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Hungary and Bosnia and Herzegovina: A Success and a Failure of Transition

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SUMMARY

This paper sets out to compare some aspects of the transition packages in two seemingly incomparable countries, in search of similarities and dissimilarities, and hints as to where Bosnia and Herzegovina may have gone wrong. Particular attention is paid to the macroeconomics part of the transition package, together with assessment of privatization and the role of FDI. The institutional aspect of the transition, particularly in Bosnia and Herzegovina, is treated in the second part.

Hungary, seen here as a success story of transition, joined the EU on May 1, 2004. However, any similarity that Hungary's transition policy and measures appears to have to the Washington Consensus will not bear more than cursory scrutiny. Privatization was conducted under wise government policy. Foreign-trade policy and foreign-trade liberalization formed a gradual, well-executed process. Hungary used exchange-rate policy to support the competitiveness of domestic and transnational corporations on the world market. Wage and income policy were supportive to economic growth and driven by productivity considerations. Monetary policy was also designed to back economic growth and inflation was successfully brought under control. The necessary political consensus was present in Hungary and due attention was given to institution and capacity building. Thus Hungary's transition policy seems to have been more Keynesian than free-market driven

The transition package in Bosnia and Herzegovina is entirely free-market driven. The state has been excluded from the economy on ideological grounds, though a 'normally' organized state still has not arisen. Under such conditions, a full protectorate might have been more efficient. For Bosnia and Herzegovina is a semi-protectorate. The country is devoid of macroeconomic management except for the currency board. Voucher privatization has been performed along entity lines, according to ethnic considerations. The loss of large foreign markets was of great importance both to Hungary and to Bosnia and Herzegovina. Hungary lost the COMECON market, while Bosnia and Herzegovina lost that of former Yugoslavia. Still worse, Bosnia and Herzegovina lost its part in the division of labour within the Yugoslav market. Then came the 1992–5 war. Bosnia and Herzegovina's starting position for transition was incomparably more difficult and complicated than Hungary's. It called for a more cautious solution than the one offered by the international community, and a more supply side-oriented economic concept than Hungary's. Despite all that, Bosnia and Herzegovina has been practising the Washington Consensus in the fullest sense, which Hungary did not.

INTRODUCTION[*]

Hungary, which became a member of the EU in May 2004, 15 years after the fall of the Berlin wall, is usually regarded as one of the most successful transition economies. At first glance, it seems that the 'Washington Consensus' has been vindicated by Hungary's case. FDI, especially investment by transnationals, contributed to Hungary's success. The government wisely refrained from much interference in day-to-day business affairs, thereby creating a favourable business climate. M. Porter's diamond seems to have been the building block of Hungarian competitiveness, though the diamond is surmounted by transnational, not Hungarian corporations.

Bosnia and Herzegovina, however, is a theoretical case of failure in transition, despite 100 per cent acceptance of the 'Washington Consensus', whose free-market ideology (even theology) with a promising role for SMEs and privatization, coupled with an expected inflow of FDI, were to provide basis of transition success. Unfortunately, in Bosnia and Herzegovina transition turned out to be more of a failure than a success. It was faced with a 40 per cent unemployment rate in mid-2004, according to official statistics. A resolution recently adopted by Parliament sets its sights on achieving 70 per cent of the GDP for Bosnia and Herzegovina in 1991. Some 50–60 per cent of students and young people say they want to leave Bosnia and Herzegovina for good.

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This paper sets out to compare some aspects of the transition packages in two seemingly incomparable countries, in search of similarities and dissimilarities, and hints as to where Bosnia and Herzegovina may have gone wrong. Particular attention is paid to the macroeconomics part of the transition package, together with assessment of privatization and the role of FDI. The institutional aspect of the transition, particularly in Bosnia and Herzegovina, is treated in the second part.

Hungary's future is well known, but that of Bosnia and Herzegovina is less easy to predict, economically or politically. The paper attempts to tackle the issue of the country's past and future in a seemingly unique way.

1) SOME ASPECTS OF HUNGARY'S TRANSITION[1]

Hungary's economic performance improved dramatically in the second half of the 1990s after strong stabilization measures and deep structural reforms. During this period, it was able to switch from economic stagnation to strong growth, while dramatically improving its external accounts. Hungary today is regarded as a top performer among the transition countries. It became a full member of the European Union on May 1, 2004.

The challenge now is to consolidate its stabilization gains and finalize its structural reforms, to make the recovery sustainable in the longer term. These objectives are well within the focus of Hungary's policymakers. In the macroeconomic field, they need to ensure that the investment expansion, which has been driving the economic recovery and build-

[1] This part of the paper is based on World Bank (1999).

ing up future potential, is not interrupted by re-emergence of external imbalances, due to a less favourable environment or excessive government and private consumption.

1.1. Stabilization and recovery in the later 1990s

Hungary, like all Eastern European transition economies, experienced deep recession early in its transition – a 20 per cent drop in GDP between 1990 and 1993 – due primarily to a collapse of its COMECON exports resulting, among other things, from price and trade liberalization and subsidy reductions. Like most other countries affected, Hungary began to pull out of the recession in 1993–4,[2] but while the others managed to consolidate their recovery in subsequent years, Hungary experienced a sharp slowdown in economic activity. In mid-decade, in 1995 and 1996, Hungary appeared to have the poorest macroeconomic performance of any Central and Eastern European (CEE) country, marked by the highest inflation rates and the lowest rates of growth in output.

The recovery in Hungary's output was delayed by the emergence of extremely severe external imbalances, exemplified by current-account deficits of almost 10 per cent of GDP in 1993 and 1994 and a marked increase in foreign debt. These were caused primarily by fiscal imbalances of the same order of magnitude *(Table 1)*, although real appreciation of the forint and other factors also contributed. The country suffered a sharp loss in creditworthiness, caused also by the perception that privatization and other important structural reforms had stalled. By early 1995, Hungary was paying very high spreads on its external borrowing (over 500 basis points above LIBOR).

Table 1
Inflation and growth in selected CEE countries, 1993–1999

	1993	1994	1995	1996	1997	1998	1999
Inflation (average CPI, per cent per annum)							
Hungary	22.5	18.8	28.2	23.6	18.3	14.3	9.0
Czech Republic	20.8	10.1	9.1	8.8	8.5	10.7	2.2
Poland	35.3	32.2	27.8	19.9	14.8	11.8	6.8
Slovakia	23.2	13.4	9.9	5.8	6.2	6.7	11.5
Slovenia	32.9	21.0	13.5	9.9	8.4	7.9	8.0
Real GDP growth (per cent per annum)							
Hungary	-0.6	2.9	1.5	1.3	4.6	5.1	4.0
Czech Republic	0.6	2.7	6.4	3.9	1.0	-2.7	-1.0
Poland	3.8	5.2	7.0	6.1	6.9	4.8	4.0
Slovakia	-3.7	4.9	6.9	6.6	6.5	4.4	1.5
Slovenia	2.8	5.3	4.1	3.1	3.8	3.9	3.8

1.2. Stabilization and acceleration of structural reforms in mid-decade

Faced with the prospect of a balance-of-payments crisis, the government introduced in March 1995 a drastic stabilization programme that also accelerating the structural reforms initiated in the early 1990s. The programme included sharp fiscal adjustment: 9 per cent devaluation of the forint followed by pre-announced crawling peg and very rigid wage policy. The extent of the fiscal support is shown by the sharp decline in the general deficit – from 8.4 per cent of GDP in 1994 to 3 per cent in 1996 (excluding privatization revenues). This was made possible by an impressive reduction in fiscal expenditures – by 10 per cent of GDP in the same period *(Table 2)*.

[2] *Ibid.*, p. 20.

Table 2
Selected economic indicators for Hungary, 1993–1998

	1993	1994	1995	1996	1997	1998
Real sector: % change						
Real GDP	-0.6	2.9	1.5	1.3	4.6	5.1
Exports of goods/services (real)	-10.1	13.7	13.4	7.4	26.4	16.3
Imports of goods/services (real)	20.2	8.8	-0.7	5.7	25.5	22.5
Fixed investment (real)	2.0	12.5	-4.3	6.7	9.2	11.4
Private consumption (real)	1.9	-0.2	-7.1	-2.7	1.7	3.8
Average CPI	22.5	18.8	28.2	23.6	18.3	14.3
Gross wage growth (real)	-0.5	5.1	-8.9	-2.6	3.4	4.4
Real effective exchange rate(unit labour cost)	4.3	7.3	19.4	8.6	2.7	8.5
Unemployment rate (end period)	12.6	10.9	10.9	10.7	10.4	9.1
Real sector: % of GDP						
Exports of goods and services	26.4	28.9	37.3	38.9	45.5	49.8
Imports of goods and services	34.6	35.4	38.5	39.9	46.0	52.3
Fixed investment	18.9	20.1	20.0	21.4	22.1	23.2
General government						
Overall balance (excl. privatization)	-6.6	-8.4	-6.4	-3.0	-4.8	-4.7
Overall balance (incl. privatization)	-6.0	-7.5	-3.2	0.8	-1.8	-4.4
Primary balance (excl. privatization)	-2.7	-2.2	2.2	3.7	2.7	1.6
Expenditures	60.8	60.4	54.3	49.0	49.2	47.1
Public debt	90.4	88.2	86.4	72.8	63.9	60.2
External accounts						
Trade balance	-8.4	-8.8	-5.5	-5.9	-3.8	-4.4
Current-account balance	-9.0	-9.5	-5.3	-3.7	-2.1	-4.8
Foreign direct investment	6.0	2.8	10.0	4.4	3.6	3.0
Gross external debt	63.7	68.4	70.9	61.0	51.9	56.3
Net external debt	38.7	45.4	36.6	31.4	24.4	26.0

1.3. Sustainable growth

Fiscal management has remained prudent in recent years. While there was some loosening of fiscal policy in 1997 and 1998, as indicated by a decline in the primary surplus and an increase in the overall deficit, this was less than it might appear. The worsening of fiscal indicators reflects in part absorption of the quasi-fiscal deficit of the National Bank of Hungary – this central-bank deficit had existed without being explicitly computed – and revenue losses from pension reform, which were neutral in terms of national savings.

The 9 per cent devaluation of the forint provided an initial gain in competitiveness, although it contributed to a temporary increase in inflation. The initial devaluation was followed, however, by pre-announced, declining monthly devaluations of the forint *vis-à-vis* a currency basket, which placed inflation firmly on a downward path. Finally, the use of wage policy as an instrument of stabilization appears in a sharp decline in real gross wages in 1995 and 1996 by 9 and 3 per cent, respectively. The low increase in nominal wages provided a second nominal anchor and improved corporate profitability and competitiveness, creating conditions for subsequent expansion of investment and exports.

The stabilization package of March 1995 was accompanied by an impressive acceleration in structural reforms. Over the 1995–8 period, Hungary implemented a comprehensive programme of corporate and banking reforms that included privatizing major utilities and restructuring and privatization of all the major banks. Hungary was also the first CEE country to implement a systematic pension reform, involving reforms to the public pay-as-you-go scheme and the introduction of a fully funded private pillar. These and other reforms restored the country's image as a pioneer in structural reforms among the transition countries, generating a surge in the volume of FDI and heightening the prospects for major efficiency gains.

1.4. Impressive performance in the second half of the 1990s

The programme of stabilization and structural reforms initiated in 1995 had impressive results. As *Table 2* shows, the combination of the pre-announced, declining crawling peg, restrictive wage policy and tighter fiscal policies brought a steady fall in inflation to 10–11 per cent by 1999. Although the decelerating devaluations of the nominal exchange rate led to some appreciation in the real exchange rate, this was relatively moderate in terms of relative consumer and producer price indices. However, the real exchange rate, measured in relative real unit labour cost, depreciated further in the second half of the 1990s, as increases in labour productivity were overtaken by increases in real wages.

The fiscal adjustment and restrictive wage policy caused the GDP growth rate to falter in 1995–6, so that Hungary grew much less than its neighbours did. However, growth accelerated again in 1997, driven by strong increases in exports and fixed investment. The output recovery, unlike that of the early 1990s, was accompanied by improvement in the external accounts. There was a sharp decline in the current-account deficit (from 9 to 2 per cent of GDP in 1994–7) and a decline in Hungary's net foreign debt (from 45 per cent of GDP in 1994 to 25 per cent in 1998).

The decline in Hungary's indebtedness resulted mainly from the decline in the current-account deficit, but also from the large FDI inflows in the second half of the decade. These were actually larger than the current-account deficits for three consecutive years (1995–7), and involved both greenfield of some 2–3 per cent of GDP per annum, and large privatization transactions *(Figure 2)*. The accumulated stock of FDI amounted to US$ 16 billion in late 1998 – the equivalent of a third of GDP, the highest proportion in the region. This contributed to a sharp drop in external indebtedness and to greater penetration of foreign markets and consequent export growth.

Hungary entered 1998 with a much healthier economy and seemed finally to be meeting the conditions for sustained growth. The recovery was being driven by exports and investment and underpinned by important structural reforms. The growth of real wages and pensions caused a recovery of private consumption after two years' decline, but the growth of real wages was kept below productivity growth and the increase in private consumption did not outpace the growth of GDP. Although the fiscal situation in 1998 still needed careful monitoring, it did not seem to cause any strong crowding out of private investment. On the contrary, the fiscal deficit did not seem to be pressing the real exchange rate or causing problems for export performance, as indicated by a reduction in relative, real unit labour costs. Public debt had fallen drastically (from 90 to 60 per cent of GDP), thanks to smaller deficits and large privatization revenues. The share of the private sector in domestic credit was increasing steadily, and nominal and real lending rates had fallen. Altogether there seemed to be ample room for further expansion in output without excessive pressure on the current account.

1.5. Trade and current-account developments in 1998

After three years of steady decline, the current-account deficit more than doubled between 1997 and 1998 (from 2.1 to 4.8 per cent of GDP). The increase in the trade account deficit amounted to 0.6 per cent of GDP, or only one fourth of the total increase in the current defi-

cit. More important were the decrease in the surplus of services (1.1 per cent of GDP) and the increase in the deficit of income (1.1 per cent of GDP), the latter largely the result of a nearly US$ 500 million increase in net profit remittances. The increase in the current-account deficit and the decline in the flow of FDI (to a level insufficient to cover the current-account deficit) resulted in an increase in gross and net external debts, and as a share of GDP - after three consecutive years of decline.

To some extent, it is not surprising that export growth should have slowed down from its torrid pace in 1997 (about 30 per cent in volume growth), since this unusually fast rate resulted from substantial greenfield FDI coming on stream after being initiated earlier in the decade. Since many exports rely on imported intermediate and investment goods, import growth also accelerated in 1997 and slowed in 1998, although the continuing expansion of fixed investment and renewed growth of private consumption also affected imports and the trade account. Overall, the increase in the trade deficit in 1998 does not seem to have been a major cause for concern.

By contrast, the increase in remitted profits was so abrupt and of such magnitude that it merits further analysis. As shown in *Figure 2*, the shift in the current account preceded the shift in the trade account, and became yet more pronounced at the end of the year. (Both series are constructed on a 12-month rolling basis.) This outcome was due in large part to very large profit remittances in June and December by a few large companies. Although profit remittances tend to peak in those two months, especially December, the unusual size of the transfers drove the ratio of remitted profits to lagged stock of FDI from 2 per cent (the average for 1993–7) to 6 per cent at the end of 1998.

1.6. EU membership and income convergence

Hungary presented its membership application to the EU in April 1994. Hungary and the then European Communities (EC) had already signed an association compact (Europe Agreement) in 1991, which became effective as the legal basis for Hungary–EU relations in 1994. Its aim was to provide a framework for political dialogue, technical and financial assistance for Hungary's integration into the EU, and expansion of trade and economic relations between the parties.

The growth effects of economic integration with the EU was apparent to Hungary in the experiences of Ireland, Greece, Portugal and Spain *(Table 3)*.

Table 3
Per capita GDP of EC entrants, 1960–98, with date of accession

Country (accession)	GDP per capita at PPP (EU average = 100)							
	1960	1973	1981	1986	1990	1995	1998	Index 1998
Ireland (1973)	61	59	65	64	74	96	108	184.4
Greece (1981)	44	71	69	63	58	66	68	98.8
Portugal (1986)	40	58	56	44	61	71	72	132.9
Spain (1986)	57	75	70	70	77	79	81	115.9

Ireland's income per capita started converging slowly with those of other EU countries soon after accession, but accelerated in the mid-1990s, 20 years after entry. Spain and Portugal showed a steady pattern of convergence, although Portugal converged faster, in part because it started from a lower initial base. Greece's income gap with the EU countries actually widened after entry. Although it started catching up in the 1990s, its relative position has not im-

proved since its date of accession. Except for Greece, these countries experienced investment booms after accession, driven primarily by reduced political risk, restructuring of capital stock in response to new trade and production patterns, and introduction of new technologies, accompanied by increased FDI. The opening of the capital account also played an important role, so that entry was generally accompanied by an increase in capital inflows.

Hungary approached EU accession with a per capita income about 49 per cent of the EU average at purchasing power parity (PPP). Hungary had the lowest fertility rate of all acceding countries and one of the highest education standards. The ratio of fixed investment to GDP in 1998 was 23.2 per cent, which was lower than the average for middle-income countries (25 per cent in 1997), and for all acceding countries except Poland. Finally, the quality of the policy framework, while below the average for the EU 13, was adequate to support integration and growth. *Table 4* shows that if these conditions were maintained, Hungary would have an average annual growth rate almost 1.5 per cent above the EU average. This being so, it would need 24 years to converge to 75 per cent and 57 years to converge to 100 per cent of the average EU income level.

Table 4
Years required for Hungary to catch up with the EU income average

Convergence to:	I/GDP=23.5%	I/GDP=28%	I/GDP=28%
75% of EU 15 average	24	19	12
100% of EU 15 average	57	41	22

However, if levels of fixed investment were permanently raised to 28 per cent of GDP (the government's medium-term target), Hungary could grow at a rate about 2.2 percentage points per annum above the EU average. *I.e.*, an increase in fixed investment of roughly 5 per cent of GDP would bring an annual growth increment of about 0.7 per cent of GDP. This may not seem striking, but it would reduce the period of full convergence to 41 years. Increasing the investment ratio *and* improving the quality of the policy framework to EU levels would increase the average annual growth rate to 3.7 percentage points above the EU average, dramatically reducing the convergence period to 22 years.

1.7. Foreign trade and competitiveness

Achieving sustainable, rapid growth before and since EU accession has required a strong export performance. This, in turn, hinges critically on the ability of Hungarian firms to compete in a single European market.

The challenge of readjusting trade patterns in the early 1990s proved formidable. The competitiveness of Hungarian exports to Western markets had been declining for two decades. Many Hungarian firms had confined themselves to 'soft', COMECON markets devoid of competition and dominated by products of poorer quality. Furthermore, the shift to convertible currencies in COMECON trade, combined with rapidly falling import demand in the Soviet Union, caused significant deterioration in Hungary's terms of trade, especially with the Soviet Union.

Hungary successfully met these challenges. After a 5 per cent drop in total exports in 1991 and a further 13 per cent drop in 1993, Hungary increased its export volume by 17 per cent in 1994, to a level exceeding that

of 1989. Thereafter, exports continued to increase rapidly, with the share sold to developed countries reaching about 70 per cent. Changes on the import side were even more pronounced, so that the process of geographical reorientation to market-driven patterns of foreign trade was quickly achieved.

The proximity of the EU countries and their high GDP quickly made them Hungary's biggest trading partners. The 15 EU countries accounted for 34 per cent of Hungary's total exports in 1989, but 50 per cent in 1991. After the trade terms of the Europe Agreement came into force in 1992, the share rose to more than 70 per cent in 1997, representing a massive reorientation of Hungary' s exports to EU markets.

The scope and depth of a country's integration into EU goods markets offer important insights into the ability of firms to compete in a single market. With the EU share in its trade turnover amounting to some two-thirds, Hungary is actually more integrated than several of the EU 15, where the average proportion of intra-EU trade was 61 per cent in 1990-96. This integration of Hungary's took place as competition from imports from EU suppliers became more intense. After 1995, tariffs on industrial products were slashed by 15 per cent a year, to reach zero in 2001. It appears that Hungarian firms have been quite successful so far in a more competitive environment.

Two phases in Hungary's exports to the EU can be distinguished: 1989–92 and 1994–7. In the first phase, the expansion of exports to the EU, triggered by the collapse of former COMECON markets and liberalization of imports and the exchange-rate regime, was driven mainly by redirection of manufactures to Western markets. Value increased by 76 per cent between 1989 and 1992. This expansion lost steam in 1993, when the value of exports to the EU fell by 12 per cent.

The expansion of Hungary's commercial ties with the EU had a discernible impact on the composition of its exports, whose expansion was driven mainly by manufactures. The share of manufactures in Hungarian exports to the EU rose from 55 per cent in 1989 to 85 per cent in 1997. The driving force here has come from machinery and transport equipment: 47 per cent by 1997 and growth of 444 per cent over the 1992–7 period.

Secondly, contrary to widespread perceptions, there was no collapse of agricultural exports. Although the share of agricultural products in the export total fell from 31 per cent in 1989 to 10 per cent in 1997, Hungary's share of EU external imports of these products fell by only 0.08 percentage points in 1989–97.

The opening of an economy, with increasing globalization of production triggered by reduced costs of transportation and information, usually leads to greater specialization and improved competitiveness. Because of the changed institutional environment and a favourable climate for foreign investment in Hungary, the capacity of its firms to compete internationally significantly improved, outperforming suppliers from many other countries. The share of Hungarian-made production in EU external imports (excluding intra-EU trade) increased each year between 1989 and 1997 except in 1993.

Hungary's export structure has been shifting towards capital and technology-intensive products and becoming higher value-added in terms of processing. According to classifications of 48 commodities developed by the World Bank for analysing different levels of processing, the share of primary and intermediate-stage products in 48 commodity chains has been declining since 1989, while the share of final-stage products has significantly increased. This shift toward final-stage products also

showed in shares of EU external imports. Taking the averages for 1989–92 and 1994–7, final-stage products were the only group to increase presence on EU markets. In fact, the share of final-stage products in EU imports increased remarkably, by over 30 per cent between 1989 and 1997.

The Hungarian export basket has moved visibly towards higher processing value-added. An increasing portion is processed domestically. As costs are internationally competitive, there is nothing wrong in exporting primary commodities, but the movement up the processing chain signifies a more sophisticated and mature industrial structure.

The Hungarian experience since 1990 provides strong evidence of the advantages of opening to foreign capital. Dramatic shifts in the composition of exports and Hungary's successful reintegration into international markets demonstrate how investment by transnationals, and to a lesser extent, outward processing have led to rapid modernization and readjustment of industrial capacities.

Although Hungary's is a relatively small transition economy, it was the largest recipient of FDI until 1994, when it was surpassed by Poland. Hungary regained top place in 1995 through privatization deals and came third after Poland and Russia in 1996–7. In the 1990–96 period overall, Hungary and Poland received between them over half the cumulative FDI flows into the region. In terms of annual flows relative to GDP and in FDI per capita, Hungary was the top recipient throughout the 1990–97 period.

Foreign firms have played a dominant role in industrial restructuring. They are much more foreign-trade oriented than domestic firms are, so making a relatively larger contribution to Hungary's reintegration into the world economy. Although firms with foreign capital generated 47 per cent of total net sales and provided 29 per cent of total employment in 1996, their shares of exports and imports were 60 and 64 per cent, respectively. These shares increased in 1997 to 73 per cent of exports and 72 per cent of imports.

An important feature of FDI in Hungary is its scope in terms of sectors covered and actual number of foreign-owned firms. Although manufacturing received the largest FDI inflows (US$ 4.2 billion) in 1992–6 and accounted for 40 per cent of the foreign investment stock in 1996, other sectors of the economy, such as public utilities and energy (the 'big' privatization of 1996) attracted US$ 1.5 billion. Since foreign firms account for almost three-quarters of Hungary's foreign turnover and that this share bas been rapidly increasing, they are largely responsible for the spectacular improvement in Hungary's export performance on EU markets. Successful development of a number of product groups can be traced to product activities by transnationals, including automotive parts (VW and Audi car engines accounted for 9 per cent of all Hungary's exports to the EU in 1996) and electronics. There is abundant evidence of rapid progress in incorporating manufacturing capacity located in Hungary into global production networks, usually by large transnationals. None of the medium-sized and large firms in the country are wholly owned by Hungarian shareholders and the top 100 Hungarian firms include several easily recognizable subsidiaries. Estimates of intra-industry trade suggest that the number of such companies in Hungary is higher than it is in some EU 15 members (*e.g.* Finland, Greece or Portugal).

The experience with FDI in Hungary allays fears that preferential trading arrangements with a highly developed EU may lead to a wholesale flight of domestic industry.

1.8. Foreign trade policies: gradual and uneven liberalization

The state foreign-trade monopoly, central allocation of convertible currency and the requirement to surrender hard-currency earnings left little room for trade liberalization under central planning up to 1987–8. But in contrast to Poland's stabilization transformation programme, Hungary's liberalization of foreign trade and exchange rates was achieved gradually, in 20–25 per cent increments over a four-year period, beginning with the liberalization of capital-goods imports in 1989. As central controls were eroded, so the process began to accelerate. Rationing of imports of intermediate goods was abandoned in 1990, as were quotas on a number of consumer goods, albeit perhaps somewhat reluctantly and incompletely.

The change in market access was enormous. Not a single sector had been open in 1987 to competition from imports (or for that matter, any competition at all), whereas by 1990, about 70 per cent of domestic production faced external competition.

Another powerful force for liberalizing the foreign trade regime came from preferential trade agreements, especially the Europe Agreement and Central European Free Trade Agreements (CEFTA), which envisaged free trade in industrial products among Hungary, Poland, the Czech Republic, Slovakia and Slovenia. By the early 2000s, the EU was the source of almost 74 per cent of Hungary's imports of manufactures. Including those from the CEFTA and EFTA countries, well over 80 per cent of imports were tariff free.

The importance of the December 1991 Europe Agreement was that it was made with Hungary's largest natural trading partner. The interim trade agreement that went into effect in March 1992 eliminated duties on about a third of all industrial products imported from the EU – mainly those required by domestic industry. Beginning in 1995, Hungary's tariff concessions for industrial products went into effect, so that rates on EU industrial imports were slashed by 15 per cent a year until 2001, when, with some minor exceptions, they were eliminated for all industrial products.

Hungary's foreign trade policy raises a question about its links with export performance. Empirical research strongly suggests that all development success stories over the past two decades have been based on a strong export orientation, combined with low or falling barriers to imports. Yet Hungary recorded its largest export expansion during a temporary reversal of foreign-trade liberalization after the 1995 stabilization programme. Furthermore, it began a year before the 9 per cent devaluation of the forint. The conclusion must be drawn that Hungary is an exception to the general rule.

One explanatory factor is that Hungary was attracting foreign investors by keeping them immune from the vagaries of its foreign-trade policies. A duty waiver mechanism allowed exporters to disregard tariff rates on imports of inputs for exports; other provisions maintained duty exemptions on imports of capital equipment. An investor wanting to avoid burdensome customs procedures could establish a *de jure* free-trade zone outside Hungary's customs territory. Many used the device. The proportion of total exports made by firms constituting free-trade zones rose from 11 per cent in 1995 to 19 per cent in 1996 and to 26 per cent in 1997. Together with outward processing, the share of exports generated from such sources came to 47 per cent of total exports. This liberal approach to foreign firms made a significant contribution to export expansion.

On the other hand, the foreign trade measures in the 1995 stabilization package seem to have had damaged the export response of small and medium-sized enterprises (SMEs). Import users in such firms incurred losses by paying more for imports. Although the draw-back mechanism allows them to recoup extra taxes on imports, this mechanism was costly to use and created a considerable administrative burden in terms of processing information for customs. The transaction costs may have been too high to warrant the extra effort involved in getting a refund on the exported portion of imports, so that the arrangements seemed unattractive to SMEs.

Tariff rates on industrial products were still much higher in Hungary than in the EU. To ease adjustment to future membership and improve growth performance during the pre-accession stage, Hungary had to consider adopting the EU (preferably post-Uruguay Round) MFN tariff schedule for industrial products. As a result, the average (simple) MFN tariff rate on industrial products fell from about 8 to about 4 per cent.

This measure had several advantages. It would level the playing field for MFN suppliers to both Hungarian and EU markets. It was simple and easy to implement. There was little, if any, domestic opposition from sectors competing with imports, which already faced formidable EU competitors. The measure could also counteract the threat of FDI falling off as the advantages of free-trade zones were eroded. Finally, it required no formal notification to the WTO of a change in statutory rates: Hungary could simply lower rates to match those of the EU without changing statutory and binding rates.

1.9. The corporate sector in transition

Capitalism was not wholeheartedly embraced in Hungary when communism collapsed. Economists and the public alike distrusted privatization after experience of self-serving and asset stripping in the late 1980s. Moreover, earlier debates about how to make central planning work better had heightened awareness of alternative structures of ownership and governance. So while the government was not averse to privatization as such, most economists argued that passive, dispersed private owners would oversee managers no more effectively than the state had. So the government sought from the outset to recruit responsible owners for firms, eschewing vouchers and other mass privatization techniques. Sales of controlling stakes to insiders was also rare: although managers and employees could buy shares at a 5–10 per cent discount, there were fewer than 100 cases where they bought a majority stake. Selling such a stake to foreigners was the logical alternative to selling to insiders or to mass privatization.

Table 5
Ownership of manufacturing firms,
% of registered capital

Types of ownership	1992	1993	1994	1995	1996
State	55.2	39.2	29.3	19.9	14.4
Municipal	8.8	1.6	1.6	1.0	0.9
Individual private		8.8	9.4	10.1	9.5
Domestic corporate	0.1	15.0	17.9	18.2	19.4
Employee	20.5	1.0	1.5	1.4	1.2
Foreign	3.6	30.9	37.1	46.7	51.1
Cooperative		2.6	1.9	1.4	1.2
Other		0.9	1.3	1.3	2.3

Table 5 shows the evolving ownership of manufacturing firms in recent years. The state divested its assets in fits and starts. Several hundred state firms were turned over to the municipalities.

When the State Property Agency (ÁVU) was formed in March 1990, it took control of 1,857 state-owned enterprises (1,700 industrial, the rest agricultural). These state enterprises were converted into company forms for eventual privatization.

Firms were sold mainly for cash through auctions and tenders, although about 7 per cent of state assets were sold for compensation certificates distributed to victims of the fascist and communist regimes. Municipalities, having accepted these certificates as payment when apartments were privatized to tenants, either sold these certificates on the secondary market for cash or used them to buy shares.

Although the ÁVU had divested about 75 per cent of its initial holdings by mid-1995, this amounted to only 35 per cent of the state' s stake, as the State Property PLC (ÁVRt) held the biggest firms: power, gas, airlines, railways (a huge loss-maker), telecommunications, banking and some chemical firms. Privatization received its final and much needed boost in 1995 when the government, supported by the central bank, drastically reduced the list of firms it would continue to own (to the railways, postal services and national parks), as part of the stabilization package. As part of this effort, the APVRt (successor to the AVRt) was merged with the AVU and given a clear mandate to sell some HUF 1.3 trillion of equity, out of the HUF 1.6 trillion it held. Again as part of this effort, the Privatization Act was amended in June 1997 to allow the sale of all but 'golden shares' in 18 firms previously considered strategic, including the savings bank (OTP) and the telecommunications company (MATÁV). Majority and minority holdings in 116 firms and golden shares in 27 others would remain in state hands. By the end of 1997, HUF 790 billion of equity had been sold, in addition to what had been transferred to the social security funds and the municipalities.

To contribute to the restructuring needs of the newly privatized firms, they were given 20 per cent of the privatization receipts as a grant. The remaining proceeds, net of the privatization agency' s direct sales expenses (about 5 per cent of revenues), went into the government budget

The meagre privatization revenues of the early 1990s were little temptation to profligacy, but the 1995 decision to privatize almost all remaining state-owned firms triggered a heated debate over how to spend the proceeds. The government decided it would be imprudent to spend non-recurring privatization receipts on recurring expenditures and transfers, especially as the stabilization package was seeking to keep the budget deficit sustainable. So the bulk of the annual receipts were used to reduce outstanding public debt (in domestic and foreign currency). This cut government indebtedness from 86 per cent of GDP in 1995 to 60 per cent in 1998. Privatization receipts clearly played a major role in this, although economic growth since 1995 also contributed.

1.10. The role of FDI

Hungary had attracted some US$ 16 billion in FDI by 1997 and the average annual increment of more than 5 per cent of GDP between 1991 and 1997 was exceptionally high. About a third of this flow went to wholly foreign-owned firms and the rest to joint ventures and partly foreign-owned firms.

Germany was the biggest source for FDI through privatization (about 35 per cent), followed by the United States (20 per cent) and France (12 per cent). New foreign investment legislation in 1998 allowed foreigners the same protection as domestic firms and abolished the distinction between affiliates and branches of foreign companies. Hungary

now has about 30,000 firms in which there is foreign participation, of which about a third – mainly larger ones – are wholly foreign owned. The proportion of wholly foreign-owned firms is likely to rise, as they were accounting for almost two-thirds of new incorporations in 1997. This suggests a shift from arm's-length Hungarian subsidiaries towards well-integrated transnational operations. FDI was most widespread in manufacturing (particularly food processing and mechanical engineering, where over half the assets were in firms with some FDI by the end of 1996, up from a fifth in 1992. In manufacturing, wholly (91 to 100 per cent) foreign-owned FDI firms tripled to reach 1857 in 1996, accounting for 70 per cent of foreign-owned assets.

Most firms in export promotion zones (over three quarters of whose exports were electronic items) had at least a proportion of foreign ownership. Although firms with FDI were scattered, they tended to be concentrated in the western half of the country, perhaps because of transport and infrastructure advantages. Firms with FDI were more trade-oriented, exporting almost half their sales, as opposed to a fifth by non-FDI firms. (These proportions are deceptive, however, because exports of the latter often appear as domestic sales to exporting firms.) The findings should not be surprising: foreign investors rarely set up ventures in small, non-traded activities. So firms with FDI are generally export (and import) intensive and often fund suppliers facing liquidity or investment constraints. FDI firms also tend to be less labour intensive than domestic firms are, although the difference may be smaller than the data suggest. Domestic firms may underreport the workers on their payroll, due to a legacy of incorporated work units and a temptation to evade high payroll tax and contribution rates. Despite the concentration of firms with FDI in Western Hungary and Budapest, the benefits were widely dispersed throughout the country.

2) Bosnia and Herzegovina: a continuing economic and political experiment

Eight years after the transition process began, the expected 'blooming landscape' seems more like a mirage for Bosnia and Herzegovina. Economic development has hardly started. The economy is unsustainable and the 'development diamond' out of reach of the country's citizens. Sixty per cent of young people surveyed said they would prefer to leave the country.

2.1. The economy before 1991

Bosnia and Herzegovina is about one-and-a-quarter times the size of Switzerland and almost as mountainous – four-fifths of the territory. About 60 per cent is above 500 metres, and some 45 per cent forested. Only a small fraction of the farmland is of a quality suited to modern agricultural techniques. The climate is Continental Mediterranean, suited to cereal production. The two main rivers have major hydroelectric potential. Between the Second World War and 1991, when Bosnia and Herzegovina was one of six federal republics of former Yugoslavia, it achieved significant economic development. Economic growth averaged 5 per cent a year. Per capita income in 1991 was US$ 2400, excluding the service sector (as was the accounting practice in socialist economies).

Twelve big firms produced 35 per cent of the GDP, four generating over 40 per cent of the republic's exports. Firms were organized as self-managed

companies of associated labour in a self-managed market economy, seen as half-way between central planning and a modern market economy. Bosnia's main trade partners in 1990–91 were the Soviet Union, Germany and Italy; its trade with the EC countries in 1991 was in a surplus. The main export sectors were chemicals, ferrous metallurgy, metal processing, leather footwear, electrical appliances, finished wood, timber and panels, and finished textiles.[3]

A brief account of the period can be presented in tabular form, which recommends itself due to the role of 'path-dependence' approach taken in discussing and creating the first best or second best solution for Bosnia and Herzegovina's future.

Table 6
Pre-war position of Bosnia and Herzegovina

Political setting	Republic of Socialist Federal Republic of Yugoslavia.
Political system	Self-managed socialism.
Economic system	Self-management.
Living standards	Well-balanced income distribution (half Switzerland's at PPP).[4]
Social security	Full coverage.
Political democracy	Second to the OECD.[5]
Economic democracy	Highest level.[6]
Ethnic configuration	Multi-ethnic republic ('leopard skin').

[3] Poeschl (1999).

[4] Meier (1995), p. 15.

[5] Vanek (1991).

[6] *Ibid.*

2.2. Post-war Bosnia and Herzegovina

As former Yugoslavia dissolved in 1991–2, Slovenia and Croatia declared independence and Bosnia and Herzegovina followed suit. The war in Bosnia began in April 1992, in the same month that the EU and United States recognized Bosnia as an independent state and a month before its admission to the United Nations.

Pre-war Bosnia had almost 4.4 million inhabitants, as opposed to a present estimated population of 3.8 million. By the end of the war in December 1995 and during its aftermath, 1.5 million people fled the country as refugees, of whom 600,000 still live in temporary locations abroad, while an estimated 700,000 or more are registered residents abroad. Other refugees have returned, often involuntarily, most to places dominated by their own ethnic group, not to their former domicile. Some highly qualified people arranged their own emigration during and after the war, often not being classed as refugees at all. Inside the country, the war displaced large numbers of people. These peaked at 1.3 million in 1995 and were down to 800,000 by the end of 1998. Those internally displaced generally suffered more than those who fled the country did.

About 60 per cent of the population in 1998 lived in poverty, defined as earnings permitting a family of four to purchase less than two-thirds of a defined consumer basket of basic needs. About a quarter of the people in poverty in the (Bosniac-Croat) Federation of Bosnia and Herzegovina were employed. Average net salaries in the commercial sector could buy only about 68 per cent of the consumer basket and those in the non-commercial sector about 87 per

cent. Only employees in financial institutions and public administration earned enough to be on or just above that poverty line. The pension and the unemployment compensation systems are in deficit, paying out late and below the minimum. Average daily income for impoverished persons was so low that they had to survive on financial support from relatives in the country, relatives and friends living abroad, international humanitarian assistance, and activities in the shadow or informal economy.

Official statistics record quite impressive GDP growth rates: 21 per cent in 1995, 69 per cent in 1996, 30 per cent in 1997 and 18 per cent in 1998. But GDP had fallen to such a low level during the war that the increases achieved afterwards were relatively disappointing. The country still produces far less than it did before the war. Many production facilities have yet to be repaired or replaced or are under-utilized. Employment is correspondingly low. Recent GDP growth has been predominantly aid-driven, as reflected in the balance of payments. The current-account deficit in 1996 amounted to almost half the nominal GDP, declining to about one-fifth in the first half of 1999 in the Federation. Only about 25 per cent of imports were met by exports in the first five months of 1999 in both the Federation and the (Bosnian Serb-led) Republika Srpska.

When considering the development strategy and its effects so far, one has to consider several external and internal factors of an economic and political nature. Two determining external factors globalization of the world economy with the Washington consensus, which provides the basis for discussing transition countries and their transformation into 'small open economies', and the 1995 Dayton Peace Accord. Signed on December 14, 1995 in Paris, the accord ended military hostilities in Bosnia and Herzegovina and fixed its external borders. The Bosniac, Croat and Serb parties agreed on an independent state, with Sarajevo as its capital. NATO forces were to implement the accord for a limited period, followed by international bodies (OSCE, OHR and UN). The accord outlines the constitution of the state, which provides for full freedom of movement of persons, goods, services and capital. The two internal entities established were the Federation, with 51 per cent of the territory, and Republika Srpska with 49 per cent. The Federation has 10 cantons.

While Dayton placed banking and customs regulation on the central state level, fiscal policy was transferred to the entities and cantons. No instruments were provided for countrywide macroeconomic policy. This hampered the central state when formulating a strategy for economic development, including industrial policy. In practice, Bosnia and Herzegovina lacks the powers to formulate and pursue independent monetary, fiscal, price and foreign-exchange policies, and policies on privatization, incomes, and social welfare. Industrial policy-making is effectively impossible under the rules of Washington consensus applied to the country by the international financial institutions.

Development prospects in such a poor country were poor, as the initial level was so low. Bosnia and Herzegovina had no developed market institutions and no strong government to implement any alternative package of development and macroeconomic policies. The policy package coming from and implemented by the IMF and the World Bank has been seen as the only way of achieving stabilization, preparing the ground for privatization, and developing macroeconomic policy under better political circumstances. Yet the evidence seems to suggest otherwise. The 'Frankenstein' economy simply does not perform as expected.

A basic strategy for recovery and the role of government was published in 1996, in a chapter entitled 'Towards establishing a market economy', in the

document *Bosnia and Herzegovina on the road to recovery*, prepared by the World Bank, the European Commission and the EBRD. The package contains all the elements adopted in theory and practice in other Eastern European countries. One unique element not needed elsewhere was physical post-war reconstruction.

The document envisaged rapid privatization, dismantling of state firms, and development of SMEs, light industry and the service sector, as basic means of economic growth. It continued, "The role of the state in the economic and development strategy which is governed by the private sector is not unimportant, but shifts its focus. It should concentrate on the maintenance of healthy macroeconomic conditions and on the establishment of a relevant legal and institutional framework, which motivates uninterrupted functioning of a free market and provides basic public goods and social services, such as defence, public order, education, health services.[7]

The reform of banks and firms was a major project that had to be implemented, the document stated. Sizeable inherited bad credits and old foreign-currency accounts had to be excluded from banks' balance sheets. At the same time, large and inefficient state-owned enterprises (SOEs) had to be closed or restructured and privatized. In restructuring firms and banks, the document considered the most appropriate approach would be for state institutions to adopt a flexible programme of privatization to be applied regionally. The Republika Srpska would be one region and regions in the Federation might consist of a group of cantons, an individual canton or more local levels. This regional approach consequently provided the basis for the so-called 'ethnic privatization' that has become a nuisance and a divisive factor, and split big companies into geographical parts.

[7] World Bank (1996).

Under the World Bank/IMF programme, the central bank functioned as a currency board for six years, starting from 1996–7. This meant integrating Bosnia into international markets as a 'price taker', with a fixed exchange rate for its national currency, which was pegged to the German mark (and now to the Euro). The country thereby lost the potential advantages offered by the effects of the Phillips.

The package contained a hard budget constraint, which Bosnian authorities accepted. A budget deficit could not be allowed to generate inflation. The external sector was given a significant role in the economic transition, as it had been in other transition countries. Foreign trade is being liberalized as quickly and fully as possible. FDI and transnationals are supposed to be main driving forces behind economic recovery.

Left without its own monetary, foreign-exchange rate or balance-of-payments policies and with different privatization policies in the two regions, the government could not even consider an industrial policy. Bosnia was left to free market forces and the international donor community. Four years after peace came, GDP had reached a little over 50 per cent of its pre-war level. However, since the pre-1991 method of calculating GDP excluded the service sector, today's GDP is less than 50 per cent of what it was in 1991.

Let us look at a series of basic macroeconomic data for January–September 1999 and comparisons with the 1998 figures.[8] Industrial production increased by 4.9 per cent over 1998 levels in the Federation and by 1.5 per cent in Republika Srpska. Retail prices decreased slightly in the Federation (less than 1 per cent) but increased substantially in Republika Srpska (13 per cent) compared to the 1998 level. Employment in the Federation reached 408,004, 3.2

[8] Central Bank 2000.

per cent above the 1998 average, with about 69 per cent in the business sector and 31 per cent in the non-business sector. In Republika Srpska, there were 244,267 employees in 1997. In September 1999, 149,214 people were looking for a job in Bosnia and Herzegovina – 5 per cent more than at the end of 1998. Skilled workers made up 35.6 per cent of the unemployed and 1.1 per cent had university degree. Average net wages had increased by 5 per cent in the Federation and by 30.1 per cent in Republika Srpska since 1998. The deficit on the current account reached US$ 1,341 million (two-thirds in the Federation and a third Republic Srpska). The trade deficit alone in January–September 1999 was $1,408 million, with exports covering only 21.8 per cent of imports. A projection for the remainder of 1999 showed the value of exports running about 15 per cent below World Bank predictions.

However, from the start of the World Bank recovery programme, the question had been where such huge exports could come from under a 'demand-management' type of policy. Economic recovery in Bosnia was approaching the limits of its capacity to service its foreign debt. If foreign aid were reduced or stopped for any reason, GDP would enter the minus zone. The economy was not prepared for self-sustaining development. Turning to human resources, unemployment was a major issue alongside refugees, emigrants and internally displaced persons (see above). Despite the demand-managed reconstruction and recovery programme, over half the country's potential workforce was unemployed at the beginning of 1999, according to a broad definition of joblessness *(Table 7)*.

Table 7
Labour-market indicators in Bosnia and Herzegovina, 1998

	Federation	*Republika Srpska*	*Whole country*
Population (projection)	2,250,000	1,392,000	3,642,000
Pop. of working age (15–64)	1,500,500	907,200	2,407,700
Workforce (total potential)	872,000	528,000	1,400,000
Officially unemployed	407,000	202,000	609,000
Registered unemployed	249,000	143,000	392,000
Laid off and deferred*	70,000	45,000	15,000
Registered/unreg. unemployed	465,000	326,000	791,000
Narrowly defined unempl. rate (%)	28.56	27.08	25.16
Unemployed + laid off (%)	36.58	35.61	36.21
Broadly defined unemployed (%)	53.33	61.74	56.50

* Firms keep waiting lists of workers not currently required
Source: UNDP (1998).

Registered employment increased by about 4 per cent in 1999. Renewal of the workforce through entry of younger employees is a factor that tends to favour productivity. However, the opposite trend pertains in Bosnia, where most of the unemployed are in the 21–5 and 31–5 age groups. A recent federal law seeking savings in the pension system by decreasing the number of pensioners could cause elderly workers to stay at work, so reducing the potential employment for younger, more productive people.

Even more counter-productive for productivity and job creation are the provisions of a recent Labour Act, allowed those employed in 1991 to return to the same job by right or be compensated by the employer if no longer needed. Yet most of the big firms were destroyed or demolished during the war, which drastically changed labour requirements. The act imposes a serious financial burden on companies already facing financial pressures. It has endangered the privatization process by making firms less attractive for buyers as

restructuring targets. It has affected potential industrial investment by diverting scarce financial resources from investment to private consumption. The act was strongly opposed by the World Bank and private business. It represents a vestige of the old self-management system in Yugoslavia and evidence of inadequate institutional change in Bosnia's transition process.

In education, the war caused a serious drop in primary and secondary school enrolment rates: down from 98 and 90 per cent of the requisite age groups before the war to 82 and 75 per cent in 1999. The number of university students decreased by 30 per cent between 1991 and 1999. The figures reflect at least partly the anarchy in the country's transition process. Human resources are used in an inadequate, wasteful, useless way. For example, most highly educated Bosnians now work for international agencies in jobs that do not require their educational qualifications, so that they are lost to the productive economy. Another factor affecting human resources potential is low mobility, due to the housing shortage caused by wartime destruction, to high unemployment and lack of job opportunities, to low pay precluding accommodation rental, and to loss of attractive markets in former Yugoslavia and of companies that produced for them.

Institutional changes in the Bosnian society are slow. Privileges from the self-management period are still prevalent. Workers are unaware of the radical changes taking place globally and even in their country's constitution. They claim rights to a permanent job and other privileges that they enjoyed under the old regime. Governments are still controlled by nationalistic political parties, which select the chief executives and boards of the surviving SOEs. Even the federal president sits on the boards of some high-priority SOEs, usually the healthiest, best-performing ones.

It is believed that the obstacles to development and adequate use of human capital can be removed by privatization and restructuring, but in fact, many other factors are involved. These include the newness of the privatization process and its unpromising political and economic environment, the incomplete institutional changes, political corruption, an acute shortage of liquidity, and lack of an economic development strategy, other than the World Bank's, which relies on free market forces and FDI that are missing. Bosnia's recovery programme still rests on a programme of 'development without a concept' set by the international community, relying on free markets doing the job and allowing 'the chips to fall where they may.' So a black or grey market equivalent to about 40 per cent of GDP has developed and degrades the quality and decency of human resources. The system of values has changed, so that the priority for the Bosnian elite, managers and politicians has become to get rich quick through short-term speculation, while neglecting long-term objectives and visions based on the postulates of hard work and sustained development.

Generally speaking, the disintegration of former Yugoslavia in 1991 stopped the processes of technology transfer and creation. After 1995, reconstruction was at the top of the agenda for the government and the international community. Donor disbursements totalled over $2.13 billion between January 1996 and August 1999, according to a 1999 government document. Of this, 82 per cent went to rebuilding and reconstructing housing, energy, transport, water supplies, health services, education, social services and agriculture (about $1.75 billion on 4,500 projects); and 18 per cent went for credit projects for the business sector (about $385 million for 919 projects). So it is not surprising to find the business sector in its infancy and at a far from self-sustainable level. The international community has refused to pro-

vide capital to SOEs, regardless of their actual and potential viability and efficiency. The modest amounts of credit available are awarded only to SMEs.

On average, 85 per cent of equipment in the business sector is obsolete. Companies were technologically backward before the war, which then destroyed much of the equipment. The international community does not support unprivatized firms.

The short-sighted, narrowly based investment policies of the international community are one of the most controversial aspects of its role in Bosnia. The modest financing provided for private SMEs is very short term. Credit terms on domestic borrowing, meanwhile, are extremely high: 1.5–3 per cent a month. Investment per job created was only KM 20,000–30,000, with a low technological content (KM 1 = 0.56 Euros). The products then receive no effective tariff protection. All these factors force managers to think short term and ignore even slight possibilities of modernizing their companies. Any R and D activity is voluntarily done by individuals, out of personal enthusiasm.

These realities and rigidities, along with the institutional malfunctioning or even absence of essential institutions, give support to the broadly supported and accepted argument that the Bosnian economy cannot move ahead without FDI. It is a vicious circle. Without capital, there is no technological change. Without technological change, there is no progress. There is no capital without transnationals and FDI. There is no FDI without free markets and a prosperous economic climate. There is no free market with state intervention, or capital, because transnationals will not come, without which there is no capital and therefore no technological change.

In May 1999, the European Commission and the World Bank published a study[9] describing three groups of barriers to the development of domestic private business and FDI:

* Fiscal barriers: complicated fiscal procedures, unforeseen and retroactive taxes, uncoordinated taxes between Republika Srpska and the Federation.
* Barriers related to an inappropriate and unreliable judicial system, including lack of professionalism and insufficient transparency of ownership rights.
* An extremely complex process for registering new businesses.

The absence of technological progress and lack of a positive vision of the country's future have left citizens with an insecure perspective on the possibilities of improvement and progress. This has contributed seriously to the brain drain out of the country.

Turning to the infrastructure,[10] a World Economic Forum[11] report sees several basic parameters for measuring the creative technological potential of a country. Nine of these are listed with comments on how Bosnia is faring.

* Investment in basic R and D: The country cannot realistically expect investment in R and D until the distant future, unless the international community changes its approach to development of Bosnia and the Balkan region as a whole.
* Average educational level: The indicator was 25 per cent lower in 1999 than in 1991, although investment in education is being heavily supported by the international community, so that an improved score might ensue as future student enrolment rises. There were predictions that the 1991

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[9] Bosnia… (1999).

[10] Contributions by F. auševi to the PHARE–ACE project 'Supply-side strategy for productivity, competitiveness and convergence between CEECs and the EU', 2000.

[11] Global… (1999).

enrolment level might be restored by 2007.

* Concentration of scientific and engineering talent: Few young scientists existed as a basis for eventually building a significant cluster of talent. Many young scientists were leaving the country and most had been well received in the United States and the EU. Almost 60 per cent of graduates with a scientific and technical education were becoming part of the brain drain. It might take 15 years for the country to restore its pre-war level of scientific talent.

* Information-communication infrastructure: The network of information and communications was rebuilt and modernized with financing from the international community. Further improvement in telecommunication services could be expected once the state PTT had been privatized.

* Protection of intellectual property rights: Practically no appropriate regulations existed.

* Promotion of R and D activities: No special fiscal policy or law exists to stimulate R and D activities, except for one incentive that encourages reinvesting earnings there.

* Venture capital: The supply is still tiny, from commercial banks in the country and from the many international NGOs active in Bosnia and Herzegovina. World Bank data show that NGO-financed credits stimulated the creation of 40,000 new jobs in 1996–8, but almost 60 per cent of the credits went to the trade sector and they averaged only KM 3,000 (1,500 Euros) – a very small contribution to promoting business.

* Openness to FDI and foreign trade: Since 1995, the country had had almost no tariff policy and could be simply depicted as a state without borders. Domestic producers faced an unfair trade position, disadvantaged by the doctrine of free trade and the lack of an appropriate institution to support and monitor the development of foreign trade. Foreign goods were cheaper than domestically produced goods by 30 per cent or more. Combined with the great outflow of domestic capital, the development of production and of the domestic productive sectors is seriously hindered.

* Level of demand sophistication: The domestic market is full of goods that lack certificates of origin and do not pass quality controls. However, given the low purchasing power of the population, goods are easily sold on the domestic market.

Central to the situation in Bosnia and Herzegovina after 1996 was the limited scale of its economy. Funds were too scarce to carry out necessary technological innovation, so that obsolescence was perpetuated. Average capacity utilization was as low as 60–80 per cent in industry. Large companies languished or failed to restart after the war, although their managers claimed that quite small amounts of money (2–3 million Euros, for instance) would allow them to restart production. But the international community did not want to finance the existing big companies. The position taken by the World Bank and the IMF on the future of SOEs precluded this possibility. The only route left was to develop SMEs.

A big obstacle to rapid privatization has been the prospect of still more joblessness and the difficult social situation this would create. Some estimates stated that privatization would increase the number of unemployed by significant amounts.

Before the war, Bosnia was one of six republics of a single state and part of a single economic area that was very important to it. For example, Croatia and Slovenia accounted for over 37 per cent of Bosnia's exports within Yugoslavia and Serbia's share was even larger. This export base has considerably weak-

ened, particularly because the Dayton Accord effectively divided Bosnia and Herzegovina into two economic zones. This immediately raised the problem of trade between the two entities, which was in practice treated as international trade. It soon became clear that this required special attention, economically and politically. Inter-entity trade could contribute to GNP growth and more efficient functioning of the market in Bosnia and Herzegovina as a whole, while politically, it might act as an integrating factor, by stimulating cooperation between citizens of both entities. The significance of trade, domestic and foreign, to economic growth and development is beyond question especially in today's global environment. It is not surprising to find some economists, entrepreneurs and politicians (especially the Office of the High Representative) arguing for trade as the integrating factor to produce economic and political recovery in Bosnia and Herzegovina.

Various OHR efforts have been made in this respect, to do with harmonizing customs duties and taxes on so-called high-tariff goods between the Federation of Bosnia and Herzegovina and Republika Srpska. The same aims explain the pressure that the OHR has put on the trade ministers of the two entities to cooperate, harmonize trade conditions, promote trade, and finally, lift various formal and informal restrictions on it. Inter-entity trade up to June 1998 was regulated by the entities themselves and resembled international rather than domestic trade. Registered trade between them was accordingly modest in volume. The police in both entities had a more complete picture of the inter-entity trade, from monitoring it closely under the given political circumstances. Similarly, is trade in Bosnia and Herzegovina really the integrating factor to the extent expected by the politicians and the OHR? Does favouring inter-entity trade tend to stimulate trade diversion or trade creation? Under what circumstances can inter-entity trade create or intensify a trade-generating effect, so as to act as an integrating factor in the Bosnia and Herzegovina economic and political area, and play its standard, textbook role in the interests of its citizens and entities?

Due to the war and Dayton, Bosnia and Herzegovina today does not even constitute a customs union. The process of disintegration in former Yugoslavia has led to the creation of independent states with their own economies, and naturally, their own policies on economic relations with others. Except for Bosnia and Herzegovina, which has relations with the neighbourhood's countries under the Dayton Accord so anomalous that it does not have a unified customs system. The country finds itself in the awkward position of having, yet not having a policy for economic relations with other countries. Until recently, its entities would cooperate with neighbouring countries on free trade-zone principles. Without customs or other trade obstacles with neighbours and with regulatory obstacles to trade between the entities until June 1998, it was natural that trade developed instead between the entities and their neighbours: between the Republika Srpska and Yugoslavia, and the Federation of Bosnia and Herzegovina and Croatia. Apart from the effects of Dayton, there were rational reasons for this diversion in the post-war period. Devastated by the war, Republika Srpska and the Federation had import needs that Croatia and Yugoslavia were able to meet.

Leaving aside the albeit weighty political considerations, the next question is whether inter-entity trade determines the economic flows in Bosnia and Herzegovina, or whether inter-entity trade is determined by the condition of the Bosnia and Herzegovina economy, the Dayton Accord, and the neo-liberal economic development strategy prescribed by the international financial institutions and supported by the OHR. Bosnia and Herzegovina is far less developed than the

economies of the neighbouring countries. In addition, special relations enable simple imports of goods from these countries, so that no rational entrepreneur has any good reason to pursue inter-entity trade. The trade-diversion effect suppresses the trade-creation effect.

The neo-liberal concept of development of the Bosnia and Herzegovina economy eliminates state intervention, the infant-industry argument, and conscious foreign-trade policy. Meanwhile convertibility and a liberal foreign-trade sector (with underdeveloped domestic production) tempts a rational entrepreneur to import products from third countries, thus increasing the balance of payments deficit of Bosnia and Herzegovina and its entities alike. The question is how long this can be tolerated without support from the international community. What are the prospects for inter-entity trade like without imports from third countries?

These questions lead to the main thesis of this paper. Bosnia and Herzegovina must have economic borders, but only if the necessary precondition is achieved, in the form of dynamic economic development, which cannot be guaranteed by the current development concept.

3) Bosnia and Herzegovina: transition and its effects, 1996–2003

War, Dayton, the Washington Consensus, the acts of domestic politicians, and the lack of institutions have transformed Bosnia and Herzegovina from a republic of former Yugoslavia into an independent state (or semi-protectorate) with a new economic system of wild capitalism

Table 8
Causes and effects

War and the Washington Consensus	An independent state
Dysfunction	A semi-protectorate (Republika Srpska; the Federation of Bosnia and Herzegovina with 10 cantons and the Brcko district)
Dayton and the Washington Consensus	A 'wild' Latin American type of capitalism on an ethnic basis
Washington Consensus	A rich few and a poor majority; total insecurity
War and Dayton	Ethnic democracy
Washington Consensus	Predatory capitalism
War and Dayton	Multinational state (Dayton 'leopard skin')

4) Bosnia and Herzegovina: process and prospects up to 2007

Over the course of the nine years since 1995, Bosnia and Herzegovina has made some visible progress. Most importantly, the country is free of warfare, mainly due to the presence of SFOR troops and the international community, and in part due to the reconciliation process among the people of Bosnia and Herzegovina. Some progress has also been achieved in economic terms. GDP growth rates were relatively high at the beginning of the economic recovery process. However, the rate decreased to 5.8 per cent in 2002 and fell still more to 3.5 per cent in 2003. The poverty rate is one of the highest in the South-East European region.

Economic growth is highly unbalanced. Per capita GDP in Republika Srpska is about 75 per cent of what it

is in the Federation of Bosnia and Herzegovina. Foreign aid, transfers from abroad, and foreigners' spending in Bosnia and Herzegovina represent about 30 per cent of GDP.[12] Porter's 'Diamond' of competitive advantage has yet to be created. The *Strategy for economic development of Bosnia and Herzegovina*[13] has underlined a few sectors as potential sources of comparative advantage: wood, textiles, footwear and metallurgy. The first three industries have low value-added content and the last faces high international competition. The living standard, as a main element in the development diamond, is improving too slowly compared with people's expectations and needs. Development is unsustainable without fresh inflows of FDI and foreign aid. The strategy calls for a $3.5 billion financial injection to achieve a GDP growth rate of 5.5 per cent in the next three years. This amount of capital is hardly attainable now that privatization has failed, without selling the most precious domestic resources. Thus he development process is not equitable. Overall it seems that the country badly needs to devise a better economic paradigm, and a more efficient political organization as it moves towards the EU and a brighter future. The strategy (known as the PRSP)[14] is the first strategic paper prepared and accepted by international financial institutions and the government of Bosnia and Herzegovina. Its main aim is to reach 70 per cent of 1991 GDP by 2007 and restore partial international creditworthiness. This calls for swift reform (accelerating privatization, creating needful institutions, upgrading political stability and social capital, reintegrating the economic space, and gathering $3.5 billion of FDI and aid donations.

Turning to recent trends as expressed in the document, GDP in Bosnia and Herzegovina had fallen to about 20 per cent of its pre-war level, but since 1995, there have been levels of growth averaging over 25 per cent per year. As a result, per capita GDP more than doubled from about KM 900 in late 1995 to about KM 2900 in 2003, although it needs to be emphasized that the latter level is still only about half the level achieved in 1990. Apart from the difference between the two entities, just mentioned, there are substantial regional variations as well.

The fall in the real growth rate from very high levels (over 75 per cent in 1996 and 35 per cent in 1997) to about 10 per cent in 1999 and 3.5 per cent in 2003 reflects several factors. One was an immediate post-war economic rebound, as donor funds flowed in, followed by falling levels of international assistance, slower than anticipated progress with economic reforms, political instability in the region, economic crisis in the world, and adverse climatic conditions in 2000 and 2003 affecting agricultural output.

Still, some progress has been achieved. The central bank was strengthened in 2003, so that reserves covered about five months of imports. Growth in public revenues brought consolidated fiscal deficits down from 9 per cent of GDP in 1999 to a modest surplus in 2003. The tax system was shored up successfully, giving a steady growth in revenues. A trade deficit amounting to 50 per cent of GDP in 1996–9 is now falling steadily. It was about 40 per cent of GDP in 2003. Exports have increased nine times over since the war. Better control of expenditure has been achieved through the treasury system that functions at state and entity level, and is being introduced at canton and municipal levels as well. Fiscal consolidation has been undertaken through additional measures to demobilize soldiers; reform of public administration is being prepared. Industrial production shows positive growth. After declines in 2001 and 2002, it grew in 2003 by 5 per cent in

[12] Strategy… (2004).

[13] *Ibid.*

[14] *Ibid.*

Table 9
Macroeconomic reform scenario in Bosnia and Herzegovina, 2003–7, projected figures

	2003	2004	2005	2006	2007
Real sector					
Nominal GDP (KM millions)	12,173	12,911	13,854	14,893	16,040
Change (%)	4.7	6.1	7.3	7.5	7.7
Real GDP (KM millions)	10,805	11,357	11,981	12,640	13,335
Change (%)	3.5	5.1	5.5	5.5	5.5
Consumer price index (period average % change)	0.1	0.9	1.8	2.0	2.2
Savings and investment (% of GDP)					
Consumption	111.1	108.4	106.1	103.4	100.5
Public	22.5	22.3	21.2	20.1	19.1
Private	88.7	86.1	84.9	83.3	81.4
Investment	19.9	20.3	21.2	21.8	22.2
Public	4.5	4.9	4.9	4.9	5.0
Private	15.5	15.5	16.3	16.9	17.2
National savings	2.3	4.5	6.0	8.3	10.4
Public	1.8	1.5	2.5	3.2	3.4
Private	0.5	3.0	3.5	5.0	7.0
Foreign savings	17.7	15.8	15.2	13.6	11.8
General government (% of GDP)					
Total revenues and grants	46.7	45.8	44.7	43.5	42.5
Grants	3.4	3.3	2.3	1.5	1.1
Total expenditure	46.3	46.0	45.4	44.3	43.1
Current	41.9	41.1	40.5	39.4	38.1
Capital	4.5	4.9	4.9	4.9	5.0
Own-financed	0.2	0.6	0.8	1.1	1.7
Foreign-financed	4.2	4.3	4.1	3.8	3.3
Overall balance	0.4	-0.2	-0.7	-0.8	-0.6
Excluding grants	-3.0	-3.5	-3.0	-2.4	-1.7
Accumulation of arrears	0.5	0.7	0.5	0.5	0.5
Financing	0.2	0.8	1.2	1.3	1.1
Domestic	0.0	-0.2	0.6	0.7	0.3
Foreign	0.1	1.1	0.6	0.6	0.8
Total foreign assistance	5	6	4.5	3.7	2.6
Total foreign assistance ($ millions)	350	486	372	322	283
Balance of payments ($ millions)					
Current account balance (including official transfers)	-1,237	-1,302	-1,368	-1,324	-1,187
Current account balance (% of GDP)	-17.7	-15.6	-15.2	-13.6	-11.3
Export growth (%)	34	22	13	14	15
Import growth (%)	22	12	5.4	6.5	6.4
Gross reserves	1,725	1,714	1,764	1,814	1,864
Months of cover for imports of goods and non-factor services	4.5	4.5	4.4	4.3	4.1
Total public debt**	2,572	4,930	4,997	5,038	5,041
Total public debt (% of GDP)	34.0	59.7	56.2	52.5	48.5
Total external debt servicing (% of goods and non-factor service exports)	8.6	7.2	7.0	6.1	4.4
Memorandum item:					
Real current public expenditure (% change)	1.3	4.9	-1.3	2.5	2.8

* Includes disbursements of foreign loans and grants.

** Includes external public debt, stock of expenditure arrears, debt to domestic banks, and frozen foreign-currency deposits. Excludes any liabilities arising out of war-damage claims.

Sources: Bosnia and Herzegovina authorities; IMF staff estimates and projections.

Republika Srpska and about 4.5 per cent in the Federation.

By mid-2003, much progress had been made in small-scale privatization: 77 per cent of state assets in the Federation and 47 per cent in Republika Srpska had been sold. Privatization of large-scale SOEs (with over 50 employees or over KM 500,000 in capital) went more slowly. In the Federation, 272 out

of 411 large SOEs had been privatized by mid-2003, and in Republika Srpska, 304 out of 648. So 86 per cent in the Federation had been wholly or partly privatized, and in 65 per cent, this has been completed. The total value of privatized state capital in the Federation was KM 5 billion or 37 per cent of the sum expected of privatization. The proceeds amounted KM to 8.8 billion, of which only KM 338 million was in cash and the rest in vouchers (KM 1.76 paid for each KM 1 of state asset). Despite international support for privatizing 'strategic' SOEs, only 17 out of 56 firms in this class had been sold by mid-2003 in the Federation and 4 out of 52 in Republika Srpska. Banks in both entities were privatized under separate legislation.

The banks could not be privatized for vouchers, only for cash, based on international tenders. The share capital of 13 banks in Republika Srpska were offered for sale, 11 of them majority state-owned. Eight were sold or merged, two closed and two others placed in receivership. Sale of the Doboj Bank is still underway. Due to the poor situation of the banking sector, the total proceeds were only KM 7.4 million. In the Federation, there were separate privatization proceedings for banks in majority state ownership and for those in which the state had a minority stake. Most were successfully privatized and sales of the remainder are underway. Five banks were placed in receivership. Banking privatization was much more effective than sale of the SOEs. There has been significant foreign investment in banking, but the privatization proceeds have been only KM 6.8 million so far.

Privatization investment funds (PIFs) emerged out of the voucher-based privatization scheme. Eleven have been registered so far in the Federation and have attracted KM 4.5 billion in vouchers. By the end of the public offering of shares, these eleven had bought KM 1.9 billion of state assets. In Republic Srpska, there are 13 PIFs, which have collected KM 1.6 billion in vouchers. The shares in these investment funds are listed on the Sarajevo and Banja Luka stock exchanges, creating conditions for secondary trading.

As in most transition countries, merger and acquisition-based FDI has been considerably greater than greenfield investment in Bosnia and Herzegovina. This is understandable, given the privatization process undertaken. Capital investment in the form of FDI increased significantly in 2002, bringing the volume of FDI attracted to Bosnia and Herzegovina since 1996 to $848,212,000. The biggest sources over that period were Kuwait and Croatia, followed by Slovenia, Germany, Austria, Serbia and Montenegro, Netherlands, and Switzerland. Six of the ten largest investors have been banks. However, investment in production has been insufficient, so that the problem of a supply-side economy is more critical in Bosnia and Herzegovina than elsewhere. The capital inflow still falls far short of what is required for economic growth or the targets of the PRSP.

There are several reasons for the FDI shortfall. Bosnia and Herzegovina is not an imminent member of the EU, does not have attractive natural resources, has not entered the decisive phase of privatization, shows itself relatively unstable politically, and remains an aid-driven economy. These features mean it is not attractive enough for greenfield investors. Above all, Bosnia and Herzegovina remains a country with two entities, so that a new company has to register twice to trade in the whole of it. Finally, privatization of telecom and power generation has been postponed on the grounds of strategic interest.

5) Bosnia and Herzegovina's future

The PRSP may succeed or fail, depending on the inflow of foreign capital and donors' aid. A new strategy may or may not be devised. Social capital may or may not be built up again. The international community may change its position on Bosnia and Herzegovina or it may not. The EU may suddenly decide, for political reasons, to contemplate the accession of Bosnia and Herzegovina or it may not. Bosnia and Herzegovina is a country whose future is hard to predict.

There is some evidence that predictions about the economy have so far failed, for instance those made by the World Bank. The GDP of Bosnia and Herzegovina reached $ 4796 in 2001, whereas the World Bank has projected a figure as high as US$ 6262.

The World Bank had also predicted exports of $1816 million by the end of 2000, but the level attained was only $1100 million. On the other hand, the World Bank prediction of $2863 for imports by that time was short of the actual figure of $3200, which took the trade deficit to KM 4402 million (about $2100 million).

Even harder to predict is the country's political future. There are several daunting scenarios to consider. Transition will depend on foreign forces (the international community) and the domestic fabric. At present, the least influential factor on the country's future is its own citizens, strange as it may sound.

The new economic concept of regionalization embodies threats and opportunities. To resolve the economic and political issues as far as possible, the international community (notably the OHR) offered Bosnia and Herzegovina in 2004 a second best solution that might turn out to be best under the pertaining circumstances. The circumstances are still the Dayton 'skin', which allows only a limited role for the state in the economy.

The decentralized (1+10+1) community in Bosnia and Herzegovina, as second best solution, promotes economic reintegration by creating economically viable regions. It might be said that from the point of view of the process of

Table 10
Transition to the future in Bosnia and Herzegovina

Political organization	Economic system
a) This calls for a concept of Bosnia and Herzegovina (a new 'Bosnian nation') and of the country in European terms. b) Dayton and Bosnia and Herzegovina as a multinational country. c) From Dayton come ethnic cantons (ESI initiative) and modifications thereto.	a) The Washington Consensus. Is there any 'real' divergence from the EU? b) The PRSP depends on inflows of FDI and foreign aid and on a role for the state. c) Regionalization depends on a political solution and economic aid. d) Alternative Keynesian economic policies depend on globalization, international attitudes and political organization in Bosnia and Herzegovina.
Political and economic democracy	*Living standards*
These are functions of both the political and the economic factors.	These depend on the economic policy choices.
Multiethnic configuration	*Social security*
This is a function of political organization and economic progress.	This depends on both economic policy and political vision.

EU accession, the best idea would be to have Bosnia and Herzegovina as one region. But reality suggests it would be politically more acceptable and still economically viable for Bosnia and Herzegovina to consist of more than one region. In terms of economic efficiency, two regions could be preferable as a solution to three regions, and so on.

Regionalization of Bosnia and Herzegovina along the lines of the EU regionalization concept is not devoid of risk. Look, for instance, at the ethnic composition of the Sarajevo macro region in 1991 and in 2002.[15] The Serb population is concentrated in one part of the region, while the Bosnian population lives in the other. The centre of the Sarajevo macro region is the city of Sarajevo, the wealthiest part of Bosnia and Herzegovina.

If applied uncritically in Bosnia and Herzegovina, the 'new economic geography', as a concept of economic development, could exaggerate the imbalance of economic growth in a region, with predictable consequences. Here it is worth quoting from Woodward at some length, while adding some comments in square brackets: 'The remedy proposed by domestic economists and required by the International Monetary Fund (IMF) in exchange for credits in 1982 was a harsh austerity program of domestic contraction and export promotion, accompanied by decade long series of economic and political reform. While the critical reform was liberalization of foreign trade and domestic prices, the creation of institutions necessary to implement such a policy mandated a radical change in the locus of political power over domestic and foreign currency. This was not the first IMF-financial effort to reform the Yugoslav socialist economy, but in all previous programs, the advice has been to decentralize..... The result, by the early 1980s when the debt crisis hit, was a central government with almost no authority over the economy and unable to act without the consent of all republics. Decentralization has gone too far, the market promoters concluded. A true central bank had to be created; authority over monetary aggregates, debt repayment, and foreign exchange policy had to be reunified; barriers to the flow of capital and labour across republics had to be removed; and a state administration capable of performing the functions necessary to an open, market economy had to be restored.

'The resulting reform program …. that was adopted by parliament in 1982, triggered three destabilizing shocks to the Yugoslav system….

'The first shock was the challenge to revise the 1974 constitution.... By 1974, the balance of power lay with the republics [entities and cantons today in Bosnia and Herzegovina], and federal government had responsibility only for the common defence, veterans, setting guidelines on foreign trade-oriented investment policy [as in Bosnia and Herzegovina] legislating standards for wage and labour policies in the separate republics, and managing the federal fund for regional development, which taxed the wealthier northern republics for redistribution to the south.....

'Liberalization required the re-creation of a single market over the entire Yugoslav area (as in Bosnia and Herzegovina today), and this in turn required the reunification of monetary and foreign exchange policy, including administrative apparatus necessary to such policy. The level of decentralization achieved by the mid-1970s, however, meant that the reform was a direct attack on the economic power of the republican governments (on the entities of Bosnia and Herzegovina today).... Those who believed in the re-creation of a single market were "unitarists" as well as "federalists".... By using the term "unitarism", they cast the centre–republic fight in ethnic-cum-national terms. They implied that this new threat from

[15] EURED (2004).

plied that this new threat from Belgrade was from Serbs (as with Bosnians in today's Bosnia and Herzegovina). Such obfuscation always was possible because Belgrade was the capital of both the federation and the Serbian republic (as Sarajevo is in Bosnia and Herzegovina today).

Their alternatives were the decentralized status quo or confederation (a striking similarity with Bosnia and Herzegovina today and, and former Yugoslavia in that respect).'[16]

A suitable concept for achieving faster growth in Bosnia and Herzegovina could be developmentalism. A strategy for economic upswing and a complementary macroeconomic policy would contribute to economic prosperity provided it contributes to 'real convergence' with the EU. The only way to achieve this in the medium term through a differential increase in productivity, and thus competitiveness:

'Macroeconomic policy can contribute to Bosnia and Herzegovina prosperity only in the short run. The nominal convergence, almost attained in Bosnia and Herzegovina, can contribute to macroeconomic stability by putting things into place. However, it is insufficient, virtually by definition. Attainment of nominal convergence by all parties implies a comparative advantage for no one.'[17]

Within such an approach to economic growth and prosperity, the economic paradigm termed here developmentalism seems the best suited to attaining the goals desired.

'Developmentalism is an economic system that takes a system of private property rights and a market economy as its basic framework, but that makes its main objectives the achievement of industrialization (or continuous growth of per capita product) and, insofar as it is useful in achieving this objective, approves government intervention in the market from long-run perspectives. Developmentalism is a political-economic system established with the state as its unit.'[18]

Developmentalism consists of market competition, a government-implemented industrial policy, export oriented manufacturing industries, development of SMEs, a search for a new mass class with importance attached to equitable income distribution and domestic centred demand, particular importance for comprehensive education, and creation of a fair and competent modern bureaucracy.

There is a need and an opportunity in Bosnia and Herzegovina to design and implement industrial policy, which requires a developed network of institutions, including chambers of commerce, ministries, scientific institutes and specialized agencies. It should be oriented primarily, and as rapidly as possible, towards economic recovery higher employment. Without hampering emerging competitive markets, every effort must be made to enable the most easily activated sectors to begin contributing quickly to GNP, especially ones with a significant domestic-resource content, such as civil engineering. The main areas of implementation of should be:

* Increasing the basic competitiveness of the economy by improving technological capabilities.
* Export promotion and development strategies that involve setting up information-gathering and export-promoting institutions as well as reviving and overhauling specialized government-controlled export-import banks.
* Export promotion involving direct help to firms, especially SMEs, to develop export strategies and reach and gain new markets.

[16] Woodward (2000).

[17] Pitelis (2000).

[18] Murakami (1996).

* Promoting R and D, particularly technological development and transfers, to reverse the negative trend that has persisted for over a decade.
* Increasing the efficiency of technology transfers from abroad.

The main components of such an industrial policy could be designation of priority industries, industry-specific indicative planning and regulation of excessive price competition. Supplementary, but necessary policies would be protection for infant domestic industry, and a policy of subsidies.

Developmentalism needs to be supported by efficient state involvement in the economy, which is a particular problem for Bosnia and Herzegovina, in view of its constitutional structure.

6) A SWOT analysis of society and the economy in Bosnia and Herzegovina

A short SWOT analysis of Bosnia and Herzegovina may serve to summarize this paper.

Strengths

The Washington Consensus has contributed to stability of nominal indicators: prices, exchange rate and currency are stable, although the liquidity position is deteriorating. Bosnia and Herzegovina has gained strength in terms of nominal indicators.

Weaknesses

Of the many weaknesses since the transition began, the most relevant to the country's economic prosperity of the country are these:

* Political instability remains.
* The economic space is still divided along entity lines.
* The market institutions are inappropriate for the country's stage of development.
* The state is weak and bureaucracy inefficient.
* There is a dangerous level of corruption.
* Development institutions lacking include a development fund, an export–import bank *etc.*
* The legal system is inefficient and poorly organized for the transition process.
* The country is aid dependent.
* The social capital is still weak. It is hardly possible to reach political consensus among ethnically driven political parties . Bosnia and Herzegovina has changed from the 'leopard skin' of the pre-war, pre-1992 period has turned into a 'Dayton skin', in which Bosniacs, Croats, and Serbs live side by side in separate areas of the country. Adamant effort are needed to get Bosnians of all three ethnic groups on the same track. The author believes that rapid, sustainable economic development is the main prerequisite for rebuilding social capital. Such economic growth is just what has been lacking since Dayton.

Opportunities

The most promising opportunities may result from changes in the following weaknesses:

* Political instability needs to be overcome.
* Market institutions have to be wisely built.
* The state must be allowed to intervene more extensively and efficaciously in the economy.
* A new strategy of growth stimulation is required to create jobs and expand human capital.
* Corruption must be sharply curtailed.

* The legal system should be improved.

The opportunities are in the hands of the inhabitants and the international community. They depend on human capital and a concept of society supported by political forces at home and abroad.

Threats

More dangerous still than the many transition-related threats are those arising out of Dayton solutions and the accord's implementation of constitutional changes. Another threat of no less importance comes from globalization and the position of Bosnia and Herzegovina in that process. In some ways resembling the 'good old days' of the gold standard, the globalization process significantly erodes the ability of an independent country, particularly one that is less developed, to manage its own economic development, which is subordinated to the rules of globalization. The difficulty is compounded if the country is aid driven. The new concept for development that Bosnia and Herzegovina needs so badly, depends on understanding the process of globalization, the actions of transnationals, and the motives of leading countries.

* * * * *

STATISTICAL APPENDICES

Hungary Data Profile			
Click on the indicator to view a definition	1998	2001	2002
People			
Population, total	10.1 million	10.2 million	10.2 million
Population growth (annual %)	-0.4	1.6	-0.3
National poverty rate (% of population)	..	..	..
Life expectancy (years)	70.5	72.2	72.3
Fertility rate (births per woman)	1.3	..	1.3
Infant mortality rate (per 1,000 live births)	..	..	8.0
Under 5 mortality rate (per 1,000 children)	..	..	9.0
Child malnutrition, weight for age (% of under 5)	..	..	..
Child immunization, measles (% of under 12 months)	99.0	99.0	99.0
Prevalence of HIV (female, % ages 15–24)	..	0.0	..
Literacy total (% of ages 15 and above)	99.3	99.3	99.4
Literacy female (% of ages 15 and above)	99.1	99.2	99.2
Primary completion rate, total (% age group)	..	..	..
Primary completion rate, female (% age group)	..	..	..
Net primary enrolment (% relevant age group)	89.5	..	..
Net secondary enrolment (% relevant age group)	84.7	..	..
Environment			
Surface area (sq. km)	93,030.0	93,030.0	93,030.0
Forests (1,000 sq. km)	..	..	..
Deforestation (average annual % 1990-2000)	..	..	..
Freshwater resources per capita (cubic meters)	..	..	11,812.2
CO_2 emissions (metric tonnes per capita)	5.7	..	..
Access to improved water source (% of total population)	..	..	..
Access to improved sanitation (% of urban population)	..	..	..
Energy use per capita (kg of oil equivalent)	2,502.9	2,487.5	..
Electricity use per capita (kWh)	2,864.5	2,998.2	..
Economy			
GNI, Atlas method (current US$)	45.3 billion	49.1 billion	53.7 billion
GNI per capita, Atlas method (current US$)	4,480.0	4,820.0	5,290.0
GDP (current $)	47.0 billion	51.8 billion	65.8 billion
GDP growth (annual %)	4.9	3.8	3.3
GDP implicit price deflator (annual % growth)	12.6	8.6	10.7
Value added in agriculture (% of GDP)	5.7	4.3	4.3
Value added in industry (% of GDP)	23.4	31.2	31.2
Value added in services (% of GDP)	70.9	64.5	64.5
Exports of goods and services (% of GDP)	62.6	74.4	64.5
Imports of goods and services (% of GDP)	64.1	75.9	66.7
Gross capital formation (% of GDP)	28.9	27.1	24.0
Current revenue, excluding grants (% of GDP)	37.9	37.1	..
Overall budget balance, including grants (% of GDP)	-6.5	-3.8	..
Technology and infrastructure			
Fixed lines and mobile telephones (per 1,000 people)	440.9	873.3	1,037.2
Telephone average cost of local call (US$ per three minutes)	0.1	0.1	0.1
Personal computers (per 1,000 people)	64.8	95.3	108.4
Internet users	400.0 thousand	1.5 million	1.6 million
Paved roads (% of total)	43.4	43.7	..
Aircraft departures	27,500.0	31,800.0	33,300.0

Hungary Data Profile			
Click on the indicator to view a definition	1998	2001	2002
Trade and finance			
Trade in goods as a share of GDP (%)	103.5	123.8	109.3
Trade in goods as a share of goods GDP (%)	214.8	..	..
High-technology exports (% of manufactured exports)	20.6	24.1	24.8
Net barter terms of trade (1995 = 100)	100.2	95.7	96.1
Foreign direct investment, net inflows in reporting country (current US$)	2.1 billion	2.6 billion	854.0 million
Present value of debt (current US$)	..	..	32.8 billion
Total debt service (% of exports of goods and services)	23.6	34.4	33.9
Short-term debt outstanding (current US$)	4.8 billion	4.6 billion	5.7 billion
Aid per capita (current US$)	23.8	41.0	46.4

Source: World Development Indicators database, April 2004

Bosnia and Herzegovina Data Profile			
Click on the indicator to view a definition	1998	2001	2002
People			
Population, total	3.8 million	4.1 million	4.1 million
Population growth (annual %)	3.0	2.0	1.3
National poverty rate (% of population)	..	..	19.5
Life expectancy (years)	..	..	73.9
Fertility rate (births per woman)	..	..	1.3
Infant mortality rate (per 1,000 live births)	..	..	15.0
Under 5 mortality rate (per 1,000 children)	..	..	18.0
Births attended by skilled health staff (% of total)	..	..	..
Child malnutrition, weight for age (% of under 5)	..	..	..
Child immunization, measles (% of under 12 months)	84.0	92.0	89.0
Literacy total (% of ages 15 and above)	..	..	..
Literacy female (% of ages 15 and above)	..	..	..
Primary completion rate, total (% age group)	..	76.6	76.7
Environment			
Surface area (sq. km)	51,200.0	51,200.0	51,200.0
Forests (1,000 sq. km)	..	..	..
Deforestation (average annual % 1990-2000)	..	..	..
Freshwater resources per capita (cubic meters)	..	..	9,119.6
CO_2 emissions (metric tonnes per capita)	4.4	..	..
Energy use per capita (kg of oil equivalent)	971.0	1,074.4	..
Electricity use per capita (kWh)	1,526.2	1,444.4	..
Economy			
GNI, Atlas method (current US$)	4.5 billion	5.2 billion	5.4 billion
GNI per capita, Atlas method (current US$)	1,190.0	1,280.0	1,310.0
GDP (current $)	4.3 billion	5.0 billion	5.6 billion
GDP growth (annual %)	15.6	4.5	3.9
GDP implicit price deflator (annual % growth)	6.9	9.1	2.1
Value added in agriculture (% of GDP)	18.5	13.3	17.9
Value added in industry (% of GDP)	32.3	28.4	37.2
Value added in services (% of GDP)	49.2	58.3	44.9
Exports of goods and services (% of GDP)	29.3	26.0	26.2
Imports of goods and services (% of GDP)	66.1	57.9	59.2
Gross capital formation (% of GDP)	35.9	19.4	19.6
Technology and infrastructure			
Fixed lines and mobile telephones (per 1,000 people)	97.5	340.1	432.9
Telephone average cost of local call (US$ per three minutes)	0.0	0.0	0.0
Internet users	5,000.0	100,000.0	100,000.0
Paved roads (% of total)	52.3	..	..
Aircraft departures	1,100.0	4,500.0	4,400.0

Bosnia and Herzegovina Data Profile

Click on the indicator to view a definition	1998	2001	2002
Trade and finance			
Trade in goods as a share of GDP (%)	74.8	86.3	78.1
Foreign direct investment, net inflows in reporting country (current US$)	66.7 million	125.4 million	293.4 million
Present value of debt (current US$)	..	..	1.8 billion
Total debt service (% of exports of goods and services)	..	12.6	6.9
Short-term debt outstanding (current US$)	118.5 million	59.7 million	72.7 million
Aid per capita (current US$)	240.4	157.5	142.8

Source: World Development Indicators database, April 2004

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