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CASE STUDY:

BOSNIA AND HERZEGOVINA

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BACKGROUND

1980s were marked by a deep political and economic crisis in the former state of Yugoslavia. At the turn of the decade, new parties appeared on the country political scene, including the political arena of Bosnia and Herzegovina (then the Socialist Republic of Bosnia and Herzegovina and one of the six republics comprising Yugoslavia). Parties that swept 1991 elections – “democratic” and largely with an ethnic prefix – were expected to replace the communist one-party regime with a pluralistic democratic political scene. Hopes were also high when it came to bringing order into the severely shaken economy.

This seemingly positive change ended up being a fatal one. The new political elite soon started inciting ethnic tensions and renewing nationalist ideologies. At the same time, inherited economic decentralization fed corruption and crime that thrived intact as a consequence of weak state control.¹ This political and economic chaos culminated in a series of wars, the one in Bosnia starting with the proclamation of independence from Yugoslavia in April 1992 and being the most brutal one. A most recent research points to approximately to 113,000 fatalities, 40% of which were civilians.²

The war ended with an internationally mediated Dayton Peace Agreement. Two main goals of Dayton were to end the war and rebuild a “viable Bosnia”.³ Dayton set up a complex powersharing system that determined the way the reconstruction strategy was to be implemented and has directly characterized the peace process itself. Externally led

¹ Donais (2003), Bougarel (1996)

² http://www.idc.org.ba/prezentacija/rezultati_istrazivanja.htm

³ Cousens & Cater (2001), p. 33

fiscal and monetary policy arrangements agreed on in Dayton have paved way for macroeconomic stabilization.

While the war itself ended in late 1995, this study will show that it perhaps continued in a subdued and covert form to this very date. As contemporary conflict theory instructs, contemporary conflicts do not allow for clear-cut analyses that include start and end dates. They usually represent a section (although highly relevant) of a wider social process.⁴

⁴ DFID (2002)

1. POWERSHARING IN POST-CONFLICT BiH

1.1. *Post-conflict powersharing trends and instruments*

1.1.1. The role of international factors in peacebuilding

Strategies to assist post-conflict countries to recover from “new” wars⁵ mostly focus on introducing an externally-controlled set of governance principles that aim to ensure sustainable peace and stability. The concept of the so-called “liberal peace” represents a set of ideological and practical concepts, namely those of democracy and market sovereignty on the one hand, and conflict resolution on the other.⁶ It sets out to combat security threats and challenges while simultaneously addressing underdevelopment and poverty as a breeding ground for insecurity and criminalization.

Bosnia’s peace model is characteristic of an orthodox peace strategy, the applied method being top-down and some bottom-up peacebuilding with a strong international presence in both governance and implementation. Actors of the orthodox model are state officials, international organizations, international financial institutions (IFIs), and NGOs, that jointly work on institutional and constitutional building covering political, economic, developmental and social issues.

The ‘transition package’ introduced in BiH is based on the so-called Washington Consensus.⁷ It includes recommendations related to macroeconomic stability,

⁵ “New” wars are those in which countries suffered from an intrastate conflict followed by the fall of sovereignty and economic disintegration, and their post-conflict recovery therefore takes place in a specific recovery environment.

⁶ Pugh & Cooper (2004), p. 6

⁷ The Consensus, a list of policies considered necessary for a developing country’s economy to successfully reform, was developed in 1989 by John Williamson (primarily envisaged for Latin American developing economies).

privatization of the business sector, regulatory reform and economic development.⁸ Policies in these areas have formed the backbone of the BiH Country Assistance Strategies (CAS)⁹ that have been implemented by the World Bank, European Union, United States Agency for International Development (USAID) and other international organizations and agencies, in cooperation - to a smaller extent - with domestic authorities.

Given the ambitiousness of plans and the chaotic state of affairs on the ground, it is natural that peacebuilding of such a kind envisaged strong involvement and even a leading role of international actors. Domestic authorities, themselves being new and faced with abundant political issues, were not – especially in the very beginning – capable of any reform independently. The IC also financially supported all these efforts, which gave it leverage over governmental institutions in principles and policies introduced and institutional backing. Such an approach, although it yielded plentiful results, contained one major flaw. Imposition of democratic principles in a post-conflict environment in which international stakeholders hold real power and domestic institutions are considered responsible for development became a major controversy of the peace model.

The role of the internationally-led Office of the High Representative (OHR) has been the most controversial one. While, in the beginning, the existence of this institution was needed to ensure that IC's recommendations on how to lead the new complex country were being implemented, it has transformed into a stumbling block for proper

⁸ Williamson (2004)

⁹ WB (1999), WB (2004)

democratization. The so-called “Bonn Powers” that allow High Representatives¹⁰ to overrule legislation and impose executive decisions helped prevent nationalist-motivated political decisions at many instances. They also helped remove from power some corrupt politicians. E.g., at the time when Paddy Ashdown was the High Representative (2002-2005), some top party officials were removed from the political scene and banned political activity due to their criminal history, nationalist rhetoric or involvement in scandals. However, when Christian Schwartz Shilling came to the position in January 2006¹¹ and started lifting vetoes on corrupt politicians and remained passive during crises in state-level authorities that could have led to serious destabilization, it became clear that the OHR does not have the strength it used to have.

The role of the IC as such has changed with time. Currently, its focus is on trying to integrate the country into regional trends and ensure its accession into the European Union. At the same time, certain analysts go as far as to conclude that the political situation in BiH today and stability of institutions is worse than in previous post-war years.¹² Hence, we can conclude that instead of the IC becoming redundant in the 13-year-long peace process, its role is perhaps more relevant than ever as the country is on a clear crossroad. One road is leading towards stagnation, isolation and destabilization and the other to the safe haven of the EU.

1.1.2. Domestic political structures and their impact on peacebuilding

Political parties in BiH are demonstrating surprising resilience to externalities. The same political structures and parties that ruled over the political scene of late 1980s, are still the

¹⁰ High Representatives are elected by the internationally-formed Peace Implementation Council (PIC) and are always foreigners.

¹¹ He stayed at the position until July 2007, when he was replaced by Miroslav Lajcak, a Slovak diplomat.

¹² UNDP (2007), Early Warning System Report

strongest parties (or political streams) in the country. Those are the predominantly-Bosniak Party for Democratic Action (SDA), Croatian Democratic Community (HDZ) and Serb Democratic Party (SDS). They have survived the war and – with the exception of SDS – are now as strong as or stronger than ever. SDA has been accompanied by the Party for Bosnia and Herzegovina (SBiH), whose leadership (composed mainly of ex-SDA politicians) is a strong advocate of a unitary state, with constant invocations of the past and suffering of the Bosniak people. SDA, SBiH and HDZ are dominant in the Federation of BiH.

SDS has been pushed aside by the Alliance of Independent Social Democrats (SNSD) in the political arena of Republic of Srpska. While SNSD entered the political scene as a seemingly progressive and liberal party, it has become a strongest advocate of an anti-unitary governmental system, ethnic separation in institutions and even dismemberment of the country based on entity lines. Leadership's invocation of Dayton-ensured ethnic quotas and the predominantly Serb entity with vast competencies are considered a major impediment to a more pronounced stabilization. The reason lies in the fact that the reform process is based on reducing the elaborate governmental system, increasing state-level competencies, overcoming of ethnic separation and sustainable return of refugees and displaced persons. This does not serve nationalist agendas.

Most disturbingly, such politics can be directly linked to the persevering ethnic segregation of the society. Children are being taught using three different school curricula that accommodate different historical and cultural views, ethnic quotas are being applied in the public administration (which is one of the largest employers) and ethnically clean areas caused by war and lack of return are creating secluded communities in which

nationalism dominates. Consequently, it can be concluded that the existing political structures are not contributing to peacebuilding but are perhaps the strongest advocates and reasons for the lack of a more efficient stabilization process.

1.2. Dayton Peace Agreement as a powersharing instrument

The Dayton General Framework Peace Agreement was initialled in Dayton, Ohio on November 21 and signed in Paris on December 14, 1995 by Heads of State of Bosnia and Herzegovina, Croatia and the Federal Republic of Yugoslavia.¹³ Mediation was materialized due to the preceding international application of military force against Serb positions at different locations throughout the country; threat of future use of force; and Serb military defeats in the autumn of 1995.¹⁴

The Dayton Agreement itself is, on the one hand, a collection of provisions and annexes that deal with most issues to arise once the war has ended. It also includes a state constitution. It is a *general* framework agreement and concrete implementation has demonstrated constant need for domestic and IC institutions to make judgments, additionally interpret provisions and develop strategies ad hoc. The Agreement as such allows for an unconsolidated IC presence in the war-shattered country coupled with constant misinterpretations by the signatories.

Eleven annexes to the agreement deal with military and civilian aspects of implementation. All aspects were to be ensured by IC implementers: NATO Implementation Force troops were to ensure an end to hostilities, Organisation for Security and Cooperation in Europe (OSCE) to organize the first elections, UN and EU

¹³ Serbian and Croatian presidents represented Bosnian Serbs and Croats.

¹⁴ Austermilller (2006)

agencies to ensure refugee return and human rights protection, European Bank for Reconstruction and Development and World Bank to revive public corporations, UN to lead an International Police Task Force, and the Office of the High Representative (a new institution) to be in charge of the overall civilian implementation. These agencies were originally supposed to oversee the transition of power to Bosnian authorities for a year, then extended their mandate for two additional ‘consolidation period’ years, and in 1997 extended it indefinitely.¹⁵

The State Constitution devolves most governmental authority to the entities, i.e. to the Bosniak-Croat Federation of Bosnia and Herzegovina (FBiH) and the Serb-majority Republic of Srpska (RS). Furthermore, the Bosniak-Croat entity is divided into ten cantons and its authority is mostly devolved to them. This is due to the inability for the Bosniaks and Croats to agree on all issues that are considered national interests of one particular ethnic group. This “cantonized” entity is dysfunctional to this very day and also divided along ethnic lines.

Entities have been allowed to carry out their own policies; economic development has been impeded by political complicities and disagreements; final accountability for most political decisions falls on the High Representative, i.e. there is no local ownership; and lines of confrontation were through Dayton simply reaffirmed. Although increased state-level competencies are noted in the sectors of justice, military and civilian affairs, most of the competencies remain at the entity level: e.g. education, health, police,¹⁶ economic

¹⁵ Chandler (2000), p. 271

¹⁶ Attempts at police reform marked most of the 2005-2008 period. Although certain provisions were agreed on paper, there have not been any concrete measures aimed at implementation at the time of writing this study.

affairs and energy. Entities – with their separate institutions and budgets – de facto exist independent of one another.

Dayton did not remove then existing political structures, but empowered wartime political elite to lead the post-conflict reconstruction and development process. As a consequence, the country has been faced with a political status quo reinforced by nationalist politics and with little to no incentive for badly needed reform. Accessibility of power to many due to the elaborate governmental system, guaranteed positions based on ethnic quotas and easy access to public goods, only increase incentives for an even longer stagnation.

1.3. The economic dimension of pre-war and post-war Bosnia ***Economic conditions in BiH before the war***

BiH was one of the three pre-war Yugoslav republics which individually had a positive trade balance between 1985 and 1991. More precisely, three of the five largest exporters in the former Yugoslavia were from BiH and two of them took turns at first place during the final ten years of the country's existence: Energoinvest Sarajevo (production of electrical equipment, engineering, oil refining and the production of petroleum derivatives, metallurgy, clay and aluminium) and Unis Sarajevo (the auto-industry, metallurgy, military industry).

During the 1980s the largest car factory in the Balkans was located in Sarajevo (in 1990, annual production was 32,000 Golf cars) as a result of a joint venture by Volkswagen and Unis (TAS – The Sarajevo Car Factory). The company with the greatest number of employees in the former Yugoslavia was also from BiH – Sipad of Sarajevo, which was a wood processing and manufacturing cluster with some 80,000 employees throughout

Yugoslavia. Between 1970 and 1991 the contribution to gross domestic product (GDP) in BiH of manufacturing, particularly metal working, the car industry, electricity, wood processing and chemicals increased markedly. The military industry was a significant source of pre-war income, but did not appear in the official statistics of the former Yugoslavia. The increasing role of middle and higher value-added products in GDP led to significant economic progress and an increase in the standard of living in BiH between 1970 and 1991.

It was also very important for BiH's pre-war economic development that Sarajevo hosted the 14th Winter Olympic Games in 1984 and that between 1978 and 1984 around one billion US dollars were invested in the development of winter and rural tourism, while the city infrastructure in Sarajevo was fully overhauled. Agriculture and the food industry also saw significant progress and pre-war BiH was home to a number of very significant food and drinks producers (UPI Sarajevo, Bosanka Dobož, Vitaminka Banja Luka). The Sarajevo Tobacco Company produced one of the best cigarettes in Europe, in cooperation with American Marlboro (the well known "Sarajevo Marlboro").

Basic characteristics of the post-conflict economic situation in BiH – war destruction (human and physical capital loss)

BiH attained international economic recognition only at the end of the war with the membership in the International Monetary Fund (December 1995) and the World Bank (March 1996). Membership of the WB meant the beginning of realization of the program of priority reconstruction and renewal in BiH.

The economic situation in BiH after the war has been bedeviled by a large number of mutually conflicting goals, which should have been attained relatively quickly after the

end of what was the most important war-related disaster on the soil of Europe since World War II. This fact has severely affected the dynamic of economic growth and the labor market equilibrium. The extent of devastation during the war (1992-1995) particularly affected the quantity and quality of human capital, as well as infrastructure and industrial/commercial property, and meant that economic recovery was entirely dependent on resources authorized by the IC (donor conferences). The degree of wartime devastation may be illustrated using the following indicators:

- The total number of recorded deaths, i.e. persons killed for whom reliable evidence exists with names and surnames, from 1992 to 1995 was 113,000;¹⁷
- The number of missing persons still being sought is around 40,000;
- The number of persons who fled abroad because of the war and have not returned to BiH is around 450,000;
- The Foreign Trade Chamber of BiH estimates the extent of wartime damage to personal and business assets to be in the range of 30 to 50 billion USD; and
- The lost GDP in the four-year period is about 40 billion USD (pre-war GDP of BiH was some 10.3 billion USD in 1991 USD terms).

The GDP of BiH was greatly reduced by extensive war-related destruction. At the end of the war in 1995, the IMF and the World Bank estimated BiH's GDP to be some 1.2 billion US dollars at current prices. Particularly important for analysis of the impact of the war on the economy is the drop in the population from 4.45 million in 1991,

¹⁷ Source: The Institute for Investigation of War Crimes in Bosnia and Herzegovina, Sarajevo.

according to the 1991 census, to 3.35 million in 1995 according to the estimates of demographic experts.¹⁸ Between 1996 and 2008 the population rose to 3.85 million.¹⁹

Donor assistance and post-war economic recovery

Between 1996 and 2000, financial resources were largely channeled into the reconstruction of housing, infrastructure, and public services. Resources available for business sector development were much more modest and limited in scope.

Table 1 – Distribution of Donor Assistance to BiH coordinated by the World Bank – 1996 – 2000

| Sectors | Shares (in %) |
|---|---------------|
| Housing construction | 16.1 |
| Electricity production and transmission | 13.0 |
| Transport infrastructure | 11.2 |
| Credit lines to business sector | 8.2 |
| Water supply | 7.8 |
| Social security support | 6.8 |
| Foreign debt repayment | 4.4 |
| Education | 4.3 |
| Capacity building of state institutions | 3.9 |
| Agriculture | 3.8 |
| Other | 20.5 |
| T O T A L | 100.0 |

Source: The authors' calculation based on International Management Group Databases, Summary Report: Donor Aid to BiH, In: Economic Task Force Secretariat, Vol.3, Issue 5.

Closure of these projects also meant a reduction in the market potential/demand for the structure of jobs sought on the labor market. Given that, leaving public services out of the equation, employment was mostly concentrated in industry. Problems with

¹⁸Population estimates for the 1995-2000 period are those of Dr Ilijas Bosnjevic published in: Human Development Report – Bosnia and Herzegovina 2002, United Nations Development Programme (UNDP) and Economics Institute Sarajevo (EIS), Sarajevo, 2002.

¹⁹ According to the data of the Agency for Statistics of Bosnia and Herzegovina (www.bhas.ba).

privatization of state companies, modest market share, and low levels of exports all contributed to falling capacity to maintain employment in that sector.

Table 2 - Gross domestic product – Bosnia and Herzegovina 1991-2000

| Year | GDP in millions of KM (local currency – current prices) | GDP in millions of USD (current prices) | GDP per capita in USD (current prices) |
|-------------|--|--|---|
| 1991 | 17,750 | 10,250 | 2,305 |
| 1996 | 4,192 | 2,786 | 670 |
| 1998 | 7,650 | 4,343 | 1,189 |
| 2000 | 9,611 | 4,536 | 1,200 |

Sources: BiH Statistics Agency (www.bhas.ba). Data for 1991 from: Statistical Bulletin of Bosnia and Herzegovina 1992, Institute for Statistics of Bosnia and Herzegovina, Sarajevo, May 1992.

The above table shows that GDP rose from 2.79 to 4.54 billion US dollars between 1996 and 2000 in current prices. That GDP grew by a factor of 1.63 over this period was largely due to the World Bank-coordinated and implemented priority renewal and reconstruction program. During the period in question, according to the World Bank Mission to BiH, some 5.3 billion KM (local currency) or 3.5 billion USD were spent on the reconstruction of basic infrastructure, educational and health care institutions/facilities, and repair and reconstruction of housing.

2. PARTICIPATORY GOVERNANCE AND SERVICE DELIVERY

2.1. Development and peacebuilding

2.1.1. Most prominent developmental projects

First developmental projects, as outlined above, focused mainly on economic recovery. The focus later expanded to reforms of more political and social nature. The EU has had a major role to play in this regard. In 2000, it initiated a new development program for Western Balkans countries called CARDS (Community Assistance for Reconstruction, Development and Stabilization). The program has focused on: reconstruction, democratic stabilization, reconciliation and the return of refugees; institutional and legislative development, including harmonization with EU norms, the rule of law, human rights, civil society and the media; sustainable economic and social development, including structural reform; and promotion of regional cooperation.²⁰

A most prominent sub-project for state capacity building has been the Public Administration Reform (PAR) project, which is also the focus of the BiH Mid-Term Development Strategy. An overlap of functions and responsibilities between different levels of authorities, as well as weak coordination and cooperation were seen as the greatest obstacle to more efficient public administration. Thus far, over EUR2 million have been mobilized for capacity-building activities. Total CARDS funding in the 2001-

²⁰ www.europa.ba

2006 period for Administrative Capacity Building and PAR follow-up totals EUR40 million.²¹

The second largest donor is the US Government. USAID projects have greatly contributed to reconstruction and development. Only in the 1996-2000 period, USAID disbursed USD890 million in assistance that focused on refugee return, infrastructure reparations and private sector support (banking sector and small and medium-sized enterprises development).²²

Current USAID projects cover multiple developmental fields and have shifted their focus from post-conflict assistance to transformational development. They center around private sector development; democratization through strengthening civil society, helping political parties introduce and practice democratic principles, justice sector and legal framework support, local-level development, and media support; and cross-cutting projects such as environmental projects, anti-human trafficking projects and gender initiatives.²³

While it can with certainty be said that all donor programs contributed to some extent to developmental efforts, lack of coordination has been a dominant topic. Donors often implement similar projects with similar outcomes, which leads to inefficiency in the disbursement of funds. That is why today, for example, there are local administration development projects by USAID and the Organization for Security and Cooperation in Europe (OSCE) that are noticeably similar and implemented in the same municipalities.²⁴

²¹ Ibid.

²² USAID (2005)

²³ Ibid.

²⁴ Sources: www.oscebih.org and www.usaid.ba

A significant recent addition to external funding is the introduction of the Instrument for Pre-Accession Assistance (IPA) funds by the EU. IPA supersedes previous pre-accession instruments (including CARDS) to unite developmental efforts in pre-accession countries, BiH included, in the 2007-2013 period. The five components of IPA are: Transition Assistance and Institution Building, Regional and Cross-Border Cooperation, Regional Development, Human Resources Development, and Rural Development.²⁵ These funds are widely acknowledged as a chance to complete the needed reforms in terms of post-conflict development, while speeding up along the EU-accession path.

As for domestic developmental tools, BiH Mid-Term Development Strategy prepared in April 2004 serves as the main document for tracking BiH economic development. Treating almost all macroeconomic indicators, coupled with others developed by EBRD, IMF and WB, this study presents an economic agenda for the period 2004-2009. Already in 2005, experts (both domestic and international) started stating their concern that the document has failed in fulfilling its function – serving as a starting point for the creation and implementation of the national economic agenda and not just a reform measure tool. Still, being the only document of such kind, it remains the only valid and reliable domestic source of statistical data and action recommendations.

Strategy's public administration reform priorities were to conduct a functional review at all levels of government and to reinforce administrative capacity of BiH for European integrations. Most of technical PAR requirements have been fulfilled, but the size and lack of functionality of the many levels of authority and the lack of political agreement on constitutional and EU questions, keep impeding progress in this field. Regarding

²⁵ www.europa.ba

private sector reform, the Strategy places export-oriented private sector in the focus of development.

Obvious high dependence on international aid and international expertise, however, will continue to represent an impediment to domestic resources employment and development. If this dependence is gradually overcome through an educational reform, targeted training and gradual withdrawal of international cadre, and if appropriate state and business mechanisms are developed, these numerous reforms will not remain only elaborated as concepts, but also properly implemented.

2.1.2. EU accession process as a peace-building tool

Given the geo-strategic position of BiH, it was clear from the very beginning of post-war reconstruction that the peacebuilding process will need to be accompanied by a strategy for eventual integration of the country into the EU in times when enlargement became a topical issue. In 1999, the EU proposed a Stabilization and Association Process (SAP) for all countries of SEE, including BiH. By June 2000, all SAP countries were declared “potential candidates” for EU membership.²⁶ At the Thessaloniki Summit in 2003, the SAP was confirmed as the EU policy for the Western Balkans.²⁷

By now, in BiH’s immediate neighborhood, Croatia has gone a long way in EU-accession negotiations and Serbia and Montenegro are also progressing, although more slowly. BiH has had – in contrary to the other Western Balkans countries – a more difficult and complex task of being forced to fully engage in the EU integration process since major issues that fall in the realm of post-conflict reconstruction, recovery and reconciliation have not yet been resolved.

²⁶ www.europa.ba

²⁷ European Council, Declaration from the EU-Western Balkans Summit (Thessaloniki, 21 June 2003)

IC institutions in BiH soon realized that a cost-effective thing to do is to ensure the implementation of some post-conflict development tasks by including them in the accession agenda. Conversely, with war issues unresolved, BiH does not stand a chance of ever being fully integrated into the European family. A very important premise has been behind the EU-accession logic: EU integration is one of the rare issues that unite the society and, therefore, most political segments. In that context it became a peacebuilding tool.

The mission was clearly set out in the Feasibility Study developed in 2003 for negotiations between BiH and the EU on a Stabilization and Association Agreement.²⁸ Sixteen priority areas were identified in relation to a Report of the European Commission to the Council of Ministers of the EU and six short-term priority areas from the European Partnership. These were: more effective governance and public administration; effective legal provisions on human rights protection; effective judiciary; tackling organized crime; asylum and migration; customs and tax reform; budget legislation; budget practice; reliable statistics; comprehensive and consistent trade policy; integrated energy market; development of BiH economic space; and public broadcasting.²⁹

Evidently, this agenda is in full compliance with the peacebuilding agenda. It can even be said that from approximately year 2003, the peacebuilding agenda was replaced by the EU agenda with consistent goals and a higher probability for success in politically-sensitive areas. However, BiH's EU road between 2003 and 2008 demonstrated institutional resistance wherever national interest of ethnic groups was perceived to be at

²⁸ DEI (2005)

²⁹ Ibid.

risk. It is obvious from the Enlargement Strategy and Main Challenges 2008-2009³⁰ document that most of accession criteria have either not been fulfilled or are in the progress of being fulfilled.

Overall, it can be said that the EU accession process has not yet accomplished its goal of bringing sustainable peace. As could have been expected, the main obstacle is the continuing nationalist politics. A lack of consensus on major issues of state building and challenges of the Dayton peace agreement can be directly linked to the inflammatory ethnic rhetoric and lack of unity in the accession process. This makes it clear that the society has not matured enough to comprehensively assess a positive aspect of EU integration that is embodied in overcoming of the identity narrative by submerging ethnic identities into a wider, European, one.

2.1.3. Impact of the external reconstruction and development strategy

There has been a shift in donor focus throughout the years and in relation to the development of the situation on the ground. The country was first exposed to reconstruction aid, macroeconomic stabilization and first attempts at political system reform. The second phase, which roughly started in 1998 and is only now dying out, has been marked by extensive High Representative involvement in domestic political affairs.³¹ It was only in 2000 that the Peace Implementation Council (PIC) presented an agenda for a systematic statebuilding.³² That was a starting point for a reform of state institutions and a first attempt at constitutional reform. The situation has by now arrived

³⁰ EC (2008)

³¹ Cox (2001)

³² “Annex to the PIC Declaration”

at a position in which post-conflict development is inextricably linked to both EU accession and stability in the entire region of South-East Europe.

Many issues remain outstanding. Firstly, neglect for root causes that had led to conflict disabled better results that could have been expected from the many implemented activities. While donor projects mobilized funds and resources to ensure reconstruction, development and sustainable peace through stable institutions, they never engaged in a comprehensive social process that would contribute to societal reconciliation.

Secondly, while IC efforts have focused on democratizing the state through efficient authorities, both executive and legislative authority was, especially in the beginning, taken away from democratically elected representatives and transferred into the hands of “unelected international officials”.³³ At the same time, global trends demanded of the country adherence to specific economic structures and regulation in order to re-enter the market. Both the IC and domestic institutions were faced with a peculiar situation: the IC was in a position where it could not have relied on domestic authorities to accomplish development autonomously, and the domestic authorities found themselves in a situation where their obligations were being fulfilled by an external factor.

Additionally, there were de facto no institutions that would have been able to implement reforms without the vast international presence. The fact that most donor programs have not been implemented through domestic structures has led to a double negative impact. Firstly, there has been a lack of sense of accountability and, secondly, lack of partnership between international organizations and governmental institutions that would ensure transparency on both sides and hence increased productivity of implemented projects.

³³ Donais & Pickel (2003), p. 10

Furthermore, the neoliberal development paradigm as such prevents extensive state intervention in the economy and trade policy while ensuring currency convertibility and liberal foreign trade.³⁴ Yet, if the state is not directly involved in economic strategic planning it cannot ensure that appropriate economic and infrastructural mechanisms are established to enable the state to strengthen. As Ashdown, a former high representative, once highlighted, a free market should flourish, but it takes a stable economic environment to accomplish that.³⁵

2.2. Reform process impact on service delivery

Keeping public institutions and the private sector under political control is a way of sustaining military efforts during war. In a case of protracted conflict, retaining this control is a way of sustaining political and economic power within the political elite in the post-conflict period. As wealth becomes a source of power, control over public-sector employment and state benefits are used to ensure support of relevant constituencies. Localization of power then ensures reinforcement of power in the hands of local elites that thus can exert their influence undisturbed by higher-level involvement and need for harmonization.

Political power in Bosnia is not dependent on formal constitutional authority. It is rather contained within parties that control public institutions, state-owned enterprises, and security and intelligence forces.³⁶ In this constellation, it is not surprising that devolvement of power to higher levels of authority is perceived as a loss of control. On

³⁴ Stojanov (2001)

³⁵ OHR, "Our reform agenda"

³⁶ Cox (2001)

the contrary, it is in the best interest of local elites to keep constitutional structures weak, and political and economic power localized.

As was previously elaborated, the constitutional reform is a direct precondition for development. The impact of the political set-up and governance solutions is by now difficult to estimate in terms of money spent, reforms delayed, citizen dissatisfaction and lack of progress in the EU accession. However, there is another major factor contributing to the overall bleak situation in the public sector. That is the impact of the decentralization of state decision-making on service delivery.

Institutional capacity of state institutions remains at a very low level. As noted above, they are reliant on external support and unable to cope with the double task of post-war reconstruction and integration into the global market. At the same time, there exist multiple, mainly internationally funded and led, projects for the improvement of service delivery at all levels of authority. UNDP, USAID and OSCE are leading major initiatives for improvement of service delivery, particularly at the local – municipal - level. Yet, these projects are vastly similar and often do not leave added value once completed. The reason can perhaps be found in the fact that they are proposing largely the same improvements and often not adapted to local circumstances, the size and needs of municipalities. Civil servants are involved in the implementation but not in the design phase, which would contribute to the feeling of ownership of the process and better contextualization of reform.

The position of state institutions, the IC and citizens in relation to the reform process has also had a major impact on the quality of service delivery. The fact that employment in civil service has mostly not been based on merit but on personal connections, as well as

the feeling that individuals cannot make a difference, has negatively influenced service delivery. Also, the impression that the IC is the final instance for all relevant decisions and that domestic institutions are disempowered negatively impacts the quality of those services that are (or should be) eventually provided by them.

Studies have shown that weak public institutions lead to a sense of lack of human security with the population.³⁷ High economic insecurity and inadequate social safety nets lead to low levels of loyalty to the state and dissatisfaction with the democratization process. Extreme cases lead to social radicalization.³⁸ A major reason for the poor reform in Bosnia and, as a consequence, poor service delivery can be identified in relation to citizen participation.

2.3. Mechanisms for citizen participation in post-conflict development

2.3.1. Citizen demand for accountability and service delivery

It is safe to state that pressure for service delivery and greater involvement in the reform process by the citizens of BiH has been absent. Sporadic attempts by civil society organizations and strikes for workers' rights have not had a large impact on either service delivery or governmental policies. They have, on the contrary, demonstrated how little can be accomplished through public protest and invocation of rights in the country.

There are several reasons for such a poor position of the ordinary citizen in Bosnia. Firstly, the war left most citizens without basic means of survival. Savings were spent on expensive commodities during the war, while many people left their homes without any

³⁷ UNDP (1999)

³⁸ Cox (2001)

belongings. All the above-mentioned facts related to localization of power and emergence of local elites created a state in which those who found employment or alternative sources of income were satisfied by the mere fact and those who did not concentrated their energy on finding employment to be able to ensure their own and their families' survival. Secondly, the International Community soon took over the reconstruction process. As such, it was perceived as the real owner of development and as accountable for progress and lack thereof. Domestic authorities were then not considered fully in charge of the future of the country and hence not accountable for the bad economic situation, lack of jobs and the instability.

A comprehensive reconciliation process never took place. Identification with an ethnic group, spurred by wartime grievances, fortified societal divisions and enabled easier manipulation of masses for nationalist agendas by politicians. The wish to act against the wartime enemy overcame the wish to ensure a better life for oneself. Last but not least, the organization of the civil society sector and its activities also negatively impacted citizens' faith in their potential to change government behavior through civic activism, which was unknown in the pre-war Bosnian society in its contemporary form.

2.3.2. Civil society organizations – peacebuilders or a profit sector?

The treatment of peacebuilders and position of the civil society affect and even reflect the stability in a country.³⁹ The sector is well placed to offer services to socially excluded groups, head reconciliation initiatives and contribute to the overall peacebuilding process by bringing people together and organizing “cross-boundary” activities. The sector has thus had, by nature of its activities, a peacebuilding role in Bosnia.

³⁹ Quaker Council for European Affairs (2009)

In parallel to recognizing its peacebuilding and democratization role, Bosnian civil society needs to be observed from a critical side, too. Namely, efforts at coordinating sector's activities are still largely missing and the situation somehow resembles the lack of coordinated endeavor by the International Community. An additional problem is that of endangered sustainability.

The number of active non-governmental organizations (NGOs) and foundations in the country is estimated at approx. 4,500.⁴⁰ The NGO sector employs 2.3% of the working population with main sectors of activity being culture and sports; economic and social services; and civic services and advocacy. It is estimated that 29% of total population receives services provided by these organizations and in 40% of municipalities in the country there is no competition, i.e. if an NGO did not exist there would be nobody else to provide the same services.⁴¹

The role of civil society organizations has from the end of the war until now been mainly to implement externally funded projects. The sustainability of organizations and associations has mainly depended on these external (largely foreign) sources of finance, while public sector financing remains low. A major consequence of this has been that projects are mainly tailored in a way to accommodate application requirements, put forward proposals that have the greatest chance of being funded and adapt the vision and mission of the organization as need (i.e. funding) arises.

However, at the same time, NGOs are considered to be centers of knowledge and skills when it comes to fundraising, budgeting, financial management in line with EU

⁴⁰ IBHI

⁴¹ Ibid.

requirements, and project management, monitoring and evaluation.⁴² Leaders of these organizations are often referred to as the “NGO mafia” for their close circles of trust and networking when it comes to applying for tenders and other forms of fundraising. These skills could be better employed for developmental purposes.

Non-governmental organizations should shift their role from being service providers that rely heavily on foreign donor support⁴³ to the initiators of active citizenry and a driving force of change based on public opinion. Timing is ripe. Foreign funding is dwindling and only those organizations that have come up with self-sustainable activities have a chance of survival. Their agenda should focus on civic engagement projects and inclusion of civil society in the developmental and peacebuilding agenda. Positive examples from other post-conflict countries should be used and adapted to local circumstances. Becoming a real democracy is a learning process for a country, but whichever path it takes towards this goal, the active role of the civil society is inevitable.

2.4. Potential for renewed violence

In order to assess the likelihood for renewed overt violence, an analysis needs to be conducted in a context of security, political, economic and social factors that bear risk for concrete situations in which a new war would become reality. In the Bosnian context, security-related risks are least poignant. Despite the fact that the unified Armed Forces still have a fragmented command structure and that the police reform has not been implemented, general crime rates are on the decline.⁴⁴ A system for destruction and moratorium on export of Small Arms and Light Weapons (SALW) has been established

⁴² IBHI

⁴³ Gagnon (2002)

⁴⁴ Ministry of Security (2008)

and only in 2007 2,100 tons of weapons were destroyed.⁴⁵ Late 2008 and early 2009 have been marked by rumors in the public about rearming of informal factions through the police, hunting associations and private security companies.⁴⁶ However, these (if existent) have not jeopardized stability as of yet.

Most risks can actually be identified in relation to the political situation. Potential fragmentation of the country is now more realistic than it was in 1996. While political parties are gaining points on the promises of maintenance of Dayton-imposed solutions, their continuing lack of serious dedication to reform is causing decreasing levels of dedication on the side of the IC to assist in the process. It has become clear that IC's presence is vital for maintaining stability and therefore its sudden withdrawal could empower local politicians to practice politics that would lead to solutions detrimental to the country's future.

Conversely, should the IC – exasperated by the lack of will on the side of domestic actors – decide to impose solutions, e.g. in the constitutional reform, resistance could be expected. An attempt to impose solutions in the police reform in late 2007 made this very clear. Following a set of procedural changes in the police reform imposed by the High Representative, state institutions were de facto blocked and the majority of RS officials threatened to withdraw permanently from state-level governmental structures. The Prime Minister (an SNSD official) temporarily resigned with a clear message that BiH will not allow the IC to rule over the country.

As for the economic factors, it is already clear that the state is incapable of mitigating effects of the global economic downturn that is further undermining the already shattered

⁴⁵ OSCE (2008)

⁴⁶ Democratization Policy Council (2009)

and weak economy. It is known that a reduced living standard and increased unemployment can lead to instability even in more developed countries as well as to a revival of social disagreements. Economic crises also often lead to increased levels of organized and economic crime. A combination of these factors could trigger both state collapse and renewed ethnic grievances. Since the EU, US and other governments that are actively involved in the Bosnian peace process could get absorbed by their own efforts to reduce the impact of the economic crisis in their respective countries, in such a scenario BiH could literally collapse faced with insurmountable obstacles.

A major social factor that could culminate into overt violence is the instability of Bosniak-Croat communities. The largest Bosniak-Croat community is Mostar, a southern city that was divided between the Bosniak east and Croat west during the war, and is still a highly unstable community. Between June 2006 and November 2008, in street fights between Bosniak and Croat youth, one person was killed, several wounded, and over 30 police officers were injured. Police managed to prevent an ethnically-motivated mass fight between high-school students late 2008 that could have had major consequences.

3. MACROECONOMIC POLICY AND ITS IMPACT ON PEACE AND STABILITY

3.1. The fiscal structure of BiH and responsibility for financing public services

As discussed above, IMF and WB membership facilitated post-war reconstruction and rehabilitation, but required clarification of the responsibilities for public revenue collection and for financing public services. Between 1996 and 2004, they were based on the administrative structures set out in the Paris Peace Agreement.

The Federation of BiH

The fiscal structure of the FBiH was quite complicated, as were the options for coordination and effective implementation. Until 2004, 85% of FBiH budget revenue came from the following three sources: customs, excises, and certain forms of corporate profit tax (financial services companies, games of chance, and public utilities). The Federal budget covered spending on the FBiH Army,⁴⁷ war-related disability pensions and payments to war widows and orphans, public administration including the police and the specialized federal administrations, the FBiH's share in Bosnia and Herzegovina's foreign debt, transfers to state-level, and capital spending involving more than one canton or the FBiH as a whole.

⁴⁷ Between 1996 and 2004, there were two official armies in BiH, one in each entity, which naturally constituted a major internal contradiction and potential cause of renewed conflict. They were paid for by the entities.

The cantons also have their own budgets. Revenues from sales tax and later from value-added tax accounted for approximately 80% of their revenues, other sources being corporate tax levied on companies not subject to federal corporate tax. The cantons also had major responsibilities for financing public services, particularly with regard to education. Over the past 10 years, education accounted for some 40% of total spending at the cantonal level. This was followed by social protection (other than war-related disability payments) and cantonal administration.

Municipalities in both entities enjoyed revenues from sales tax on properties, property tax, and municipal charges, while also receiving a percentage of sales tax and, after 2006, VAT revenue. They were responsible for spending on municipal administration, municipal-level services, and municipal infrastructure.

Republic of Srpska

RS budget revenues came from customs, excises, sales tax, and corporate income tax, which together made up 90%. There are no cantons to share sales tax or value-added tax revenue. Between 1996 and 2004, the most important public services financed out of the RS budget were the RS army and police force, war-related disability payments, social protection other than pensions and unemployment benefit, education (though primary and secondary education is co-funded in the more developed municipalities), capital spending/infrastructural investment, transfers to state-level, and entity-level bureaucracy, including specialized administrative units. The entity-level is thus responsible for financing many public services funded by cantonal as well as entity budgets in the FBiH.

The burden represented by social protection for war victims is best approached through numbers. In mid-2008, there were 169,929 disabled war victims in the FBiH, compared to 65,184 in the RS,⁴⁸ a ratio of 72.3% to 27.7%. The population ratio is 63.2% to 36.6%, (the remaining 0.2% are in Brcko District, a small area still under international arbitration). This is due to the nature of the war in BiH. The towns of Sarajevo, Mostar, Zenica, Bihac, Gorazde, Srebrenica, Tuzla, Tesanj, and Maglaj suffered prolonged siege as enclaves. More than 80% of veterans or civilians with war-related disabilities in the FBiH are from these towns or cities. All except Srebrenica remained within the FBiH under the postwar settlement.

As discussed above, in 2000, the International Arbitration Commission established Brcko District (BD) as a separate district with its own budget, financing the same functions and services as the cantonal and municipal budgets within the FBiH. Between 2000 and 2004, BD revenues came from the same sources that in the RS belonged to the entity level – including customs levied at the Brcko international border crossing.

A major paradox in the fiscal structure of the country between 2000 and 2003 is that the state budget was less than that of BD: 195 million KM on average compared to 210 million KM. In fact, before 2005 the state level was entirely financed by transfers from the entity budgets, with no practical scope for active development or economic policy and no authority for fiscal policy until mid 2004.

⁴⁸ Papić 2008, p. 265

Table 3 – Budgetary spending 2003-2006*- millions KM (1EUR=1.956 KM)*

| Level of Government | 2003 | 2004 | 2005 | 2006 |
|--|----------------|----------------|----------------|----------------|
| BiH (State) | 198.0 | 245.0 | 473.0 | 802.0 |
| FBiH (Entity) | 1,001.5 | 962.8 | 968.2 | 1,175.1 |
| FBiH cantonal/municipal budgets | 1,413.5 | 1,560.6 | 1,667.8 | 1,598.2 |
| RS (Entity) | 991.4 | 996.6 | 995.0 | 1,068.6 |
| RS municipal budgets | 298.3 | 339.8 | 366.8 | 399.8 |
| Brcko District | 175.0 | 156.0 | 179.0 | 201.0 |
| TOTAL BUDGET | 4,077.7 | 4,260.8 | 4,649.8 | 5,244.7 |
| Budget expenditure as % of GDP (excluding social insurance transfers) | 33.1 | 31.5 | 31.3 | 32.8 |

Sources: Ministry of Finance and Treasury of BiH; FBiH Finance Ministry; RS Finance Ministry; Central Bank of BiH.

As the table shows, in 2003 the BiH budget was just 20% of the FBiH (entity-level) budget, just 7% of the combined cantonal and municipal budget in FBiH, and 20% of the RS budget. In 2006, defense spending was transferred to the BiH budget, reducing the gap, but state-level influence on functional coordination of the economy remains very modest.

3.2. Changes to fiscal structures and public financing

Fiscal reform pushed under BiH's EU Accession process saw responsibilities for collecting and allocating indirect taxes transferred to state-level – the Indirect Tax Authority. As this reform has been explained from the institutional point of view above, we focus here on changes in responsibility for financing services which took place at the same time.

Defense reform, which took place parallel to fiscal reform, was one of the 16 priorities required for a Stability and Association Agreement with the European Union and a condition for further negotiations on NATO membership. The twin official military structures were replaced during 2005 and 2006 by a single defense system (the Armed Forces of BiH and a state-level Ministry of Defense), funded via the BiH Council of Ministers.

Defense, indirect taxation, and border control reforms sharply increased the state-level budget, but also the scope within the entity budgets for financing capital projects in cooperation with international financial institutions. Between 2006 and 2008, the state-level budget averaged 1 billion KM. Spending concentrated in the Ministry of Foreign Affairs, the Ministry of Defense and the Armed Forces, the Indirect Taxation Authority, and the State Border Service. Stronger state-level capacity was expected to remove certain threats to security and stability (the entity military structures) and help combat cross-border crime (the State Border Service).

According to Milante and Skaperdas's model (2008, pp.2-3), defense reform in BiH entailed a significant reduction in spending on the military, with investment in entity and state-level institutional capacity. Their model shows investment in (σ) up and the threat of war down since 2006. The professional corps was cut from more than 60,000 in 1997/1998 to fewer than 10,000, reducing related spending and allowing reallocation to social transfers and job creation for demobilized soldiers. This rebalancing was due largely to external actors interested in maintaining peace – NATO, the US, and the EU.

Special non-budgetary public funds are responsible for collecting pension, healthcare, and unemployment insurance contributions in both entities. These public pension and

health insurance funds finance the public pension and health insurance systems, while employment bureaus fund healthcare for the registered unemployed, unemployment benefits, and re-qualification or training programs for jobseekers.

Table 4 – Fiscal balance - BiH
(consolidated budget at BiH level and social insurance funds)
- percent of GDP

| | 2003 | 2005 | 2007 | 2008 |
|-----------------------|--------------|--------------|--------------|--------------|
| Public revenues | 41.5 | 42.1 | 45.4 | 45.8 |
| Public expenditures | 40.8 | 39.6 | 44.1 | 47.3 |
| Fiscal balance | + 0.7 | + 2.4 | + 1.3 | - 1.5 |

Sources: Ministry of Finance and Treasury of BiH; Ministry of Finance of FBiH; Ministry of Finance of RS; Agency for Statistics of Bosnia and Herzegovina..

Thanks to EU pressure and fiscal reforms, BiH was in the black between 2003-2007. In 2008, there was a fiscal deficit, forcing the authorities to negotiate a Stand-by-Agreement with the IMF for 1.2 billion USD over the next three years (signed on May 5th, 2009), conditional on cutting social transfers (by 414 million KM in the FBiH and 146 million KM in the RS).

3.3. The monetary regime in BiH

A common central monetary institution and a single currency were central to the Quick Start Package (1997) and were in fact provided for in the Dayton Agreement (Annex IV). The High Representative imposed the Central Bank of BiH (CBBH) Act, establishing a currency board with no authority to carry out discretionary monetary policy. The CBBH could not carry out open market operations, extend loans to commercial banks, or issue securities, but could impose required reserves. Local currency could be issued only if

covered by foreign exchange reserves at 105% of all domestic currency in circulation plus commercial bank reserves held by the CBBH (the monetary base).

The CBBH therefore cannot carry out discretionary monetary policy and lacks the lender of last resort function. For the first seven years, the Governor was a foreigner (Mr. Peter Nicholl), with deputies from each of the three constitutive peoples. The aim was to prevent manipulation for political party or interests of constituent ethnic groups, which would have undermined the currency very quickly, while stoking conflict over division of the monetary spoils between the entities or regions. Given the political environment when the CBBH was created (1997) and its subsequent performance, the international community's insistence that the CBBH not set discretionary monetary policy was perfectly logical. The currency was called the convertible mark (domestically designated the KM, but internationally the BAM). It was introduced into circulation in June 1998 and for non-cash transactions in late 1999. The CBBH Act stipulated a peg of 1 KM : 1 Deutschmark. Since 2001, the exchange rate has been 1 EUR = 1.95583 KM. In South Eastern Europe, aside from BiH, only Bulgaria operates a currency board. Croatia and Serbia run managed floats. Albeit not an EU member, Montenegro introduced the Euro as exclusive means of payment in 1999.

A key author of the monetary regime in BiH, Steve Henke locates the basic advantage of a currency board for politically unstable countries at risk of renewed conflict in preventing abuse of monetary policy for day-to-day political advantage,⁴⁹ while eliminating the possibility of a rush on monetary institutions, leading to the issue of unbacked currency, accelerated depreciation, economic destabilization, and threats to

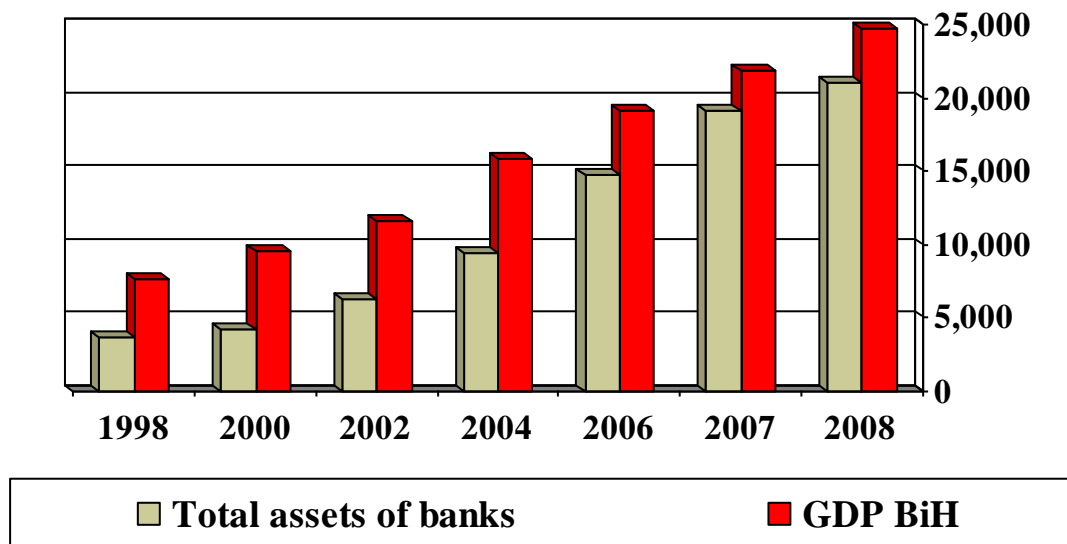
⁴⁹ Henke, 1998; Henke, Jonung, Schuller, 1993.

economic sustainability. A stable single currency eliminates exchange-rate risk, while foreign direct investors like currency boards, as they foster high economic growth.

These arguments for a currency board peg showed their worth after the single currency was introduced for cashless transactions in BiH. This helped attract foreign investors, particularly in banking, but also trade and manufacturing. In 2000, the first Western European bank, the Austrian Raiffeisen Bank, entered the market, buying a small but fast-growing domestic private bank (the Market Bank). The Hypo-Alpe-Adria Bank (Austria), Hypo Vereinsbank (Germany), Volksbank (Austria), NLB (Slovenia), and later (2005-2008) the UniCredit Bank, Banka Intesa, and the Erste Bank all followed. By 2004, the banking system was largely under the control of foreign banks.⁵⁰

Figure 1 - Banking assets and GDP in Bosnia and Herzegovina

(billions of KM)



⁵⁰ According to the EBRD, nearly 94% of banking assets in BiH are now controlled by banks owned by non-residents (EBRD, 2008, p.110).

Commercial banking in BiH is amongst the better organized in the Western Balkans, and BiH was the first country in transition to implement internal payment system reform (the first quarter of 2001). The intensive development of commercial banking between 2000 and 2008 facilitated economic growth on two bases:

- Rapidly increased personal lending, stimulating consumer demand; and
- Gradually increased business lending.

Table 5 – Loans (in millions KM)

| Year | Loans to enterprises | Loans to households |
|-------------|-----------------------------|----------------------------|
| 2002 | 2,715 | 1,506 |
| 2003 | 3,038 | 2,038 |
| 2004 | 3,182 | 2,700 |
| 2005 | 3,956 | 3,538 |
| 2006 | 4,760 | 4,480 |
| 2007 | 5,839 | 5,754 |
| 2008 | 7,430 | 6,856 |

Source: Central Bank of Bosnia and Herzegovina

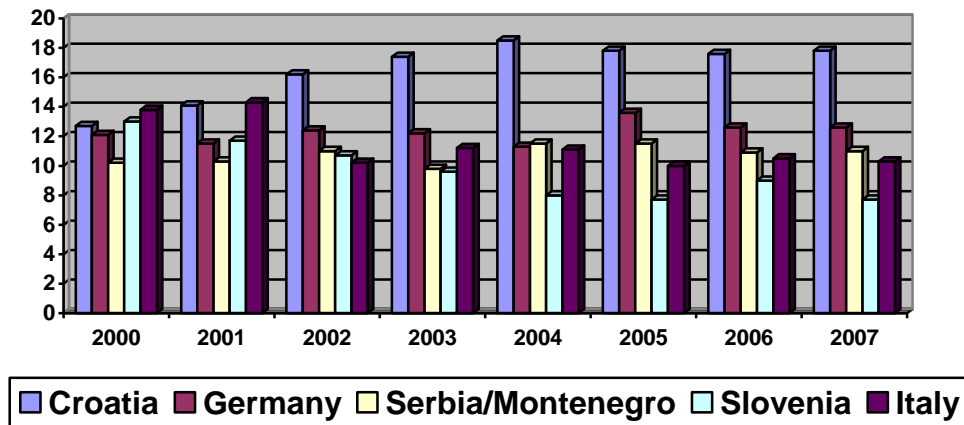
The table presents cumulative totals for loans to households and enterprises between 2002 and 2008. Business lending grew an average of 18.3%, compared to 28.7% for household loans. Consumer demand rising more quickly than demand for capital goods was a factor in BiH's yawning trade deficit, albeit not unrelated to the impact of ethnic composition on liberalized foreign trade.

3.4. BiH Trade Policy

After imposition of the Foreign Trade Policy Act in 1997/1998, trade policy has been formally state-level. Before creation of the Indirect Tax Authority in 2004, the state-level authorities lacked concrete instruments, however. Only in mid-2004 did they get a tool-kit (customs and excise policy). In the meantime, BiH had to sign free trade agreements

under the Stability Pact for South Eastern Europe. During the second phase (2000-2003), the country signed agreements with all of the countries of Eastern Europe, including Turkey, which were replaced in late 2006 by a regional trade agreement, CEFTA. In June 2008, the EU Stabilization and Association Agreement was signed, liberalizing trade with EU member states. BiH's foreign trade suffers from high trade and current account deficits, most marked with countries where the ethnic groups within BiH have special business and other interests: Croatia, Serbia, and increasingly Turkey. Imports from these countries are generally for household consumption. Capital goods are more likely to come from Germany, Italy, and Austria.

Figure 2 - Main trade partners (in %)



Source: the authors' calculations based on the CBBH data

This pattern of trade reflects unwillingness to promote manufacturing (local competitiveness), as well as the political elites' involvement in trade, which has contributed to a form of primitive accumulation and the creation of economic elite groups in all three peoples of BiH. These elite groups have successfully adapted to the principles of free trade, using the "mantra" for profit. Easy personal lending added fuel to this fire.

The demography behind the deficits is very important: the deficit with Croatia is more than 80% due to trade with companies in the FBiH (mostly Bosnian Croat or Croatian); more than 85% of the deficit with Serbia arises in the RS (through Bosnian Serb or Serbian trading companies); the fastest growing trade deficit over the past three years has been with Turkey, largely via trading companies owned by Bosniaks or Turks.⁵¹

Trade liberalization with EU countries (removing customs) has finally removed one of the main irrationalities of fiscal policy, as Bosnian companies paid customs to import equipment, machinery, tools, semi-finished goods, raw materials, and components from EU countries, which is to say capital goods needed to improve their competitiveness. Given the removal of customs on final products from South Eastern European countries, very poorly defined excise policy which allowed cigarettes, coffee, petroleum, and alcohol to be sold more cheaply in BiH than their countries of origin, and customs on capital goods, local producers faced an uneven playing field, particularly vis-à-vis Croatia, Serbia, and Turkey.

3.5. Foreign Direct Investment and the Bosnian Economy

BiH's main exporters are in manufacturing. Foreign investment in this sector has been mostly, but not exclusively brown-field. The Foreign Direct Investment Policy Act, imposed as part of the Quick Start Package at state-level, allows non-residents to invest with 100% ownership in all branches except arms manufacture and military equipment, games of chance, and public media. Both entities exempt companies receiving foreign

⁵¹ This problem of asymmetries in trade with neighboring countries was recognized as early as 1999 by WB and EC experts: "*Customs tariffs ... For full harmonization of the customs system, the Entities must also eliminate their special trade arrangement with Croatia and Yugoslavia, which effectively exempts most imports from customs tariffs and subjects these commodities to domestic rather than foreign excise tax rates.*" (the World Bank, the European Commission, 1999, p.33)

direct investment from corporate income tax for five years in direct proportion to the percentage of foreign ownership - 100% foreign ownership meaning 100% exemption.

The foreign direct investment legislation applies almost entirely at the entry-level.

The legal arrangements governing FDI and the parallel creation of institutions that marked the beginning of economic integration, e.g. the CBBH, resulted initially (2000-2003) in relatively stronger FDI into commercial banks (see above). In 2002-2008, FDI in wholesale and retail increased (from Croatia – Konzum; from Slovenia – Mercator and Tus; from Serbia – Delta Holding; from France - Interex). Tax incentives based on FDI and corporate income tax legislation meant financial and trading activities headed the growth rate and GDP growth table over the past seven years. This FDI-based symbiosis of the financial sector and trade fed the widening trade deficit (Daniel Kanda, IMF, 2006).

Some of the most important investments in manufacturing related to metal production and processing, car parts, wood processing, and mining. Foreign investors were willing to invest in these sectors because even in Yugoslavia BiH was not a centrally planned economy. By the late 1950s, and increasingly thereafter, the former Yugoslavia was already a mixed economy, strongly oriented towards external markets, including joint ventures with Western companies in manufacturing, particularly the car industry. By the 1980s, Sarajevo was the Balkan Detroit, with the largest car plant in the region, while companies in Tesanj, Bosanski Samac, Konjic, Srebrenica, and Brcko produced parts for Volkswagen. FAMOS from Sarajevo had a manufacturing contract with Daimler-Benz during the 70s and 80s and a number of its hived-off subsidiaries now enjoy significant foreign direct investment. Between 1997 and 2005, foreign direct investors invested in

manufacturing related to car parts. Important fully or partly foreign owned companies in the sector include:

- VW Vogosca Sarajevo (previously part of TAS, which produced the VW Golf);
- ASA Prevent Group (producing car seat covers and brakes and holding car dealerships – part owned by the pre-war employees of TAS);
- PS Cimos TMD Gradacac (car parts for major European producers – Peugeot, Citroen, Fiat, Audi, and Mercedes Benz – the part of FAMOS that worked for German Daimler-Benz before the war).

Between 2000 and 2007, it was the following companies that received the most FDI:

- Arcelor Mittal Zenica. The Zeljezara Zenica (Zenica Steelworks) was purchased by Mittal Steel in 2004. The tradition of steel production and related industries goes back more than a century, a key reason the Mittal family decided to invest here. The Bosnian subsidiary's total revenue increased from 180 million KM in 2004 to 800 million KM in 2008, almost entirely due to exports. The recession has hit hard, but the earlier revenue shows the results that can be achieved in manufacturing here over a relatively short period of time.
- The Bosanski Brod oil refinery, purchased by the Russian oil company Zarubeznjeft, was established in the early 1970s as a subsidiary of the former Yugoslavia's largest exporter – Sarajevo's Energoinvest. The Russian partner agreed purchase with the RS government. Here too, there was existing human capital stock, though significant investment was required to update productive capacity.

- The Birac company from Zvornik, which produces alumina, was bought by a Lithuanian investor. This company was another subsidiary of Energoinvest and a major pre-war exporter.

The five main exporting branches over the past six years (2003-2008) were:

- Iron, steel, and related products. This branch's share in overall exports rose from 7% to 14.1%, while the value increased from 163 to 998 million KM.
- Machinery, equipment, and electronics. This branch's share in exports increased from 8.2% to 12.9%, while the value rose from 191 to 793 million KM.
- Electricity generation and mineral extraction is the third major branch, with a share up from 9.5% to 11% and value up from 220 to 660 million KM.
- Aluminium and related products is the fourth branch, albeit with decline in share of the export market from 13% to 10.8%. The value of exports, however, increased from 338 to 655 million KM.
- The fifth branch is wood processing, products, and furniture, with combined exports of 1,040 million KM.

Foreign direct investors have been major players in the first two branches, assisting the recovery of the Bosnian economy or at least allowing reasonable results to be achieved. They did not play a dominant role in the other three branches. BiH's geography (coal deposits and water flows) favours electricity generation and it is one of the few countries in Southeast Europe with a surplus. Aluminium production is largely focused at Mostar's Aluminij, another Energoinvest subsidiary. Wood processing was highly developed here under the former Yugoslavia and many of the major pre-war exporters of furniture or prefabricated buildings have re-established their production lines.

3.6. Privatization and the Concentration of Economic Power along Ethnic Lines

Privatization was a central pillar of post-war economic program. The Washington consensus, which underpinned economic reform in transition countries, saw privatization as indispensable. By early 1997, legislation was ready for privatization at the entity level, ignoring the state-level. Certificates were allocated to adult members of the public so they could buy shares. Companies in the former Yugoslavia were not owned by the state. They were "socially-owned," so that the revenue belonged to the companies. In 1990 and 1991, privatization began in all of the former Yugoslav republics. In 1994, the wartime authorities passed a law converting social property into state-owned. This is why the post-war privatization took place at entity level and was largely based on buying shares with certificates. As this was an entity matter and the Dayton agreement defines the FBiH as the Bosniak and Croat entity and the RS as the Serb entity, the process facilitated the privatization of some 10 billion KM worth of property without any inflow of fresh capital. Even worse, it effectively legalized the principle of ethnic privatization. The legislation in both entities allowed the members of the majority people in a given area to become the exclusive owners of a given company. This produced worse results than privatization by tender, where the privatization contract required part payment in cash, the introduction of new equipment and technology, resolving employee issues, and activities developed.

Results have shown that tender-privatized companies bought by solid investors from Western Europe or elsewhere have helped integrate the BiH economy, while voucher privatization reinforced administrative and political divisions.

3.7. Growth rates and economic performance

After the war (1996-2000), economic growth was due to the Priority Reconstruction Program, based on donations or IDA/IBRD loans. Politicians in power at the time have represented this as a period of particularly high growth. The growth rates of 85%, 61% and 14% for 1996, 1997, and 1998 were hardly surprising, however, given that GDP was approximately 13% of the 1991 figure.

Since 1998, growth has come less from the Priority Reconstruction Program than private sector job creation thanks to privatization, an FDI favorable environment, and domestic investment in export-oriented or import-substituting projects. This period of economic restructuring and growth corresponded to the implementation of priorities from the second and third reform packages (2000-2003 and 2003-2008). Both these periods saw much higher FDI: largely in banking and trade during the second period (2000-2003), but also in production during the third (2003-2008).

Given Dayton's negative impact on economic policy and the many institutional barriers to business development, the business sector here has achieved relatively good results. The rate of actual economic growth has improved considerably and the economy was one of the 13 fastest growing between 1998 and 2004 (Causevic, 2007). Between 2000 and 2007, it was the 23rd fastest-growing economy in the world, as the growth rate had slowed relative to most of Central and South Eastern Europe.

The following table presents economic growth rates for the group of case-study countries. Economic growth is based on the wealth coefficient (introduced by the author in his 2006 book *Economic Sovereignty and Global Capital Flows*; the coefficient is the ratio of a country's share in world GDP to its share in the world's population). Using the coefficient to measure economic growth places BiH in second place, after the Lebanon, in the group of seven countries considered under this project. In 2007, the GDP/pc gap between the Lebanon and Bosnia and Herzegovina was 44.6%, compared to 201.4% in 2000. The Lebanon's relative position has deteriorated by some 15.6% between 2000 and 2007, while Bosnia's relative economic position has improved by 76%. The country in this group that saw the greatest relative improvement in its global ranking between 2000 and 2007 was the Sudan (an increase of 112.7%).

Table 6 – Changes in the wealth coefficient 1990-2007

(in percent)

| C O U N T R Y | 2007 | 2000 | 1990 | 2000/ 1990 | 2007/ 2000 | 2007/ 1990 |
|------------------------|-------------|-------------|-------------|-----------------------|-----------------------|-----------------------|
| Lebanon | 0.710 | 0.841 | 0.220 | + 282.73 | - 15.58 | + 222.73 |
| Bosnia and Herzegovina | 0.491 | 0.279 | 0.643 | - 56.61 | + 75.99 | - 23.64 |
| Colombia | 0.453 | 0.388 | 0.293 | + 32.42 | + 16.75 | + 54.61 |
| The Sudan | 0.151 | 0.071 | 0.121 | - 41.32 | + 112.68 | + 24.79 |
| Sri Lanka | 0.199 | 0.163 | 0.113 | + 44.25 | + 22.09 | + 76.11 |
| Iraq | 0.060 | --- | 0.646 | --- | --- | - 90.71 |
| Rwanda | 0.041 | 0.037 | 0.088 | - 57.95 | + 10.81 | - 53.41 |

Source: F. Causevic's calculations based on the World Bank data

On the other hand, between 1990 and 2007 the Lebanon experienced the fastest progress, while in 1990 BiH enjoyed GDP/pc that was 192% greater. At that time, Lebanon was severely affected by the civil war, while BiH was still within the former Yugoslavia, with

a better than average economic performance for that former country. Moreover, the United Nations Development Programme (UNDP, 2007) places BiH among the high human development index countries, thanks to above-average accumulated investments in health and education or human capital (1970-1990). Keefer (2008) also points out that BiH has far higher human capital stock than the post-conflict countries analysed in his paper.

3.8. Key barriers to economic development

The World Economic Forum (2007, pp.128-129) has identified the following six barriers to improved national competitiveness and faster economic development in BiH: inefficient administration; political instability; corruption; government instability; tax burden; and organized crime and theft.

Five of these obstacles are institutional or political in nature. The translation of the Dayton structure to economic governance gave the entities greater effective economic policy authority than the state. While indirect taxation reform (2004-2006) enabled the state-level to take effective control of this area of fiscal policy, direct taxation policy and social welfare transfers have produced constant problems of ineffective coordination and often counter-productive measures, particularly during 2008 and 2009. It is the entity governments who negotiate with foreign direct investors and therefore they pick the main strategic partners for infrastructure companies. They also retain authority over the privatization of state-owned companies.

The split of effective economic policy between the entities and the ethnic division of management at the utilities have contributed directly to loss of revenue, as for example with the electricity generation and distribution and the management of related natural

resources. An artificial lake built before the war in the South of BiH was intended to serve electricity generation in neighboring Croatia. Croatia has not made a single payment under the pre-war contract which requires her to do so. A hydroelectric reservoir on the Drina River that belongs to BiH is also used to generate electricity in Serbia, which has not paid its dues since the war either.

The explanation lies in the ethnic carve-up of the electricity sector in BiH. A natural and economic system for managing the electricity generation and distribution was "broken up" into three companies on an ethnic key. The RS Electricity Company is managed exclusively by Serbs in BiH who have never requested payment for the use of the Drina hydroelectric resource. The example in the FBiH is even clearer: The Herzeg Bosna Electricity Company was created in areas where Croats are in the majority, while the BiH Electricity Company is based in Sarajevo and controlled by Bosniaks. Since the Busko blato hydroelectric reservoir belongs to the Herzeg Bosna Electricity Company, compensation has never been requested from the Croatian Electricity Company for its use.

We may ask what the basic sources of economic growth in BiH, which was relatively high in the 1998-2007 period, are albeit hampered by the mounting institutional and political barriers. Part of the answer must lie in human capital, much inherited from the previous system, but upgraded after the war by domestic and foreign investment, with support from the EU and the US.

CONCLUSIONS

The state of Bosnia and Herzegovina as it was created by the Dayton Peace Accord demonstrates significant flaws of governance and lack of tools for long-term stability and democratization that were sacrificed in order to fulfill the short-term goal of ending the war. The heavy reliance on external aid for economic and political stabilization yielded plentiful results in rebuilding war-destroyed assets, introducing development programs and building capacities for the governmental and NGO sectors, but at the same time it produced a dependency that will be difficult to overcome in the long-term.

A major reason for lack of more expedient development can also be found in the flawed reform process. The country is administratively separated into two ethnically-divided entities that exert vast authorities and undermine the state-level institutions. Without a full-blown constitutional reform that would simplify the gigantic state apparatus and disable ethnically-motivated decision-making, there is little hope for long-term stability. Supporting this elaborate institutional system is not only a burden to the economy but also a clear signal that ethnic segregation is condoned upon and ethnically-motivated decisions are acceptable.

The lack of demand on the side of citizens should not be underestimated as an important factor for institutionalization of ethnic divisions and marginalization of moderate, non-ethnic movements. The NGO sector is well developed but the motivation of most civil society organizations is linked to external funding and even profit. Real grass-root civic movements never came to life and the country's civil society is now suffering from the lack of institutionalized citizen engagement in development and democratization. However, the power of civil society should not be overestimated. One potential way of

correcting political elitism is by engaging the civil society more actively in the developmental process and pointing out the negative effects of this state on every single citizen.

As for the macro-economic outlook, it is obvious that the situation is stabilizing. Monetary and fiscal policies are in place, foreign direct investments and exports on the rise and the vast natural and human capacities promise further progress. However, many issues remain. As other pillars of the BiH society, its economy is emerged into politics and, thus, asymmetries in trade with neighboring countries, ethnic privatization that has reinforced administrative and political divisions at many places and politically-motivated leadership in the utility sector, prove that the economy is not immune to the post-conflict ethnic divisions.

The six main barriers to improved national competitiveness and faster economic development in BiH remain inefficient administration, political instability, corruption, government instability, tax burden, and organized crime and theft. These obviously fall into the realm of the political dimension and demonstrate the need for political stabilization that will then positively affect economic development. BiH still has significant natural potential and human capital stock capable of achieving above-average rates of economic growth and development relatively quickly. This requires a better institutional structure of economic governance, with no barriers between the entities or cantons, integrated to benefit all the constitutive peoples.

The strongest light at the end of the tunnel seems to be the accession into the European Union. Most analysts see the accession as a tool not only for institutional and governance reform, but also for introducing into the society a new identity – a European identity.

Ethnic groups have been so emerged into their separate ethnic identities that it seems Utopian to believe that such a thing as a Bosnian identity will ever be created in the mainstream society. Therefore, only a broader identity, a European one, could possibly be a unifying force among the ethnic groups that will overcome the ethnic grievance and turn the society to something we could call a European future. The road is long (and hence people are somewhat tired of the process) but the end goal could be the only long-term means to stabilizing this war-shattered country.

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