the rights of individuals**

The representatives of the international community have started to tackle the property problem. In his report of May 2000 the High Representative Wolfgang Petritsch writes: '... property related matters continue to be among the most difficult to implement. Decisions regarding property are generally only implemented with strong international community pressure, and there is no indication that the governments have taken appropriate steps to prevent future property-related violations of the European Convention on Human Rights and other international human rights instruments.' As the report stresses, 'continued difficulties are anticipated ... in the implementation of the Human Rights Institutions' recent decisions, which require the eviction of current occupants of previously abandoned accommodation'.

The High Representative has amended property laws in both the Federation and Republika Sprska. The Property Law Implementation Plan of October 1999 introduced harmonized property legislation in both entities. Key international agencies (OSCE, UNHCR, OHR, UNMIBH) have concerted their efforts. Property claims have been registered and the municipal housing authorities are supposed to confirm the claimants' rights. The international community has started monitoring the process and on a monthly basis publishes related statistics on progress in each municipality. This has led to an increase in the repossession of property across the country. The implementation of property law has begun in almost all municipalities across Bosnia and Herzegovina; none the less, in a number of municipalities progress is still almost non-existent – notably in municipalities with a Croat majority and a few municipalities in the eastern reaches of the Republika Srpska. The OHR publicly advised donors not to assist those municipalities as long as they persist in their obstructive behaviour.<sup>69</sup> Of a total number of 249,000 claims for repossession of property on FBiH territory in 2000, 115,500 cases were resolved, yet only 51,500 judgements were put into effect. The rate of implementation of the Property Laws in the FBiH was 29%, while in the RS it was 13%. Local authorities often fail to evict illegal occupants, even after a claim has been duly recognized. The High Representative dismissed 30 officials for having disregarded property laws.<sup>70</sup> He says he will continue to remove civil servants from office for the same reason and will advise donors and investors not to invest money in communities, which fail to return flats and houses to their rightful owners.<sup>71</sup>

Returnees not belonging to the ethnic group that dominates an area are subject to almost daily infringements of their social and economic rights. This precludes them from achieving any sustainable level of return and hampers their integration within the communities.

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<sup>69</sup> OHR press release of 27 July 2000

<sup>70</sup> The Helsinki Committee for Human Rights in Bosnia and Herzegovina, faxletter No 98, 1 March 2001

<sup>71</sup> BBC World Service, 20 February 2001

Obstruction is to be observed at all levels. Problems arise with respect to administrative integration following their return. Minorities and returnees face discrimination where the issuance of identity cards is concerned; the cards are a basic requirement for gaining access to social services such as health care. Moreover, discrimination poses problems for many wishing to draw a pension or secure a job. Utility companies in many parts of the country continue to discriminate against minorities and returnees, failing to reconnect them to basic services, arguing for example that they accumulated payables during their absence.

The return of displaced persons in Bosnia and Herzegovina remains inextricably linked to refugee movements elsewhere in the Balkans, particularly in Croatia and the FRY, as the High Representative Wolfgang Petritsch has repeatedly emphasized. He expressed the hope that the newly elected Government in Croatia and the Regional Return Initiative launched by the Stability Pact would ultimately lead to progress on this issue. Many Croatian Serbs now living as refugees in Republika Srpska, would like to return to Croatia. Their movement would free up the space needed for Bosniac and Croat returnees. Procedures governing a return to Croatia, so Wolfgang Petritsch, remain obstructive and will have to undergo a complete overhaul before Croatian Serb refugees can exercise their right of return and have confidence in the return process. 'As foreseen in the return programme, the Croatian Government must allow all its former residents, including those who for reasons beyond their control do not possess Croatian citizenship, to return. The Government of Croatia still needs to extend its consular services in full, and on a non-discriminatory basis, to Croatian Serb refugees in both Bosnia and Herzegovina and the FRY. Only by giving Croatian Serb refugees access to passports will they have genuine freedom of movement to travel to and from their homes of origin in order to make an informed decision about return.'<sup>72</sup>

## **Privatization**

### **An absolute priority from the very outset, yet no major gains in the manufacturing sector to date**

On embarking on the design and administration of the reconstruction programme, the representatives of the international community and their experts had no doubts in their own minds that one of the first things to do was to launch a full-scale privatization programme. Only private entrepreneurs, so the argument, behave in the manner essential to a functioning market economy. Given this absolute priority from the very outset, it may come as a surprise that the enterprise sector has not witnessed privatization to any large degree.

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<sup>72</sup> Report to the Secretary-General of the United Nations, 3 May 2000, Wolfgang Petritsch, OHR Sarajevo.

International experts helped to draw up privatization scheme<sup>73</sup>. The international community was confident that within less than two years a massive transfer of enterprises and banks from state control into private ownership would take place. In 1997, the FBiH parliament passed a set of privatization laws including deadlines for the preparation and start of the privatization process only to be followed by an endless series of delays. The BiH authorities repeatedly promised that privatization was imminent, yet little happened, despite threats uttered by donors and international financial institutions. Finally, in the middle of 1999 the purchase of apartments – the easy part of privatization – got under way, followed later by the privatization of the first small enterprises. Larger state-owned enterprises remained more or less intact. Towards the end of 1999, the US government lost patience and suspended its aid to privatization in the FBiH. Exposed to massive pressure, the Federation authorities intensified the sale of small enterprises. To mark the start of ' privatization on a large scale', they drew up a list of major enterprises earmarked for deregulation.

Privatization offered the State a unique opportunity to discharge its debt obligations towards its citizens. The arrears had accumulated for a number of reasons. In the final phase of Former Yugoslavia, many citizens had held deposits in foreign currencies; however, in the course of the country's dissolution the banks could no longer provide access to the monies deposited. The State's debts also stem from the fact that during the war (1992-1995), the State had failed to pay its soldiers and civil servants and retirees had not received their pensions. Moreover, the State had confiscated so-called 'social property' to open the way for privatization, yet recognized that citizens of working age should be compensated for their contribution to the development of the enterprise sector. The State had honoured all those claims by issuing privatization certificates.<sup>74</sup>

It proved extremely difficult to organize the distribution of privatization certificates. In the FBiH, ten privatization agencies at the cantonal level were occupied for two years with preparing lists of those citizens entitled to receive privatization certificates. Even more difficult was it to stipulate the amount, as it depended on different criteria such as age or occupation during the war. This work was essential to the commencement of the privatization process. In parallel, the privatization law obliged managers of State enterprises to formulate privatization programmes for their enterprises and draw up initial balance sheets, yet the authorities did not encourage such activities.

In the FBiH, privatization certificates amounting to DEM 15.6 billion were distributed, thus creating a dilemma for a large majority of people. They had suddenly received certificates with a nominal value of several hundred thousand DEM, but invariably they had no job, not

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<sup>73</sup> Primarily experts from [PriceWaterhouseCoopers](#) hired by USAID

<sup>74</sup> The RS authorities distributed a slightly different type of certificates: vouchers with no indication of the face value.

even a home and hardly the means to finance their daily lives. The certificates can only be used to purchase apartments, enterprises or shares in a company; however, people are free to negotiate the sale of their certificates. There was a major delay between the distribution of the certificates and the first step towards actual privatization: that of apartments and small shops. Thus, for a protracted period the certificates were of no use at all. Many people may have regarded the face value of their papers as a bad joke from the very beginning; others lost confidence over time and started selling their papers for cash. The market price of the certificates dropped to a mere three percent of their nominal value.

For people with some cash at their disposal, this opened up unique opportunities as soon as the sale of business premises and small enterprises started. To buy such an asset, at least 35% of the price had to be put down in cash; the rest could be paid in certificates that could be acquired for almost next to nothing. The large majority of people lacked the cash to participate. Watching the rate at which those more privileged acquired assets<sup>75</sup>, they may well have concluded that their claims were going the same way as their foreign currency deposits had ultimately gone.

In the course of 'privatization on a small-scale', people spent about DEM 2 billion out of a sum-total of privatization certificates equivalent to DEM 15.6 billion. They used them to purchase apartments and other property, such as small enterprises and shops that had previously been in government ownership. After 12 January 2001 it was no longer possible to trade certificates for shares in the context of the round devoted to small-scale privatization. Thus, certificates with a nominal value of about DEM 13.6 billion remained available for the ongoing 'privatization on a large scale'. Up to January 2001, privatization investment funds (PIFs) amassed some DEM 2 billion in certificates, the residual certificates remained at the disposal of the population.

The average citizen's main point of contact is smaller holdings in the neighbourhood; however, for the economy as a whole, the fate of larger enterprises is of crucial significance. On 30 October 2000 large-scale privatization in the FBiH started with a widely publicized call to subscribe to shares. A total of 1,029 companies with a book value of DEM 13.4 billion will ultimately pass into private ownership. Some (752 companies) may be purchased with privatization certificates. As for the rest, 277 companies with a total book value of DEM 10.8 billion, majority shares will be offered for cash through public tender. International experts have categorized 86 of the latter companies as strategically important. They should be sold primarily to foreign strategic investors who will be offered

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<sup>75</sup> Remarkably enough, the Sarajevo Holiday Inn, which had played a role at the begin of the war, highlighted privatization problems when after an international call for tenders a local business man was able to acquire it at a price which was regarded to be far below the value it might have demanded under fair conditions.

67% of the entire capital of each firm. FBiH residents, who own privatization certificates, will be granted an opportunity to buy the residual 33% through public subscription.<sup>76</sup>

It was projected that 1,029 companies would be privatized in two waves. In the first wave already past, some two million FBiH citizens had the opportunity to use their privatization certificates to acquire shares in 547 companies with an aggregate book value of somewhat over DEM 3 billion.

The chairman of the administrative board of the Federal Privatization Agency expressed the hope that in the next three to four years, the government would obtain some DEM 15 billion – six billion of that in cash. Independent economists do not share this optimism, pointing out that the book value of domestic firms is 'inflated' and far above their real market worth. Results of the first wave confirm their scepticism.

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**Table 5: FBiH: corporate sector privatization**

	Companies number	Aggregate book value DEM billion
total	1029	13.4
<i>split by privatization waves<sup>1)</sup>:</i>		
First wave	547	3.1
Second wave	482	10.3
<i>split by privatization methods:</i>		
companies privatized via certificates	752	2.6
companies privatized via tender	277	7.1
<i>of which: strategic</i>	86	.
Shares to be distributed later <sup>2)</sup>		3.7

Notes: 1) Preliminary distribution. - 2) The book value of tender-privatized companies is DEM 10.8 billion. Of this, DEM 3.7 billion are to be offered to certificate holders.

Source: Drazen Simic, Alternativna Informativna Mreža (AIM), 22 November 2000, 30 December 2000.

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As for the mechanics of privatization via certificates, allotment to individual shareholders depends on the value of the certificates submitted. In the first round of the first wave a company was privatized if the sum total of certificates paid in ranged between 80 and 120% of the stipulated price. Were these parameters not met, privatization was postponed and the company was moved up to the second round. According to the results of the first round of April 2001, only about one of seven companies was within the required range. Several companies, for example two breweries, the refinery Energopetrol and a tobacco factory, exceeded the limit. On the other hand, 27 companies failed to attract any

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<sup>76</sup> Two of the most profitable enterprises in the Federation at present - telecommunications and the electricity industry – have been exempted inasmuch as only 15% of their government-owned capital will be sold through public subscription of shares.

subscription of certificates at all, neither from the PIFs nor from their own managers or other employees. This latter group figure includes the iron ore mine in Vares, a carpet factory, a furniture manufacturer, two textile factories and the Croat-controlled railway company.

In the first wave, the large majority of people were reluctant to swap their certificates for shares. Their motives may have been varied. While many might have lost confidence, others may have decided to wait for the second round of the first wave or the second wave proper when shares in more attractive companies will come up for sale. With fewer participants, the possibility of securing a cheap acquisition will rise for those people with inside knowledge.

No upper or lower limits were set for share prices in round two of the first wave and the same holds true for the second wave. Some 386.000 FBiH citizens participated in the first wave, which ended in June 2001. The Federation's privatization revenues amounted to DEM 223 million in the first round and DEM 4.7 billion in the second. However these were revenues in terms of the certificates, which the State had previously distributed. Prior to this certificate-equity swap there had been a certificate-cash swap between citizens, with prices for certificates below 3% of the face value.

As soon as the mass privatization programme reaches its conclusion, unused certificates will be declared null and void. USAID and others have spent more than USD 2 million over the past two years alerting people to the functions of privatization certificates. However, the majority of people still do not know what to do with the certificates and where to deposit them. The majority have the impression that the entire process of transferring ownership is some kind of trick. Experience from the earlier campaign devoted to 'privatization on a small scale' has confirmed their suspicions. They have no confidence in certificates invested today yielding additional income in the form of dividends in the near or somewhat more distant future. Some hope that investing their certificates in the company where they work will help them to keep their jobs. Others hope that one day the State will adopt a serious course and offer them compensation for their claims – in cash instead of certificates. Paradoxically, the widespread apathy and the lack of trust in the certificates and privatization in itself, makes things all the easier for privatization profiteers.

In the RS too, privatization started with small-scale privatization: sales of small enterprises, but unlike the Federation not apartments, for a mixture of cash and vouchers. The ongoing large-scale privatization relates to some 1000 units. Most of them will be sold off predominantly for vouchers, whereas for the most important enterprises strategic investors are to be sought<sup>77</sup>.

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<sup>77</sup> In its recent study, Balkans Report No. 115 from 7 August 2001, the International Crisis Group criticizes the fact that Investment Privatization Funds can acquire up to 55% of a company's share, but not send more than two



In summary, the basic economic problems that have made and still make it difficult to privatize industrial enterprises are:

In many instances, equipment in the plants has been badly damaged, in addition to being technically obsolete. As already mentioned, during the war production in numerous cases broke down completely. In the meantime production has resumed albeit partially, if at all. Furthermore, much of the know-how was lost when people were forced or found it advisable to leave their former homes.

As already mentioned, in the years after 1995, the division of the territory into small isolated areas deprived producers of their sources for material inputs. At the same time, this isolation reduced the area in which they could offer their output; sales markets were almost non-existent. In the meantime the situation has relaxed slightly, but it has yet to return to normal.

During the war, corruption may even have had a positive function: Without it, any form of administration would have ceased to exist. For want of both democracy and transparent rules, corruption has persisted since the war. Segments of society, especially all kinds of business people, have to come to terms with corrupt bureaucrats and the political elite, both of whom are interested in maintaining the bulk of existing and often counter-productive regulations.

Under the conditions that prevailed in the initial post-war years, a potential investor would more often than not have been reluctant to take over and run a manufacturing company in BiH.<sup>78</sup> This meant that the market value of many companies was zero or even negative, since a large sum would have had to be paid to the potential investor in order to make the plant an attractive proposition. Even if BiH politicians had not dampened the international experts' enthusiasm for privatization, it would have been impossible – or would still be impossible today – to privatize the core of industrial plants in such a way that they would be transformed into thriving private enterprises. In 1995 it was misguided to believe in industrial enterprises being successfully privatized on a large scale in the near future.

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representatives to the governing board. However, this rule may be based on bad Czech experience with IPF representatives, and it would give an investor, who acquired 30% of shares, an absolute majority in a governing board consisting of 10 persons.

<sup>78</sup> Anybody acquiring a company has a choice between liquidating it or running it, depending on the expected net gain of each option. In many instances neither of these options was likely to yield positive results under the given conditions in the early postwar years. Only the expectation of profits over the long term would have attracted an investor – but in most cases, there was no reason to expect such developments.

## **A local lack of willing**

Transition countries such as former Czechoslovakia, Hungary, Poland or Russia were quick off the mark to develop privatization schemes of their own accord and did not hesitate to put them into effect. This was not the case in BiH; despite massive support and pressure from outside. There may have been a number of reasons.

The structures that were developed in Former Yugoslavia differed fundamentally from those in countries controlled by Moscow. This may be one of the reasons. In Former Yugoslavia the employees managed the enterprises themselves, at least in principle. This meant that they were under indirect instead of direct bureaucratic control. Again in principle, they could hire or fire the CEO. In practice, however, that was only feasible in poorly performing companies of no interest to the bureaucrats. Operation of the system was far from optimal and it deteriorated over time. However, the enterprises enjoyed a considerable degree of autonomy. Even decades before 1989, enterprises had acquired experience of commodity markets for inputs and outputs: they were acquainted with the workings of labour markets and commercial banks. Both the employees and the local population in general developed an emotional allegiance to 'their enterprise'. Throughout Former Yugoslavia reforms or new realities eliminated this system in the course of the nineties, yet in political terms this very special legacy still seems to play a role. Slovenia may serve as an example here with employees and local authorities having become the main shareholders. The most highly developed of the transition countries, Slovenia privatized its industrial sector in a way that bore some similarity to the former system, thus making privatization acceptable to the people at large.<sup>79</sup>

Privatization necessarily entails a redistribution of power. In the transition countries of Central and Eastern Europe, ambitious privatization programmes offered individuals vast opportunities to gain control over productive assets. Those equipped with special skills – including networking – were able to avail themselves of the opportunities and they formed a new elite. A special feature in BiH is that property issues are inextricably mixed up with ethnic issues and are thus a highly sensitive matter. In fact, when the external pressure to privatize became imperative in the first half of 2000, the initial privatization projects of any size rapidly degenerated into ethnic battles. From the very beginning, BiH politicians may have been aware that privatization could disrupt the fragile system of power distribution among ethnic groups. For example, by applying the rules accepted in the Dayton agreement and under corresponding international supervision, auctioning off a plant in Republika Srpska (RS) could mean ending up with a Croat as the new owner. By virtue of the principles of the Dayton agreement, the representatives of the international community

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<sup>79</sup> A warning published in a Sarajevo daily in January 2001 illustrates the sentiment of employees. In the construction company Vranica, a loss-making state enterprise, which was put up for sale in the privatization process, the trade union representing the workers warned 'all those who want to invest in Vranica without the consent of its workers that the employees would not let them do it without prior agreement of the persons in charge' (AIM, 29 January 2001).

are compelled to touch upon precisely all too sensitive matters of this kind. In the transition countries of Central and Eastern Europe, restituting property to owners from the pre-Communist era or their heirs had posed no major problem. The same held true for the privatization of publicly owned flats: tenants became the owners. In BiH, however, given the high proportion of people who de facto cannot return to their pre-war homes, even implementing such programmes is a gargantuan task. In 1999 with the financial support of the US Government and urged by the Office of the High Representative, the Federation authorities established an office in Banja Luka, the capital of the RS, to assist those people eligible under the Federation's privatization scheme. The RS authorities opened up similar branches elsewhere in the Federation offices to support the scheme.

In its recent report on BiH, the International Crisis Group says privatization was 'misconceived from the start' (ICG Balkans Report No 115, 7 August 2000, p. 18). One of the points the authors make is that the scheme was entity-based. As a result, so the argument, the ongoing privatization strengthens ethnic cleansing. This is true at least as long foreign investors do not get involved to any large degree. However, in the post-war atmosphere a scheme implemented at the state level would have provoked strict opposition among the ruling politicians and the local elites behind them. The ongoing battle for control over the highly profitable aluminium producer Aluminium Mostar<sup>80</sup> offers an indication of future conflicts that can be expected in the context of the privatization of strategic enterprises.

Over the past few years, the representatives of the international community frequently managed to achieve some progress in their preparations for the privatization programmes. Only when trying to force privatization through to its logical end, did they find themselves running up against a wall. Political resistance led to legislative barriers becoming insurmountable obstacles that surfaced as stubbornness on the part of bureaucracies and managers alike. Consistently confronted with these tactics, the US Government finally decided in early 2000 to suspend temporarily its assistance to the Federation privatization programme; any further technical assistance is conditional on progress being achieved.<sup>81</sup>

By being accorded an ethnically unbiased position, foreign direct investors could help to redirect the population's attention towards economic activities, thus shifting the ethnic

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<sup>80</sup> The Croat-controlled company exports most of its output via the port of Ploce and has recovered pre-war export levels. In 2000, export revenues amounted to USD 150 million. EBRD BiH Investment Profile April 2001.

<sup>81</sup> Report of the High Representative, May 2000. In the report, the High Representative cites examples of legislative hurdles: The 'State Draft Law on Restitution in Bosnia and Herzegovina, drafted by my Office, has not yet been considered by the State Parliament. The Federation Law on Restitution is pending before the Federation Parliament. This is due to disagreement on contentious issues such as the restitution of socially owned apartments. In the Republika Srpska, a Draft Law on Restitution has been submitted to the National Assembly'. In October 2000, the High Representative reports the approval of tender regulations meeting international standards; with the assistance of international advisors the privatization authorities selected 86 companies in the FBiH and 52 in the RS for tendering.

aspect into the background. However, for this to happen investment and market conditions would have to be favourable.

### **Taking the easy route?**

In the countries of Central and Eastern Europe the speed and methods of privatization varied greatly. All of them were confronted with the fact that some of their major enterprises were notorious loss-makers. Fearing political turmoil, the politicians usually preferred to avoid plant shutdowns, such was the general backdrop to privatization. Some countries distributed vouchers – or certificates – to the population or employees. This method made it possible to privatize companies regardless whether they were profitable or otherwise. If nobody was willing to acquire a given state-controlled company, the governments could use the voucher method to privatize it; however, they were first obliged to transform it into a joint-stock company and then distribute, via vouchers, shares to employees, creditors or other segments of the population. Often, the manager was allowed to borrow money to purchase a portion of the shares and this way gain control over the firm and assume responsibility for its future development.

It is possible to find companies in Central and Eastern Europe, which were in relatively good shape prior to voucher privatization and remained so afterwards. Such instances are rare, however. Practically non-existent are instances of companies that were in a bad shape prior to voucher privatization, but improved substantially thereafter. If a company was initially in bad shape (either because of the company's internal situation or its exposure to non-standard external conditions), this method of privatization failed to make the company viable. As we know from the experience of Central and Eastern Europe, this method does not promote restructuring as it introduces neither new managers nor fresh capital. Managers of those voucher-privatized companies which were notorious loss-makers often used their positions to make their economic fate independent of that of the companies, extracting as much value as possible. This is understandable given the companies' hopeless situation; it made any long-term planning irrational. Managers often started to engage in asset stripping and tried to prolong the grace period by servicing existing loans through new ones. While the companies writhed in the agony of privatization, it was not only the companies that suffered, but the banks and other creditors as well. Voucher privatization often resulted in non-standard financial relations within the manufacturing sector, as well as with equally non-standard ties financial institutions.

In the transformation context, one approach found repeated advocacy: existing enterprises should be handed over to private ownership, regardless whether the new owners were capable or not, be they criminals or honest people. Whoever they were, they should be given a chance, so the argument, to prove their ability to manage their newly acquired property successfully. Should they prove capable, the past should simply be forgotten. This

argument sounds logical, but disregards the time dimension. As experience has shown, it can take a long time for a new unsuccessful owner to lose control of a company. This means many months of destruction instead of technological recovery.

The voucher method was swift and could be easily sold to people in the transition countries. Not everybody may profit from it, but nobody seems to lose. Furthermore, and this has been very tempting in the case of BiH, it opens up possibilities for compensating people for all kinds of outstanding claims that have accumulated – be they claims against the government, the banks or state-owned enterprises. Privatizing desolate companies with the voucher method and using the vouchers to compensate people for old claims is not a honest procedure. Sooner or later, the new formal owners will come to realize that what they own is of no value. In those cases where privatization fails, it is a costly prolongation of a company's basic problems.

In a recent report<sup>82</sup>, the US Agency for International Development (USAID) published a list of the twenty FBiH companies, which had incurred the largest losses over the period January-June 2000. Six companies, most of them involved in the production of public utilities, recorded double digit losses (between KM 30 and 10 million). Losses incurred by industry as a whole totalled some KM 400 million. The nine largest profit-makers<sup>83</sup>, led by PTT Sarajevo with profits of over KM 70 million, accounted for almost 38% of all profits (totaling about KM 270 million). These figures point to the difficult conditions governing comprehensive privatization.

### **Better preconditions for privatization in the near future?**

Critical voices frequently stress that the BiH economy would be much better off today, had a comprehensive privatization process been pushed through in the initial post-war years. That was never a viable option. One option would have entailed privatizing – through restitution and sales for cash not generated from bank loans – small enterprises on the one hand and a handful of profitable strategic enterprises on the other. To be successful, the second option ( comprehensive privatization of the whole enterprise sector) would have first required the establishment of a viable business infrastructure as a prerequisite. Even today that infrastructure is not to hand; as a result a trick had to be devised – the voucher privatization of a large number of enterprises that nobody would want to pay money for.

If an enterprise has zero or negative market value, the question arises whether its liquidation is the sole solution. This is not necessarily the case. At present, a given enterprise may be exposed to a non-standard business environment, but might be viable

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<sup>82</sup> BiH Economic Update 2000 – Third Quarter, 31 October 2000.

<sup>83</sup> in the first half of 2000.

under other more regular conditions. If a return to regular conditions can be expected in the foreseeable future, it may be more rational to keep the enterprise alive. Its market value should revert to positive over time.

Over the past few years, the extreme strictures of the sales markets have been the most crucial problem. Under such conditions, even a company equipped with the latest technology and first-class personnel could easily fail. The environment for productive activities has to improve further in BiH, otherwise many enterprises will have no future, regardless who their new owners might be. Certainly, the situation differs from industry to industry and, to a lesser extent, from region to region. Nevertheless, in general, producers in BiH are exposed to less favourable conditions compared to manufacturers in Central, Eastern or Western Europe. Potential investors are probably right in refusing to get involved. In the case of many existing companies, this means that circumstances prevent successful privatization, and from a managerial point of view the companies should be shut down. However, it would be wrong to draw the conclusion that de-industrialization offers the best solution for BiH. On the contrary, the correct conclusion is that de-industrialization can only be avoided if access to potential output markets improves substantially – within the country, in neighbouring countries<sup>84</sup> and above all else in the EU. If it is to achieve self-sustaining growth, BiH has to eliminate its internal trade barriers and promote an atmosphere conducive to trade in the region and with the EU. External conditions may improve. First, the recent political changes in Zagreb and Belgrade bear promise. The most significant development in the country's efforts to develop its foreign trade sector has been the signing of a Free Trade Agreement with Croatia, its main trading partner.<sup>85</sup> Secondly, in September 2000 the EU announced that it would open its borders to duty-free imports from Albania, BiH, Croatia and Macedonia. For the companies in the region, this may provide access to a huge sales market. A decisive question is whether they will be able to:

- (a) exploit this potential and find customers,
- (b) adjust output volume and quality to demand; and
- (c) meet tough EU quality standards. So far the BiH authorities have failed to put an important prerequisite into effect – a state-level institute for standardization. For exports to the EU, non-tariff barriers will continue to exist; companies will need capital and expertise to overcome them. At the same time, an anomalous type of non-tariff barriers could well continue to spoil the local companies' free access to

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<sup>84</sup> On 27 June 2001 Albania, BiH, Bulgaria, Croatia, Romania, FYR Macedonia and Yugoslavia signed a memorandum of understanding, aiming at the creation of a network of bilateral free trade agreements by the end of 2002. (Newsletter No 9 of the Special Co-ordinator of the Stability Pact for South Eastern Europe, 11. July 2001). This step has the potential to stimulate trade within the region.

<sup>85</sup> BiH products imported into Croatia will be immediately exempt from duties, while duties on Croatian imports into BiH will be reduced by 30% in 2001 and will be gradually eliminated by 2004. (Report by the High Representative for Implementation of the Peace Agreement to The Secretary-General of the United Nations, 12 March 2001.)

regional sales markets. For example, in many ways administrative procedures tend to discriminate along ethnic lines. As a result, trade links are exceptionally weak in some cases, and exceptionally intensive in others. For example, the Banja Luka region maintains close trade links with Yugoslavia, while trade links with neighbouring Croatia – or with the FBiH – are underdeveloped.<sup>86</sup> Tariff officers or policemen tend to exert lax or strict control depending on the ethnic affiliation of the persons they are supposed to check. Such an attitude is not a question of good or bad training; only supervision from outside can help the State to collect the legally justified tariffs.<sup>87</sup>

With the opening of EU borders to imports from BiH and other Balkan countries providing greater export openings, potential investors might see better opportunities for achieving adequate profits in the future. Companies with a negative net value might now become attractive propositions for investors, thus opening the door to successful privatization. A substantial increase in real per capita income could follow in the wake of increased export activities, thus giving a much-needed fillip to the domestic market.

It would seem that the positive evolution of internal relations within BiH has now become the key to economic and political progress.

Let us assume that over the coming months we will see a significant lowering of the current barriers hampering access to both internal and external input and output markets. In order to attract those willing and able to invest in the long-term development of a BiH company, in many cases it would first be necessary to remove accumulated obligations from the company's balance sheet and offer the potential investor some kind of financial support, at least indirect. Otherwise, the potential investor may not see any sense in getting involved in a plant equipped with damaged and obsolete machinery and buildings, for which new market ties have to be established. Faced with the amount of initial investment required, the potential investor will need to see an opportunity for securing an adequate return to cover the initial outlay and make the whole project profitable within a reasonable number of years.

Under certain conditions, even an enterprise equipped with obsolete technology can show a profit. If it produces tradable goods, the chances of its being profitable are higher, the

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<sup>86</sup> According to USAID data (BiH Economic Update 2000 – Third Quarter), in the first three quarters of 2000, 39.6% of registered RS exports went to Yugoslavia, 26.4% to Italy, but only 2.3% to Croatia. In the same period 23.5% of imports came from Yugoslavia, but only 6.9% from Croatia. As regards unregistered trade, the picture may be different. Even during the war trade flows between conflicting parties did not stop completely. After the war, there was, for example, a boom in illegal trade of second-hand motorcars.

<sup>87</sup> The Customs and Fiscal Assistance Office (CAFAO), a European Commission-funded programme is working with the Federation Customs Service and the Republika Srpska Customs Service to establish Customs Enforcement Sections within each Service. Each Section comprises three disciplines: intelligence, anti-smuggling and investigation units.

more favourable the exchange rate. In the countries of Central and Eastern Europe, most companies were, by Western standards, equipped with old technologies when transition started. Some of the companies developed into notorious loss-makers despite favourable exchange rates. Others, however, became profitable thanks to an exchange rate that allowed them to offer their output at prices that were very low compared to similar products from Western manufacturers. Given the obsolete production technologies in use, labour productivity was very low. However, wages measured in terms of Western currency were also extremely low.<sup>88</sup> In this way, manufacturers in Central and Eastern Europe were able to offer their products at competitive prices when their borders opened.

In the case of BiH the exchange rate is fixed in the context of the currency board regime. The competitiveness of BiH producers cannot be boosted through nominal depreciation. However, compared to Western Europe average wages are, as was mentioned above, rather low. At the same time, prices for tradable goods in BiH are rather high. This gap between the level of wages and prices should offer producers an opportunity to step in. If this does not occur to any appreciable degree, it means that things are not blocked by wage costs, but other factors are at play.

Sales conditions may have played a decisive role in recent years. For transnational manufacturers it was definitely not advisable to concentrate production for the whole of the Balkans on one site in BiH, such as Banja Luka, Mostar or Sarajevo. Without doubt, importing products from a more 'central' location outside the region was the more promising option. This may change in the future.

Whereas it is relatively easy for an EU or US manufacturing company to offer and distribute its products throughout the Balkans, this is certainly not the case for a company located, for example, in Banja Luka, Mostar or Sarajevo.

To sum up, any production firm, in whose development an investor is willing and able to invest, should be privatized as swiftly as possible. Attempts to privatize companies with zero or negative value will not yield any positive results. It will merely make the financial system even worse – it is already in disastrous shape anyway. If the borders between BiH entities, Balkan countries and European regions no longer act as trade barriers, it will create the preconditions for the successful privatization of BiH companies accompanied by an increase in foreign direct investment.

At the end of 2000, the accumulated amount of post-war foreign direct investment was about KM 580 million. The main investors were the Kuwait Investment Agency (which

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<sup>88</sup> The remarkable exception was the former German Democratic Republic, and consequently a large percentage of the manufacturing sector did not survive



invested KM 200 million in the steel plant in Zenica), Coca Cola (KM 55 million), Heidelberger Cement ( KM 55 million), Volksbank (KM 51 million), and Raiffeisen (KM 33.5 million), as well as the retail chain Mercator from Slovenia and the food processing company Agrokor from Croatia. The RS attracted hardly any foreign investors, the main exception being a textile company in Dubica. Several of these investors, such as Coca Cola and Volksbank, profited from the political risk insurance facilities developed by the World Bank in co-operation with the EU and Lloyds. The EBRD also helped to finance FDI projects, such as the Agrokor project.

Thus far, in the case of BiH the basic precondition for effective foreign direct investment (or at least foreign investment in the manufacturing sector) has been stimulation through special provisions such as risk guarantees, favourable credit lines or political considerations. Only to a minor degree is FDI in manufacturing the outcome of free market forces.

### **The new payment system: functional, yet no panacea**

Following the dissolution of the Yugoslav Federation, the Payment Bureau (PB), a remnant of former times, has lived on, albeit in rudimentary form, in all successor states. The bureau was introduced in the sixties and apparently became deeply rooted in the years thereafter. Companies are obliged to effect their payments via the bureau. On being commissioned by a client to transfer money to a business partner's account, the bank has to arrange the transaction through the PB. The commercial banks go about their business as usual, granting and recovering loans, for example, but the PB has to be involved in all payment flows, as it has the monopoly to store money. When USAID and ICG studied BiH structures in some detail, they voiced sharp criticism of the PB system.<sup>89</sup> They came to the conclusion that the bureau increased the costs of doing business in several ways:

- The PB charges a fee for its services.
- It takes too long for a payment made by one company to be credited to the account of another. This increases the amount of working capital that companies need, so the argument goes.
- The PB maintains unnecessarily high stocks of money.
- Political motives lead to the abuse of funds.
- The PB enjoys a monopolistic position and its officials often extort bribes from the business community.

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<sup>89</sup> Hitherto, BiH hosted three separate payment systems: The SPP in Republika Srpska, the ZAP in Bosniac-controlled areas of the FBiH and the ZPP in the Croat areas of the Federation.

This criticism culminated in the proposal that all PB offices be shut down as soon as possible; commercial banks and tax authorities should do the job as was customary everywhere else. The experts advising the donor community considered the transformation of the payment system crucial to economic reform. At the Madrid Peace Implementation Council meeting in December 1998<sup>90</sup>, the governments of BiH accepted the need to transform the system by the end of 2000.

A programme has been drawn up by an International Advisory Group on Payment Bureau Transformation (IAG), formed by the World Bank, the International Monetary Fund, USAID, the European Union, the US Treasury, the Office of the High Representative and the Customs and Fiscal Assistance Office. The group advises and assists the authorities in both entities.

In the second half of 2000, the International Advisory Group (IAG) announced the completion of the financial verification of the assets and liabilities of the payment bureaux of Bosnia and Herzegovina (BiH). This opened the way to closing down the payment bureaux by the end of the year 2000. Financial verification is critical to ensuring the appropriate redistribution of payment bureaux assets and liabilities. Three local auditing firms<sup>91</sup> conducted the verification exercise under the guidance of a team of international bank examination and audit experts retained by USAID.

The majority of close on 3,000 PB employees have moved, together with their functions, to new or existing institutions such as the Ministry of Finance, the clearing house<sup>92</sup> or commercial banks. The functions of the payment bureaux have thus been transferred to appropriate governmental and private sector entities. These functions include:

- Authorizing commercial banks to compete for the processing of financial transactions on behalf of both businesses and consumers. This is tantamount to privatizing the system of payments and is expected to yield lower costs and a more efficient and timely processing of transactions.
- Shifting responsibility for processing information relating to tax payments and the collection of tax dues and customs levies.
- Transferring to the Government's Statistics Bureaux responsibility for collecting and processing national income statistics.

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<sup>90</sup> In the Madrid Declaration of 1 December 1998, governments in BiH expressed their support for the establishment of a Western-type financial system and accepted it as an obligation.

<sup>91</sup> Recon doo (Sarajevo), Deloitte & Touche (Banja Luka) and Ekonomski istraživački biro 'Luković' d.o.o. (Mostar)

<sup>92</sup> So far, the implementation of a clearing house is still lacking.

- Establishing a treasury function within the Ministries of Finance to provide for the centralized administration of public revenues and budgets. This entails establishing regional treasuries in Republika Srpska as well as canton treasuries in the Federation.

This ambitious project has to overcome at least three potential threats:

- (1) The new privatized payment scheme has to rely on a completely desolate banking system. In December 1999, the governor of the CBBiH characterized the country's banks as incapable of playing the role required of them to help the economy developing. 'It's a clear symptom of the weakness in the banking system that the banks are going to have to go through an authorization process to be able to carry out domestic payments. In most countries that's what banks do.' In the meantime, foreign investors have entered the BiH banking sector. However, the problems facing the major banks domestic banks have still not been resolved.
- (2) In the initial phase after the transformation of the payment system, both the business sector and the state authorities are likely to encounter difficulties in monitoring and controlling the flow of in- and outgoing payments. This could provide an opportunity for fraudulent activities and tax evasion could well skyrocket. The coincidence with increasing customs revenues may to some extent offset increased tax erosion.
- (3) In the transitional period, the public budgets will not only suffer from tax evasion, but also from the fact that the PB used to deduct taxes from incoming payment flows at source, whereas under the new system tax payers will have to declare and pay tax ex post.

The payment bureaux represent a system, which over the next decade or so will disappear completely from the Balkans. In a developed market economy, administering payment flows via a state monopoly makes no sense. The interesting question is whether it can serve a useful purpose during a transitory period. Of the counter-arguments cited above, some are not utterly convincing. For example, it may not be justified to criticize the system for charging a marginal handling fee (0.4% on every transaction). Financial institutions in developed countries, for example, also charge fees on transactions effected via credit cards – demanding margins of up to 5% in some countries. In order to assess the efficiency of the PBs, one would have to compare their performance with that of commercial banks in transition countries. The same holds true for the claim that the institution had been abused to serve the interests of politicians: Once again, it might be salutary to establish whether under comparable conditions in transition countries such as Bulgaria and Romania, a western-type financial system proved more resistant to political abuse, fraud and corruption.

Under the conditions prevailing in the successor states to Former Yugoslavia, especially when a completely unreliable and malfunctioning banking system prevails, PBs can exert a

controlling function since they guarantee that all payment flows are centrally monitored. They may also be better suited to the task of collecting taxes and gathering statistical data. Of course, in a society devoid of democratic control, any instrument, and hence the PBs as well, can be abused. The question is whether the instrument helps or hinders such abuse. It may well be that the PB system has shielded BiH society from still greater abuse of power. In a decentralized and privatized system of payments, it is much more difficult to establish what has been paid and to whom.

A brief glance at Slovenia, the most developed among the successor states of Former Yugoslavia, may be useful in this context. Several years ago, when confronted with the demand to close down the PBs, the Slovene authorities refused. In a sense, they were right. The PBs had proved their usefulness as tax collectors since they deducted tax at source more or less automatically. In this way, Slovenia was able to avoid high budget deficits due to tax evasion. During the initial phase of transition, the PB served its use at least in Slovenia, and only now that the country has reached a very advanced stage of transition is the institution being dismantled.<sup>93</sup>

In 1999, when the konvertibilni marka (KM) was introduced as the new currency, the payment bureau system proved to be a powerful instrument, as can be concluded from comments made by Peter Nicholl, the governor of the CBBiH. Initially after its introduction, the people were hesitant to accept the new currency. Parallel currencies – the German mark, the Croatian kuna and the Yugoslav dinar – undermined the KM until, according to Peter Nicholl, they were removed from the payment bureau system. From then on, large floats of non-invested cash, released as a result of that change, boosted the central bank's reserves.

Notwithstanding the arguments in favour of the PBs as a transformation tool, international experts have opted for their abolition, and expectations concerning the new system are quite high. It should become one of the key elements in the process of strengthening institutions in BiH. Independent external audits will cover government financial activities at all levels and thus, it is hoped, reinforce public sector management through increased transparency in public finance and accountability of public officials, and ultimately increase the efficiency of the administration as a whole.

These expectations may well materialize in the longer term, after considerable teething troubles. The new system will be expensive, as its merits will develop solely on the basis of comprehensive independent external audits. This should be clear, if other Former Yugoslav countries are going to copy the BiH payment reform. The new system is not a

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<sup>93</sup> In February 2001, the director of the direction for the Slovenian Payments System of the Bank of Slovenia, Peter Centrih, visited Sarajevo to study the BiH reform steps (CBBiH Newsletters, February 2001).

panacea, but should, so the hope, contribute to the solution of the main problem: the establishment of sound financial relations between individual enterprises as well as between enterprises and commercial banks, enterprises and state, or enterprises and the rest of the world.

For the time being, the whole financial sector is fully occupied with the transition to the new payment system, following the abolition of the former system of payment bureaux, which has since been split up into a Bosniac, Croat and Serb system. As for the handling of cash, three servicing institutions have emerged from the previous payment system – at least for the transitional period. They administer the distribution of cash among 15 individual treasuries covering all commercial banks and their head offices. With effect from 5 January 2001, the majority of commercial banks have become direct participants in both the real time gross settlement system (RTGS) and the giro clearing centres. The hope for more transparency in the financial sector, as an outcome of the implementation of the new system, has still to materialize. The efficiency of the new system has still to improve; the processing of transactions takes up to two weeks now compared to 48 hours previously.

### **New developments in the banking sector**

In its report of January 2001 on BiH, the IMF listed 38 banks operating in FBiH and 18 others that had lost their licences. On its homepage of 16 July 2001, the CBBiH listed 31 banks in FBiH and 19 banks in RS. In October 1999, 43 banks were reported as operational in the Federation and 18 in RS.

The domestically owned private banks currently in operation are small institutions with only limited capital. For the most part they process international transfers and rely on revenue derived from handling fees rather than interest. Mainly or entirely State-owned banks – 10 in the FBiH, 7 in RS<sup>94</sup> – control the bulk of banking assets. These are, by the way, non-earning and non-recoverable assets inherited from the Communist era. In both entities, public enterprises have been the main shareholders in the state banks hitherto. They thus exercise a major influence over bank governance. They are their main depositors and borrowers alike. As a result, these banks fall far short of commercial lending standards. The majority of state banks are financially unsound. Some encountered temporary difficulties in observing reserve requirements and were close to insolvency. Unless they enjoy control over a bank, borrowers are confronted by high interest rates – prohibitively so, if they need to take a loan for more than a few weeks and have every intention of

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<sup>94</sup> On page 24, the EBRD Investment Profile 2001 mentions two different figures when discussing State owned banks in FBiH: ten and eleven. According to this report, in FBiH 11 State-owned banks control three quarters of banking assets, whereas in RS the four biggest of the seven State-owned banks control two thirds of all assets. In its Balkans Report from 7 August 2001, the International Crisis Group however maintains that foreign banks now control 40% of FBiH bank assets.

repaying. It thus follows that the financial conditions for small and medium-sized manufacturers are extremely unfavourable, a factor that has contributed substantially to their lack of development.

Up to 2000, the Turkish Bank Ziraat Bank was the only foreign bank in the country, and it dealt merely with trade finance and money transfers. Then, however, foreign participation started to expand: in July 2000, Austria's Volksbank opened subsidiaries in the FBiH, and in August Austria's Raiffeisen Zentralbank acquired the Market Banka, which it renamed Raiffeisen Bank BiH, and later the Postanska Banka as well. The Lithuanian-owned Balkan Investment Bank opened a subsidiary in RS. The Italian-owned Zagrebska Banka bought a majority share in a local bank and renamed it Zagrebska Banka BH. In 2001, Zagrebska banka brought Universal Banka and later also Komercijalna Banka Tuzla under its control. In November 2000, three banks from Islamic countries founded the Bosnia International Bank. Also since 2000, the Slovenian Bank Domzale has purchased majority shares in a BiH bank and now runs it under the name Commercebank. Austria's Hypo Alpe Adria used its Croatia affiliate Slavonska Bank to buy a 20% share in Auro Banka (Mostar). The Kuwait Investment Agency bought Bor Banka, CIMC (US) acquired shares in Investicijska Banka. So far, only 5 banks, all of them foreign-owned and FBiH-based, qualified for the newly introduced deposit insurance. When the declaration of independence was in the offing, the former National Bank of the Socialist Federal Republic of Yugoslavia seized the foreign currency deposits of BiH banks, which were quite substantial at the time. The population lost all confidence it may ever have had in commercial banks, and this lack of trust has been the source of all current problems. People are more inclined to place their trust in reputable Western banks – which, however, for a long time were reluctant to engage in financial activities in the country. For foreign banks, which often also have a better service, it is easier to attract deposits, which is the very basis for the loan business. These banks invest part of the funds at their disposal, abroad, where the risk is lower compared to the loan business in BiH. Inadequate legislation concerning bankruptcy, an underdeveloped land registry and an unreliable judicial system are major risk-increasing factors.

Foreign observers frequently argue that the involvement of foreign investors will increase competition in the banking sector. This new competition will exacerbate the troubles of the domestically owned banks, and will be fatal for them if nobody emerges to support them. From an economic point of view, this would be an adequate solution. Nevertheless, it will trigger political turmoil. In banking sector in the FBiH, changes have started to pick up speed. Apart from sales of shares to foreign investors, cases of bankruptcies and liquidations have occurred and several cases of major fraud have given rise to ample discussion. By way of contrast, the banking sector in the RS gives every impression of being paralysed. Foreign involvement is marginal, and fraud is likely to remain unrevealed.

In recent months the main topic has been rumour about links between the finance minister and two banks, Zepter Bank and Agroprom Banka.

The population's aversion towards domestic banks offers foreign banks every opportunity to launch into profitable activities, despite the fact that the industry's main business – loans – will only develop slowly. Over time, the gradual recovery of the non-banking sector will increase the number of creditworthy clients. Despite the recent drop, high interest rates will remain a problem for quite some time. The interest gap between BiH and Germany reflects the much higher risks involved in doing business in BiH. In the absence of special programmes it will continue to constitute a serious barrier for several years to come. Even under favourable political and economic conditions it will take several years for the banking business to function in the manner customary in market economies. Nevertheless, even now profitable banking should be feasible for the frontrunners. However, it is unlikely that Western banks will be eager to participate in deregulating the major BiH banks. In most cases, in its attempts to rouse their interest in a strategic partnership with a major bank in a transition economy, the State has had first to embark upon a comprehensive clean up of the bank's loan portfolios. As experience shows, the costs involved in such an operation usually exceed revenues from the sale of shares. It is still an open question whether and in which manner things will develop in BiH: a country that is not a prime attraction for leading Western banks.

Donor support for lines of credit has been almost the only source of credit for private enterprises. From 1996 to 1998 the total amount of this kind of loans was KM 402.1 million. USAID was responsible for more than half of it; other players were World Bank and IFC. Results were mixed at best, as loan recovery was a major problem. In 1998, KfW<sup>95</sup>, a publicly owned German development bank, started an allegedly quite successful loan support programme in BiH. The institute set up a fund and contacted a number of carefully selected BiH banks. The programme involves nine BiH partner banks. They signed a framework loan agreement under the terms of which they undertook to repay the amount received to the Fund semi-annually and assume full liability for the local loan operations planned. The first step involved providing people with loans to build houses. Technical advice and supervision helped the partner institutes to select those applicants who appeared able and willing to repay the loans. Loans – DEM 35,000 maximum – were long-term and ran for up to 12 years, with equal monthly repayment rates. The annual interest rates were set at 8-10%. This is not really cheap<sup>96</sup>, but people with a monthly income of DEM 700 can afford it. Local banks not included in this program offer loans with very short maturity periods, at monthly interest rates ranging between 1 and 3%. One year later, in

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<sup>95</sup> Sarah Jurreit, 2 October 2000, European Cooperation – Rebuilding a ravaged county: KfW implements the European Fund for Bosnia and Herzegovina, [http://www.oneworld.org/thinktank/eucoop/eureform\\_jurreit.htm](http://www.oneworld.org/thinktank/eucoop/eureform_jurreit.htm)

<sup>96</sup> Compared to previous 12 months, in the period October 1999 - September 2000 retail prices in the FBiH increased by 0.5%.

1999, KfW launched a second programme aimed at small and medium-sized enterprises (with up to 50 employees) seeking loans. Over a third of them were companies starting up for the very first time or others starting anew. KfW staff advised BiH colleagues on ways of assessing the applicants' creditworthiness. Qualified applicants were offered a six-month grace period prior to the start of the repayment period, an interest rate of 12-16% and a repayment period of no more than five years. Hitherto, arrears have been an extremely rare occurrence in both programmes. Another programme in the same context was aimed at enabling local banks to finance exports.<sup>97</sup> These programmes are remarkable in that their mechanics are absolutely identical to those of the *Marshall Plan* – albeit on a laboratory scale.<sup>98</sup> The very basis of the whole project, the revolving fund, currently holds only DEM 53 million, about half a per cent of the money pledged for BiH by the donor community. By the end of 1999, it had backed just over 1,000 housing reconstruction loans and around 100 loans for small and medium-sized enterprises. Austria and Switzerland are likely to increase the KfW fund somewhat, whereas the EBRD<sup>99</sup> is running a separate DEM 30 million support programme for local banks granting loans to small and medium-sized enterprises.<sup>100</sup>

The minuscule KfW exercise could serve as a model for a broader and more efficient support of economic recovery in the Balkans. The scheme relies on two pillars: local bank staff trained in assessing clients' creditworthiness, and their ability to offer loans on reasonable terms. Both bankers and clients have embarked on a steep learning curve. After gaining adequate experience in financing housing construction and SME projects, the next logical step would be to extend the scheme to larger clients.

Not only small and medium-sized enterprises have a need for loans at affordable rates, something that hitherto the banking sector was completely unable to provide. Lack of working capital was one of the reasons for the immense trouble most of the major manufacturers in BiH had in resuming production, at least partially. The international financial institutions (IFIs) ignored their needs, as the companies were State-owned and not yet restructured. Under the circumstances, the IFIs opted to develop, as compensation for the lack of affordable bank loans, loan subsidization schemes for small and medium-sized enterprises. The main players in this context were the EBRD, IFC, the World Bank, USAID and last, but not least KfW. Together with the IFC, the EBRD established a micro-enterprise bank in November 1997. The EBRD also established a credit line that uses four

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<sup>97</sup> KfW will also establish a credit guarantee fund in order to enable qualified local banks to gain access to international capital markets.

<sup>98</sup> If the extent surpasses a certain threshold, the envisaged supply side improvements start to stimulate overall demand; the business climate improves and eases the repayment of loans.

<sup>99</sup> EBRD press release from 20 December 1999.

<sup>100</sup> For a more global view on this topic see Jonathan Morduch, 'The Microfinance Promise', *Journal of Economic Literature*, Vol. XXXVII (December 1999), pp. 1569-1614.



local banks as intermediaries; by now, most of them foreign-owned. The IFC also runs the South-east Europe Enterprise Development (SEED) initiative. By the end of 2000, its funding commitments for South-east Europe (Albania, BiH, FYR, Macedonia and Kosovo) amounted to USD 20 million. Since 1996 the World Bank has been running two rather modest programmes: the Local Initiatives Project for start-ups and business developments, which uses local NGOs as intermediaries; and the Private sector Development project in co-operation with local banks. Compared to all these programmes with funds of the order of USD 10-30 million, the Business Development Programme run by USAID is a large-scale undertaking; it has a total of USD 278 million at its disposition. It subsidizes loans granted by local banks to SMEs. The recipients of USAID-subsidized loans account for half of BiH's exports. As is the case with all projects of this kind, part of the funds is used for loans, whereas the other part finances foreign consultancy.

The Central Bank of BiH scrupulously observes the currency board rules laid down in the Dayton Agreement. The soundness displayed by the central bank contrasts sharply with the unending series of disasters in the commercial banking sector. The architects of the currency board system may never have imagined that such long-lasting coexistence was possible. The monetary authority responded by reinforcing bank licensing procedures, introducing a greater degree of regulation and supervision and promoting a unified financial system. The instruments available to a central bank are restrictive in nature – it is beyond their means to turn starving commercial banks into well-nourished institutions.

## **Conclusions**

Drawing conclusions from the experience gained in BiH could benefit the design of a recovery programme for Yugoslavia and other Balkan countries – including BiH itself. In Chapter I, we dealt with the inability of the economy in BiH to return swiftly to pre-war levels, despite considerable external support. We mentioned three points: the collective trauma of the BiH society, the obstructionism of local politicians and the lack of techniques for an economic kick-start. The three aspects are inter-related. The BiH population has experienced a most severe trauma which it will take time to overcome. This has to be achieved before the BiH territory can merge into one unified economic area. All economies are based on human interaction. As those who led the population into that trauma or had been unable to prevent its occurrence, the political leaders were certainly the wrong people to lead the country out of the self-same trauma. They have exploited the mutual distrust between the ethnic groups that had arisen as an outcome of the war, using it to expand their power and strengthen their position. Given their control of the mass media, ownership of large segments of the economy and their stranglehold on the public administration, they and their clans have been able to abuse their power as economic parasites. As long as the population is in the throes of their trauma, the war-time politicians can sell their objections to the goals of the Dayton agreement as good policy. It is beyond any shadow of doubt that

the systematic obstruction has proved efficient and effective, causing an inordinate delay – and the situation persists until this day. Finally, the past five years in BiH have also revealed the macro-economic difficulties inherent in leading a crisis-ridden country onto the fast track to economic prosperity, even if considerable financial sources are available. The funds available were used to secure expert knowledge from all over the world and fund reconstruction activities of a number of foreign, and to a certain extent local, companies. Only a small minority of local people were immediately involved in reconstruction activities. The majority wished to go about their economic lives as before with a minimum of delay: however, over a long period of time they could do no more than passively observe the implementation of major reconstruction projects. They were given no means to repair their houses or flats; no funds were released to start small workshops or increase farm productivity. And this still holds true for many. In the initial years, the reconstruction programme kick-started but a limited segment of the economy. It failed to bring about a rapid mobilization of a large part of the population of working age. In general, as an integral part of the market economy, inequity is supposed to stimulate the economic activities of individuals; in the case of post-war BiH, however, the majority were long deprived of all chances of involvement. The outcome was unequal and uneven development. The contrast between an affluent minority and a large impoverished majority has become very pronounced. In some parts of the country people have gone back to living off their smallholdings, where for want of money interpersonal transfers in kind and barter deals prevail.

From the experience in BiH we can conclude that it is not enough to consider certain macro-economic indicators and pump money into specific projects. A kick-start of that kind may or may not induce economic recovery, depending on countless institutional and other factors. Institutional settings – in a very broad sense that includes traditions and patterns of social behaviour – have a crucial bearing on economic and social development. They differ from country to country. It is important that they be studied carefully in each individual case, if more is to be learnt about the reasons for overall social and economic success or setbacks.

In the case of BiH, legitimacy is an aspect of essential significance to economic and overall progress. Though convinced that it ran counter to their interests, regional politicians yielded to the pressure of adverse circumstances and signed a treaty. A gap now yawns between the content of the agreement and the reality. Unless bridged in one way or the other, this gap will persist and hinder any kind of progress. A consensus that would satisfy everybody's wishes is impossible, but it would be enough, were the new arrangements to enjoy solid political support on all sides. It is necessary to find a new *modus vivendi* for the entire Balkan region – the sooner, the better. It has to entail a solution for the Kosovo for FYR Macedonia and for all those people in the region, who were expelled from their homes

and deprived of their property. Otherwise the social and economic reconstruction will never gain momentum.

If used with care, examples taken from history are of analytical value. A brief look at two instances of an economic kick-start is rewarding. After World War II, Austria, Germany and Italy developed their own programmes for transition from comprehensive regulation to a free market system. In Germany, for example, a currency reform was introduced. On a specified date in 1947 the former currency was declared invalid and each citizen received DEM 80 in new currency. All claims and liabilities were likewise declared invalid. When notice was given of the reform, manufacturers already began preparing for the new situation; they intended to compete for the new money, thus making for a perfect economic take-off. After 1989, none of the other transition countries in Europe adopted a similar approach – and possibly with good reason. It may have been that the corporate sector in Germany was more capable of a productive response. Moreover, the German economy was more closed at the time; competition from abroad was less vigorous. None the less, the experiment demonstrated that manufacturers with vast idle capacity can rapidly adjust the volume and structure of their output to an expected boost in demand, if money injected into the economy offers them prospects of greater revenues and profits. A further example of successful stimulation of economic growth was the European Recovery Programme. In a brief initial phase it funded post-war Europe's imports in order to reduce widespread misery, while in a long second phase it supported the expansion of productive capacities linked to an increase in demand. Market enlargement by lifting foreign trade barriers opened up an additional source of demand. One instrument common to the whole program was the provision of loans with long grace and repayment periods as well as low interest rates. In post-war BiH, preconditions did not favour such a programme. The reconstruction or expansion of productive capacities would soon have grown out of all proportion given the extreme tightness of the output markets, which for a long time proved an insurmountable hurdle and still persists today to a certain extent. That notwithstanding, a strategy of that kind could make sense for the Balkan region as a whole today. In November 2000, under the auspices of the EU, leaders from the countries of Former Yugoslav met for the first time. It should have become clear at that meeting that integration into EU structures has to go hand in hand with a removal of trade barriers in the region.<sup>101</sup> As a result, it might now be possible to expand capacities and markets in parallel. Under favourable conditions, a relatively small amount of foreign capital, if invested in the right manner, can initiate economic take-off on a comprehensive scale. In order to be efficient, donor money would have to finance an initial boost in demand for investment goods. This would have a positive impact on the demand for consumption goods. It might also be

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<sup>101</sup> On 22 February 2001 the World Bank approved a USD 11 million equivalent (SDR 8.7 million) credit for the Trade and Transport Facilitation in Southeast Europe Project (TTFSE) in Bosnia and Herzegovina (BiH) that will foster trade by promoting more efficient and less costly trade flows across the borders in South-east Europe and provide EU-compatible customs standards.

advisable to force-feed demand for consumer goods. For a limited period of time, domestic producers should be protected against foreign competition – by means of either the exchange rate policy or taxes on imports. Projects should help to facilitate the access to foreign capital. This should provide domestic enterprises with an opportunity to improve their presence on internal and external markets as well as update their technical equipment and production methods. Favourable loan terms combined with careful monitoring of their use would be of major importance. The legal infrastructure would have to be sufficiently developed to provide for penalties on any infringements.

Balkan exports could thus be given a much-needed boost. In preparing for the EU-Balkan Summit in Zagreb on 23-24 November, the EU Commissioner for External Relations, Chris Patten, said that the Commission would like to push through far-reaching trade liberalization measures so as to help the Balkan countries export their products to the EU markets. Four countries – Albania, BiH, Croatia and the former Yugoslav Republic of Macedonia – would benefit from the removal of quotas, along with Kosovo, which is now virtually a United Nations protectorate. The projected measures, which apply to both industrial goods and all farm products except beef, wine and some types of fish, are unilateral – the countries of South-east Europe are under no obligation to reciprocate in full. The European Union has also discussed plans to sign accords to grant preferential trade conditions to, and enter into stability pacts and association agreements with, the countries of former Yugoslavia. EU sources report that the Union has adopted exceptional measures that open up trade with the Balkan countries; it has also abolished customs duties on 95% of imports from the Balkans. All this sounds excellent; however, one should not be overoptimistic. A mere 5% of the items on the list of import goods may in fact constitute major export goods from the Balkan countries. Furthermore, in countries such as BiH, most of the companies might be in such bad shape that they are simply not strong enough to make use of the doors being opened by the EU. In order to export successfully, companies will have to redesign their products to meet EU quality standards and norms; they will have to make potential EU clients aware of their products, and they will have to prepare all the documentation required by the EU. Opening the doors of the EU to Balkan products might be like a carrot that the donkey can see, but never reach. If it is to be effective, the corporate sector will have to undergo a process of recovery.

## **Outlook**

### **Ethnocentric concepts could move backstage**

For the present, ethnocentric parties have been excluded from both the new BiH government and the Federation government. After having assumed power, the pro-Dayton block is under immense pressure to yield swift results – otherwise the population will soon start to feel disaffected: an additional strain that could easily stifle co-operation between the

pro-Dayton parties. A change of government or new elections would be the outcome. The population will measure the governments' success primarily in economic terms, using indicators that may differ fundamentally from those that international analysts usually focus on. The new governments have at their disposal only a very limited set of instruments, mainly in the sphere of administration, with which to achieve rapid economic success. Reforms in the legislative and judicial sphere are extremely important to long-term economic and overall development, yet tend to be time-consuming. Once again, whether rapid economic success is achievable will depend on the international community.

In Croatia, after a mere twelve months of sluggish economic success the population is already starting to show signs of disillusionment.<sup>102</sup> The same thing could soon happen in Serbia as well. Most probably, the nationalistic parties in Croatia, Serbia and BiH will be able to regain some of their former power. At the same time it is unlikely that they will be able to re-assert their firm control over the State in the foreseeable future. Undeniably, they will change – in line with the preferences of their leaders and the constituents. In BiH, for example, their obstructionism may slowly waste away as the race for rapid EU accession quickens in the individual countries.

Over the next few years it will be difficult in BiH to ignore the ethnocentric parties: a fact that may well add to the fatigue of those supporting the BiH project in the West. The omnipresent threat to cut financial support will continue to hang over the country. For the time being, Western governments and international organizations alike will probably adopt a waiting position and see how things develop. The new US government has already indicated its desire to maintain a presence in the Balkans. Nevertheless, a shift of responsibility towards the EU is quite feasible.

In BiH today, the most serious problem emanates from the Croat side. The HDZ, led by Ante Jelavic, wants to split the FBiH in two: a Bosniac and Croat entity. The latter is supposed to unify all Croat-majority cantons.<sup>103</sup> The party representatives want to lend formal status to the current situation. De facto, Croat-dominated regions are an entity per se, maintaining their own institutions and pursuing their own policies. HDZ-politicians participate in joint institutions only if they are offered leading positions. Obviously the current pressure in favour of merging public institutions such as financial administration, border control, banking supervision and the like is heightening Croat fears. Croats are afraid of losing the power to defend their interests in legislative and administrative bodies – with interests being defined predominantly in ethnocentric terms. They do not share the donor community's vision of an individual's ethnic affiliation ultimately becoming an

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<sup>102</sup> Verpuffter Reform-Elan in Kroatien, *Neue Zürcher Zeitung*, 6 February 2001, p. 6.

<sup>103</sup> On 3 March 2001, parties led by the main nationalist Croat Democratic Union (HDZ) agreed to form an inter-regional council to establish "temporary Croatian autonomy in Bosnia-Herzegovina ... until the full constitutional and real equality of Croat people in Bosnia-Herzegovina can be ensured" (Agence France Press).

insignificant criterion in everyday life in BiH. Maybe this is a realistic judgement, yet by their very behaviour they make it still more realistic. From an ethnocentric point of view it is clear: with only one sixth of the votes in nation-wide elections and about one third in Federation polls, each parliament could vote down all Croat initiatives, if the rest of the house voted en bloc. In the same vein, from a formal standpoint administrative bodies would have the power to discriminate against Croats at all levels.

Clearly, these fears are widespread among Croats. Ethnocentric HDZ politicians enjoy the support of the overwhelming majority of BiH Croats. This is a seedbed par excellence nurturing their threat to boycott BiH institutions at all levels and declare a separate entity unilaterally. This would disrupt the workings of state institutions. The international authorities would have to respond in some way: either they would have to take over the administration of the country to a much greater degree than at present or they could withdraw, possibly leaving SFOR troops behind to protect those BiH citizens who have returned to areas where they enjoy only minority status.<sup>104</sup> The first move might well provoke permanent passive resistance on the part of the Croat population; the second would lead to economic disaster and violence within BiH. Croat concerns are a serious matter; unless taken seriously, the conflict could escalate.

In Croatia and BiH alike, government spokesmen, business people and many intellectuals have declared that EU accession is an important objective. It may also become a popular target in all successor states to Former Yugoslavia. There is every likelihood of this development increasing despite sporadic disappointment with EU politics – or lack of politics. Ethnocentric concepts could move backstage. However, it would be exaggeration to hope that EU accession, which is still a long way off, necessarily eliminates such concepts. As we can see, the EU has eliminated the danger of armed conflicts between States that have become members, yet it has not eliminated the problem of ethnically motivated tension within individual States. None the less, escalation into a broader conflict is no longer a major threat in EU member countries.

### **Rapid economic progress in sight?**

The people of BiH enjoy an environment in which foreign powers provide the basic prerequisites for survival – in security, legal and economic terms. Under this umbrella, the local population organizes its daily life. Confronted with a situation that is troublesome in terms of productive activities, large parts of the economic and political elites have engaged in developing strategies for rapid personal enrichment, mainly through all kinds of legal and illegal forms of internal and external trade. A large part of the society does not feel any

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<sup>104</sup> In an article in the *International Herald Tribune* from 31 January 2001, Wolfgang Petritsch deals with feasible consequences of a division of BiH.

loyalty to or allegiance with the State and shares the opinion that in economic life circumvention of the law such as tax evasion is not a criminal offence. As it is up to these elites to draft and enforce criminal codes, they have no need to take the penalties stipulated therein seriously. Establishing the rule of law is one of the most difficult tasks confronting the international community. If it fails in this respect, the creation of value, measured in terms of GDP, will not grow at a rapid rate and potential foreign investors will maintain their hesitant stance.

Even under favourable conditions economic recovery will take time in BiH. It would be misguided to hope that recent developments such as the abolition of the former accounting system and the ongoing deregulation of companies will yield swift gains. On the contrary, both programmes will lead to disruptions in the short term, and the achievement of positive results will take a number of years.

Economically, the country will probably remain on the track that it is already running down. For the next few years GDP may continue to grow at rates close to 5% implying some catching up vis-à-vis EU – albeit from a very low basis. If trade integration progresses well, the volume of exports could rapidly rise and influence the growth rate positively. The decisive question is whether a significant number of BiH producers will be able to benefit from the opportunities resulting from the opening of EU borders. At present, most enterprises are in dire financial straits and will hardly be able to adopt EU standards. Bureaucratic requirements might pose an additional hurdle. Experience in transition countries points to export success being predominantly the domain of so-called ‘foreign investment enterprises’.

The currency board system could give rise to serious problems where the international competitiveness of BiH companies is concerned. Problems could arise from externally generated cost increases: for example, those due to a devaluation of the euro or increasing world market prices for energy and raw materials. Problems could also follow in the wake of wage hikes exceeding the increase in labour productivity. A contrary development, however, is also conceivable: for example, thanks to massive foreign direct investment labour productivity might rapidly improve and lead to improved competitiveness and financially sounder local firms. That notwithstanding, in the short term it will hardly be possible to create conditions favourable enough to attract a substantial inflow of FDI. Most probably, FDI will remain restricted to those few branches which have proved attractive in many less developed countries – financial institutions, telecommunications, transport equipment, energy, wholesale and distribution chains.

In summary, the next couple of years will bring a marked improvement in economic fundamentals. A miracle in terms of GDP, income and employment growth is unlikely, given that no change is in sight in the way economic affairs are handled. As for GDP

development trends over the next few years, the forecasts vary and views are sharply divided as shown in Table 6:

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**Table 6: Forecasts: BiH real GDP growth rates 2000 to 2003**

	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>
IMF Press Release 22 Dec 2000	10.0	14.0		
IMF-WB base-case projection	15.0	14.0	10.0	6.0
PSD-TF <sup>1)</sup> Base scenario	6.1	4.5	3.2	2.3
PSD-TF liberalization scenario	7.6	5.8	4.3	3.4

*Note:* 1) Private Sector Development Task Force Secretariat.

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The WIIW forecast (see Appendix table) expects growth rates to range between 5% and 10%.



## APPENDIX

**Table A/1: Bosnia and Herzegovina: Selected economic indicators**

	1995	1996	1997	1998	1999	2000 <sup>1)</sup>	2001 forecast	2002 forecast
Population, th. pers., excl. refugees overseas (USAID)	3660	3646	3651	3700	3750	.	.	.
BiH Gross domestic product, BAM mn, nom. (IMF)	2873	4125	6116	7141	8043	8773	.	.
Federation BiH	1962	3049	4748	5407	5833	.	.	.
Republika Srpska	911	1076	1368	1734	2210	.	.	.
Annual change of BiH GDP, real, in % (IMF)	50	86	40	13	9	5	5	5
GDP/capita, BAM	785	1131	1675	1930	2145	.	.	.
Industrial production, real, % change (IMF)								
Federation BiH	.	88	36	24	11	8.8 <sup>2)</sup>	5	5
Republika Srpska	.	39	27	23	2	5.6 <sup>2)</sup>	3	3
Employment, th pers., end of period (NBBiH)								
Federation BiH	.	.	.	407.0	410.1	412 <sup>3)</sup>	.	.
Republika Srpska	.	.	.	244.3	244.3	228	.	.
Unemployment, th pers., end of period (NBBiH)								
Federation BiH	.	.	.	256.5	261.8	266	.	.
Republika Srpska	.	.	.	142.2	147.5	154	.	.
Unemployment rate in %, end of period (NBBiH)								
Federation BiH	.	.	.	38.6	39.0	39.4	41	43
Republika Srpska	.	.	.	36.8	37.6	40.1	42	45
Average net monthly wages, DEM (95-97), BAM (NBBiH)								
Federation BiH	43	168	266	357	386	413	.	.
Republika Srpska	21	50	90	237	272	277	.	.
Consumer prices (in BAM terms), % p.a. (IMF)								
Federation BiH	-4	-25	14	5	0	1.2 <sup>2)</sup>	1	1
Republika Srpska <sup>4)</sup>	13	17	-7	2	14	13.6 <sup>2)</sup>	5	3
Consolidated government, BAM [DEM] mn <sup>5)</sup> (IMF)								
Revenue (including grants)	1051	2173	2398	3148	3987	.	.	.
Expenditure	1060	2355	2429	3657	4568	.	.	.
Deficit (-) / surplus (+)	-9	-182	-31	-509	-581	.	.	.
Deficit (-) / surplus (+), % GDP	-0.3	-4.4	-0.5	-7.1	-7.2	.	.	.
Money supply, BAM mn, end of period (IMF)								
M0, Cash outside banks	.	.	113	162	515	546	.	.
% of GDP	.	.	1.8	2.3	6.4	6.2	.	.
M1, Money	.	.	252	310	1100	1295	.	.
% of GDP	.	.	4.1	4.3	13.7	14.8	.	.
M2, Broad money	.	.	1178	1547	2165	2322	.	.
% of GDP	.	.	19.3	21.7	26.9	26.5	.	.
Current account, USD mn <sup>6)</sup> (IMF)	-193	-1306	-1482	-986	-1058	.	.	.
% of GDP	-9.6	-47.6	-41.9	-24.3	-24.1	.	.	.
Gross reserves, USD mn <sup>7)</sup> (IMF)	213	235	80	175	455	.	.	.
Gross external debt, USD mn (IMF)	3361	3620	4076	2985	3095	.	.	.
Exports total, fob, USD mn <sup>8)</sup> (IMF)	152	336	575	697	649	.	.	.
annual change in %	67.0	121.1	71.1	21.2	-6.9	.	.	.
Imports total, fob, USD mn <sup>8)</sup> (IMF)	1082	1882	2333	2656	2502	.	.	.
annual change in %	21.0	73.9	24.0	13.8	-5.8	.	.	.
Trade balance, USD mn <sup>8)</sup>	-930	-1546	-1758	-1959	-1853	.	.	.
% of GDP	-46	-56	-50	-48	-42	.	.	.
Average exchange rate BAM/USD (NBBiH)	.	.	1.7301	1.7614	1.8343	2.074	.	.
Average exchange rate BAM/EUR [ECU]	.	.	1.9558	1.9558	1.9558	1.9558	1.9558	1.9558
Average exchange rate BAM/DEM <sup>8)</sup>	.	.	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000

Notes: 1) Preliminary. - 2) OHR Newsletter April 2001. - 3) A further 40,252 were on stand-by. - 4) Until mid-1998 prices were observed in YUD and converted into BAM using the YUD/DEM exchange rate in the parallel market in Belgrade (IMF). - 5) Excludes municipal government operations for RS. From 1996 on excluding military expenditures financed by external grants. - 6) Estimates. - 7) In 1995 gross international reserves, from 1996 on gross official reserve. - 8) In mid-1998 the konvertibilna marka (BAM) replaced the BH dinar, the currency used up until then in Bosniac-controlled areas. In the same way as the new currency, it was tied 1 to 1 to the German mark.

Source: National Bank of Bosnia and Herzegovina (NBBiH), IMF, USAID, OHR.

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