

ECONOMIC TRANSITION IN POST-WAR EASTERN EUROPE: A STUDY OF BOSNIA AND HERZEGOVINA FROM 1945 TILL 2020

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Abstract:

After the second world war, many countries in Eastern part of Europe became part of the Union of Soviet Socialist Republics (USSR) headed by Russia. These countries embarked on a socialist path of economic development, which was entirely different from the rest of the world. After the dissolution of the USSR, countries like Bosnia and Herzegovina had to transition from a closed socialist economy to a market driven capitalist economy under terms dictated by international bodies like International Monetary Fund (IMF) and World Bank. This created conflict with socialist countries' economic structure of social welfare schemes and cash transfers. A significant part of the government's expenditure is spent on continuing the existing welfare schemes which leaves very less for investment and infrastructure development. As a result, the economy is only driven by domestic consumption while production lags behind. External loans continue to pile up, further increasing the country's total debt. This paper is an attempt to study Bosnia and Herzegovina's economic transition after the second world war. While the transition from socialism to capitalism is considered as a boon by many economists, this paper finds that, for countries like Bosnia and Herzegovina, it is exactly the opposite. Economically successful socialist countries in the latter half of twentieth century had robust social security measures such as cash transfers to the elderly and unemployed. However, the advent of capitalism signaled the wastefulness of such social security benefits. There exists, and will always exist, a conflict between abandoning socialist economic policies and embracing market driven capitalist policies. Thus, this paper seeks to study the economic changes in Bosnia and Herzegovina emanating out of the transition from socialism to capitalism.

Keywords: Socialist, Welfare, Consumption, Budget, Public Sector.

Introduction

Bosnia and Herzegovina is a country situated in the Balkan region of Southwest Europe. It has a diverse history before joining the Kingdom of Yugoslavia in 1945, gaining independence in 1990 and getting embroiled in a civil war between 1992-1995. Despite its violent and troubled past, the country has made impressive economic strides between 1945 and 1990 when it was a part of socialist Yugoslavia. However, post 1995 the country has suffered governance and territorial setbacks which badly impacted the economic progress, welfare and employment prospects. As of 2020, the country is an upper middle-income country and a potential European Union (EU) candidate.

After the end of World War II, the Socialist Federal Republic of Yugoslavia was established and Bosnia and Herzegovina became one of the six constituent republics through the constitution of 1946. Due to its strategic geographical position within the Yugoslavian republics, Bosnia was chosen as the base to develop military industries. Bosnia's existence within socialist Yugoslavia was very prosperous. High employment, export-oriented economy,

universal education and healthcare were some of the key characteristics. International corporations like Volkswagen, Coca-Cola, Marlboro etc. had set up plants in Bosnia's capital city Sarajevo.

After the dissolution of the Socialist Federal Republic of Yugoslavia in 1990, multi-party elections were held in Bosnia where the communist party was defeated. Multiple parties representing multiple ethnicities came to power which was followed by a bitter civil war. The three main ethnic communities in Bosnia and Herzegovina are Bosniaks (Bosnian Muslims), Serbs and Croats. Militias formed by the Serbs unleashed violence on Bosniaks and Croats who responded with equal ferocity. The country ended up being divided into two parts. The area captured by Serb militias was named Republic of Srpska (RS), comprising 49% of the total land area. The area captured by Bosniaks and Croats was named The Federation of Bosnia and Herzegovina, which comprises 51% of the total land area. There is a third region, the Brcko district, which is ruled through local governance under the sovereignty of Bosnia and Herzegovina. Both the parts of the country are referred to as 'entities. The larger of the two entities, the Federation of Bosnia and Herzegovina, is made up of 10 cantons and each have their own constitution and government. Due to the existence of these two entities and the establishment of a rather clunky constitution, the central government had very limited power and issues of practical governance began to arise immediately after the country of Bosnia and Herzegovina was established.

Political situation

As a successor state of the former Socialist Federal Republic of Yugoslavia (SFRY), Bosnia and Herzegovina faces multiple challenges in its dual transition from socialism to free market economics and from war to peace. Since the 1992-1995 war, Bosnia and Herzegovina has made progress in peace implementation under the supervision of the High representative, appointed by the European Union (EU). Due to the presence of two entities as mentioned earlier, the powers and functions of the common institutions are quite limited. The central government is constrained in its ability to assert an authority and to develop and prosecute a consistent policy agenda. Also, the central government has very few options to raise revenue. There is neither a countrywide system of administration nor a proper judicial system. The civil war of 1992-1995 also paved the way for localized illegitimate institutions and parallel systems of governance which are hindering the economic stabilization process as well as the rule of law. Another disturbing consequence of the civil war has been the displacement of populations due to methods of ethnic cleansing. The efforts to reverse the effects of 'ethnic cleansing' are underway through programs of refugee return and returning properties to rightful owners. This is an important requirement for the future stability of Bosnia and Herzegovina. Displaced people are unwilling to contribute towards the revival of the economy until their livelihoods are secured and protected by the government. Moreover, international investors and firms are hesitant to invest in a country where property rights are not clarified properly. Thus, the return of displaced refugees is not just an issue of moral concern, it affects the economic prospects of a country too. On a positive note, there are indications that the political situation in Bosnia and Herzegovina is changing gradually. The 2000 elections saw the defeat of ethnic nationalist parties and the rise of parties who want to work closely with the international community. Moreover, the Constitutional Court has outlaid citizens right for all the 'constituent peoples'

irrespective of ethnicity or religion. This has led to return of refugees and displaced persons even to places where they are a ‘minority’.

Economic situation, structure and performance

Despite the help obtained from the International Monetary Fund (IMF) and the World Bank, the double transition for Bosnia and Herzegovina from a closed-socialist economy to an open-market economy and from war to peace has not been smooth. Much of the physical infrastructures of the country were destroyed in the war from 1992-1995 which resulted in the independence of Bosnia and Herzegovina. Recovery from the cyclical (short term) economic crisis is difficult due to problems concerning Bosnia and Herzegovina’s decentralized system of decision making along with the lack of unified economic policies and markets. High GDP growth rates were sustained only due to large inflow of external assistance (3.8 billion US dollars till 2020) which will reduce after one point of time. The reduction in external assistance will severely affect the GDP growth. In spite of high growth, Bosnia and Herzegovina remains the second poorest country of Southeast Europe, with GDP per capita only half of the pre-war level. Also, the pattern of economic growth has been uneven between the two entities, with the Federation of Bosnia and Herzegovina growing more rapidly than the Republic of Sprska (RS).

The global financial crisis of 2007 affected Bosnia and Herzegovina as well. The macroeconomic conditions of Bosnia and Herzegovina started displaying negative economic trends in the third and fourth quarters of 2008 which contributed to a general decline in economic activity. As a result of the economic slowing, the unemployment rate shot up, which again inversely affected the growth of the GDP. These many problems cumulated into an unequal distribution of income among the citizens which led to social unrest such as strikes and protests. The economic recovery model of Bosnia and Herzegovina has been based on attempts to catch up with the rest of Southeast Europe as well as other member nations of the European Union. This model of economic recovery required a fair degree of liberalization in both external and internal economic relations. For this purpose, Bosnia and Herzegovina signed the CEFTA (Central European Free Trade Agreement) agreement in 2006 and the Stabilization and Association Agreement (SAA) with the EU in 2008. However, the economic growth resulting from trade liberalization was based on the expansion of Bosnia and Herzegovina government’s lines of credit since it was mainly credit (welfare schemes) that increased domestic consumption. This reliance on government credit led to a severe national deficit, amounting between 12% and 15% of the Gross Domestic Product. Thus, the stability of an entire country’s economic system relied on external credit, which ended up increasing the government’s total debt.

| Bosnia & Herzegovina | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---------------------------|--------|--------|--------|--------|--------|------|
| Nominal GDP (in billions) | 16,928 | 19,121 | 21,647 | 24,552 | 26,541 | NA |

| | | | | | | |
|--|-----|-------|-------|-------|-------|-------|
| Real Growth rate (%) | 3.9 | 6.2 | 6.8 | 5.5 | -3.0 | NA |
| Unemployment rate (% of total labor force) | NA | 31.10 | 29.00 | 23.40 | 24.10 | 27.20 |
| Inflation, CPI | 3.6 | 6.1 | 1.5 | 7.4 | 2.0 | NA |

Main macroeconomic parameters (International Monetary Fund, April 2010)

Foreign Direct Investments (FDI) in Bosnia and Herzegovina decreased by 50% from their 2008 levels. After the civil war (1992-1995), the fiscal sector has been permanently out of the desired stabilizing flows. Government spending has been increasing since 1995 due to the complex structure of the administration as well as the lack of a unified economic policy or clear development plan. Thus, public budgets of Bosnia and Herzegovina were unsustainable even before the recession began. On top of that, the global economic crisis caused the unemployment rate in Bosnia and Herzegovina to rise further. The current imbalance in the labor market is thought to have been caused by a severe consequence of the global recession in Bosnia and Herzegovina, that is, the creation of both structural and cyclical unemployment. The existence of structural (long-term) unemployment and cyclical (short-term) unemployment imply a significant cost to the unemployed individuals as well as to the potential output of the country. Imbalances in the labor market often arise from changes within the business cycle which are cyclical (temporary) in nature, correcting itself over time. But the extended period of global economic crisis has transformed the cyclical unemployment in Bosnia and Herzegovina into persistent or long-term structural unemployment.

Periods of sustained high unemployment produce the effect of further increasing the rate of unemployment below which a phenomenon known as hysteresis occurs, when inflation starts to accelerate. Hence, if demand for labor does not increase, there is very less chance that unemployment in Bosnia and Herzegovina will return to the rates where it stalled after the country gained independence in 1995. High rates of current unemployment, on the other hand, place pressure on the country's budget, which further lead to conflict regarding uneven distribution of income. Economic inequality between citizens, both employed and unemployed, is increasing and affecting social cohesion in Bosnia and Herzegovina. Higher income inequality in a country leads to higher degree of crimes, corruption, macroeconomic instability and lower life expectancy. These structural problems have made the labor markets inflexible, which resulted in a very low GDP growth. The cyclical problems started in 2006, when a legislation was adopted for fund transfer increase without having the financial means to back it up. Cash transfers in regards to the benefits of war veteran population were adopted and these have placed extra burden on already stretched budgets. Social transfers amounted to somewhere between 60-65% of the entire budget. Starting from 2007, budget expenditures started exceeding budget revenues.

Budget imbalance

Recession usually leads to deficit due to the fact that decline in economic activity brings along decline in tax revenues, employment and income. However, the current budget crisis in Bosnia and Herzegovina is not solely caused by the global recession. The structural problems faced by Bosnia and Herzegovina started all the way back from the Dayton agreement, the peace agreement that ended the civil war in the country. The budget crisis in Bosnia and Herzegovina must be understood as a function of the country's own poorly considered fiscal choices and its unique political landscape. The first mistake made by Bosnia and Herzegovina with regard to budgetary crisis was when it opted to finance imports externally, which ultimately increased the country's debt. Now when the world's financial markets have slowed down, Bosnia and Herzegovina finds itself with no way to finance the import of goods. At the same time, Bosnia and Herzegovina's own exports have slowed, which has further decreased the national revenues. The problems in Bosnia and Herzegovina are both structural and political.

Bosnia and Herzegovina, like its immediate neighbors, has undergone a long and painful economic and political transition process. Although the transition was a neo-liberal approach guided and aided by the International Monetary Fund (IMF) and the World Bank, the country's economic system has retained some of its socialist characteristics. Almost 60-65% of the entire annual budget is spent on the social welfare of its citizens. After this, there are hardly any funds left for investing in the infrastructure or in general, the economy. There is no production of new value and the economy keeps slowing down, further increasing the rate of unemployment. This way of allocating budgetary funds led to a liquidity problem. Thus, Bosnia and Herzegovina saw no alternative but to approach the International Monetary Fund (IMF) and the World Bank for assistance and guidance. As instructed by the International Monetary Fund and the World Bank, the elimination of political sources of imbalances had to be the first approach within the solution order. Political sources of imbalance referred to those legislation passed in 2006 that placed extra burden on already stretched budgets. The International Monetary Fund explicitly stated that the country, that is, both the entities, the Federation of Bosnia and Herzegovina and the Republic of Srpska, had to reduce social expenditures by a certain percentage spelled out in the Letter of Intent. The public expenditures category had to be decreased by 10% across the board, including austerity measures.

Three major imbalances

- **A large public sector and limited private wealth creation:** Bosnia and Herzegovina has a unnecessarily large public sector, which dates back to second half of 20th century and has only been partly reformed since. Public expenditures amount to more than half of Gross Domestic Product and if state-owned enterprises and costs from corruption are added in, the public sector may be as large as 70 percent of Gross Domestic Product. Although public spending is high, it is not pro-poor. High social protection benefits the wealthy as much as the poor. While state-owned enterprises maintain employment even in cases when factories no longer operate, they also generate bills, which are ultimately paid by the taxpayer. This creates a negative spiral: taxes are high and biased against employment. A large tax slab swallows over a third of even the low paid workers' wages, making it almost impossible for employers to create formal jobs.

- An economy based on consumption rather than production: During the post-war economic recovery, Bosnia and Herzegovina did not create new foundations for sustainable economic growth. Financial inflows, aid and remittances, averaging around 20 percent of Gross Domestic Product, fueled consumption-based economic growth. Today, consumption remains at over 100 percent of Gross Domestic Product. To achieve high levels of income, create prosperity and eliminate poverty, Bosnia and Herzegovina will need to shift towards an economic model based on production of goods and services rather than mere consumption.
- An under-performing export sector: Exports constitute only 30 percent of Gross Domestic Product, one of the lowest in Europe and a sign of the country's weak competitiveness. This stems from the poor business climate, high cost of employment and poor transport conditions. If Bosnia and Herzegovina exported as much as it did during the socialist regime, its exports would be three times as high. To achieve this figure today, the country needs firms that can compete in the international market.

Structure of Public Sector Finances and Main Sectoral Policies

- Public expenditure management: The authorities have recognized that privatization proceeds should not be used to finance recurrent expenditure and that Parliament should exercise oversight of expenditure of proceeds through the budget process. There remains an urgent need to reduce the levels of public spending by implementing measures which include reform of the social system, restructuring of the public sector and a reduction in military expenditure. These reforms have to be supplemented by efforts to enhance revenue mobilization including further progress in tax reforms by reducing incentives for tax evasion and by broadening the tax base.
- Customs and tax reforms: Tangible progress has been achieved in the area of customs and tax reform. On the revenue side, both entities have implemented a common schedule of excise duties, reduced customs duties exemptions and have eliminated temporary sales tax exemptions. They have established working groups that meet regularly to discuss implementation issues. Sales tax harmonization is proceeding through convergence. Customs revenues have been increasing year on year although there are large revenue losses due to illegal sales. Revenue Task Forces have been established in both Entities to tackle the sale of smuggled goods. The progress made in customs needs to be consolidated.
- Privatization: Small-scale enterprise privatization has been advancing in both Entities and should be completed in the Federation of Bosnia and Herzegovina before Republic of Sprska. After major delays, progress has been achieved in creating the framework necessary for carrying out the privatization of large enterprises.

- Financial sector reform: Adequate banking regulations have been established in both Entities, although procedures continue to fall short of best practice in some areas. Minimum capital requirements are being gradually increased in accordance with schedules introduced in both Entities. An important development has been the changes allowing banks incorporated in one entity to carry on business in the other entity without a new registration. The Federation of Bosnia and Herzegovina, which has established a Deposit Insurance Agency, is more advanced in this regard than the Republic of Srpska which has yet to implement the approved Entity legislation. Non-payments functions such as tax control and information collection have been relocated to relevant institutions. A large number of foreign banks are now present in the markets of Bosnia and Herzegovina.
- Investment climate-creating a single market: The scope for foreign investment in Bosnia and Herzegovina continues to be difficult, with one of the lowest rankings among Eastern European countries. Complicated regulations, corruption, inefficient judicial system and weak financial system are major factors behind this. Combined with barriers to internal trade and a lack of integration with neighboring markets make Bosnia and Herzegovina one of the least attractive markets for foreign direct investment.

Long-term problems: Economic Growth and Competitiveness

The main crisis for Bosnia and Herzegovina is the unsustainability of economic growth and the absence of real and structural convergence. If Bosnia and Herzegovina fails to narrow the gap of income per capita relative to the European Union, the challenges of real convergence will remain relevant in the medium and long term. Bosnia and Herzegovina's structural establishment is still in line with the neo-liberal approach of an open-market economy. Inefficient structural convergence has caused an even higher unemployment rate and mismatch between labor demand and supply. Since 2001, Bosnia and Herzegovina has had a stable and dynamic path of economic growth, but considering its low starting point and questionable sustainability of economic growth, such growth was insufficient according to European Union standards. This was mainly due to the fact that this type of dynamic economic growth was a result of foreign donations and aids, not a result of successful implementation of structural, institutional and economic reforms. Revenues from the privatization, international economic aid and remittances from abroad played a great role in relatively high pre-recession growth. Bosnia and Herzegovina has received around 10 billion US dollars in international financial assistance intended to aid in the country's economic reconstruction, but most of that aid are still subject of investigation. Pre-recession growth of the Gross Domestic Product for the period of 2001-2007 was 6% annually and was supported by very high growth of domestic expenditures that were financed by the powerful increase of credit lines, diaspora remittances and high metal prices.

The recession of 2007 caused an immediate fall of exports and foreign remittances. This was followed by the increase of bank interest rates and the decrease of investments. When it comes to macroeconomic stability of Bosnia and Herzegovina, the country only enjoys

stability of so-called nominal economic indicators. However, this stability is handicapped by the 'two-entity' establishment of the country that undermines macroeconomic stability and does not correspond with the real economic progress. Each of the two entities has its own economic policy and a different direct taxation system, which additionally undermines the possibility of the existence of a unified economic policy on the national level. Considering other components (employment, external trade etc), real convergence of Bosnia and Herzegovina is even more endangered. On one hand, the country has a very low starting Gross Domestic Product and GDP per capita and on the other hand, there are very serious structural problems that are faced by the country. Dominant formation of the GDP is represented by the sectors with very low new value, whereas sectors that characterize GDP growth (manufacturing, industry) have very low growth rates.

Anti-cyclical policy

The authorities of Bosnia and Herzegovina are considering a complementary strategy of the implementation of anti-cyclical policy along with short and medium-term policies of business environment improvement and the integration of economic and social development in the medium and long-term periods. In simple sense, anti-cyclical policy can be reduced to (i) a reduction in public spending and (ii) the increase of public revenues, which can be made possible through monetary and fiscal policy measures. While analyzing the nominal and real GDP, it is to be noted that the inflation rate is not taken into account because of the existence of a Currency Board within the Central Bank of Bosnia and Herzegovina. This currency board has pegged the convertible mark (KM-BAM) to the Euro, which helps contain the inflation rate. Thus, the Euro is being used as an anchor. By definition, the inflation rate of a country using a currency (Euro in this case) as an anchor should never exceed the inflation rate of the country from which an anchor currency rate comes. This arrangement enables Bosnia and Herzegovina to have stable monetary policy but it also prevents the Central Bank from employing active monetary policy measures intended to stimulate the economy. Hence, the Central Bank is not in a position to undertake monetary operations such as expansionary monetary policy, which would stimulate the business cycle as well as economic growth. Even though this system still seems to be very efficient, problems arise in times of crisis. Because of the Currency Board, the Central Bank of Bosnia and Herzegovina is incapable of implementing active monetary policy measures such as discount rate, open-market operations and lending operations. There are only two instruments of monetary policy that Bosnia and Herzegovina's Central Bank can undertake, which are prescribed levels of reserves for commercial banks (lowered from 18% to 14%) and very low degrees of open-market operations.

Suggestions for a better future

In order to improve the sustainability of financial stability and achieve long-term economic growth, two things need to be secured: political stability and a functional and unified market, which will require structural reforms and measures for improving competitiveness. The sector of commercial banking must take more proactive role in order to increase the liquidity of the business sector and to stimulate the business cycle. Investment banks in both the Federation of Bosnia and Herzegovina and Republic of Sprska have been operating like commercial banks where all credit loans were approved by Credit Boards that did not take into

consideration specificities of the development of small and medium enterprises, export-oriented companies and the agricultural sector. It is imperative for both entity governments to rethink and revise the role of these banks in order to stimulate economic growth. In conclusion, for Bosnia and Herzegovina to get closer to the European Union (EU) average, it is necessary to secure a high rate of economic growth through removing the existing trade barriers and administrative bottlenecks. The economy should be transformed from a consumption-driven to a production-driven one.

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