Economics in Peacemaking: Lessons from Bosnia and Herzegovina

The Portland Trust

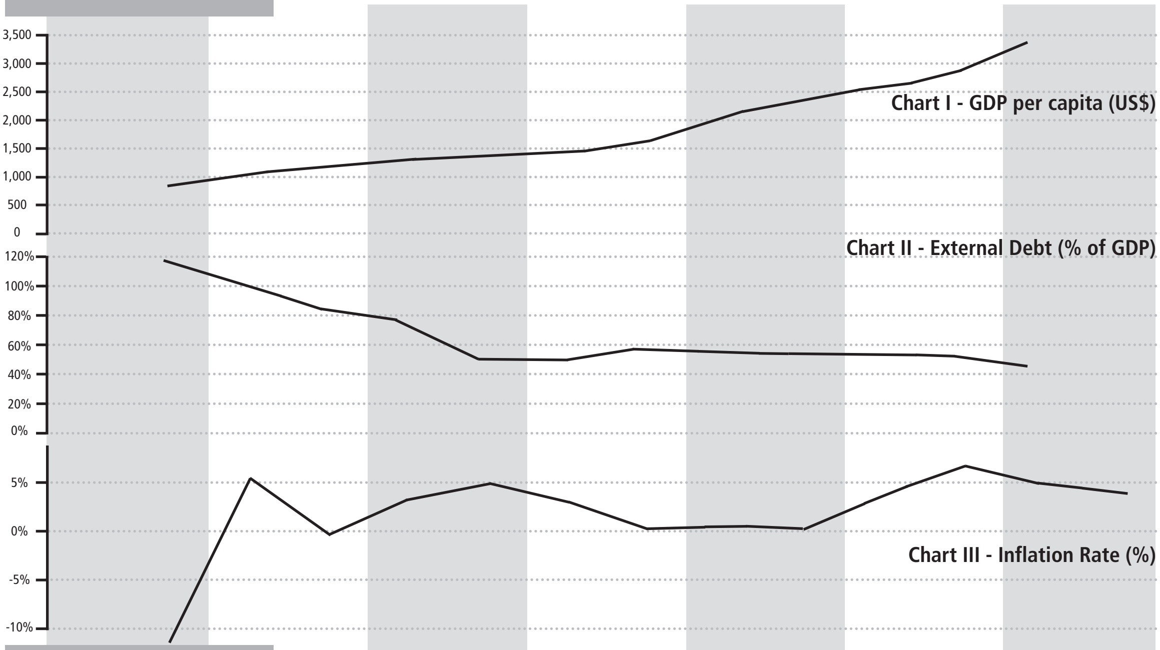
March 2009

The Portland Trust was founded in London in 2003 by Sir Ronald Cohen, co-founder and former Executive Chairman of Apax Partners and Sir Harry Solomon, co-founder, former chairman and CEO of Hillsdown Holdings. Sir Martin Gilbert, the historian, and David Freud, former vice-chairman of UBS Investment Banking, are the other trustees.

The Portland Trust is a not-for-profit British foundation committed to encouraging peace and stability between Palestinians and Israelis through economic development. It promotes initiatives which are designed to support the development of the private sector and alleviate poverty in the Palestinian Territory and the Israeli periphery, focusing on financial and physical infrastructure, trade, training and entrepreneurship.

The Portland Trust has offices in London, Ramallah and Tel Aviv.

The Good



The Bad

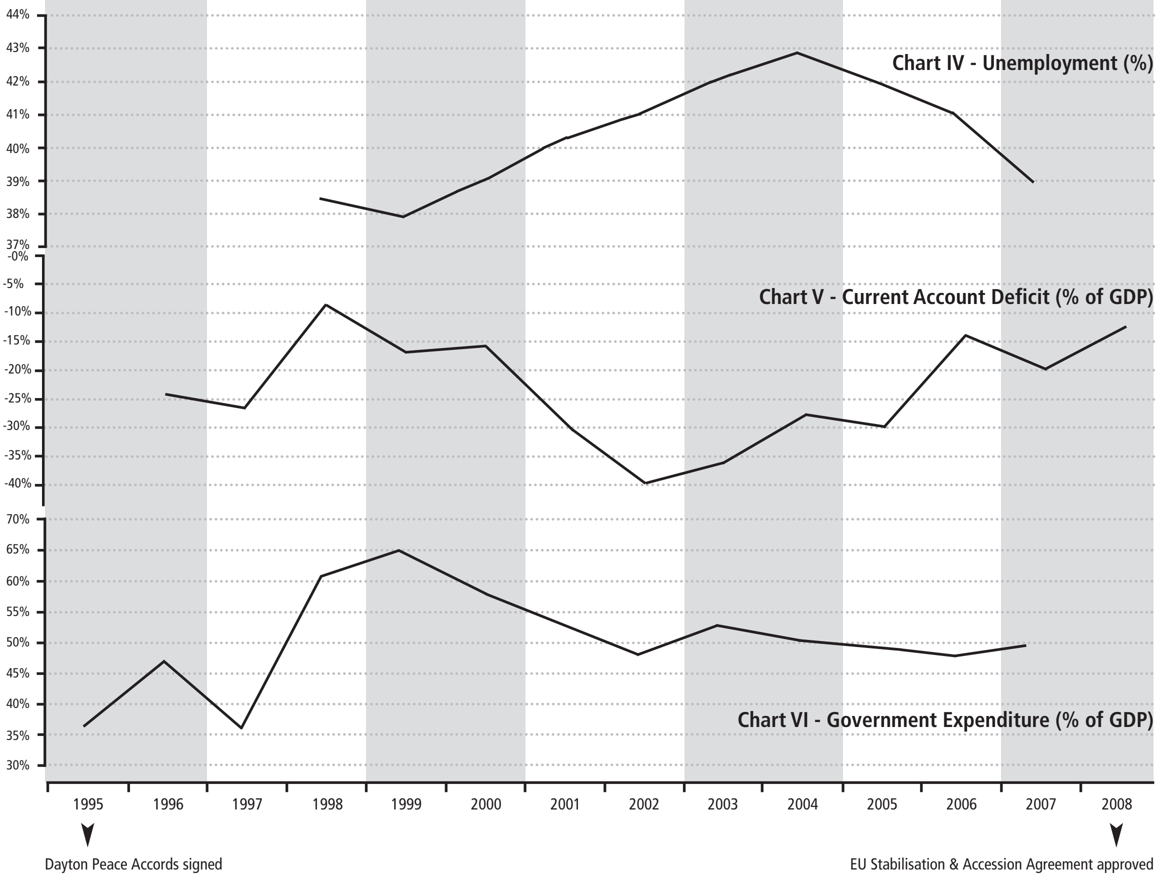


Chart I – GDP per capita has been steadily increasing since the end of the war in 1995 and there has been strong GDP growth in recent years.
Source: European Bank of Reconstruction and Development

Chart II – Public debt as a percentage of GDP has fallen, and continues to fall, from a high point of 120%. Current estimates put total external debt at 47% of GDP, comparable to other EU countries.
Source: European Bank of Reconstruction and Development

Chart III – Inflation is low and in line with the most developed countries in the EU.
Source: International Monetary Fund and European Bank of Reconstruction and Development

Chart IV – Unemployment, while falling, is still extremely high.
Source: European Bank of Reconstruction and Development

Chart V – The current account deficit is unsustainable and driven by a large trade deficit.
Source: European Bank of Reconstruction and Development

Chart VI – Government spending, at approx 50% of GDP, is high and may crowd out further private sector development.
Source: European Bank of Reconstruction and Development

Chart VII – Real GDP is still 20% lower than pre-war levels.
Source: European Bank of Reconstruction and Development

Chart VIII – The majority of the population are unhappy with the current situation in Bosnia and Herzegovina (BiH) and do not trust officials or each other. A driving factor in this is likely to be the ongoing inequality and tension between the two main entities of Republika Srpska and the Federation of BiH.
Source: Oxford Research International Report July 2007: Snapshots of Today and Visions of the Future for Bosnia and Herzegovina

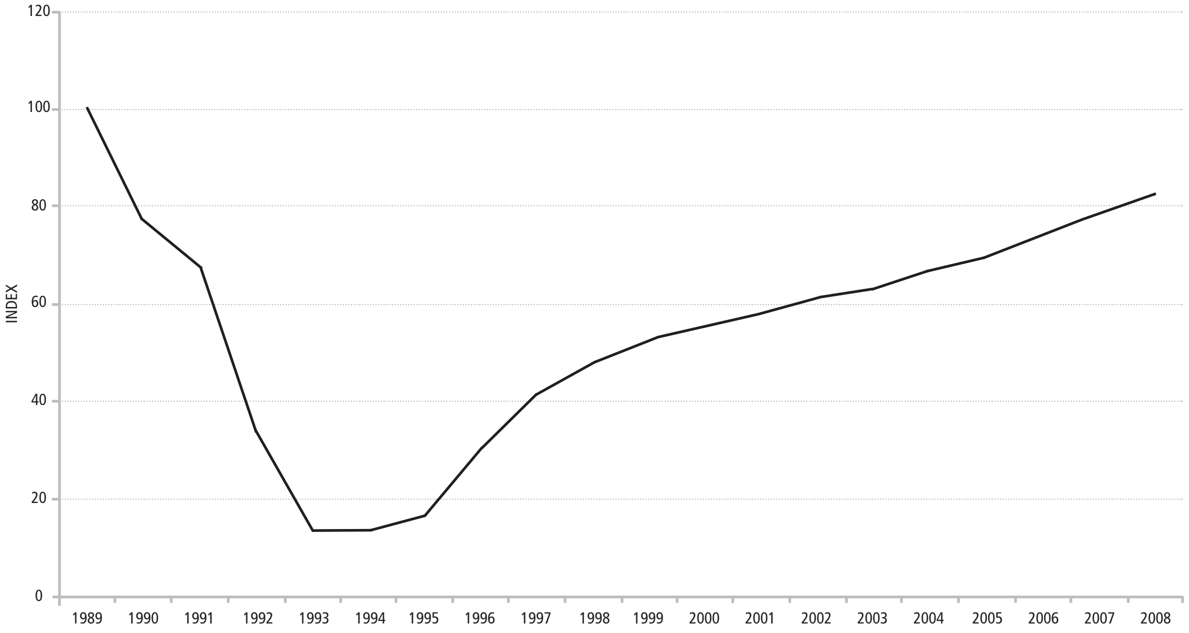
"It goes without saying that for a country defined as a country of three peoples, the protection of their respective national interest is crucial for maintaining social balance and political stability. In the long-run one should not be frustrated by its slowness. Countries with far more advanced democratic experience than BiH are still struggling with guaranteeing full professionalism, rule of law and impartiality of state institutions for all under their jurisdiction."

Dr Zoran Pajic, Avaz, 12 December 2007

The Ugly

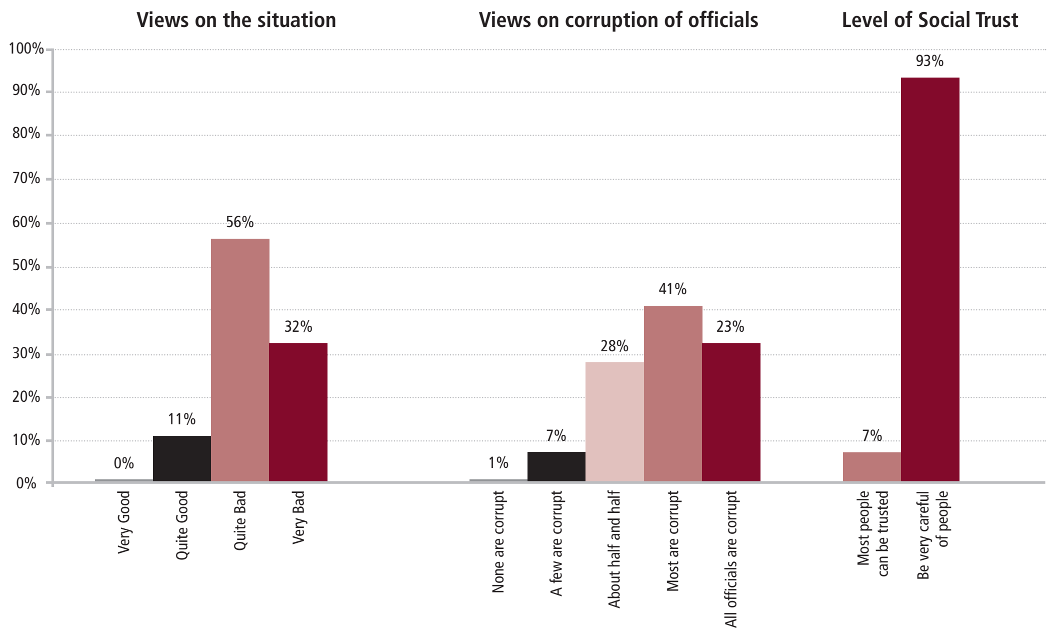
Income is 20% lower than two decades ago

Chart VII - Change in GDP (Real terms, 1989 = 100)



Trust is at an all-time low

Chart VIII - Perceptions, Corruption and Trust



Contents

Summary

Thirteen years have passed since the signing of the Dayton Peace Accords, ending a murderous and economically crippling war in the former Yugoslavia. The ceasefire arrangement established a complicated and fragmented state structure in Bosnia and Herzegovina (BiH), with two separate entities, to keep the warring factions apart. Billions of dollars poured into Bosnia and Herzegovina and a Stabilisation and Association Process began to bring BiH and other Western Balkan States into the European Union.

But despite the enormous amount of aid, the Bosnian economy remains precariously weak, if not in crisis. Many believe that the promotion of free market economy reforms weakened the state and its economy to such an extent that it aggravated ethnic tensions across BiH, pushing it closer to a new round of conflict.

In this paper we analyse the lessons that can be learned in post-conflict Bosnia and Herzegovina. In particular, we examine the efficacy of the international recovery programme, the consequences of a weak investment and trade strategy and the hurdles posed by a fragmented and ethnically divided state. Given the mission of The Portland Trust, we hope that some of these lessons may prove useful in the Middle East.

The overarching economic lesson from Bosnia and Herzegovina is that the structure of the political settlement controls the nature of the post-conflict economy. So it is of the utmost importance that any political solution is structured in a way that encourages optimal economic development. A strong post-conflict economy is essential for keeping the peace. Or put negatively, economic disparities and poor financial prospects endanger a fragile peace accord.

If this is the central theme emerging from the case of Bosnia and Herzegovina, there are three specific economic lessons to draw:

1. The Dayton Peace Accord was designed as a ceasefire agreement and to that end it achieved its goal. But one of the costs of reaching this peace was the creation of a fragile state with a dysfunctional economy. Dividing BiH into two separate entities of Republic Srpska and the Federation of Bosnia and Herzegovina (with the district of Brčko as a de-facto third entity) and introducing a tripartite presidential system and even more complicated layers of local and national administration created endless obstacles for economic growth, increased corruption, exacerbated income inequality and ultimately entrenched ethnic divisions.

2. While billions in aid poured into Bosnia and Herzegovina, very little was directed to the mainstream business community. There was no real injection of foreign investment (essential for the growth of a weak economy) and not enough capital was allocated to education, research and technology, production and manufacturing. Labour mobility remains difficult and a single economic zone between the two entities does not yet exist. The trade deficit continues to rise.

3. There is no doubt that the initialling of the EU Stabilisation and Association Agreement in December 2007 prevented a full-blown crisis over Police Reform in BiH. The promise of great economic rewards from joining the EU, has given the EU an effective "carrots and sticks" regime through which they can condition aid and enforce reforms.

Many resent the international role in BiH and believe that the imposition of a free market economy on a weak state, with little input from the Bosnians themselves, has created unnecessary tensions. Economic integration is still unattainable despite efforts made to harmonise the legal and institutional structures of the two entities. There is no doubt that successful state building takes time and requires patience. There are unexpected hurdles and hindrances along the way. But it is unfortunate that the private sector has not played a much larger role in Bosnia and Herzegovina in building solid foundations for the future.

Section 1

Economic Malaise

The Dayton Peace Accords (DPA) led to the creation of a weak state by dividing the country into separate entities along ethnic lines. The ethnic divisions led to major corruption and to political gains for local warlords. It has had disastrous consequences for the implementation of a fair and constructive economic policy.

Recovery Strategy

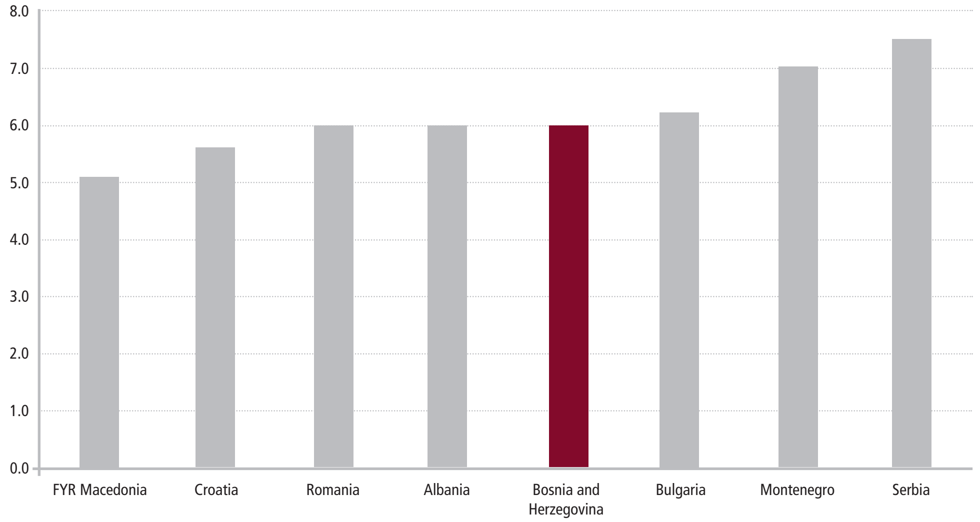
In 1996, the World Bank, the European Commission and the European Bank for Reconstruction and Development (EBRD) laid out their economic strategy.[1] The document concluded that "the role of the state in the economic and development strategy which is governed by the private sector is not unimportant, 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".

Macroeconomic Figures

The International Monetary Fund (IMF) report on the Bosnian economy (2007) highlighted the strong GDP growth of the past few years. Inflation has been low and very much in line with the most developed countries in the EU. The foreign exchange rate of BiH's currency has been stable and convertible, and government expenditure has been falling.

Growth rate of GDP has been comparable to other transition economies and relatively high, consolidating at around 5-6 per cent per year in the last few years. Low inflation in BiH, according to the IMF, "reflect[s] the benign international environment, the effects of past reforms in certain sectors, and the currency board."[2]

GDP growth, 2007 (real terms)



Source: European Bank of Reconstruction and Development

Public debt, according to the IMF report, has been relatively low. It amounts to 23 per cent of GDP. The real depreciation of the domestic currency ensures the competitiveness of BiH exporters. Overall, the nominal economic indicators were more than encouraging at the end of 2007.

A different picture

But this is not the whole story. Official unemployment is extremely high (the unofficial level even higher), the balance of payments deficit is barely sustainable, income inequality is rising, social exclusion is extreme and the informal economy is widespread.

Unemployment

There are currently 3.8 million people living in Bosnia and Herzegovina. According to the latest Labour Force Survey from the Agency for Statistics of BiH (September 2007), there are 1,196,314 persons in the BiH labour force and 1,528 870 inactive persons. This means that there are more economically inactive people in BiH than active.

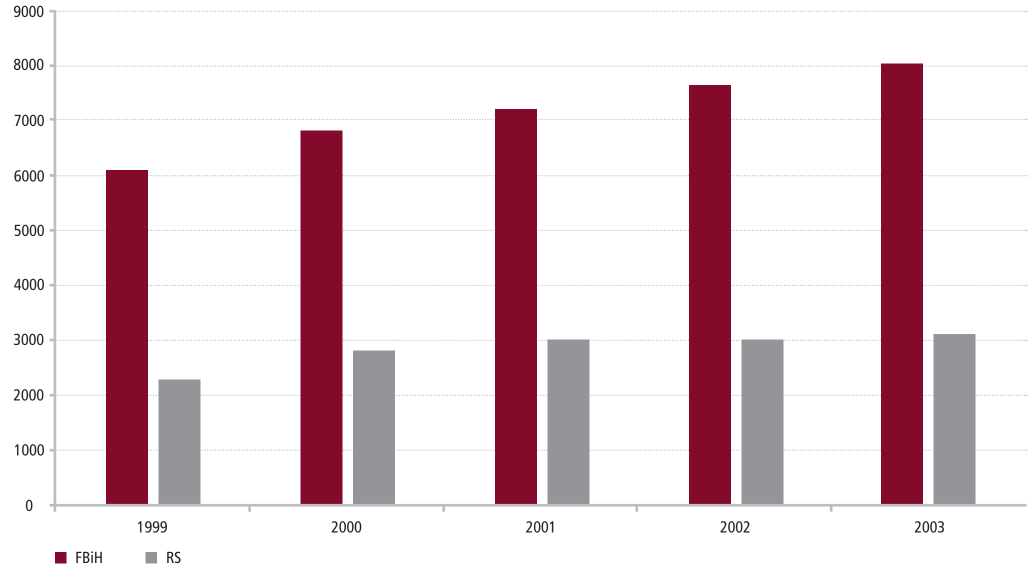
Within the labour force, 849,570 are in employment and 346,744 are unemployed. The ILO 2007 unemployment rate is 29 per cent. 47.6 per cent of the employed work in the service sector, 32.6 per cent in industry and 19.8 per cent in agriculture. According to EBRD statistics, the level of unemployment hovers at around 40 per cent.

Levels of unemployment and inactivity are intolerably high. There are many reasons for this. These include a passive macro-economic policy; the lack of an industrial policy; limited labour mobility; high interest rates for businesses; a lack of social trust; poor business confidence; and high levels of corruption.

Income Inequality and Poverty

Income is not evenly spread across BiH. Until recently, the GDP growth rate of Federation of BiH (FBiH) was significantly higher than the growth rate of the Republic Sprska. This was explained by the uneven levels and distribution of foreign aid. However, since the recent privatisation of the state assets of Republic Srpska (telecoms and the oil refinery) at the end of 2006 and during 2007, Republic Srpska's GDP growth rate has surpassed the Federation of BiH. The establishment of a development bank[3] in 2007 to boost SME development and improve Republic Srpska's public infrastructure and education has also contributed to GDP growth.

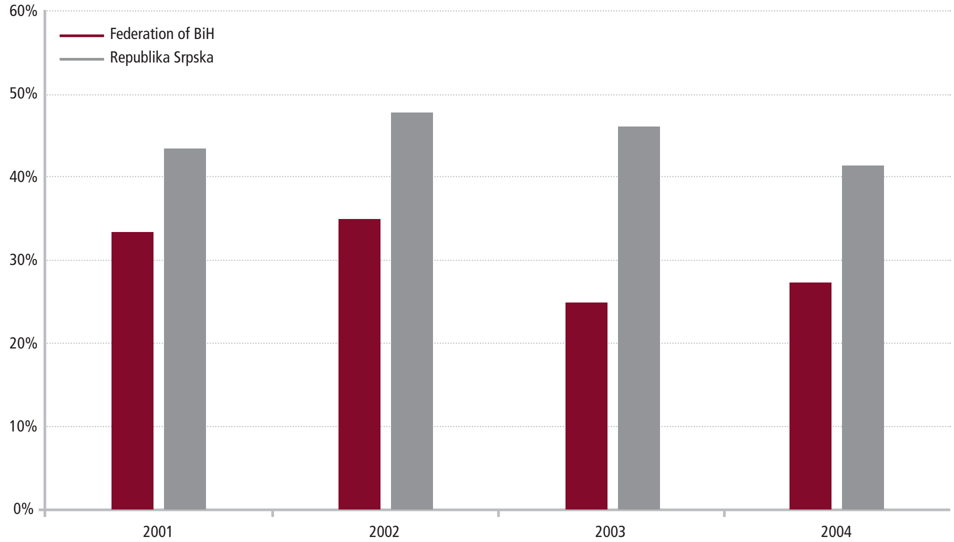
Nominal GDP in the Entities (KM millions)



Source: BiH Poverty Reduction Strategy Paper (2004-2007)

The 2004 Living Standards Measurement Study (LSMS) indicates that 17.8 per cent of the BiH population (i.e. 680,000 people) live below the poverty line. The poverty line for BiH is defined as KM2223 or €1136 per year. 51 per cent of the poor live in Republic Srpska, while 49 per cent live in the Federation of BiH. Almost half of the poor live in rural areas, over a third in mixed municipalities and 17 per cent in urban areas. Using a definition of poverty as two thirds of median income (KM 250 per month)[4], poverty levels rise to 35 per cent of households, 42 per cent in Republic Srpska and 28 per cent in FBiH.

Poverty in the Entities (Households below two-thirds median income)



Source: DFID, Labour and Social Policy in Bosnia and Herzegovina: The Development of Policies and Measures for Social Mitigation, May 2005

Social Exclusion and Trust

Social trust is now at its lowest level since the signing of the DPA. Everyone openly speaks about the possibility of a new war in Bosnia and Herzegovina.

An Oxford University research paper (2007) indicates that social trust in BiH is virtually non-existent. In international comparisons, Bosnia and Herzegovina is relegated to the last position.

Social Trust[4]

(Others can be trusted in %)

China	54.5
Belarus	41.9
Montenegro	33.7
Croatia	20.5
Serbia	18.8
Macedonia	13.7
Bosnia and Herzegovina	7.2

Most BiH citizens see the situation in BiH as "bad". Four in ten would leave BiH if given an opportunity. Two thirds of respondents aged between 18 and 30 say that they would like to move abroad. Nearly half of the Bosnian people believe they are first and foremost BiH citizens; most of the others subscribe to a dual identity. Critically, 14.2 per cent of 3,580 respondents reject a BiH identity.

Many experts believe that this feeling of social exclusion is a result of the poverty in Bosnia and Herzegovina. 31.3 per cent of households in the Federation of BiH and 22.5 per cent in the Republic Srpska have no apparent monetary income. Other studies found that 50 per cent of the population is generally socially excluded. On a long-term basis, 47 per cent of the population is excluded. [6]

What went wrong?

The Dayton Peace Accords (DPA) signed in Paris in 1995 ended a brutal war. The nature of the agreement preserved the Bosnian state as a whole, despite efforts from all sides to divide the country. But the DPA was structured in such a way that it allowed all sides, Croatian, Bosnian, Serbian and the international community, to claim some sort of victory. As a result, all three nationalist and ethnically defined political parties, in power since November 1990, survived the war and resumed political power. It enabled each ethnic group to impose its own hegemony over political and business activities. In addition to government institutions, entities, cantons and municipalities, every company, and in particular public corporations, were in the hands of one of the ethnic parties.

The DPA set out the State's Constitution and provided for the full freedom of movement of persons, goods, services and capital. It established two internal entities – the Federation of BiH, with 51 per cent of the territory and 10 cantons, and Republic Srpska with 49 per cent. But the separation of the state into entities divided the ethnic groups geographically and changed the ethnic spread significantly. Many refugees could not and did not want to return to their homes which were "in the wrong ethnic part of town". Those seeking employment were unable to move across the country to find a job.

Those best placed after the conflict took control of state assets and invested the proceeds into various speculative ventures, most of which quickly failed. Stripped of any serious regulatory power, Bosnia and Herzegovina was not in a position to prohibit such activity. A willingness to break the rules, to use power and force in business and other "mafia-style" techniques, became widespread and increasingly divided along ethnic lines. These days no-one is sure which factor is more damaging to the future of BiH: ethnic tensions or deeply rooted corruption.

Conclusion

The need to end the war was so urgent that the political agreement reached did not create a strong central authority and, instead, led to the greater entrenchment of ethnic divisions. The roots of social exclusion lie both in high unemployment and in the ethnic division of the country. The poverty rate remains one of the highest in the South-East European region, despite the relatively high GDP growth rates achieved at the beginning of the economic recovery programme. Annual GDP growth now stands at approximately 6 per cent.

A successful economy and real political reform are the foundations for BiH's future. The political accord should have responded to the challenges of social and economic integration.

Section 2

Market Reforms

Bosnia and Herzegovina was encouraged to privatise, liberalise the market and minimise the role of the state and in so doing was thrown head-first into the free market economy.

Market Economy Strategy

Following the DPA, the World Bank/IMF strategy for Bosnia and Herzegovina detailed steps needed for the establishment of a market economy. The strategy envisaged rapid privatisation, the dismantling of state firms, and the development of SMEs, light industries and the service sector, as a basic means for economic growth.

The package offered by the World Bank and IMF in their economic strategy programme imposed severe budget constraints. But the package was seen as the only way of achieving stabilisation, preparing the ground for privatisation and establishing a pro-development macroeconomic policy to be implemented when the politics improved.

The DPA placed banking and customs regulation at the central state level, while fiscal policy was transferred to the entities and cantons. This hampered the central state's ability to formulate a national strategy for economic development. BiH was not given the powers to devise and pursue independent monetary, fiscal, price and foreign-exchange policies, as well as policies for privatisation, income and social welfare.

Many of the World Bank/ IMF reforms were successful. But without a strong state and a national economic policy, the reforms did not have the desired effect and a weak market economy was created.

Banking Reforms

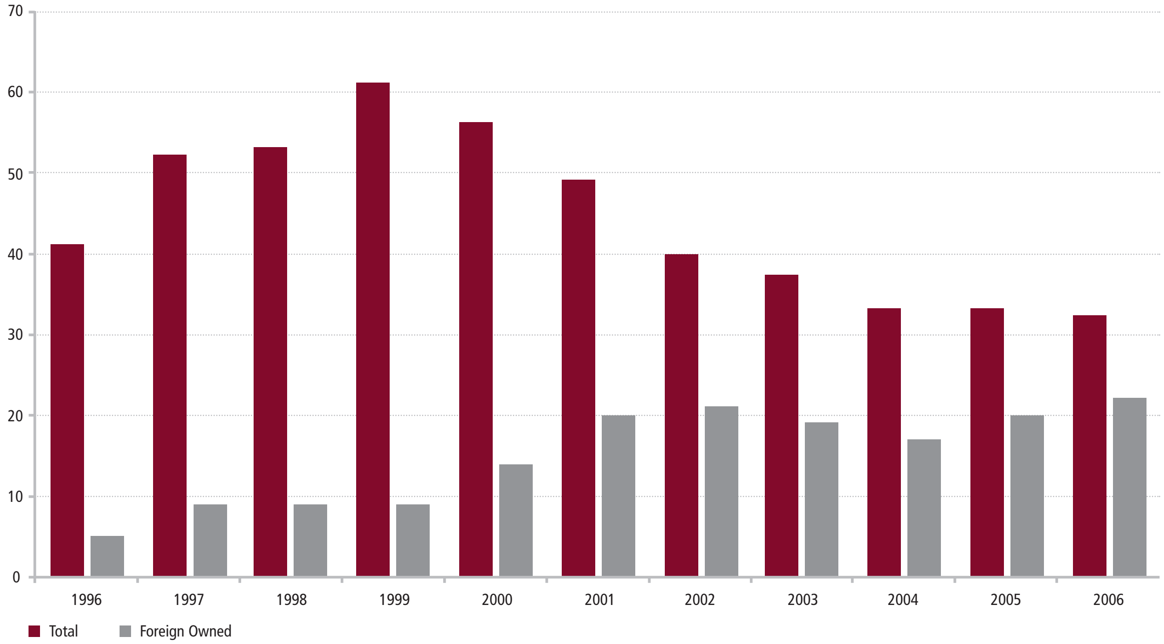
The World Bank and the IMF promoted the reform of the banking sector. From 1996/7 – 2004, the Central Bank functioned as a currency board. This meant integrating Bosnia into international markets as a 'price taker', with a fixed exchange rate for its national currency. This was pegged to the German mark (and now to the Euro). The country effectively lost complete control over its monetary policy.

There were 32 commercial banks in Bosnia and Herzegovina at the end of 2006. 23 were based in Federation of BiH and 9 in Republic Srpska. The privatisation and almost total sale of the banking sector to foreigners was extremely problematic. Smaller bank branches were closed, leaving many communities without banking facilities.

Only no-risk projects were supported. Luxury vehicle purchases were approved at a time when obtaining SME finance was virtually impossible. More importantly, the bulk of local savings was transferred out of Bosnia and Herzegovina and invested in the 7-day money market or deposited in EU bank accounts paying a reasonable rate of interest (risk free). This meant that BiH was drained of its own resources.

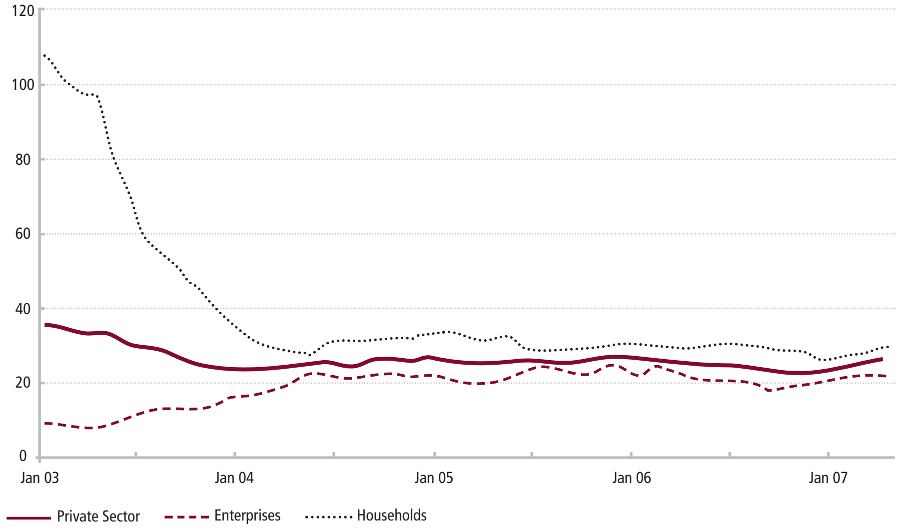
In 2002, sudden increases of credit to households were recorded: in relation to 2001, the increase was 102 per cent. Business loans increased in the same period by nearly 40 per cent. Total credit to households represented 49 per cent of total loans issued in 2003. By the end of June 2007, household credit amounted to KM 5.04bn and made up 47.6 per cent of total credit. [7]

Number of Banks



Source: European Bank of Reconstruction and Development: Bosnia and Herzegovina

Private Sector Credit Growth (% year-on-year change)



Source: The IMF Country Report (2007)

State Owned Enterprises vs. Small Medium Enterprises

Despite international aid and support for privatising 'strategic' state owned enterprises (SOEs), by mid-2003 only 17 out of 56 firms were privatised in the Federation of BiH and 4 out of 52 SOEs in Republic Srpska. Large companies languished or failed to restart after the war, although their managers claimed that small amounts of money (€2–3m, for instance) would have allowed them to restart production. The international community rejected financial support for the existing big companies[8] and the SOEs were left open to asset striping. Some SOEs were managed poorly on purpose in order to decrease their value and were then sold cheaply to ethnic groups. The privatisation of the SOEs led to a massive increase in unemployment.

Without a strong SOE base, the only route left was to develop Small and Medium Enterprises (SMEs). But BiH ended up with an uncompetitive and unpromising micro-economic structure. Due to the micro-financing of businesses, the lack of FDI inflow and an incoherent strategy for industrial and technological development and export promotion, BiH's micro-businesses disappeared in the informal economy.

Two States and Privatisation

The World Bank/IMF believed that state institutions needed to adopt a flexible programme of privatisation, to be applied regionally. This meant that a national company that operated throughout Bosnia and Herzegovina before the war or the DPA, was suddenly split into two different parts; one part of the company belonged to the Republic Srpska and formed part of its state assets; the rest of the company became state property in the Federation of BiH. Ethnic privatisation and entity division also meant that a member of one ethnic group was unable to find a job in the space dominated by the other ethnic group. This entity approach toward privatisation recognized two states de facto in one state.

The issue of property rights became particularly divisive and counter-productive. Before the war, an apartment inhabited by private individuals was socially owned. In the privatisation process, apartments were sold for vouchers to those people who enjoyed the right to use it. As the ethnic division of the country prevented many people from returning to their homes, BiH experienced an enormous sale of apartments. The consequences were twofold. Refugees did not return to their place of pre-war residence and the sale led to a massive outflow of capital from Bosnia and Herzegovina.

Conclusion

The segmented state divided BiH both ethnically and economically and in so doing, destroyed a unique economic space. A weak state with little room for manoeuvre is not the right basis from which to promote a free market economy. Left without its own monetary, foreign-exchange or balance of payments policies and with different privatisation laws in its two entities, the government could not even consider developing an industrial policy. The World Bank's approach to free market economy might have been correct under the right circumstances. But could a functioning, sustainable market economy really have flourished in the fragmented, war-torn and fragile state of Bosnia and Herzegovina?

Section 3

Trade

Without full economic integration between the two entities, trade could not become the integrating factor in Bosnia and Herzegovina.

Trade Liberalisation

It was unsurprising to find economists, entrepreneurs and politicians (especially the Office of the High Representative - OHR) arguing for trade as the integrating factor to produce economic and political recovery in Bosnia and Herzegovina. Various OHR initiatives were directed at harmonising customs duties and taxes on so-called high-tariff goods between the Federation of Bosnia and Herzegovina and Republic Srpska. The OHR put pressure 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.

Internal trade has now been successfully liberalised and a unique trading zone created. However, different social security, health and higher education policies have prevented the establishment of a unique economic space and a single labour force. The convergence process has begun but is advancing at a very slow pace. Full economic integration between the two entities is unattainable so long as the different legal and institutional structures have not been harmonised.

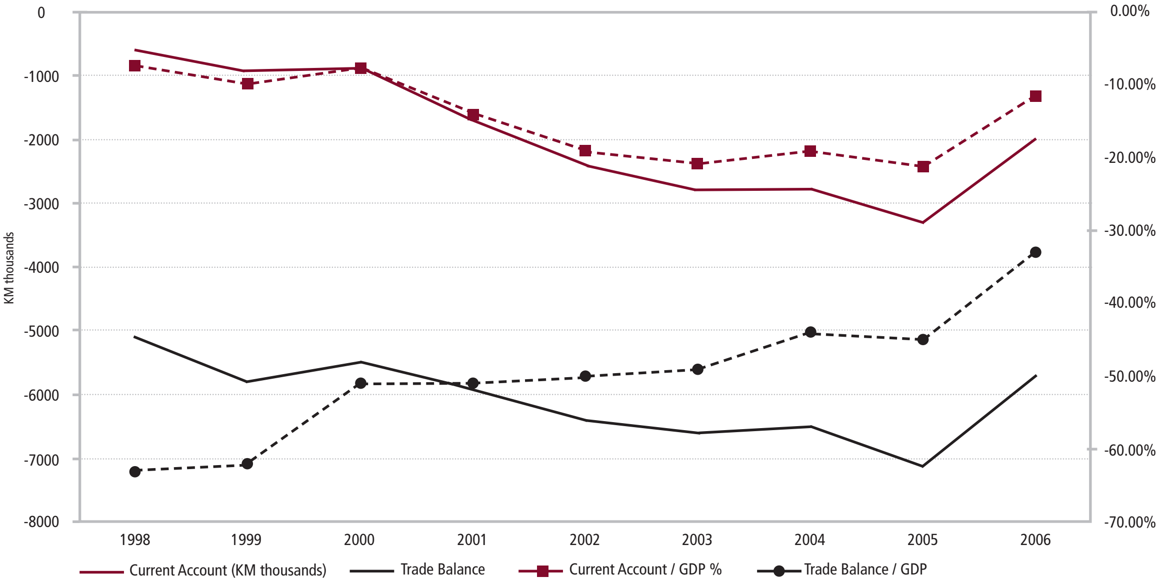
Regional Trade

The DPA provided the entities with special ties with their neighbours Serbia and Croatia. As a result, entities cooperated with neighbouring countries on the principle of a free trade-zone. Without customs or other trade obstacles with its neighbours but with regulatory obstacles to trade between the entities until June 1998, it was natural that trade developed across borders rather than between the two entities. Devastated by the war, the Republic Srpska and the Federation of BiH had import needs that Croatia and Serbia were able to meet.

Exports and Production

By the end of 2005, the structure of the Bosnian economy was not dissimilar to that of a developed economy. The service sector was the dominant sector, followed by industry and then agriculture. But this structure was not the result of natural development. The structure reflected the lack of domestic production, industrial policy and investment. Exports played a minimal role in the BiH economy.

Current Account and Trade Deficit in BiH



Source: Current Account Deficit Sustainability in BiH, Didik & Gligorov (2007)

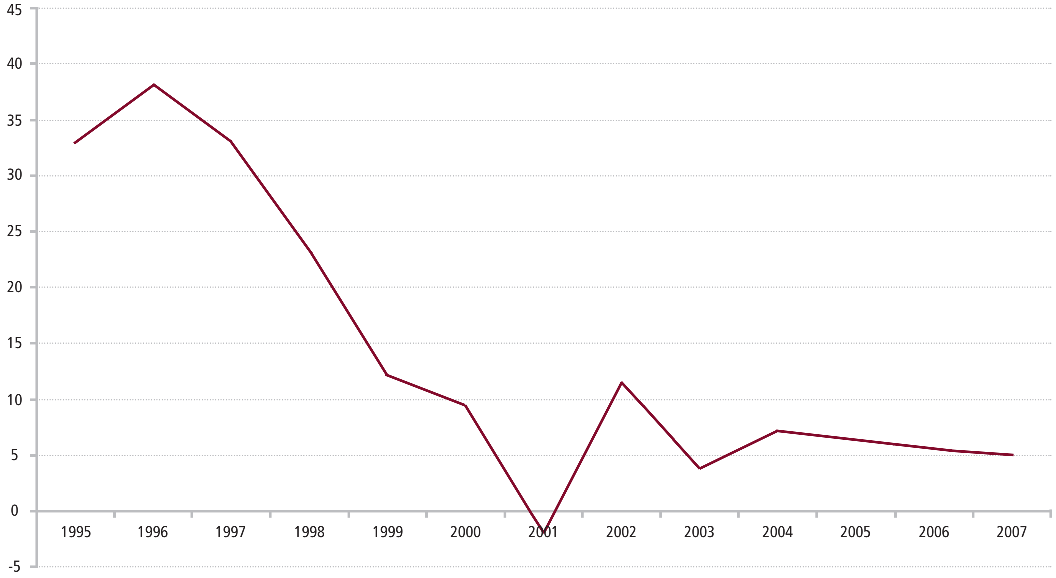
According to the BiH's Economic Policy Planning Unit (EPPU), "the largest twenty exporters amount to some 4-5 per cent of total employment but with 80 per cent of exports".

Domestic production in Bosnia, which would have done much to revive local income and provide a base for future development, received no effective support either from the state or from the international community. This led honest managers to think short-term and to overlook the need to modernize and improve their companies. Any R&D activity was carried out by individuals out of personal enthusiasm. The absence of technological progress and lack of a positive vision for the country's future left citizens uncertain about the likelihood of progress.

Trade Deficit

A liberal foreign trade sector (with underdeveloped and insufficient domestic production) tempted the local entrepreneur to import products from third countries, thus increasing the balance of payments deficit of Bosnia and Herzegovina. The highest trade deficit registered so far in BiH was for the period of January 2007-November 2007 and amounted to KM 7.2 billion (€3.6 billion). [9]

Industrial Output (% change in real terms)



Source: European Bank of Reconstruction and Development

Conclusion:

Trade liberalisation was seen as the engine for development in Bosnia and Herzegovina. But it had the opposite effect. The free market approach discouraged nurturing new industries. Trading with the surrounding regions supplanted the desired "trade creation" effect between the entities. As a result, Bosnia and Herzegovina now faces a massive trade deficit and an unsustainable current account.

Section 4

Sources of Finance

Reducing dependency on foreign aid and remittances can only take place when the foundations have been laid to attract massive Foreign Direct Investment (FDI) into the Bosnian economy. But because of the latest financial turmoil, FDI will be harder to attract.

Foreign Direct Investment (FDI)

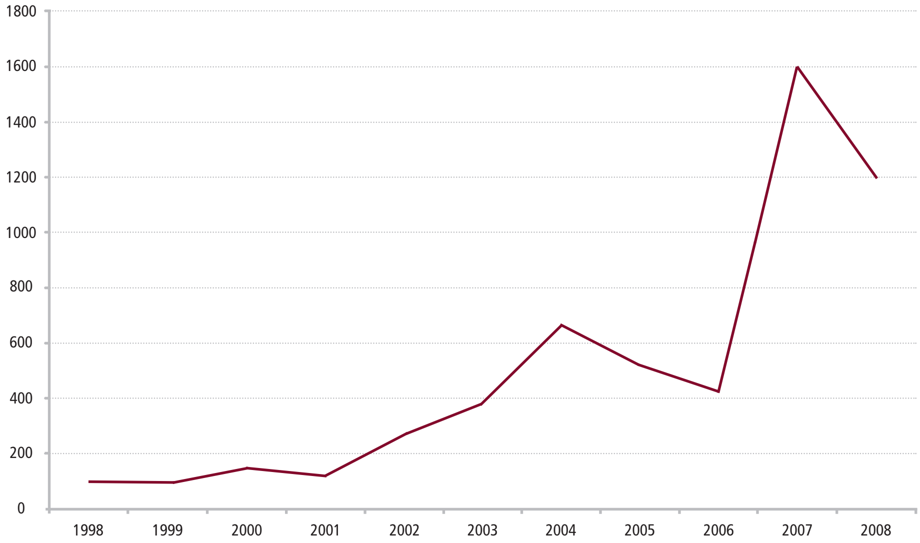
FDI was considered by international financial institutions as the best route to the reconstruction and recovery of BiH's economy. FDI was essential to boost job creation and tackle the inadequate competitiveness of domestic production. Compared to other transition economies, FDI made up a significant percentage of BiH's GDP. But not enough FDI was attracted as was necessary.

The structure of this investment was also a serious problem. Slightly less than half of FDI inflow went into service sectors (banking 16 per cent), and only 58 per cent of FDI was invested in production. The inflow into production did not increase the total industrial capacity of BiH. It was invested instead in the property assets of companies and focused on domestic rather than export oriented production.

There were several reasons for a relative FDI shortfall in BiH. Bosnia and Herzegovina was not an imminent prospective member of the EU; it did not have attractive natural resources; it had not entered the decisive phase of privatisation; it was relatively unstable politically; and it created unnecessary bureaucracy because of the double registration process.

Recent surges in FDI in 2007 can be attributed to the privatisation of the Republic Sprska's telecom and oil industries. It is estimated that as much as KM 2.89bn flowed into the Republic Sprska. FDI flows have since fallen and no recovery is expected following the global financial crisis. BiH remains to this day an aid-driven economy.

Foreign Direct Investment (US $m)



Source: European Bank of Reconstruction and Development

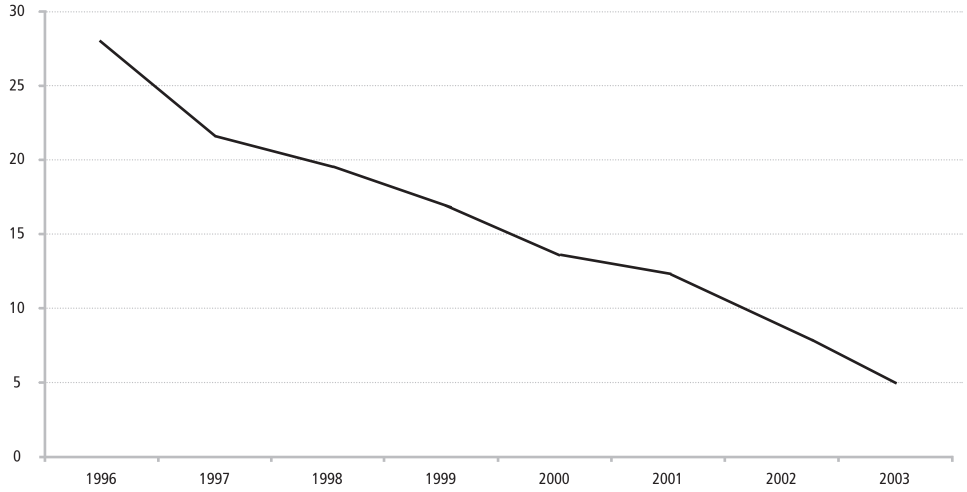
Aid Driven Economy

In the absence of FDI, the international community has had to inject massive sums of capital. The first donor conference was held in December 1995. The World Bank was appointed lead donor coordinator to BiH. In the first priority reconstruction programme, $5.1bn was pledged. Initially most of the aid was directed to infrastructure reconstruction, the return of refugees and the rebuilding of institutions. Less was devoted to business development and to enterprise support.

Donor disbursements are estimated to have totalled $2.13bn between January 1996 and August 1999. 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 was disbursed as credit for the business sector (about $385 million for 919 projects).

In the first two years of economic reconstruction, foreign aid significantly contributed to the impressive growth of GDP. In later years, real GDP growth slowed and assistance as a percentage of GDP fell.

Foreign Aid (% of GDP)

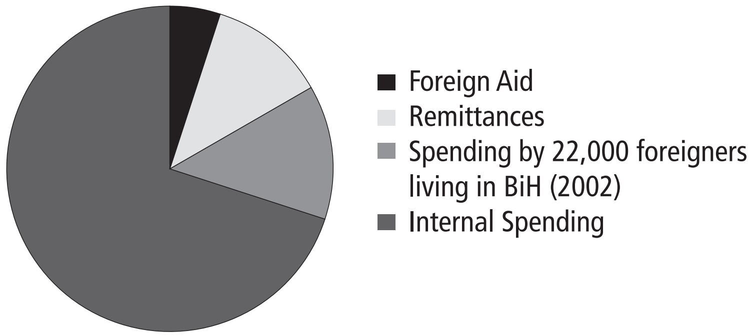


Source: Data from Poverty Reduction Strategy Paper (2004-2007), IMF and Tzifakis, N and Tsardanidis, C (2006), Economic Reconstruction of Bosnia and Herzegovina: The Lost Decade, Ethnopolitics, Vol. 5. No. 1.

Foreign Spending

Demand-led growth played a dominant role in the development of the BiH economy, stimulated by foreign aid, spending of foreigners in BiH and remittances. One study shows that foreigners used to spend around US $3m daily in Sarajevo alone.

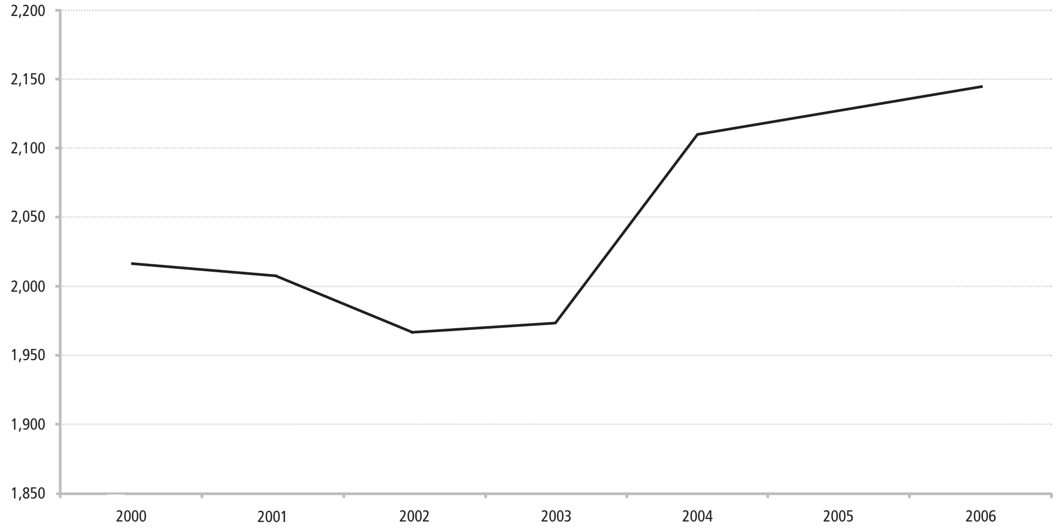
External Sources of Spending



Source: BiH Poverty Reduction Strategy Paper (2004-2007)

Over the last few years, decreasing foreign aid and spending by foreigners have been compensated by a significant flow of remittances from abroad and an increase in consumer lending. The contribution of remittances to economic growth is a strong factor in determining demand-led growth, even stronger than FDI and foreign aid. Some believe that annual remittances to BiH total as much as 22.5 per cent of GDP.

Remittances (KM m)



Source: Current Account Deficit Sustainability in BiH, Didik & Gligorov (2007)

Conclusion

Dependence on aid, foreign spending and remittances is not a sustainable base for a thriving economy. Bosnia and Herzegovina needs to find new sources of capital to propel its economy forward. Private sector investment and development, alongside political and social progress, are essential if the Bosnian economy is to halt its decline.

The future

The EU is the only real path to economic, political and social development for Bosnia and Herzegovina. In 1999, following the Kosovo crisis, the EU offered the Western Balkan states the prospect of joining the EU through the Stabilisation and Association Process, once certain requirements were met. These included a swift transition to, and the stabilisation of, a market economy, the promotion of regional cooperation and the implementation of international and European Community standards.

In September 2002 Commissioner Chris Patten declared that the 'EU Road Map' - a first tranche of reforms designed to begin the process of preparing Bosnia and Herzegovina for EU accession - was 'essentially complete'. The next step was the Feasibility Study, published by the Commission in November 2003. The study outlined sixteen areas in which BiH had to show significant progress before the Commission could recommend the opening of SAA negotiations. The areas include the Rule of Law, standardisation of taxation, customs and trade issues and legislation, and standards.

In November 2005, negotiations over a Stabilisation and Association Agreement with BiH were officially launched. The 2007-2009 Multi-Annual Indicative Planning Document (MIPD) for Bosnia and Herzegovina which provides financial assistance from the EU was adopted in June 2007. Assistance totalled €62.1 million in 2007.

The prospect of joining the EU has given the EU significant political leverage in insisting on reforms in Bosnia and Herzegovina. It was only the initialling of the Stabilisation and Association Process in December 2007[10] that averted the threatened outbreak of hostilities and kept Bosnia and Herzegovina on track with political, social and economic reforms. On 16 June 2008 the Stabilisation and Association Agreement between the EU and BiH was signed.

Conclusion

The Stabilisation and Association Process is a crucial factor in keeping the peace alliance together. The promise of economic rewards has, so far, contained the political crises and ethnic tensions arising in BiH. But many of the current economic and social problems might have been avoided altogether if the ceasefire agreement had placed more emphasis on rehabilitating the local economy and strengthening the administrative functions of the state.

Appendices

Bosnia and Herzegovina: Fact Sheet[11]

The Kingdom of Serbs, Croats, and Slovenes was formed in 1918 in the aftermath of the First World War and changed its official title to Yugoslavia in 1929. Following the Second World War, communist Partisan Leader, Marshall Tito, took control of the country and ruled it for the next 40 years. Following Tito's death in 1980, Yugoslavia began slowly to disintegrate in a process that culminated in the Balkan wars of the early 1990s. Slovenia, Croatia and the Republic of Macedonia declared their independence in 1991, BiH in 1992. The remaining republics, Serbia and Montenegro, declared a new Federal Republic of Yugoslavia in 1992 and, under Slobodan Milosevic, resorted to military intervention to achieve the integration of ethnic Serbs into 'Greater Serbia'.

This policy was ultimately unsuccessful and prompted a co-ordinated military response from the United Nations and the international community, primarily in BiH, which eventually led to the Dayton Peace Accords (DPA) of 1995. The agreement fixed internal borders in the Western Balkans along lines that still exist today. The Office of the High Representative (OHR) was established to oversee the implementation of the DPA and was granted "Bonn Powers" to enforce the terms of the agreement.

Bosnian political leaders signed a commitment to pursue constitutional reform in Washington on 21 November 2005. Discussions had been ongoing, facilitated by the international community, with the goal of improving the functionality of BiH institutions. The leaders of the largest political parties agreed to a constitutional reform package on 18 March 2006, which would have established a rotating Presidency with a single President and two Vice Presidents (as opposed to the previous, tripartite structure) and would have built a more effective Parliament. This would have been an important first step for BiH on the path of reform towards a more functional state, European integration and human rights. But the agreement was blocked in the BiH House of Representatives on 26 April 2006.

At its meeting in February 2008, the Bosnia Peace Implementation Council Steering Board (PICSB) agreed to maintain the Office of the High Representative (OHR) and its Bonn Powers, despite former recommendations that the OHR close in 2007. There were a number of reasons for the change of heart: the ongoing political instability; a lack of progress on key reforms; and continued challenges to the Dayton Peace Accords. Closure of the OHR will now depend on a positive assessment by the PICSB of the political and security situation in BiH, based on full compliance with the DPA.

Dayton Peace Accords and the Compound State[12]

The General Framework Agreement for Peace in Bosnia and Herzegovina was initialled on 21 November 1995 in Dayton (USA) and signed on 14 December 1995 in Paris. The Agreement set out fundamental principles and the legal and political organisation of Bosnia and Herzegovina. BiH is a compound state, which in line with the General Framework Agreement for Peace, consists of the Federation of Bosnia and Herzegovina (51 per cent of territory) and the Republic Srpska (49 per cent of territory). Brčko, which was the subject of dispute and international arbitrage, was proclaimed a district. Thus, Bosnia and Herzegovina has two entities and the Brčko District.

Federation of Bosnia and Herzegovina

The Federation of Bosnia and Herzegovina (FBiH), as the entity, consists of ten cantons (which, in administrative terms are further split into communes) as follows: – Una-Sana Canton, Posavina Canton, Tuzla Canton, Zenica-Doboj Canton, Bosnia – Podrinje Canton, Central Bosnia Canton, Herzegovina-Neretva Canton, West Herzegovina Canton, Sarajevo Canton.

The Parliament of the Federation of BiH has legislative powers and is composed of the House of Representatives and the House of Peoples. Executive powers are performed by the President of the Federation and two Vice Presidents, as well as the Government of the Federation of BiH. Sarajevo is the capital city.

Republic Srpska (RS)

Republic Srpska is administratively split into regions (Banja Luka, Doboj, Bijeljina, Pale and Trebinje). Regions are further split into communes.

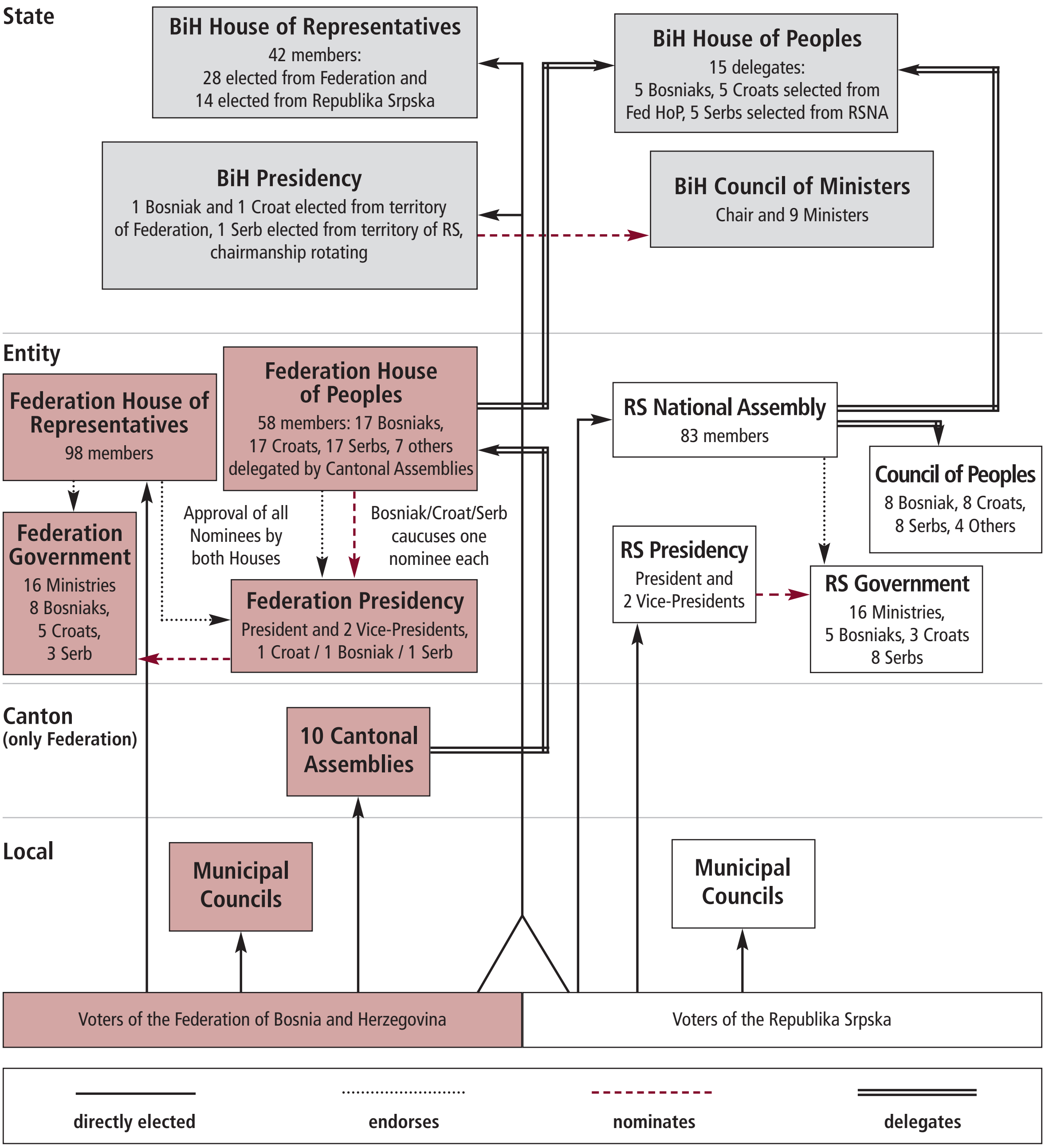
The National Assembly and the Council of Peoples of the Republic Srpska exercise legislative powers in the entity. Executive powers are excercised by the President and two Vice Presidents of the Republic Srpska, as well as by the Government of the Republic Srpska. Sarajevo is, de jure, the capital city.

Brčko District

The territory of Brčko was under arbitrage and was attached neither to the Federation of BiH nor to the Republic Srpska. By decision of the International Arbitrary Commission, close to the end of 2000, Brčko was put under the administration of Bosnia and Herzegovina, as a separate district.

Brčko District has its own multi-ethnic government, Assembly, Executive Board, jurisdiction and police force.

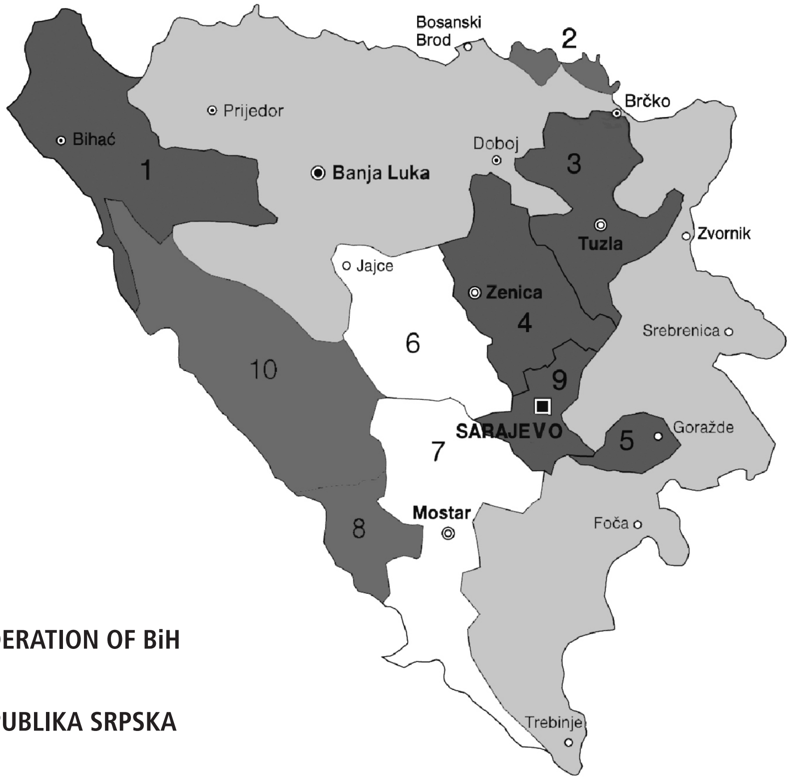
Legislative and Executive Bodies of Bosnia and Herzegovina



Source: EBRD (2007) Strategy for Economic Development of BiH

Map and Key Facts about Bosnia and Herzegovina

1 - Una Sava (Bosniak)
2 - Posavina (Croat)
3 - Tuzla Podrinje (Bosniak)
4 - Zenic Doboj (Bosniak)
5 - Bosna Podrinje (Bosniak)
6 - Central Bosnia (Mixed)
7 - Herzegovina Neretva (Mixed)
8 - West Herzegovina (Croat)
9 - Sarajevo (Bosniak)
10 - Herceg Bosna (Croat)



Bosniak Canton
Croat Canton
Bosniak-Croat Canton
} **FEDERATION OF BiH**
→ **REPUBLIKA SRPSKA**

Source: Office of High Representatives (OHR)

Population	3,800,000 (World Bank 2007 est.)
Bosniak percentage of population	48 per cent
Serb percentage of population	37.1 per cent
Croat percentage of population	14.3 per cent
Other (percentage of population)	0.6 per cent
Area	51,200 km² (19,970 sq. miles)
Federation of Bosnia and Herzegovina	51 per cent
Republika Srpska	49 per cent
GDP	US $15 bn (2007 World Bank)
GDP per capita (current)	US $3,808 (2007 IMF)
Unemployment Level	29 per cent approx. (Labour Force Survey 2007)

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Professor Dragoljub Stojanov, February 2009

This paper was prepared by Professor Dragoljub Stojanov and edited by The Portland Trust. All comments, suggestions or complaints should be sent to: feedback@portlandtrust.org

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