The IMF, the World Bank, and Economic Policy in Bosnia

David Woodward
The IMF, the World Bank, and Economic Policy in Bosnia: a Preliminary Assessment

David Woodward

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Preface

This paper was written during the first quarter of 1997, on the basis of a visit to Bosnia in January of that year. Unfortunately, it has not been possible to up-date the draft since. In view of the rapidly evolving situation, this inevitably means that it is likely to be somewhat dated in parts. Hopefully, it will nonetheless be of some use in helping to understand the economic issues and policy dilemmas in Bosnia.

I am very grateful to all those in Oxford and Sarajevo (and in Banja Luka and Bijeljina) who helped in the planning, preparation and execution of my visit to Bosnia. I am particularly grateful to Marijana Aksin-Maćak for her excellent translation; to Indir Kurtović for his patience and endurance during our longer-than-expected drive from Banja Luka to Zagreb; and to all of Oxfam's staff in Sarajevo for their exceptional friendliness and hospitality. I would also like to thank all those who generously spared their time to meet me in Sarajevo and Banja Luka.

It should be emphasised that the views expressed in the paper are those of the author, and should in no way be attributed to Oxfam.

David Woodward
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Introduction

This paper is the second in a series of studies being commissioned by Oxfam on the role of the IMF and the World Bank in economic policymaking in post-conflict situations. Like the first paper on Rwanda (Woodward, 1996), it considers the economic effectiveness of the proposed strategy, its potential social impact and the implications for the achievement of a viable solution to the political problems of Bosnia and Herzegovina (BH) in the long term.

This paper is more preliminary than that on Rwanda. This partly reflects the current political situation: the author’s visit to BH took place a little over a year after the end of the war and the signature of the Dayton Agreement, which established the framework for a completely new political structure, and just four months after the September elections, which effectively started the process of forming most of the new institutions. As a result, the institutions of government are less well-established; and the emphasis is primarily on reconstruction and institution-building rather than on the consideration and development of detailed economic policies for the long term.

As a result of this, and of the complexity of the economic and political constraints, the paper concentrates on identifying a number of dilemmas in economic and donor policies, rather than on making alternative proposals. There are no simple answers in BH, and whatever course is chosen is likely to raise as many problems as it resolves.

The paper begins with an outline of the political and economic situation of BH. The key political, economic and social constraints on policy are set out, and the current relations between the IMF, the World Bank and the various authorities are discussed in Part B. This includes an assessment of BH’s debt situation, and the prospects for a satisfactory solution. A discussion of various donor-driven problems, such as delays in disbursements and political conditionality, follows in Part C. Part D contains an extended discussion of the policy proposals currently envisaged, in terms of their economic viability, social impact and political implications. Part E assesses the social dimensions of economic policy. The Conclusion seeks to draw together the diverse threads of the paper.
A. Political and economic background

A.1 The war and its consequences

Prior to 1991, Yugoslavia was a federation, consisting of six republics (of which BH was one) and two autonomous territories (Kosovo and Vojvodina) within Serbia. Decision-making was very decentralised under the 1974 Constitution, and at the central level each republic and autonomous territory had one representative on a collective presidency. Central control and coordination were maintained by the personal authority of Tito, leaving a serious power vacuum following his death in 1980.

The result was increasing incohesion within the Federation through the 1980s, and the reawakening (and political exploitation) of rival nationalisms and historical resentments. These arose primarily from Yugoslavia’s traumatic experience during the Second World War, when the Nazis brought the extreme Croat nationalist Ustasas back from exile in Italy and installed them in power in part of Croatia and the whole of Bosnia-Herzegovina (BH). The Ustasas were terrorists who had overnight been handed total power (Bennett, 1995, p43), and they had as a primary objective a virtual genocide of the Croatian Serbs. ‘The objective, somewhat crudely but not incorrectly stated, was to convert one-third of Orthodox Serbs into Catholics, to expel another third to Serbia, and to exterminate the rest’ (Crnobrnja, 1996, p65). Estimates of the number of Croatian Serbs killed vary enormously between Serb and Croat sources. The more methodical estimates suggest a figure in the order of 300,000.

Opposition to the Ustaša régime came primarily from Tito’s partisans (who were Yugoslav in orientation, and came from all ethnic groups, although the greatest number were Serbs); and the Serb nationalist Cetniks. After an initial period of cooperation, the two groups came into increasingly bitter conflict as Tito’s wider political ambitions became apparent. BH, because of its ethnic mixture, became a particularly important area of conflict. Muslims and Croats were faced with a choice between at least passive collaboration with the Ustaša régime, or joining the partisans. Inevitably, most chose the quiet life, leading Serb nationalists to identify Croats with the Ustašas, and to see Muslims as collaborators. These caricatures were revived and accentuated by nationalist propaganda in the 1980s.

The revival of nationalism, actively promoted by (often crude) media propaganda, culminated in the break-up of Yugoslavia in the early 1990s; and it was this process which led to the war in Bosnia, starting in 1991. However, the conflict in Bosnia, more than any other part of the former Yugoslavia, arose primarily as a result of forces external to the Republic itself. It is ironic that it was here that the war was longest and bloodiest.

The process of disintegration began in earnest when the Serb nationalist Slobodan Milošević manoeuvred himself into power in Serbia on a tide of populist nationalism. Once in power, he proceeded to expand the power of Serbia within the then Federal Republic of Yugoslavia. By fomenting Serb nationalism, he succeeded in ousting the existing authorities in the two autonomous territories (Vojvodina and Kosovo), installing his own supporters in their place. Together with the pro-Serbian Montenegro authorities, this gave Milošević effective control over four of the eight votes on the collective presidency.

Slovenia and Croatia became seriously concerned at the increase in Serbian power, and the extreme Serb nationalism which underlay it. The Slovenian authorities ultimately responded by declaring independence, and, after a brief attempt by the Yugoslav national army (JNA) to force them back into line, achieved it. Croatia quickly followed suit, motivated partly by Serbia’s still stronger position in the Federal institutions in Slovenia’s absence; partly by growing nationalism among the large Serb minority in Croatia; and partly by the increasing Croat nationalism which this provoked.

Croatia had much greater difficulty in escaping from Yugoslavia than had Slovenia. The intervention of the Yugoslav army was
more forceful and less successfully resisted; and the Serb minority within Croatia, with JNA support, took control of substantial areas of the country where they were in the ascendant (for example, the Krajina and Eastern Slavonia). A long and bitter struggle followed, and one-third of the country's territory remained under Serb control when Croatia was internationally recognised in January 1992. In early 1997, the Zagreb authorities have only just re-established control over Eastern Slavonia, the last Serb-controlled area.

With the withdrawal of Slovenia and Croatia from the Federal institutions, Bosnia was faced with a choice between secession and remaining within a Federation now heavily dominated by Serb nationalists. The situation of the Bosnian Serbs, however, was the mirror image of this — they faced a choice between being part of the majority within a rump Yugoslavia, or being an ethnic minority within an independent Bosnia. The latter option was made more unattractive by the rise in nationalism among the Croats and Muslims (itself largely a response to increasing Serb nationalism both in Serbia and within Bosnia), and by vigorously nationalistic Serbian propaganda.

These dilemmas were made more acute by Bosnia's ethnic composition, and the geographical spread of the various ethnic groups. While there was some degree of ethnic diversity throughout the whole of Yugoslavia, it was most marked in BH: uniquely, no single ethnic group represented an overall majority of the population. In 1991, 44 per cent of the population were Muslims, 31.5 per cent Serbs, and 17 per cent Croats. Of the remainder, 2 per cent were of other ethnic groups, while 5.5 per cent considered themselves Yugoslavs (mostly people of ethnically mixed parentage). In all, 16 per cent of children in BH were of mixed parentage, a higher proportion than anywhere else in the former Yugoslavia.

There was a significant regional pattern in the distribution of ethnic groups, with a disproportionate presence of Serbs in Western Bosnia, and of Croats in Herzegovina. However, there was a very high level of integration. Only three of 112 opstinas (the local administrative areas) were essentially homogeneous in ethnic terms, while 30 had no overall ethnic majority. Of the remainder, 37 had an absolute majority of Muslims, 32 of Serbs, and 13 of Croats.

The authorities responded to the political dilemma by holding a referendum on independence in March 1992. Muslims and Croats voted overwhelmingly for secession; but there was an almost complete boycott of the vote by the Serbs. The tension between the two sides escalated, and the Yugoslav national army — virtually the only remaining institution holding the federation together — moved in, ostensibly to keep the peace. However, as Croats and Slovenians had largely deserted, the JNA was by now Serb-dominated; and the remaining Bosniacs (Bosnian Muslims and other supporters of a united Bosnia) also left the army as it came into conflict with their compatriots. In May 1992, the army was notionally withdrawn from Bosnia; but in practice its Bosnian Serb component remained, together with much of the weaponry, to join with local Serb militias.

Thus, while the war was largely brought about by external forces, it was primarily fought between Bosnians. It was therefore extremely divisive, splitting Bosnian society into its three main ethnic components. For most of the war, the conflict was between the Serbs (whose main objective was secession and unification with Serbia) and an alliance of Bosniacs and Croats. However, in April 1993, the Bosniac/Croat alliance broke down, as it became clear that any negotiated solution would take the form of a three-way division of territory, based at least partly on military control on the ground at the time. There was also a large faction, at least on the Croatian side, for whom the alliance was a tactical one and the ultimate objective was secession of the Croat statelet of Herceg-Bosna from Bosnia and its unification with Croatia. Full-scale war between Muslims and Croats followed in May of the same year.

The conflict between the Croats and the Bosniacs was brought to an end, following political intervention by the US, in February 1994. Nonetheless, this conflict seriously embittered relations between Bosniacs and Croats, especially in mixed areas. The legacy, which is most clearly illustrated by the current situation in Mostar, is a serious impediment to the establishment of new institutions and policy-formulation in the Muslim/Croat Federation.

Relations have been particularly badly affected by the process of 'ethnic cleansing'. Fear, intimidation, and violence (including massacres in some areas) have brought the country from a multi-ethnic mix developed over centuries to an almost complete polarisation of the population into distinctly Muslim, Croat, and Serb areas. Some mixed areas (generally
Political and economic background

Muslim/Croat) remain; but, with the notable exception of Sarajevo, there is a high level of tension, and in some areas, such as Mostar, ethnic cleansing and polarisation continue.

In addition to the death of some 250,000 people, the war and ethnic cleansing gave rise to enormous population movements, both internally and externally. It is estimated that between 1m and 1.4m people left the country as refugees, while a further million were displaced within the country. In total, this represents about half of the country’s pre-war population. While the internal displacement largely represented an exchange of members of one ethnic group for those of another, it gave rise to major increases in population in some areas (for example, the Muslim part of Mostar). This both added to the strain on housing and infrastructure resulting from war damage and dislocation, and compounded tensions between ethnic groups in these areas.

While the Dayton Agreement envisaged a return of refugees and internally displaced people to their areas of origin, this has yet to happen on any significant scale, and it seems unlikely that the economic, social, and political conditions for large-scale return will be achieved in the near future.

As well as its dramatic effect on inter-ethnic relations, the war was also very destructive in physical terms (the economic damage arising from the war is described in greater detail in Box 1 in Section B1). Much of the damage was to civilian targets, particularly to economic and social infrastructure, such as roads, railways, water and electricity supplies, schools, health facilities and housing. However, the destruction was very localised: within areas which remained under the control of the same ethnic group throughout, the physical damage was relatively limited, although such areas are still affected by the broader effects of the war; in other areas, where the conflict was most acute and prolonged, the destruction is almost total.

While the Serb area sustained less physical damage than the Muslim and Croat areas as a result of the conflict, it was seriously affected by the more general economic disruption associated with war, and especially by UN-imposed economic sanctions. These factors brought about a drastic downturn in economic activity and an almost complete lack of maintenance to infrastructure and productive facilities, which deteriorated seriously as a result.

A.2 Political structures under the Dayton Agreement

Four years of war in Bosnia and Herzegovina were brought to an end by the Dayton Agreement in December 1995. This established Bosnia and Herzegovina (BH) as a single sovereign country divided into two Entities: the Serb-controlled Republika Srpska (RS), with 49 per cent of the territory and a population of around 1.2m; and the Bosniac/Croat-controlled Federation of Bosnia and Herzegovina, with 51 per cent of the territory and a population of around 2.3m. The Federation in turn is divided into ten cantons, with boundaries essentially fixed on ethnic lines: five are predominantly Muslim, three predominantly Croat, and two ethnically mixed. There is no equivalent division of Republika Srpska (RS). The lowest unit of government in each case is the municipality. (See Figure 1.)

The ethnic division is strongly reflected in the distribution of power between the different levels of government: in effect, power is concentrated as far as possible at the highest level consistent with ethnic uniformity. The central government has very limited power, its role being limited to the bare minimum necessary for BH to be considered as a single sovereign country (foreign policy, international trade and debt, monetary policy, immigration, international law enforcement, and air traffic control), plus relations between the Entities (inter-Entity transport, communications, and law enforcement).

The Entities have responsibility across a much broader range of issues, including many which are more commonly held by national governments. These include:

- defence;
- internal affairs, policing and justice;
- taxation and customs administration;
- agriculture, industry, and other economic policies;
- health and social policies;
- environmental policies;
- refugees and displaced persons; and
- reconstruction programmes.

Under the Dayton Agreement, each Entity is also allowed to establish its own relationships with neighbouring states, and to enter into agreements with states and international organisations with the consent of the (national) Parliamentary Assembly.
Within the Federation, the cantonal level of government is responsible for education, housing, public services, local land-use, and social transfer expenditures. However, these responsibilities are automatically devolved to the municipal level in municipalities where the majority ethnic group is different from that of the canton as a whole. More generally, municipalities in the Federation have 'self-rule on local matters'. In RS, the responsibilities of municipalities correspond to those of the cantons and the municipalities in the Federation.

Financially, the Entities retain control of customs and excise receipts within their respective territories, while in the Federation, cantons retain revenues from sales, income, and property taxes, together with revenues generated by charges for public services. The national government has no independent tax base, at least for the time being, but is wholly dependent on transfers from the Federation (two-thirds) and RS (one-third). Ultimately, it will be able to raise tax revenues, if this is approved by the national parliament.

Under the Dayton Agreement, elections were to be held at all levels in both Entities within six to nine months, and this deadline was met (just) when elections were held on 14 September 1996, at all levels except for municipalities within the Federation, where elections were postponed following allegations of fraud. The elections resulted in an overwhelming victory for all three nationalist parties. While not surprising, this seriously complicates the process of securing a constructive, collaborative approach to the formation of institutions, both at the national level and within the Federation. The postponed municipal elections are now expected in April.

One important issue remains outstanding under the Dayton Agreement, namely the status of the Brčko corridor—a narrow strip of land in northern Bosnia, which links the eastern and western parts of RS, and which is contested by Serbs, Croats and Bosniacs. The corridor is currently under Serb control, but is subject to international arbitration. This was originally to be completed by mid-December 1996, but the deadline has now been extended (for the second time) until February 1998. Whatever the findings, the announcement of the arbitration results could raise the political temperature substantially, due to the central strategic importance of the area, the mutually-exclusive claims of the various parties, and the strength of feeling on all sides.

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**Figure 1. The political structure**

**LEVEL:**

- **National**
  - Bosnia and Herzegovina (3-person collective presidency; Council of Ministers; bicameral parliament)

- **Entity**
  - Federation of Bosnia and Herzegovina (President; government; bicameral parliament)
  - Republika Srpska (RS) (President; government; bicameral parliament)

- **Canton**
  - 10 cantons

- **Local**
  - 73 municipalities
  - 64 municipalities
A.3 The pre-war economy

After a brief experiment with central planning after the Second World War, Yugoslavia positioned itself both politically and economically between the communist East and the capitalist West. This strategic position enabled the country to receive substantial financial support from Western donors through the 1950s and 1960s. In 1965-8, there was a temporary move towards market socialism, before the principle of worker self-management — a form of decentralised socialism — was adopted. At the same time, there was a shift towards commercial borrowing, leaving the country seriously exposed when the 1982 Mexican crisis led to a generalised loss of confidence in lending to developing countries.

While Yugoslavia's debt situation was substantially less serious than those of the major Latin American debtors, the authorities responded with a series of IMF- and World Bank-supported adjustment programmes and rescheduling of bilateral and commercial debts. This entailed a very rapid adjustment of the balance of payments, and very large net resource transfers to creditors, especially from the mid-1980s. This contributed to a serious slow-down in growth from the very rapid rates prior to 1980, rising unemployment, and hyperinflation — and thereby, arguably to the conflicts of the 1980s.

The pre-1991 Yugoslav economy was relatively well developed and diversified, with a strong industrial base and good infrastructure. The workforce was skilled and well-educated, with 9.7 per cent of 20-24-year-olds in full-time tertiary education — more than in the UK, Ireland or New Zealand, though less than in other developed countries (UNDP, 1992, Table 34). While agriculture was an important source of employment, representing about one-quarter of all jobs in the economy, the driving forces of the economy were industry and (in Croatia) tourism (Table 1).

BH was poorer than Yugoslavia as a whole before the war, with GDP per capita 32 per cent less than the national average in 1989 (Vojnić, 1995, Table 4-2). Agriculture was substantially more important, particularly in terms of employment: it employed around 40 per cent of the work-force (about half part-time), and accounted for about 14 per cent of output (EU/EBRD/World Bank, 1996b, p103). The economic importance of the industrial sector appears to have been broadly in line with the national average, while services were somewhat less significant, possibly reflecting the limited development of tourism.

Major industrial sectors in BH included energy (coal, coke and electricity); other raw materials (especially wood and bauxite); textiles; leather and footwear; and machinery and electrical equipment. Much of the former Yugoslavia's armaments industry was also relocated in BH, following Tito's split with Stalin, as it was seen as being safer in the most central of the Republics. Industrial production, both extractive and manufacturing, was dominated by about a dozen large socially-owned conglomerates, which were mainly export-oriented, with about a thousand small and medium enterprises, directed mostly towards the domestic market.

Electricity production was mostly thermal, using domestically produced coal, but with

<table>
<thead>
<tr>
<th>Table 1: Composition of production and employment in pre-1991 Yugoslavia (per cent)</th>
<th>GDP (1990)</th>
<th>Employment (1987)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>10.9</td>
<td>25.8</td>
</tr>
<tr>
<td>Industry</td>
<td>44.8</td>
<td>26.8</td>
</tr>
<tr>
<td>Services</td>
<td>37.5</td>
<td>47.4</td>
</tr>
</tbody>
</table>

Notes: Employment data are from World Bank (1989); GDP data are from World Bank (1992a). GDP figures exclude 6.7 per cent representing indirect taxes.
some hydroelectricity. Prior to the war, a small surplus was generated for export to Serbia and Croatia. Coal production was 17.9m tonnes in 1990, but is subject to serious environmental concerns: BH’s brown coal and lignite have a high sulphur content; and desulphurisation systems are not in place in power stations, and would be expensive to instal. As well as coal and bauxite, BH has substantial reserves of iron ore, lead, zinc, barytes, rock salt, and ceramic clays.

In the services sector, BH had a major capacity in civil engineering and construction, with 500 companies generating around 7 per cent of GDP, including a significant proportion of export and overseas contracts. Tourism, however, remained relatively under-developed, despite some efforts at promotion following the 1984 Winter Olympics. The services sector accounted for the bulk of private enterprises. In 1990, about 1.6m ha (30 per cent of BH’s total area) was farmed, 95 per cent of it by some 540,000 small private farms (generally less than 10 ha²); and the cultivated area was divided more or less equally between crops, pasture, and meadow/fallow. BH’s terrain is an important constraint on agriculture, 45 per cent of the total area being forest, and much of the remainder too steep for cultivation; and agriculture was technologically backward even before the war, during which much of the available machinery and equipment was destroyed.

Major crops were wheat and maize, while livestock and forestry were very important, as was horticulture in the south of the country. Before the war, between one-third and half of total food requirements had to be imported; and cereal production was concentrated in what is now RS, which had a substantial surplus in wheat production, while the Federation was heavily dependent on imports.

Forestry and wood products are important sectors in both Entities, accounting for some 10 per cent of GSP, and $200m of exports before the war, and employing some 22,000 people in forestry alone. However, there are again important environmental constraints: deforestation ‘could be seen in some areas of central Bosnia even before the end of the war’ (EIU, 1996a, p20).

A.4 Recent economic developments in the Former Yugoslavia

Apart from BH, where economic performance has been greatly affected by the ending of the war and the reconstruction programme, economic performance has been relatively consistent across the various countries which formerly made up Yugoslavia. Economic reform is proceeding, or at least beginning, though slowly and grudgingly in the Former Republic of Yugoslavia (FRY: Serbia and Montenegro); economic growth is relatively modest, at around 2-3 per cent pa, with some expectation of a gradual improvement in the next year or two in most cases; unemployment is high and rising; and the balance of payments current account is generally in deficit, though to varying degrees, and with marked variation in ability to finance it. The greatest difference is in inflation, which is well under control in Croatia and Montenegro, but a potential problem in Slovenia, and very high in the FRY.

Bosnia and Herzegovina has performed very well, at least statistically. Economic growth in 1996 was estimated at around 35 per cent, reflecting a recovery of output from the artificially low level in 1995 because of the war, coupled with the inflow of aid to finance reconstruction. However, output remains far below the pre-war level, and unemployment is estimated at 50-60 per cent. Inflation has been kept very low, reflecting the convertibility of the dinar at a fixed exchange rate against the Deutschmark, coupled with tight fiscal and monetary policies; and, while there is a large current account deficit, this is entirely appropriate during the reconstruction phase. Serious problems remain, as discussed elsewhere in this paper.

Slovenia remains the richest part of the former Yugoslavia, with income per head of around $10,000 — more than Greece or Portugal. It has been moderately successful economically since breaking away from the former Yugoslavia. Economic growth was 3.5 per cent in 1995, and is expected to return to this level in 1997 after dipping to about 2 per cent in 1996 (though with stronger growth in investment). Inflation has returned to below 10 per cent, and the current account deficit is relatively small. A successful bond issue indicates renewed access to international financial markets; but this could yet be threatened by the FRY’s legal challenge to the country’s agreement with its commercial creditors.
Around half of state industry has been privatised, but foreign investment has been limited, and rising real wages have driven out low-wage industries, leaving unemployment at 13 per cent (and rising). Slovenia’s greatest advantages relative to its former Yugoslav neighbours are its political stability, its relatively high level of development, its very limited involvement in the war, and its geographical position on the fringe of the EU. However, the benefits of Slovenia’s growth to the other countries in the region will be limited by its preference for stronger economic links with the EU rather than any development of stronger ties with its Balkan neighbours.

In Croatia, economic growth resumed at around 4 per cent in 1996, despite heavy (and rapidly increasing) debts in the business sector, widespread insolvencies, strongly deflationary macroeconomic policies, and very high real interest rates. Despite renewed growth, employment continues to fall, and the unemployment rate remains above 20 per cent. Inflation is still relatively low at 3.5–4 per cent, but there is a substantial current-account deficit. A three-year IMF programme is in preparation, and commercial debts have been renegotiated.

The FRY (Serbia and Montenegro) has been pursuing conservative fiscal and monetary policies, and is expected to negotiate a stand-by arrangement with the IMF in 1997 (if the remaining obstacles to IMF membership can be lifted), as a basis for debt renegotiation. Broader economic reforms are also possible, despite marked reluctance on the part of the Serbian leadership: there has already been some liberalisation of foreign investment laws, a privatisation law has been approved, and some trade reform is expected. Progress on reform has been faster in Montenegro than in Serbia. Economic growth was around 2.5 per cent in the first half of 1996 (down from 6.5 per cent in 1995); but inflation remains around 30 per cent pa, unemployment is high and rising, and there is a large ($2bn) trade deficit, financed from hard-currency resources held abroad. Both economic performance and the prospects for economic reform are likely to have been seriously affected by political instability following the contested local elections in November.

The Former Yugoslav Republic of Macedonia (FYROM) has been promoted by the World Bank as a case of successful structural adjustment, with significant progress on privatisation and banking reform. However, this has yet to be reflected in overall economic performance. Moderate economic growth was achieved in 1996, after a decade of stagnation and decline; and inflation is in single figures and declining. However, exports fell by 30 per cent in the first half of 1996, increasing an already large current-account deficit; access to foreign commercial lending has not been regained; and unemployment continues to rise. Inter-ethnic polarisation represents a potential threat to political stability and continued growth. The régime for foreign direct investment is to be liberalised, and trade policy rationalised.
B. The IMF, the World Bank and economic policy

B.1 The constraints on economic policy

The formulation of economic policy in BH is complicated by three interlocking sets of constraints: political/institutional, social and ethnic, and economic constraints.

Political/institutional constraints
These arise directly or indirectly from the terms of the Dayton Agreement. Among the actual terms of the Agreement, the most important is the operation of the Central Bank as a currency board for six years. This means, in effect, that domestic currency can only be issued against foreign currency held by the government, which effectively removes governmental discretion in monetary and exchange rate policy, and prevents budget deficits from being financed domestically. (This is discussed further in Section D1.)

A second key component is the administrative arrangement of the country, specifically the very high (and arguably excessive) degree of decentralisation of power, to the Entity level and, in the case of the Federation, beyond. While the four levels of administration in the Federation may have been necessary politically, to secure the agreement, the arrangement will increase administrative costs substantially, and may well prove cumbersome.

The reliance of the political structures on cooperation between ethnically-based political leaderships gives rise to a considerable level of political inertia, due to the mutual suspicion both between the two Entities and between the Muslims and Croats within the Federation (and within ethnically mixed cantons such as Mostar). This is exacerbated by the fact that Serb nationalists, whose ultimate goal is secession from BH and unification with the FRY, have every incentive to ensure that their policies and economic systems are incompatible with those adopted by the Federation, as a means of pushing BH towards partition. It should be noted, however, that some observers (including some donors) see the political tensions within the Federation as being at least as problematic as those between RS and the Federation.

Social and ethnic constraints
There are tensions at a number of levels; the most obvious being between the three major ethnic groups within BH. Such tension represents a serious obstacle to any lasting political settlement, and has a central role in the current political inertia. These tensions also represent an important constraint to economic (or other) interactions between the Entities, for example, the intimidation of people who cross between Entities (or their fear of violence), and the likely reluctance by some to buy goods from the other Entity, if they were available. It is hoped that ethnic tensions can be eased by increasing economic interaction between the Entities; but the tensions themselves limit the pace at which this can be achieved. For economic and short- and long-term political reasons, it is therefore essential to avoid compounding inequalities between the ethnic groups, or creating new or exacerbating existing sources of tension.

Another potential source of tension, especially in the Federation, is between those who stayed in Bosnia during the war and those who left as refugees. Those who stayed, especially in enclaves such as Sarajevo, Zenica, and Tuzla, have in many cases been impoverished and traumatised by the experience. Many of those who left — who include most of those who were relatively well-off initially and many of the most skilled and educated — have in varying degrees escaped these ill-effects; and many professionals have accumulated substantial savings while abroad. The resulting disparities in economic opportunities could give rise to considerable resentment as the refugees return, in direct proportion to the opportunities available. This would be further compounded by programmes providing additional assistance specifically for returnees, to give refugees an incentive to return.
Overlaying these social constraints is the more general need to reduce poverty and access to basic necessities, such as food, health services, housing, water supply, and sanitation. This is partly a moral issue, but also contributes to the political dynamics: increasing poverty was an important factor contributing to the conflict in the Former Yugoslavia; and the persistence of chronic poverty would be a substantial obstacle to a durable political solution in BH. Reducing poverty would require the creation of employment opportunities, not only for the 50–60 per cent of the workforce who are currently unemployed, but also potentially for more than a million refugees if and when they return.

**Economic constraints**

Economic constraints arise not only from the effects of the war, but also from a number of other changes in the economic environment which coincided with it. The war damage is the most obvious and severe constraint. BH’s economic and social infrastructure and productive capacity has been severely reduced. (See Box 1.) In addition, the human capital base has been severely eroded by the exodus of a large number of educated and skilled people. Of those who remain, people with specialist skills have been internally displaced, and it is likely that many will no longer be in (or able to return to) an area where their skills can be used productively.

The Former Yugoslavia’s strategic position between East and West was lost with the end of the Cold War, and with it the prospect of favourable financial and economic support from both sides. Reconstruction assistance has been a temporary substitute, but will be of limited duration (until about 1999). A viable economic future is unlikely to be based on continued funding at the pre-war level.

**Box 1: Economic and social effects of the war**

**Population:** Some 250,000 people were killed in the war. A further 1–1.4 million left the country as refugees, of whom only 6 per cent have returned; around a further million were internally displaced, of whom 360,000 remain homeless; and some 2–300,000 entered the country as refugees from neighbouring states. More than 200,000 people were wounded, of whom 13,000 have permanent physical injuries, including 5,000 who have lost limbs. About 245,000 people have been or are being demobilised in the Federation and 180,000 in RS. This implies that around two-thirds of the pre-war population of 4.4 million have been killed, disabled, internally or externally displaced or demobilised. An estimated one-third of the population (about 1.2 million people) are suffering from post-traumatic stress disorder.

**Landmines and other hazards:** There estimated to be between 1.5 million and 4 million landmines in BH, of which only about 15,000 had been located as of November 1996. These are mostly concentrated in bands about 5km wide along former lines of confrontation, including areas around Sarajevo, Banja Luka, Zenica, Vitez, Mostar, Srebrenica, Tuzla, Medugorje, Bihač, Žepa, Gornji Vakuf, and Gorazde. In addition, there is other unexploded ordnance in areas of conflict, and booby traps remain in areas of ethnic cleansing. Coupled with uncertainty about the location of mines, this is a serious deterrent to land use. Mines have also been laid in some areas to obstruct the use and reconstruction of infrastructure.

**Transport and communications:** More than 2,000km of main roads are in need of immediate repair, all railway lines have been rendered inoperative, and Sarajevo airport was partly destroyed and closed to civilian traffic. All bridges connecting BH with Croatia were destroyed, and a total of 70 bridges have yet to be rebuilt. Public transport vehicles and facilities were destroyed or damaged, or have become run down due to lack of maintenance. Around 50 per cent of the telecommunications network has been damaged or destroyed, including transmission and switching equipment, buildings, towers, overhead cables and the entire backbone transmission network. Call-completion rates in the worst affected areas are 1–2 per cent at peak times, compared with 35–38 per cent before the war.
Energy and heating: Almost all power stations, thermal and hydro, were damaged either directly or by lack of maintenance during the war, and more than 50 per cent of electricity generation capacity was put out of operation. At the end of 1995, electricity generation was estimated to be operating at only 10 per cent of capacity. In addition, 60 per cent of the transmission network and control system was seriously damaged and about 50 per cent of the distribution network damaged or destroyed. District heating systems were either seriously damaged (as in Sarajevo, where the number of households served fell by about two-thirds) or disrupted by lack of energy supplies (as in Banja Luka, where only 5–6 per cent of installed capacity was in use in 1995–6). Further damage has occurred due to non-use and lack of maintenance.

Water and waste management: War damage and lack of maintenance, compounded by population movements, imposed serious strains on the water and sanitation systems. Leakage-loss rates for water increased from 30 per cent to 50 per cent, and 27 of 69 municipalities in the Federation no longer have 24-hour supplies. Clogged sewage and drainage systems have caused extensive flooding. While war damage has been relatively limited in RS, facilities have suffered from lack of maintenance. Cross-boundary access to water supplies has been denied, further limiting access. Solid waste services have been affected by extensive damage to equipment; and limited access to landfill sites due to landmines has led to over-use of small urban sites.

Housing: In the Federation, 50 per cent of the housing stock was damaged, and 6 per cent destroyed; in RS, 24 per cent was damaged and 5 per cent destroyed. Deterioration of the remainder has occurred due to lack of maintenance. About 90 per cent of destroyed and damaged housing has yet to be repaired, and some 30 per cent of inhabited housing has no glass in the windows.

Industry: As well as physical destruction, industry and finance have been affected by the disruption of domestic and external trade links, and by the legal confusion created by the conflict. The industrial sector is operating at about 15–20 per cent of its capacity in the Bosniac area of the Federation, and at 8–10 per cent in RS. Industrial activity has also been reduced, though to a much lesser extent, in Croat areas. Non-agricultural unemployment is estimated at 50 per cent in the Federation and 60 per cent in RS.

Finance: The freezing of foreign exchange deposits at the beginning of the war created a deep distrust of the banking sector, compounding its already weak financial position. Banks have large foreign exchange liabilities, while household deposits are negligible, and commercial and public sector deposits very low; 90 per cent of bank assets are non-performing. The capital of the large state-owned banks has been wiped out, while the newer private banks are small, under-capitalised and inexperienced. As a result, only limited amounts of short-term credit are available, and only at very high real interest rates.

Agriculture: 70 per cent of farm equipment and 60 per cent of livestock were lost during the war, and farm buildings and irrigation equipment damaged or destroyed. Some 15 per cent of farm land and 20 per cent of forests remain inaccessible due to landmines, and high-value orchards and vineyards were destroyed. In 1995, wheat, maize and potato crops were 30–40 per cent below pre-war levels, and fruit production was down by about 50 per cent. Forestry and food-marketing systems were also disrupted.

Health: More than 13,000 people sustained permanent physical injuries during the war, and communicable diseases increased by between 100 per cent and 400 per cent. Between 35 per
The economic system of the Former Yugoslavia was proving unviable long before the war. Even without the war, some form of economic transition would have been necessary. Yugoslavia’s debt burden was also heavy prior to the war. In the light of the war-damage to the economy, BH’s share of the debt is clearly unsustainable. While the World Bank has already acted to provide some debt relief, and action is expected from bilateral and commercial bank creditors, some potentially serious problems remain. (See Section B2.)

In addition to the foreign debt, the government faces a heavy burden of domestic liabilities, particularly foreign exchange deposits frozen during the war; and arrears owed to pensioners, soldiers, and public servants. These liabilities are very considerable (in the order of DM13bn); and failure to settle them in a satisfactory manner could be politically destabilising. Some 80 per cent of all households had foreign exchange deposits of up to DM1,000 frozen; and public sector workers (including soldiers) are owed substantial salary arrears. Settling arrears to pensioners should be regarded as a high social priority, in view of the very high incidence of poverty among elderly people.

Globalisation and the transition process elsewhere in Eastern Europe represent additional challenges. In particular, BH’s exports must compete with those of a number of other developing country and Eastern European economies with (in some respects) similar economic endowments, as all scramble to attract foreign investment and increase their foreign exchange earnings. A viable economic future will depend on the country’s ability to compete effectively in the world market.

Finally, the current level of aid should also be regarded as a constraint. Clearly, it would be possible to provide additional aid; but, given the tight financial constraints on most donors’ aid programmes, this would have to be at the expense of current (or increased) allocations to other, mostly poorer, countries. The current level of aid to Bosnia is already very high compared with many other post-conflict countries in the recent past, although it is both richer and better-endowed with economic resources. Aid commitments to Bosnia for 1996 (GNP per capita $250–500) amounted to around $400 per capita, compared with $80–90 for Rwanda (GNP per capita $80) and $60–70 for Mozambique (GNP per capita $60) at an equivalent stage of reconstruction.
B.2 The debt dimension

Yugoslavia faced a significant debt problem prior to the war, and efforts at external adjustment to service the debts represented an important contributory cause of the conflict. Now, BH has inherited its share of the foreign debts of the former Yugoslavia; and its debt situation is a great deal more serious than that of Yugoslavia in the 1980s. Bosnia’s debt situation is more than usually complicated. It is not simply a question of having too much debt and needing to find ways of reducing it to a sustainable level; in Bosnia, there are two additional dimensions to the problem.

First, the debts accumulated by the Former Yugoslavia had to be allocated between the independent states into which it is now divided. Second, the cost of servicing the Bosnian share of the debt has to be divided between the two Entities: while the central government is formally responsible for servicing the debt, it is ultimately dependent on contributions from the Entities to do so.

The first issue has, in principle, been resolved. Of the Former Yugoslavia’s $15.3bn of external debt at the end of 1991, $12.2bn could be divided between the Republics according to the ‘final beneficiary’ principle. The remaining $3.1bn was divided up in proportion to the five independent countries’ shares of the Former Yugoslavia’s IMF quota. This resulted in BH taking responsibility for a total of $1.9bn of 1991 debt, which, with accumulated arrears and charges, has increased to $3.4bn. There is, however, a potential complication with respect to the part of this debt owed to the commercial banks, as discussed later.

The second issue — the division of the Bosnian debt between the Entities — was originally to be resolved in line with the two-thirds/one-third rule used in other contexts. However, the entities have now agreed to use the final beneficiary principle instead. The switch to the final beneficiary principle has two major implications. On a financial level, it is likely that the RS will end up paying significantly more, and the Federation significantly less, than under the two-thirds/one-third rule. At first sight, this might appear to suggest the possibility of the RS side reneging on the agreement. However, there is also a significant political dimension. The final beneficiary principle is the approach normally used to divide up the debts of a country (such as the Former Yugoslavia) which splits into two or more separate independent states. In other words, by accepting this principle, the RS authorities appear to be accepting a greater financial burden in order to do so.

The normal sequence of debt reduction is for the bilateral debt to be renegotiated first, followed by the commercial bank debt, and only then (if at all) the multilateral debt. In Bosnia’s case, this might well be reversed. The only concrete progress made to date has been with the World Bank, which has consolidated BH’s $625m debt over 30 years at 0.5 per cent interest. This was done by treating Bosnia as a new member of the Bank (rather than as a successor to the Former Yugoslavia), and was presumably preferred to the option of including Bosnia in the recent multilateral debt initiative for highly-indebted poor countries (the ‘HIPC Initiative’) as providing more immediate benefits.

Bilateral debt cannot be reduced, or even rescheduled, until an IMF programme is in place. This makes the timing very uncertain — it is hoped, but by no means assured (see below), that a Fund programme will be in place by June. However, there is a much greater need for urgency in the case of the commercial bank debt, which must reach the ‘agreement-in-principle’ stage before 30 June 1997. The reason for this is that the previous rescheduling of the Former Yugoslavia’s debt (the New Financial Agreement, or NFA, of 1988) included a ‘joint and several liability’ clause between the Republics. This means that each individual Republic could be held liable for the entire amount of the Former Yugoslavia’s debts in the event of non-payment by the other Republics. The banks agreed to waive this part of the agreement in June 1996; but the extension of the waiver beyond 30 June 1997 is conditional on an agreement-in-principle on BH’s bank debts before that date.

In principle, it would be possible for the banks to extend the deadline. However, this would require the support of banks holding two-thirds of BH’s debt; and the FRY has bought enough of Bosnia’s commercial bank debt on the secondary market to be able to block such a move. It is therefore imperative to reach agreement-in-principle before the end of June, even if this is before the Paris Club agreement. There is concern in some quarters that the terms achieved on commercial bank debt may be less
favourable (to BH) if it is agreed before the Paris Club; but this may be a price which has to be paid.

If agreement-in-principle is not reached in time, BH's debt would be re-merged with the FRY's; and the FRY could block any reversal of this move, unless (ironically) their legal action against the Slovenian debt deal were successful. Any debt agreement would then need to be negotiated jointly by the FRY and BH authorities (and the Macedonians if they were in a similar position), and provide equivalent treatment to both (or all) parties. This would seriously complicate the negotiation process, delaying a final settlement, possibly for some years; and, given the much more limited goodwill towards the FRY, it would almost certainly provide less favourable terms. The prolonged hiatus would also limit BH's access to international financial markets until there was a resolution of the issue.

Even if agreement-in-principle is reached, it would seem possible, at least, that the FRY could block the finalisation of the deal, which generally requires a greater than two-thirds majority of participating creditors. However, the relaxed attitude of the authorities to this issue suggests that they expect a loophole to be available. Even if it were not, BH's debt would remain legally distinct from that of the FRY; and the blockage of a final deal would seriously reduce its value on the secondary market. This could allow the authorities to buy back their debt informally on the secondary market and, in effect, to cancel it.¹³

There are various possible motivations for the FRY authorities' actions in buying Bosnian debt and seeking to block a deal:¹⁴

• They may be hoping that the FRY could obtain a more favourable deal on its own commercial debt if it were treated jointly with that of BH. In these circumstances, there might well be some pressure on banks from their governments to provide debt reduction, so as not to jeopardise BH's economic recovery; and this would allow the FRY to benefit from equivalent terms. Such pressure for favourable treatment would be unlikely if the FRY debt were treated separately.

• The FRY authorities may hope to reduce their own debts more directly. While any subsequent re-division of the debts would again be based on the final beneficiary principle (so that the FRY-held debts would still be owed by BH), it might be possible for the FRY to exchange the debts it holds with other creditors, possibly at a discount, for FRY debts. After a re-division, the FRY authorities would then be in a position to cancel a substantial part of their own debt.

• It is also possible that there is a political motivation. By re-merging their commercial debts with those of BH, the FRY authorities might be trying to restore an obstacle — albeit a largely symbolic one — to BH's autonomy. If the debts held by the FRY are those attributable to RS under the final beneficiary principle, the authorities could off-set any negative effect on RS by cancelling their debts. This would allow the RS authorities to benefit financially as well as politically from their acceptance of the final beneficiary principle for the inter-Entity allocation of debts.

Some of these motivations, at least, could give the RS authorities themselves an incentive to block any extension of the joint and several liability waiver. In the third case, there would be a direct financial benefit to RS, in the form of a greater degree of debt reduction than would otherwise be available, as well as the political advantages. In the first two cases, the benefits would accrue mainly to FRY; but the RS might wish to support this, either for reasons of Serb solidarity or in return for a quid pro quo of some kind. In view of the likely financial costs (in the form of less favourable treatment of BH debt), a quid pro quo would be essential under the first case.

The question of the complicity or otherwise of the RS authorities is critical, because this could encourage them to obstruct the achievement of agreement-in-principle before the end of June. The most obvious way of doing this would be to delay the approval of an IMF programme. The absence of an IMF programme would not represent an insuperable obstacle to agreement-in-principle, as the procedures for commercial bank renegotiation are somewhat more flexible than those of the Paris Club. Nonetheless, there would be substantially greater impetus towards reduction of commercial bank debt with an IMF programme and the prospect of a Paris Club agreement than without. If an IMF programme were delayed, this could lead to a more general disruption of BH's financial arrangements, for example by delaying World Bank adjustment lending, and would effect negotiations with the commercial banks.

As noted above, the $825m owed to bilateral creditors can only be reduced once an IMF programme is in place. The authorities are hoping to secure a reduction of 80 per cent in
net present value (NPV) terms; but it seems possible, at least, that they will be offered only 67 per cent. This might be topped up to 80 per cent after a track-record of economic adjustment policies has been established (in line with the HIPC Initiative). Much will depend on the strength of the political pressures for more favourable treatment.

A 67 per cent reduction in the NPV of commercial and bilateral debt, coupled with the consolidation of World Bank debt would reduce the overall NPV of debt to about $1.5bn, or 250 per cent of estimated 1996 exports. The absolute NPV figure would be increased over time by new borrowing, although this should be relatively limited, and mostly on concessional terms. The ratio of NPV to exports should decline rapidly if the predicted rapid growth of exports is achieved: based on the World Bank's projections (World Bank, 1996b, Table 5.2), the NPV of BH's external debt might reach about $2bn — about 80 per cent of exports in 2000.

However, the export projections appear very optimistic (quite apart from the political risks), so that the rate of improvement may be substantially slower. The effect of slower export growth is threefold: as well as reducing the level of exports, and thus increasing the NPV/export ratio directly, the need for additional borrowing to finance the larger current-account deficit increases the level of the debt, and the higher level of debt increases interest payments, adding to the need for additional borrowing.

If export growth were reduced by one-third, without a corresponding reduction in imports, and the resulting financing gap were filled with non-concessional borrowing, the NPV/export ratio would remain at about 250 per cent in 2000. This outcome could be avoided by reducing the growth rate of imports; but to neutralise the impact would imply imports some 20-25 per cent below the levels currently projected in 2000; and, without the possibility of devaluation (see Section D1), this would imply a similar reduction in GDP. This would have a serious impact on incomes and employment.

**B.3 IMF and World Bank relations with the authorities**

BH joined the IMF in December 1995, and the World Bank in April 1996 (although its membership was back-dated to February 1993, when the membership of the former Yugoslavia was terminated). It is now represented on the Executive Boards of both institutions by the Executive Director for the Netherlands.

The most important obstacle to IMF and World Bank membership was the need to settle BH’s share of the arrears accumulated by the former Yugoslavia. This was a relatively minor problem in the case of the Fund, as the arrears were fairly small (less than $50m). They were settled by a bridging loan from bilateral donors, enabling BH to join the Fund and make a first credit tranche drawing of 25 per cent of quota, without policy conditionality. This was then used to repay the bridging loan.

The problem was much greater on the World Bank side, as arrears to the Bank amounted to some $450m. However, this problem was resolved flexibly and constructively by the Bank, which consolidated the entire amount of Bosnia’s $625m debt to the Bank over 30 years, at 0.5 per cent annual interest. This could be done only by treating BH as a new member of the Bank, rather than as a successor state to the former Yugoslavia, following the precedent established by Bangladesh in 1975.

Relations between the IMF and the World Bank and the authorities were complicated initially by the Muslim domination of the national government prior to the September 1995 elections, and the resulting suspicion of the RS and Croat political leaderships. Since the elections, problems have included the split of responsibilities between the Federation and the RS, and the strong mutual suspicion between the two; and the tensions between the Croat and Muslim sides within the Federation, resulting in the continued de facto operation of the Croatian statelet of Herceg-Bosna. These factors contributed to a prolonged hiatus in the formation of the national government, and a continuing state of political inertia.

Nonetheless, the IMF and the World Bank maintained contacts with at least some of the authorities during this period. The IMF, in particular, was among the first to establish links with the RS authorities, at the beginning of their relations with BH immediately after the Dayton Agreement. The Bank was initially in contact only with the Federation side, but has, since the elections, established a more symmetrical relationship. Both the Fund and the Bank are now in regular contact with the authorities of both Entities as well as the national government.

The World Bank started to support reconstruction in BH before the country actually
joined the Bank, through a Trust Fund managed by the Bank, funded by donor contributions. This also allowed part of the Bank financing to be provided on grant terms. The first project was the Emergency Reconstruction Project in February 1996. A further twelve projects have been approved since, for a total of $325.6m of IDA funds ($1,045.5m including cofinancing by other donors). (See Table 2.) Only five of the 13 loans have included RS: the remainder, accounting for 80 per cent of total funding and 83 per cent of World Bank resources, have gone exclusively to the Federation.

Further support is expected to take the form of three approximately annual policy-based structural adjustment credits (SACs). BH is expected to make the transition from concessional IDA credits to non-concessional IBRD loans in 1998, reflecting its increasing per capita income and improving creditworthiness.

An IMF programme is also expected in the near future. While BH is eligible for concessional funding under the enhanced structural adjustment facility (ESAF), the first programme will be a twelve-month stand-by arrangement (SBA), on non-concessional terms. The SBA option is preferred because it takes less time to prepare than an ESAF, which would entail longer and more detailed policy discussions. The important consideration at this stage is to get an IMF programme in place, to allow debt negotiations to proceed (see Section B2), rather

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Notes: Data are from World Bank (1996c), and cover loans effective in November 1996. Coverage: F = Federation only; F/RS = Federation and Republika Srpska.
than the nature of the support provided. However, the high cost of the funds provided suggests either that they should not be drawn (a 'classical stand-by'), or that they should be added to the reserves, rather than being used to finance imports. The intention is to negotiate an ESAF, which would cover a further three years, while the SBA is in place.

The policy conditionality included in an SBA would effectively be limited in BH's case. The conditions relate only to macroeconomic variables such as the budget deficit, the money supply, and the exchange rate; and these are in any case effectively imposed by the currency board arrangement mandated under Dayton. An ESAF would go beyond this into structural policies. While this would require more extensive policy discussions, with greater scope for dispute with and between the Entities, the policies entailed would overlap significantly with the World Bank SACs.

The extent of pro-active policy-making by the authorities appears to be limited. The process is one not so much of negotiation as of consultation: the IFIs consult the various authorities, formulate policy proposals, and put them to the authorities, who accept them. Moreover, the donors (and other international agencies, such as UNOHR) appear to be presenting a very united front: all are firmly committed to the general principle of economic reform, and seem agreed on virtually all the details. The result is very heavy conditionality: the authorities are reminded that if they do not comply with the programme outlined, there will not be another donor conference — or, by implication, further substantial assistance for reconstruction.

It is clear that the threat is not limited to a major failure of the reform. The OHR/EU/UST (1997) paper, 'elucidated with the cooperation of the IMF and the World Bank, states explicitly that:

*There is no room for hesitancy or half measures and the reform program must be implemented quickly and in full...[I]f it were limited in urgency or scope...the willingness of the international community to provide large-scale resources would...be likely to diminish.*

As a general principle, such heavy-handed conditionality seems less than ideal. However, it would probably be necessary to ensure the implementation of any kind of policy framework — not because of political opposition, but because of the inertia generated by the current political arrangements. Much of the initial part of the reform process is either essential to the establishment of BH as a state or mandated by the Dayton Agreement (for example, the formation of the Central Bank, customs authorities, and so on).

Nonetheless, some elements of the policies being thus enforced are less clear-cut; and no distinction is made between the essential state-forming components of the policy proposals and those relating to the particular economic strategy to be adopted. Thus, while the establishment of a regulatory framework for international trade is necessary, the abolition of administrative controls and the setting of tariffs at a low and uniform rate, with minimal exemptions, is not. Other measures, such as privatisation, are wholly unrelated to the Dayton terms. However, the authorities appear to accept the principles of reform which have been put forward, most of which are probably either sensible, or inevitable in the current circumstances (subject to the concerns discussed in Section D). It is difficult to assess the balance between genuine commitment and compliance based on financial dependence, but there is at least an element of the former. RS (1996) would appear to suggest that the financial aspect may be of greater importance, and genuine commitment more limited, in RS.

The unanimity of the donors is presumably based on the fact that much of the package being proposed is essential, and that it will not be implemented unless they speak with a single voice, and make it impossible for any of the authorities to dilute or obstruct it. The elements which go beyond the essential are at least acceptable enough to the rest of the international community to be seen as a price worth paying for securing the essentials — although there is little evidence of dissent.

Three more specific concerns may be noted with respect to the international community's approach to promoting the reform process:

• The underlying ideology does occasionally show through. The OHR/EU/UST (1997) paper, for example, concludes that: 'the time has come to shift the emphasis of economic policy-makers [NB not for policy-makers themselves to shift their emphasis] from reconstruction after the ravages of war to policy reform after the ravages of socialism.'

• EU/EBRD/World Bank (1996a, p101) proposes using the media to promote the principles of policy reform and transition, through soap operas as well as educational
programmes, documentaries, and debates. This seems highly questionable, particularly in the light of the role of the media in the conflict, and would seem to be at odds with the objective of increasing its political independence.

- As well as the stick of reducing reconstruction assistance and withholding debt reduction, a carrot has been dangled before the authorities in the form of accession to the European Union. While this is seemingly an almost universally-held objective, and there appears to be a great deal of optimism on this score, the prospect of achieving it remains uncertain, and at best distant. There is also a conspicuous divergence of views, both between the EU itself and other donors, and between the Federation and national authorities on the one hand and the RS authorities on the other (Box 2). This tactic would therefore seem to carry with it a high risk of disillusionment and frustration in the medium term; and could create a rift between the two Entities.
Box 2: Divergent views on BH accession to the European Union

There is a marked disparity in the views of different parties on the likelihood and desirability of BH’s accession to the European Union in the foreseeable future. This can be seen from the following quotes.

The donor vision of the benefits:

Donors, in putting forward their policy recommendations, have put substantial emphasis on the potential benefits of EU accession and the necessity of market-oriented economic reforms as a prerequisite for its achievement:

Joining the European Union and becoming increasingly integrated with the rest of Europe is the common vision shared by the people of Bosnia. It is a vision of prosperity for every citizen of Bosnia, and a vision of a modern market economy, and underpinned by a small but effective government ... To realise this vision of integrating with Europe would require forward-looking policies and reform.

(EU/World Bank, 1996b, p1)

The National Government view:

The national government appears to aspire to EU accession.

The Government of Bosnia and Herzegovina will continue its negotiation with the EU in relation to gaining access to the PHARE programme and to conclude a Trade and Cooperation Agreement, and Financial Protocol. The Government of Bosnia and Herzegovina reiterates its position that Bosnia and Herzegovina deserves special treatment, as an unprecedented case, for Associate Membership in the European Union.

(World Bank, 1996d, p103)

However, there are two dissenting voices:

The broader EU view:

Despite its involvement in the preparation of the first document quoted, elsewhere the EU has been much more ambivalent:

In the case of Bosnia-Herzegovina, the peace process, reconciliation between the various sides in the civil war and reconstruction must first be seen to bear fruit before further steps, such as the negotiation of a Europe Agreement, can be taken. Only when they have borne fruit could the Phare programme be used as a means of preparing Bosnia-Herzegovina ... for accession to the EU.

(European Parliament, p10)

This suggests that the European Parliament, at least, may be less enthusiastic about the prospect of BH membership than the Commission. Some other donor documents co-authored by the Commission itself have also been noticeably reticent on the possibility of BH accession: OHR/EU/UST (1997, p6), for example, says only that the EU is ‘prepared to consider establishing a contractual relationship’ with BH.

The RS view:

While the second quote above is probably a realistic representation of the aspirations of Federation representatives on the national government, it is by no means clear that their enthusiasm is shared by the RS. The RS Policy Statement on ‘Foreign Economic Relations Policy’ (RS, 1996, pp119-120), for example, does not mention the EU, referring instead to a free-trade zone within the former Yugoslavia and ‘projects for integration within the Balkans’.
C. Donor-related issues

C1. Disbursement delays

As is almost invariably the case in reconstruction (or other aid) programmes, there has been a substantial difference between pledges and actual disbursements and project implementation: as of November 1996, of $1,851m committed, only $720m had been disbursed. A further $456m was under implementation, of which contracts had been signed for $330m (EU/World Bank, 1996a, Table 3). However, this is no worse than is normal in such circumstances. A substantial part of the $1,851m commitments — including all of the World Bank programmes — was designed to be phased over a period beyond the end of 1996. Moreover, where delays have occurred, this has often been as a result of political conditionality. (See Section C2.)

Disbursement delays may have hampered the reconstruction process to some extent, which in turn suggests some negative effect on employment. However, their wider economic effects are likely to have been limited, particularly as balance-of-payments support has not been greatly affected. The delays to the reconstruction process may have some significance, however, if they mean that other components of the transition process, such as privatisation, take place at a lower level of infrastructure and economic activity than was anticipated. (The pace of privatisation is discussed in Section D3.)

Disbursement delays, and particularly those related to political conditionality, have altered the balance of assistance between the Federation and RS, as the latter has been much more affected. (See Section C3.) However, this does not so far appear to have done any serious damage to the political situation; and the need for international financial support has been a major factor in the development of a more cooperative approach on the part of the RS authorities.

There are, inevitably, marked differences between donors in the translation of pledges into actual disbursements. (See Table 4). While this no doubt partly reflects differences in the nature of their support and its distribution between sectors, it seems likely that some more general variations, for example, in political commitment or bureaucratic efficiency, also play a role.

Overall, multilateral agencies have performed somewhat better than bilateral donors in translating pledges into commitments and projects under implementation; but a significantly larger proportion of pledges have been disbursed by bilaterals, partly due to the apparent failure of the EBRD to get any projects to the implementation stage. The EU has also performed relatively weakly in terms of disbursements, while the World Bank has been well above average in both implementation and disbursement.

Among bilaterals, the G7 have mostly performed reasonably well, with the exceptions of Japan and Italy. Smaller developed countries have been more variable, the Netherlands performing well (possibly reflecting their status as Bosnia’s representative within the IMF and World Bank), while Spain has performed particularly badly. The weakest performances are registered by countries which might be expected to be particularly partisan — ie the FRY, Russia and the Islamic countries (Saudi Arabia, Kuwait, Turkey and Malaysia)12 — possibly reflecting lack of experience in aid or limitations in their administrative capacity. Between them, these six countries made pledges of $183.5m (nearly 10 per cent of the total), but had disbursed only $5m (2.7 per cent) of this by October 1996, compared with an average of 48.4 per cent for other bilateral donors.
### Table 3: Pledges, commitments, project implementation and disbursements by donors, October 1996

<table>
<thead>
<tr>
<th>Donor</th>
<th>Pledges ($m)</th>
<th>commitments</th>
<th>as per cent of pledges implementation</th>
<th>disbursements</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>367.1</td>
<td>105</td>
<td>58</td>
<td>28</td>
</tr>
<tr>
<td>World Bank</td>
<td>330.0</td>
<td>99</td>
<td>89</td>
<td>49</td>
</tr>
<tr>
<td>EBRD</td>
<td>80.2</td>
<td>109</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Islamic Dev. Bank</td>
<td>15.0</td>
<td>127</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>other multilateral</td>
<td>25.0</td>
<td>95</td>
<td>55</td>
<td>51</td>
</tr>
<tr>
<td><strong>TOTAL MULTILATERAL</strong></td>
<td><strong>817.3</strong></td>
<td><strong>103</strong></td>
<td><strong>64</strong></td>
<td><strong>35</strong></td>
</tr>
<tr>
<td>USA</td>
<td>281.7</td>
<td>105</td>
<td>82</td>
<td>44</td>
</tr>
<tr>
<td>Japan</td>
<td>136.7</td>
<td>70</td>
<td>32</td>
<td>27</td>
</tr>
<tr>
<td>Netherlands</td>
<td>100.0</td>
<td>100</td>
<td>70</td>
<td>58</td>
</tr>
<tr>
<td>Italy</td>
<td>63.7</td>
<td>111</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Russia</td>
<td>50.0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>50.0</td>
<td>84</td>
<td>40</td>
<td>10</td>
</tr>
<tr>
<td>Norway</td>
<td>40.8</td>
<td>104</td>
<td>92</td>
<td>92</td>
</tr>
<tr>
<td>UK</td>
<td>39.7</td>
<td>98</td>
<td>98</td>
<td>86</td>
</tr>
<tr>
<td>Germany</td>
<td>39.3</td>
<td>99</td>
<td>91</td>
<td>72</td>
</tr>
<tr>
<td>Kuwait</td>
<td>35.0</td>
<td>100</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Switzerland</td>
<td>33.5</td>
<td>82</td>
<td>78</td>
<td>36</td>
</tr>
<tr>
<td>Sweden</td>
<td>30.4</td>
<td>103</td>
<td>65</td>
<td>61</td>
</tr>
<tr>
<td>Turkey</td>
<td>26.5</td>
<td>43</td>
<td>8</td>
<td>0</td>
</tr>
<tr>
<td>Canada</td>
<td>25.4</td>
<td>88</td>
<td>46</td>
<td>46</td>
</tr>
<tr>
<td>Spain</td>
<td>17.5</td>
<td>101</td>
<td>27</td>
<td>27</td>
</tr>
<tr>
<td>Malaysia</td>
<td>12.0</td>
<td>100</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>Austria</td>
<td>11.5</td>
<td>200</td>
<td>196</td>
<td>101</td>
</tr>
<tr>
<td>FR Yugoslavia</td>
<td>10.0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>France</td>
<td>9.3</td>
<td>142</td>
<td>125</td>
<td>118</td>
</tr>
<tr>
<td>other bilateral</td>
<td>164.2</td>
<td>126</td>
<td>85</td>
<td>57</td>
</tr>
<tr>
<td><strong>TOTAL BILATERAL</strong></td>
<td><strong>1,077.1</strong></td>
<td><strong>94</strong></td>
<td><strong>60</strong></td>
<td><strong>40</strong></td>
</tr>
<tr>
<td><strong>ALL DONORS</strong></td>
<td><strong>1,894.4</strong></td>
<td><strong>98</strong></td>
<td><strong>62</strong></td>
<td><strong>38</strong></td>
</tr>
</tbody>
</table>

C.2 Political conditionality

A critically important element in the equation of donor financing has been direct and indirect political conditionality. Aid commitments have been seen by donors as an important means of applying pressure on the various political factions and authorities (most notably in RS) to secure progress on the implementation of the Dayton Agreement. While it has not been wholly successful, the actual or implied threat of withholding funding seems to have had some effect in terms of political progress; and without it, it is unlikely that even the current level of cooperation would have been achieved.

Political conditionality has been applied to various issues. Probably the clearest, as well as the most important, has been on the formation of national institutions. The RS authorities have no real political commitment to BH, or to cooperation with the Federation. Left to themselves, they would therefore be unlikely to cooperate to construct institutions at the national level. On the contrary, they have every incentive (and, given the level of decentralisation, every opportunity) to undermine the prospects of reunification by adopting policies inconsistent or incompatible with those of the Federation. It may be possible to push them some way towards cooperation by the threat of withholding financial support.

In some areas, political conditionality has been directly relevant to particular projects. This applies particularly to infrastructure rehabilitation projects, where donor support has been conditional on the linking of infrastructure between the two Entities. Where the viability of the infrastructure to be rehabilitated depends on the reintegration of the Federation and RS components, their continued separation represents an important obstacle to achieving the objectives of such aid. Moreover, the nature of the support required depends critically on whether one integrated or two separate systems are being supported. To design rehabilitation on the basis of two independent systems would not merely provide implicit backing for their separation, but would entrench the separation in practical terms.

In other areas, political conditionality has been less effective. For example, while donors were successful in securing the removal of Radovan Karadžić and Ratko Mladić from public office, there is little prospect of their extradition to face the Hague war-crimes tribunal. Conditionality on the freedom of movement and the return of refugees and displaced people appears to have been given less weight by donors, and has had minimal effect.

There is a potentially important cost to political conditionality. Not only does it give rise to delays in disbursements, it also skews the pattern of disbursements between Entities; and this applies particularly where, as at present, its application is asymmetric. The main aim of political conditionality, from the donors' perspective, is to influence the policies of the RS. But the result has been that only a tiny proportion of total aid flows have reached RS. (See Section C3.) While this could be effective in putting pressure on the RS authorities, if economic recovery in RS were jeopardised, it could equally well strengthen the political position of the extremists.

Dilemma 1: Political conditionality

Some form of political conditionality is necessary for donors. Providing support to all parties irrespective of their political actions would be an acute embarrassment, as it might well lead to donors providing financial support to policies in direct contravention of the Dayton Agreement. It has also proved to have some (though by no means complete) success in influencing policies and promoting the implementation of the Dayton terms. However, some caution is needed in the application of political conditionality. It cannot necessarily be assumed that the RS authorities will comply with political conditionality, even where they appear to have a very strong financial incentive to do so. They have in the past proved very stubborn in the light of donor threats, not least in the case of extradition. Even if conditionality is successful in promoting cooperation, if this is forced on the RS authorities by financial threats without any genuine political commitment, it is likely to be superficial: it may be possible to ensure the creation of national
Dilemma 1: Political conditionality (continued)

Institutions, but it would be difficult to ensure a constructive and cooperative approach within them (as Muslim/Croat relations within the Federation demonstrate). Only in the long term could this be expected to contribute to political progress, and then only if there were a shift towards more moderate political leadership in both Entities.

Moreover, an over-zealous application of political conditionality could result in inadequate financial support to reconstruction and economic recovery, particularly in RS. This would have a direct negative effect on the economy, and thereby on living standards; and this, coupled with the opportunity to allege ‘persecution’ by the donors, would provide considerable ammunition to political extremists. ‘All-or-nothing’ political conditionality, if its requirements were seen by the authorities as excessive, could lead the RS to turn their backs on the Dayton process, and look to Belgrade for support instead. The very low level of disbursements to RS so far suggests a real possibility of movement in this direction.

It is also possible that the RS authorities may have an incentive to derail or delay some particular aspects of donor support (e.g. IMF programme; see Section B3). In such cases, political conditionality may simply provide them with an opportunity for doing so.

This suggests a need for carefully graduated political conditionality, so that the amount of aid received depends on the extent of compliance, as against an all-or-nothing approach (however tempting the latter might be to donors). Conditionality should also be selective, prioritising those areas which are of greatest importance to the peace process, which are also within the control of the authorities. This suggests that the creation of national-level institutions and the reunification of infrastructure should be regarded as high priorities.

Unnecessary conditionality, or conditioning of aid on factors not fully within the control of the authorities, would be counterproductive, and should be avoided. It would reduce the amount of aid the authorities would expect to receive, weakening their incentive to comply with other political conditions; it would risk reinforcing the perception of the donors as biased towards the Federation; and it would slow recovery and worsen living conditions in the RS. All these factors would contribute to perpetuating extremism.

Conditionality based on the return of refugees and displaced people is arguably a case in point. The obstacles to return arise as much at the popular level — the fear of violence and intimidation — as they do from the actions of the authorities. To impose political conditionality based on the rate of return, when this is largely beyond the control of the authorities, would have little effect. In fact, to the extent that living conditions were worsened by the withholding of aid, the (social) obstacles to return would be increased. Any conditionality in this area should be confined to specific administrative and policy measures.

The question of war criminals is more difficult. There may be a case for conditionality on the extradition of Radovan Karadžić and Ratko Mladić, if they are seen as retaining positions of influence with the RS authorities. However, this is a matter of political judgment, on which views differ. In other cases, economic and political considerations would appear to suggest that conditionality should not be applied, at least for the present, as the costs would be greater than the benefits. It must be stressed, however, that considerations of natural justice also need to be taken into account (and not only because of their political importance to donors). The relative importance of extradition for political reconciliation is likely to increase as (or if) other problems are resolved.

Overall, donor policies on political conditionality seem broadly appropriate. There is a risk that they are erring on the side of under-funding RS, but this issue is well recognised, and it is expected that disbursements to RS will increase substantially in 1997. However, it will be important to keep this issue under review, to maintain a realistic assessment of what can be achieved, and to proceed with considerable caution.
C.3 The distribution of donor funding

A greater problem than disbursement delays has been that of financing gaps for particular programmes and components of programmes. The availability of donor funding and the rate of project implementation have varied considerably between sectors, as shown in Table 4. While some areas of support (for example, housing and 'government and social') have been over-subscribed relative to the original estimates of requirements, others have faced serious shortfalls.

Because of the nature of some of these shortfalls, there is a risk that this could substantially worsen the social impact of the reform process.

- As of November, none of the expected $31m cofinancing from non-Bank-administered funds for the Emergency Public Works and Employment programme had materialised, suggesting a reduction in the scale of the project of more than two-thirds. This implies a reduction in employment of about 5-6,000 jobs for the two years of the project, and a small reduction in real wage levels as a result of the lower demand for labour.

- There has reportedly been a substantial shortfall in cofinancing for the Emergency Social Fund (ESF), although this is difficult to evaluate as figures for ESF financing are not provided separately by the Bank. The entire of the $44m fund was to be financed by other donors;18 and at the time of approval, only $13.6m of this had been committed (World Bank, 1996c, p29).

- Commitments to the health sector amounted to $83m, 43 per cent less than the estimated needs of $145m (EU/EBRD/World Bank, 1996, p132). A particular gap has been in the area of health workers' salaries, where no significant support has been provided, although 'most health workers are paid insufficient salaries' (ibid, p137).

The effects of these shortfalls are discussed in Sections E1 (EPW and ESF) and E3 (health).

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### Table 4: Financial requirements, commitments, and project implementation by sectors, October 1996

<table>
<thead>
<tr>
<th>Infrastructure</th>
<th>Commitments as % of Requirements</th>
<th>Implementation as % of Commitments</th>
<th>Implementation as % of Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity/Coal</td>
<td>85</td>
<td>75</td>
<td>64</td>
</tr>
<tr>
<td>District Heating/Gas</td>
<td>35</td>
<td>55</td>
<td>19</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>17</td>
<td>31</td>
<td>5</td>
</tr>
<tr>
<td>Transport</td>
<td>51</td>
<td>58</td>
<td>30</td>
</tr>
<tr>
<td>Water</td>
<td>60</td>
<td>66</td>
<td>40</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Productive Sectors</th>
<th>Commitments as % of Requirements</th>
<th>Implementation as % of Commitments</th>
<th>Implementation as % of Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>65</td>
<td>96</td>
<td>62</td>
</tr>
<tr>
<td>Industry/Finance</td>
<td>140</td>
<td>53</td>
<td>74</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Social Sectors</th>
<th>Commitments as % of Requirements</th>
<th>Implementation as % of Commitments</th>
<th>Implementation as % of Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>118</td>
<td>63</td>
<td>75</td>
</tr>
<tr>
<td>Government/Social</td>
<td>136</td>
<td>78</td>
<td>106</td>
</tr>
<tr>
<td>Health</td>
<td>58</td>
<td>42</td>
<td>25</td>
</tr>
<tr>
<td>Housing</td>
<td>165</td>
<td>78</td>
<td>129</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Miscellaneous</th>
<th>Commitments as % of Requirements</th>
<th>Implementation as % of Commitments</th>
<th>Implementation as % of Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Landmine Clearance</td>
<td>61</td>
<td>52</td>
<td>32</td>
</tr>
<tr>
<td>Peace Implementation</td>
<td>n/a</td>
<td>89</td>
<td>n/a</td>
</tr>
<tr>
<td>Balance of Payments</td>
<td>n/a</td>
<td>84</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Notes: All figures are approximate, being based on figures transcribed manually from EU/World Bank (1996a), Chart 1.
Other particularly acute shortfalls in funding commitments have occurred in telecommunications (83 per cent) and natural gas (69 per cent). In the former case, the problems have been largely a result of the lack of progress in reunifying the national network.

The regional distribution of disbursements has also been strongly skewed. This is illustrated in Figure 2, in which the area of each block is proportional to the amount of aid. Only about 2 per cent of projects being implemented as of October 1996 were in RS, with a similar
Donor-related issues

proportion in Croat cantons in the Federation. Most of the aid from which Serbs and Croats benefited were at the national level or (for Croats) to the Federation or mixed cantons — that is, it represents their notional shares of aid provided to administrative units in which the Bosniacs are also represented. It seems quite possible that the benefits of such aid are skewed towards Bosniacs; and, to the extent that it is aimed at promoting reunification and cooperation, this may be seen as furthering a primarily Bosniac objective.

Some skewing of aid towards Bosniac areas is justifiable in economic terms, to the extent that it is here that the physical damage, human costs, and economic disruption caused by the war were greatest. However, the extent to which the aid is skewed seems less clear-cut, since the economic situation in RS is now no better — and may well be significantly worse — than in Bosniac areas.

There may be important costs from a political point of view. Firstly, the almost exclusive focus of aid on Bosniac and part-Bosniac administrative units risks compromising perceptions of political neutrality on the part of the donors. This could weaken the legitimacy of their attempts to influence the political process. Secondly, the minimal levels of financial support to the RS and to the Croat cantons means that their authorities are likely to see little financial incentive to comply with political conditionality. This could seriously jeopardise the whole political process: quite simply, the Serb and Croat authorities may see little reason to comply with the political objectives of agencies they believe to be siding with their opponents, and little to lose by failing to do so.

C.4 Donor coordination and NGOs

A third donor-driven problem arises from the failure of donors to coordinate their activities effectively with the authorities. According to the BH Minister for Foreign Trade and Economic Relations:

*Overall reconstruction coordination is still not satisfactory. The donor sector task forces still operate too much in isolation from the Government.*

(Muratovic, 1997, p4)

This applies particularly to NGOs, which in some cases fail even to inform the authorities of their activities. This complicates the planning process, and results in geographical imbalances in social provision. If the projects established were ultimately to be continued with government resources, it could also skew government budgets towards those areas favoured by NGOs in the future. This could, in principle, contribute to increasing tensions within or between Entities.

This situation is now improving; and the budget problem, at least, should be eased by the Federation authorities’ intention that NGO projects should ultimately be taken over by local NGOs rather than by the public sector. Nonetheless, NGOs should, where necessary, increase their consultation and coordination with the relevant authorities; and the lesson should be learned for the future.

More generally, there is a certain feeling of suspicion with regard to the motivations of both NGOs and official international agencies. Many are seen in some quarters as having hidden agendas of one kind or another (particularly, but by no means exclusively, religious-based NGOs); and both types of organisation, and at least some of their staff, are seen as being motivated by financial rather than purely altruistic motives. The high salaries they pay (by local standards) contribute to this problem, as does the habit of flying in expatriate consultants (at even greater cost), often to perform tasks which could have been done (and in some cases are seen as already having been done) equally well by locally-recruited personnel. Officials, at least and quite possibly many ordinary people, are acutely aware that the cost of all this comes out of the funds pledged by donors, so that the more extravagant foreign agencies are, the less reconstruction gets done.

The tendency of some NGOs to go their own way, without consulting or informing the relevant authorities, does nothing to help, particularly in a country with a strong bureaucratic tradition. The fact that international agencies were virtually absent from Bosnia until the last few years (in contrast to many poorer post-conflict countries) probably also contributes to this problem.
D. Economic policies

D.1 The Central Bank as currency board

Macroeconomic policy for the whole of BH is largely dictated by the requirement of the Dayton Agreement that the Central Bank should operate (for the next six years) as a currency board. As noted above, this means, in effect, that currency can be issued only against the Central Bank’s holdings of foreign currency; and this in turn prevents the authorities from running a budget deficit, unless it is financed by foreign loans or grants. It also means that the currency is convertible (i.e., there are no restrictions on buying or selling foreign currency), and that the exchange rate is fixed (at 100 Dinars to 1 Deutschmark), with no possibility of adjusting it up or down.

This arrangement is not unique—Argentina, for example, has operated a similar system since 1991. Its main advantage from an economic point of view is that it provides a much higher level of confidence in the currency, both locally and internationally, than would be likely with a more discretionary arrangement—anyone who holds Dinars knows that he or she can exchange them at any time for Deutschmarks at a fixed exchange rate. Together with the tight constraint it imposes on monetary policies, this means that the arrangement is very effective in keeping inflation down. (Hence its use in Argentina, after the inflationary problems of the 1980s.)

The currency board approach raises some potential problems, in particular through the limits it imposes on exchange rate policy (World Bank, 1996a, pp 17-19). Normally, one would expect to find a real appreciation of the exchange rate during reconstruction, as the large-scale aid inflows increase the supply of foreign exchange. As reconstruction progresses, and the associated aid inflows fall, the appreciation would be reversed, and the exchange rate would fall. However, under the currency board arrangement, the exchange rate cannot be adjusted in this way—instead, real exchange rates adjust themselves through price changes. Thus, rather than an appreciation of the nominal exchange rate during the reconstruction phase, any real exchange rate adjustment would have to take place through price inflation.

This is not, in itself, a very serious problem. A real exchange rate appreciation will only be necessary if the economy approaches full utilization of capacity; and this seems unlikely over the three to four years of the reconstruction programme. (See Section E1.) Moreover, if the capacity constraint is reached, and a real appreciation is necessary, this will occur, as excess demand will push up prices for non-tradeable goods.

A much greater problem will arise when the effect is reversed: in order to achieve a real depreciation as reconstruction aid winds down, inflation would have to be lower than in Germany (since the currency is fixed against the Deutschmark). Even with zero inflation, the rate of real depreciation would be inadequate.

This means, that, during the later stages of reconstruction (say from about 1999 onwards), either domestic policies would have to be so deflationary as to achieve a strongly negative rate of inflation, which would severely depress output, increase unemployment, and reduce real incomes; or the exchange rate would become increasingly over-valued, making exports and domestically-produced import substitutes less competitive, which would result in faster accumulation of foreign debt or, if financing were not available, a foreign-exchange crisis.

Since unemployment will almost certainly still be very high at this stage (see Section E1), the former option would imply an extremely high social cost. Apart from the general role of worsening social conditions in exacerbating ethnic and political tensions, the effects of deflation would be seen as directly attributable to the national institutions. It seems almost certain that this would be used by Serb nationalists as a further argument for secession—and it could be a fairly convincing one. The same might also apply on the Croat side. Certainly, the effect on the very fragile cohesion of the BH state would be extremely destructive.
The second option — allowing the exchange rate to become over-valued — might therefore appear more attractive. However, this is at best a temporary solution; and the scope for taking this path will be critically dependent on Bosnia’s debt situation. There would again be a cost in terms of employment, as export and import-substituting industries would be less able to compete than with a more competitive exchange rate.

The over-valuation option is only viable to the extent that the country is able to borrow internationally to finance its balance of payments deficit. If it already has an unsustainable level of debt, creditors will be unwilling to lend. Moreover, their reluctance will be greatly increased (and the sustainable level of debt greatly reduced) if creditors see the country’s debt servicing capacity as being compromised by institutional arrangements which prevent adjustment of an exchange rate which is already over-valued.

The problem of over-valuation could be compounded in the event of adverse political developments, such as rising social or political tensions. During the reconstruction phase, this could disrupt financial flows, either because of political conditionality or by impeding policy changes or specific reconstruction projects. In the longer term, it would represent a serious obstacle to private borrowing. In either case, the effect would be to reduce the supply of foreign exchange, and thus reduce the (notional) market exchange rate; and this would widen the gap between the fixed official rate and the notional market rate; in other words, it would increase the degree of over-valuation.

Adverse political developments, or the perception of exchange rate over-valuation, could also cause a loss of domestic confidence. If people believe that the exchange rate is over-valued to such an extent that some form of downward adjustment (ie a change in the currency board system) is likely, this will encourage people to convert their local currency into foreign exchange, to avoid losing out. A loss of confidence for political reasons could well have a similar effect, as well as a more direct effect in making the exchange rate even more over-valued.

In principle, people have the right to convert their local currency to foreign exchange at the mandated exchange rate. This is not an immediate problem, precisely because the Central Bank has to hold enough foreign exchange to match the value of base money (ie notes and coins in circulation), and not, for example, bank deposits. While it would in theory be possible to require the currency board arrangement to operate against the total stock of money (including bank deposits), this would effectively mean a shutdown of the banking system (World Bank, 1996c, p18).

With the narrower system, a general loss of confidence domestically would create serious problems. If people try to withdraw their bank deposits and convert them into foreign exchange as well as their cash holdings, ‘the authorities have only two options...: they can try to block the deposit withdrawal or refuse the exchange of money, that is, they can choose between a banking crisis or a foreign exchange crisis’ (World Bank, 1996c, p18).

The currency board also means that the country will face a binding constraint on public expenditure, which can only be financed from government revenues and receipts from donors. While the tax base has not collapsed to the extent to which it has in many other post-conflict countries, and the exceptionally high level of the authorities’ domestic and foreign liabilities would make further significant borrowing both difficult and unwise, this will represent an important limitation on the flexibility of policy.

Thus the currency board arrangement raises some potentially very serious problems. However, from a political perspective, it is probably inevitable over the medium term, precisely because of the constraints it impose on economic policy. In the current political circumstances, a discretionary monetary policy would only be viable if all decisions were made jointly by representatives of all three ethnic groups, on a consensus basis. Disagreements would be inevitable, leading to a very damaging inertia in decision-making, which would undermine economic policy, macroeconomic stability, and confidence, with potentially serious knock-on effects. For example, there would be a strong temptation to resolve inter-Entity (and intra-Federation) disputes over resources by competitive inflationary financing. In view of the extent of the needs for resources and the very low level of cooperation, there is a serious risk that this would lead ultimately to hyper-inflation, as in the former Yugoslavia.

It should also be noted that the currency board broadly represents a continuation of the policies being pursued in both Entities since 1994.
The IMF, the World Bank and economic policy in Bosnia

Dilemma 2: The Central Bank as currency board

The currency board principle is probably the only way to ensure effective macroeconomic policy-making in a decentralised system with a high level of political conflict and inertia. However, it imposes important constraints on economic policies (specifically fiscal and exchange rate policies); and it raises a serious risk of a financial crisis after about 1999. The latter could have a major social and political impact, potentially jeopardising the whole Dayton process.

Abandoning the currency board principle is not a realistic option, as it is mandated for six years under the Dayton Agreement, and it would almost certainly lead to serious problems in macroeconomic policy, either through the two Entities printing money competitively to finance their own programmes (leading ultimately to hyper-inflation), or through complete inertia. Either would lead to a loss of confidence, domestically and internationally, which would be very damaging economically.

Shortening the period of operation of the currency board might be more feasible politically, but it could only be achieved, and would only be viable, if there were a much greater degree of mutual trust between the various parties than exists at present — or than seems likely over the next few years. Otherwise, the same problems would arise. Even discussions of changing the Central Bank arrangements (which would almost certainly be protracted) could seriously undermine confidence, increasing the risk of a financial crisis, even in a relatively favourable political climate.

Even ending the currency board arrangement after its six-year term could be difficult without a substantial improvement in the political climate; and while elections in the mean time might moderate political positions, it is at present far from clear that this will happen. In any event, serious economic risks will arise long before the currency board’s six-year term has elapsed.

In view of these problems, serious and urgent consideration should be given as to how the political benefits of the currency board can be retained while minimising the associated economic risks. Two options might merit further (and more expert) consideration:

- A self-financing system of import tariffs and export subsidies. This could be used to adjust the effective exchange rate through its effects on the prices paid for imports and received for exports. When an exchange rate depreciation is required, subsidies and tariffs would be increased, averting the problem of exchange rate over-valuation. However, this would be at odds with the trade policies currently being recommended, and, in the absence of some form of exemption, with WTO membership. This option is discussed further in Section D6.

- A temporary support facility for the Central Bank. This could take the form of a fund, financed by donors, to provide balance of payments and fiscal support in the event of a crisis beyond the authorities’ control. Clearly donors would not be willing to write a blank cheque: support should be graduated according to need, as determined by some previously agreed formula; and the facility would need to be subject to a fixed ceiling. Some conditionality on appropriate adjustment measures would also be required in the event of its activation.
D.2 Public finances

The financial position of the authorities represents a critical constraint on economic policy; and this constraint is rigidly enforced by the currency board principle mandated by the Dayton Agreement (as discussed in Section D1). The authorities, taken as a whole, will only be able to spend what they receive, either from taxation or from donors, for at least the next six years.

While the tax base has not collapsed to the same extent as in some other post-conflict countries (for example, Uganda, Mozambique, and Rwanda), it has nonetheless narrowed substantially. The sales tax base had declined by about 75 per cent from its pre-war level (roughly in line with GDP) by 1995; and pay-roll taxes have plummeted due to the reduction in both formal sector employment and wage levels. As a result, BH has 'extremely limited fiscal capacity'. At the same time the prewar fiscal and tax collection system has collapsed and been replaced by different (and incompatible) tax systems and separate administrations in the two Entities (EU/EBRD/World Bank, 1996, p141).

This suggests a need, firstly, to reconcile the two tax systems so that they can operate effectively within the same country; and secondly, to increase revenues sufficiently to meet the country's financial needs.

The development of compatible taxation systems in the two Entities is problematic in itself. The RS authorities, in particular, because of their separatist aspirations, have every incentive to ensure that their taxation (and other) systems are incompatible with those in the Federation, so as to create an additional barrier to reunification of the country. There may be a similar temptation for the Croat nationalists within the Federation itself.

There is also a need for compatibility in the structures and rates of taxes, particularly import tariffs and the proposed value-added tax, if BH is to operate as a single national economy. This suggests that the donors will have to take a very proactive role, not only in the development of tax collection and administration systems, but also in the details of tax policies, to ensure their compatibility.

Strengthening the public sector finances will be complicated by two major tax reductions (or constraints) being pressed by donors for reasons of economic efficiency: on import tariffs; and on wage-related taxes and social security contributions. (These recommendations are discussed in Sections D4 and D5 respectively.) In 1995, these two sources represented more than one-third of the authorities' total revenues in the Federation (World Bank, 1996b, Table 3.1).

Because of the currency board arrangement, any reduction in revenues from these sources will feed through directly either into lower government expenditure or into higher rates of other taxes. It has been suggested (EU/World Bank, 1996b, p20) that the cut in payroll contributions should be compensated by increases in excise and sales taxes. However, these are already very high: in the Federation, they represent around 16 per cent of GDP (World Bank, 1996b, Table 3.1); and in RS, the general rate for the goods and services tax (with some exemptions and reductions) is already 31 per cent (RS, 1996, p113). This suggests that there will be little if any scope for further increases, and that the main burden of the adjustment will fall on public expenditure.

The trade-off between tax rates and government expenditure will be particularly stark because both customs duties and payroll taxes and contributions are ear-marked for specific uses. Customs duties are to be used to finance the central government. Reducing import tariffs could thus leave a shortfall in financing for the central government (unless it is fully offset by a reduction in external debt-service payments); and this could substantially weaken the forces for political cohesion. Pay-roll taxes and contributions are the sole source of financing for pensions, benefits, and health services. Any limit on the rates of such taxes would therefore also constitute a limit on social safety-nets. This will become still more problematic over the longer term, as the proposed transition from a pay-as-you-go pension system to a system based on individual accounts will entail a substantial increase in costs over a transition period of perhaps 40 years. (See Sections E1 and E3.)

Over-tight fiscal constraints represent an important obstacle to effective policy-making, efficient administration, and the provision of high quality public services. A particular problem in this context is that of public sector salaries: donors have shown themselves willing to finance shortfalls in other types of recurrent spending, such as money for essential drugs and other consumables in the health sector, and for teaching and learning materials; but they are
not generally willing to contribute towards wage costs. As a result, the tight fiscal constraints in BH limit both the numbers and the quality of staff; and this represents a potential bottleneck in project implementation and policy-making:

While most of the Bosnian implementing agencies have competent staff, their number is very limited, and their capacity to handle a large number of projects may be stretched to the limit. Furthermore, there is competition for highly-qualified people among foreign institutions located in Bosnia and a growing demand coming from the private sector, resulting in a salary structure that makes it hard to keep staff in the public sector.

(EU/World Bank, 1996a, p6)

The World Bank’s approach to public-sector salaries has been based primarily on raising salaries at the Federation level into line with those in the Croat areas (and at the national level to about 25 per cent higher), so as to attract an ethnically balanced civil service. This is an essential objective; but it still leaves some problems. In particular, the financial support for this policy totals only $5m, compared with an annual additional cost of $9m pa.19 This leaves the authorities to find an extra $6.5m pa until March 1998, and $9m pa thereafter. Also, no support is planned for the cantons or municipalities; and no account is taken of salary levels available in the private sector or from donor agencies and NGOs themselves.

It is interesting to compare the level of support for salary supplements with the cost of providing consultants under the Emergency Reconstruction Credit. The former is $5m, to support 2,520 staff over the two years of the project’s duration — an average of about $1,000 per person-year. Almost the same amount ($4.53m) is allocated for some 26 person-years of consultancy services — an average of $174,000 per person-year (World Bank, 1996a, Annex I Appendix 5). In other words, the externally-financed salary supplement for the average civil servant for a year is enough to finance the average consultant for about one and a half working days.

Another potential problem is the distribution of revenues between levels of government. The most sensitive aspect of this problem is the requirement of contributions from the Entities to the national government. This is essential to the operation of the BH government, which has no independent source of revenue (until such time as the national parliament approves taxes at the national level); but, as the World Bank (1996b, p34) points out, the system ‘clearly runs the risk of vulnerability to the transfer from below not being forthcoming’. This problem will be the more acute if, as one World Bank study suggests, ‘Tax rates will need to be higher in the Serb Republic than in the Federation to generate the respective revenue contributions because of the greater aggregate population and incomes in the Federation’ (Fox and Wallich, 1997, p12).

The implications of this vulnerability are extremely serious: ‘The state’s sustainability is a concern in this environment, where a strong degree of distrust exists’ (Fox and Wallich, 1997, p11).

RS, like the Federation, itself faces a tight financial constraint. At the same time, the RS authorities have no real political commitment to the BH government: given the choice, they would prefer autonomy or unification with the FRY. This provides them with little incentive to divert resources from their own spending priorities to finance the national government. In 1996, the RS authorities made no contribution to the national government, and their initial budget was sent back for adjustment by the Parliament because it envisaged expenditure 50 per cent above anticipated revenues, with no means of financing the deficit. Further spending reduction was required because of a 15 per cent shortfall in revenues (Fox and Wallich, 1997, p16).

There are signs that the RS authorities remain very reluctant to fund the national government; and, while it is possible that this is only political posturing, this can by no means be assumed. Overcoming this reluctance may well require heavy-handed donor conditionality; and to some extent this will be automatic, since a viable national budget would be an essential precondition for an IMF programme, and thus for debt reduction (see Section B2), quite apart from more direct donor conditionality.

However, it is not clear that this form of conditionality will be effective; in fact, there would appear to be a risk that it could prove seriously counter-productive. As noted earlier, it is possible that the RS authorities would see a political advantage in derailing the debt reduction process, and delaying the IMF programme until after June could contribute significantly to this objective. This in turn would require no more than procrastination on their commitment to funding the national government. More direct and explicit (and possibly heavy-handed) donor pressure may therefore be required to secure a favourable outcome.
A second issue in RS is that of transfers from the Entity level (where most revenues are collected) to the municipalities. While Serb nationalists dominate the Entity authorities, the dependence of municipalities on such transfers provides an opportunity to manipulate the system to penalise more moderate authorities at the local level. There are signs that this is already occurring: the authorities in Banja Luka (the centre of the more moderate political forces in RS) have ‘argued strongly that [Banja Luka] is receiving less than its legislated share of taxes’ (Fox and Wallich, 1997, p16).

A related issue is the direct or indirect transfer of resources between administrative units at the same level (for example, between the Entities or between cantons within the Federation). This is critically important because of the high level of decentralisation and the ethnic base of administrative units. As the World Bank has observed:

as the failure of the Former Yugoslavia demonstrates, a decentralized structure is only viable if inter-entity and cantonal links are mutually beneficial. It is essential...that there not be too much cross-subsidization.

(World Bank, 1996b, p xx)

The problem is that there are marked differences in the levels of economic activity, incomes and employment between different areas of the country; and these differences are, to a great extent polarised along ethnic lines. Most Croat areas escaped both the worst of the direct effects both of the war (which afflict the Muslim areas) and of the UN sanctions (which have severely affected the RS economy); and they have received substantial support from Croatia. As a result, these areas have substantially higher living standards than the rest of the country (Table 6). If, as seems likely, the effects of UN sanctions on RS can be reversed more quickly than the destruction and disruption resulting from the war in Bosniac areas, a similar gap could open up between these two regions.

In the absence of transfers between the various administrative units, the very tight fiscal constraints imposed by the currency board limit spending within each Entity, canton, and municipality to the amount of revenue which can be raised by its authorities. This would allow a much higher level of spending (and thus of social provision, and support to production) and/or lower tax rates in richer areas, while imposing

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<th>Table 5: Regional Economic Indicators, 1996</th>
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<tr>
<td>Source</td>
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<tr>
<td>Total production (% of pre-war)</td>
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<td>Industrial production (% of pre-war)</td>
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<td>Non-agricultural unemployment (%)</td>
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<td>Average net wage (DM pm)</td>
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<td>Per capita income ($, 1995)</td>
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NB data from different sources may not be directly comparable.
very harsh financial constraints and/or higher taxation in poorer areas. The result would be an increasing polarisation between the areas inhabited by the three ethnic groups. This would both increase poverty (as income growth would be lower in the areas with the higher rates of poverty), and widen the political gaps between the ethnic groups (since richer areas seldom want the encumbrance of poorer areas within the same country).

Dilemma 3: Inter-regional inequality and transfers

In principle, the extreme inequality between the different ethnic regions of BH suggests a need for some inter-regional redistribution of resources, both between the Entities and within the Federation. However, political considerations, combined with binding fiscal constraints, impose a very tight limit on the scope for any such redistribution.

Given the level of inter-ethnic political tensions, any substantial transfer of resources between administrative units of different ethnic composition could give rise to considerable resentment. As the World Bank (1996b, p xxv) has noted, 'tolerance for interregional subsidies is low, if not nil'. Once again, this problem is exacerbated by the currency board. Since the public accounts need to be balanced overall, a deficit in one area is possible only if there is a corresponding surplus in another area. This makes the transfer much more apparent than if there were merely different levels of deficits. Any country with a fiscal surplus would immediately know that it was effectively subsidising those areas with deficits; and, if they were areas with a different ethnic base, this would give considerable ammunition to political extremists.

One way of circumventing this problem is by adjusting the geographical distribution of aid in accordance with local economic conditions. This is already happening in terms of the distribution of aid between Bosniac and Croat areas; but the exceptionally low levels of assistance to RS are seriously at odds with this objective. (See Figure 2 in Section C3.)

However, there are three important limitations to this solution:

- Correcting regional imbalances is not the only criterion for the geographical distribution of aid. In particular, it may conflict with wider political objectives, such as applying political conditionality to secure the level of cooperation necessary to the smooth functioning of institutions. This means, firstly, that aid to each ethnic area must be sufficient to provide an incentive for compliance, in order to avoid losing it; and secondly, that it may be necessary to withhold aid from low income areas as a means of applying political pressure (as in RS in 1996).

- More generally, an explicit geographical targeting of aid, largely corresponding with ethnic boundaries, could merely transfer part of the burden of resentment from other ethnic groups towards the donors. They could come to be seen more explicitly as being ethnically partisan, rather than merely as partisan in terms of their preferred political outcome; and this could further undermine their position in seeking to influence the political process.

- Aid is concentrated very heavily on capital expenditure rather than recurrent spending; and what support there is for recurrent expenditure is selective, missing a number of critical areas, such as wage costs. Capital spending for reconstruction and rehabilitation is helpful to the local economy, generating employment and providing the facilities for renewed provision of essential services; but if inadequate resources are available for recurrent spending, poorer areas will remain at a distinct disadvantage, and there may be serious inadequacies in essential public services and social provision. Over-compression of recurrent spending may also undermine the viability of investment and reconstruction programmes and weaken administrative capacity, due to inadequacies in staffing levels, wages, other necessary inputs and maintenance.
Dilemma 3: Inter-regional inequality and transfers (continued)

One possible approach to this problem would be for donors to establish a fund for support of recurrent expenditure, on a regional basis. This could be done using anticipated balance-of-payments support, for example, under World Bank adjustment loans. Resentment against donors could be limited by basing the geographical distribution of funds clearly on an explicit formula measuring needs (for example, providing funds in direct proportion to the shortfall of local income in the jurisdiction of each administrative unit relative to the national average).

This would not eliminate potential political problems. It would require the initial approval of all parties, which would be difficult to secure without additional aid flows; it would mean skewing funds strongly away from Croat areas; and some areas would inevitably receive less than they are currently expecting. However, the use of a transparent formula based on income levels would at least make the rationale of the process explicit, and the use of aid flows rather than domestic resources would make the trade-off between the interests of different areas somewhat less acute.

D.3 Privatisation and the settlement of domestic liabilities

It is currently proposed that there should be a rapid and wholesale privatisation of the economy. This idea, and the outline of the approach to privatisation, appears to originate with the World Bank, appearing in their first post-war paper on BH (World Bank, 1995b, Chapter IV).

As elsewhere, the recommendation for privatisation is partly motivated by the view that it will lead to a more efficient industrial sector, promoting faster economic recovery, while limiting the cost to the public sector. In particular, coupled with efforts to promote the development of new enterprises (see Section D4), it is intended to avoid any tendency to recreate the pre-war industrial sector. This objective is entirely appropriate. (See Box 2.)

In the Federation, at least, there is also a second motivation for privatisation: to provide the means for the authorities to settle the domestic liabilities accumulated during the war. This linkage is important: since it is unlikely that the proceeds even of the full privatisation programme will be sufficient to settle all of the liabilities in full, any reduction in its scale would need to be matched by a reduction in the payments to holders of such liabilities; and, in view of the nature and spread of the liabilities (which include arrears on wages and pensions, and frozen foreign exchange deposits held by 80 per cent of the population), failure to settle them could have high social and political costs. This problem does not arise in RS, where the authorities claim to have no such liabilities.

It is proposed that state companies should sell off functioning assets (e.g., vehicles and other equipment) as quickly as possible, retaining the proceeds, before the enterprises themselves are privatised. The companies would also hive off non-viable operations (which would be liquidated) and assets not related to their core activities, such as workers’ housing, which would be sold where possible. The large conglomerates would then be split into their component parts, which would be privatised. The intention is that small-scale privatisation should begin during the first half of 1997, and large-scale privatisation during the second half; and that at least one bank should be privatised by the end of the year (OHR/EU/UST, 1997).

There is a high level of decentralisation in the proposed approach to privatisation, at least within the Federation. Each enterprise (or component of a conglomerate) is to be sold by the canton or group of cantons in which it operates. This is largely intended to preserve the ethnic identities of enterprises, so as to prevent resentments arising from ownership transfers between ethnic groups, or the operation of enterprises by different ethnic groups from those in the areas where they operate.
On the buyers' side, the proposal is that outstanding liabilities (for example, salary and pension arrears, restitutions for war damage, and frozen foreign exchange deposits) should be settled by issuing their holders with vouchers. There has been some suggestion of an additional issue of vouchers to the population at large, as elsewhere in Eastern Europe; but the scale of the liabilities (estimated at more than DM\(13\text{bn}\)) relative to the likely proceeds of privatisation suggests that this is unlikely to be viable. The vouchers could then be used, together with cash, to buy privatised assets, including housing, and company assets such as vehicles and equipment, as well as shares in privatised companies. In some cases, priority may be given to bids which include a cash component, or full payment in cash may be required.

There is a great deal of urgency in the recommendations on privatisation. Wherever it
is proposed, the emphasis is always on completing the process as quickly as possible. The reason advanced is that privatisation will be necessary for a resumption of production by the enterprises concerned (which will itself be essential to recovery, given their importance), since the government does not have the resources to finance their rehabilitation.

The need for rapid privatisation is generally supported by a strong emphasis on the severity of the enterprises' plight:

Most of these conglomerates were...heavily damaged during the conflict. (EU/World Bank, 1996b, p8)

The prewar conglomerates were especially hard hit by the war.... Most of them were split between the Entities, their industrial facilities have been damaged, and their management methods are inappropriate in the new market economy. (EU/EBRD/World Bank, 1996, Box 3, p82)

However, the speed at which privatisation is expected to take place has some severe disadvantages:

• Selling off assets and enterprises quickly will greatly reduce the proceeds. In the current situation, where the economy is still at a very low ebb, domestic demand is weaker than it is likely to be in a few years. This will substantially reduce the profitability of the enterprises. At the same time, incomes are low and savings in many cases depleted. This will limit the extent of cash contributions to purchasing assets.

• Where cash contributions are required or preferred, rapid privatisation will skew participation towards those with money. In Muslim areas, at least, these broadly include returnees (who are, in some areas at least, resented by those who stayed to suffer the privations of the war); war profiteers and criminals (who are resented even more); and employees of international agencies (who may be seen as profiting further from the policies of their employers).

• Selling off functioning company assets (unless they are genuinely surplus to requirements) is likely to reduce the value of the companies themselves, since they will ultimately have to be replaced, almost certainly at higher cost.

It is also unclear that the justification put forward for rapid privatisation is wholly valid.

The strong statements of the plight of socially-owned conglomerates is at odds with assessments made elsewhere — sometimes elsewhere in the same documents — where a more positive picture is presented, for example as evidence of ‘indicators of a revival of the industrial sector’.

Only a small proportion of the overall industrial capacity has been damaged, and some regions have been almost completely spared (Banja Luka and southern Herzegovina, for example)....[M]any plants are still relatively well-equipped with serviceable machinery capable of producing and marketing good quality products. (EU/EBRD/World Bank, 1996, Box 1, p78)

Equally, the financial constraints on the government's ability to rehabilitate socially-owned enterprises arise primarily because the donors are unwilling to provide support for this purpose. This, in turn, is presumably because they have a preference for the rapid privatisation option.

Confidential survey evidence for the donors' Industry Task-Force suggests a picture of the situation of socially-owned conglomerates somewhere between the two extremes quoted above. Of the 50 largest socially-owned enterprises in the Federation (ie those 'especially hard hit' by the war, in the Entity with the more severe war damage), enterprises accounting for 35 per cent of pre-war employment had 70 per cent or more of their pre-war capacity still operable in 1996 — in some cases more than 95 per cent. Those accounting for a further 45 per cent of pre-war employment had between 40 per cent and 65 per cent of their previous capacity.

A greater problem than the damage to pre-war capacity is under-utilisation of the capacity which remains. Of the 50 enterprises, 20 (accounting for 60 per cent of pre-war employment) were operating at 20 per cent or less of their present capacity, while only nine (5.5 per cent of pre-war employment) had capacity utilisation of more than 50 per cent. Only two enterprises, representing just 1 per cent of pre-war employment, were operating at more than 75 per cent of capacity.

In many cases, the capital investment required to achieve full utilisation of the remaining capacity, or the restoration of pre-war capacity, is very limited. By providing capital selectively to socially-owned enterprises to this end only where the cost is DM11,000 ($6,500) or less per job, it would be possible to generate nearly 45,000 jobs at a total cost of less than
DM200m ($120m). This represents a one-time capital cost of DM4,350 ($2,570) per job — less than half the cost per person-year of employment created by the Emergency Public Works programme. The scale of the benefits could be increased further by expanding the scheme to cover smaller enterprises and those in RS.

At present, orthodox commercial lending is very limited, almost entirely short-term, and extremely expensive, so the main sources of financing for the industrial sector are various credit schemes being supported by donors such as the World Bank and USAID. However, these schemes are exclusively for small and medium enterprises and focused heavily on the private sector, and are therefore likely to exclude most of the above investments. Socially owned enterprises are eligible for support under the World Bank programme only if they are 'have good privatisation potential'.

To the extent that the larger socially-owned enterprises are excluded from access to these (or other affordable) funds, the result will be to impede their rehabilitation, by limiting their ability to invest; to force them into more expensive sources of funding, damaging their long-term financial position; and to force them to sell assets which may be needed for their future operation, or which might be sold in more favourable market conditions later. The overall effect will be to weaken their financial position, possibly to jeopardise their viability, and almost certainly to reduce the proceeds if or when they are ultimately privatised.

As well as the pace of privatisation, the mechanisms proposed also raise some potentially serious problems:

- Sale to domestic buyers through the voucher system will not provide the capital necessary to finance rehabilitation. Enterprises will be under-capitalised and critically dependent on their ability to borrow; but the availability of commercial lending is likely to remain relatively limited over the medium term. This could represent a significant obstacle to economic recovery.

- Because of the war, enterprises have fallen several years behind in technology compared with foreign competitors; and for some industries, catching up in technology will be essential to regaining their competitive position. However, selling enterprises to domestic investors is unlikely to provide the technology transfer which could be gained in the case of foreign investors. There is thus a risk of creating an economy based on technologically backward and under-capitalised companies, which would substantially weaken BH's long-term prospects.

  - The weak financial position of most of the population would give rise to considerable pressure to sell shares, raising the risk that the market would be flooded and prices would plummet. Once again, those with cash would be able to buy up assets very cheaply, skewing economic power to a relatively small elite, and greatly reducing the benefits to the bulk of the population (who might understandably feel hard done by).

  - The decentralised basis of privatisation will entrench the ethnic division of ownership, implying a strong polarisation of ownership, with major enterprises clearly divided along ethnic lines.

Politically, there was initially some degree of ambivalence towards privatisation on the part of the RS authorities. The 1996 policy statement, for example, seems somewhat at odds with the objectives of rapid and near-universal privatisation and the operation of market principles:

> In the sector of the economy with majority state ownership (state corporations), the state will determine prices. The essential principle governing this...is 'cost plus'...The role of the state is to 'iron out' losses and income between state corporations.

(RS, 1996, pp120-1)

However, this now appears to have been resolved, and there seems to be a reasonable degree of commitment to privatisation — although the depth of such commitment may be open to question.

The privatisation process envisaged in RS is very different from that in the Federation. Under the Privatisation Act of July 1996, 55 per cent of shares in enterprises to be privatised will be transferred to six social funds, which will ultimately be transformed into stock-holding companies, but will not participate in their management; 30 per cent of shares will be distributed free to the adult population, through a voucher system; and the remaining 15 per cent of shares will either be offered for sale on the capital market, or be sold to strategic investors subject to conditions relating to business activities, investment, employment, and so on.
Dilemma 4: How to privatise in the Federation?

In the absence of strong domestic opposition, there is little reason to oppose the principle of privatisation for non-utility companies. Large state-owned companies are present throughout the productive sectors, in activities for which there is no strong argument for state involvement. However, the questions of how and when to privatise are more open to debate.

Domestic versus foreign investment: The proposed sale of enterprises to domestic investors has some advantages: it keeps the control and profits of the enterprises in local hands (at least in the short term), and avoids the potentially high long-term foreign exchange cost of foreign investment. However, it will limit the proceeds of privatisation, the capital available to enterprises for rehabilitation, and the technological advantages of privatisation. The proceeds of privatisation are important, as a limited settlement of outstanding claims on the public sector will have a significant social and political impact.

Rapid versus gradual privatisation: A very rapid privatisation process is proposed as a means of getting the economy moving quickly. However, this will further limit the proceeds of privatisation: in view of the low level of economic activity at present, and the depletion of savings, people will be less able to pay for stakes in privatised enterprises than might be the case in the future. The rapid approach will also skew the benefits of privatisation away from those who fared worst in the war, while a more gradual approach could provide a wider ethnic ownership base if freedom of movement and residence were reestablished.

Decentralised versus national approaches: The decentralised privatisation process should avoid disputes and reduce conflict, by ensuring that each enterprise will be owned by the majority ethnic group in the area in which it is located. However, the polarisation of major companies along ethnic lines (rather than having a broad mix of ownership) is more conducive to a separatist than a united future for BH.

A possible alternative approach would be as follows:

- The claims on the authorities could be reduced to some extent by limiting the immediate settlement of claims for frozen foreign exchange deposits, either to those below a specified income level, or to a maximum absolute amount. Settlement of the remainder would be contingent on a settlement of the corresponding claims on the FRY, which should be backed by the international community.

- Holders of the remaining public sector liabilities could be issued with vouchers in the form of tradeable financial instruments — either indexed instruments with no interest, or perpetuals — if possible guaranteed (by donors) against political risk. This would allow holders of government liabilities to receive compensation immediately (although probably at much less than face value, since there would be substantial financial pressure on holders to sell in the early stages). No vouchers should be issued to those not holding claims on the public sector.

- Potentially viable socially-owned enterprises which can achieve full utilisation of their existing capacity at relatively low cost per job could be reactivated immediately, using a fund established with donor funds, before their privatisation was considered. Others could be considered for privatisation immediately.

- Within each of these categories, enterprises could be further categorised according to their need for capital and technology inputs. A 51 per cent stake in those enterprises needing substantial inputs could be offered for sale to foreign investors. Either the sale could be conditional on the investor fully financing the rehabilitation, this being reflected in the price; or the investor’s contribution could be used to settle the government’s (49 per cent) share of the costs of rehabilitation.

- The remaining 49 per cent stakes in these enterprises, together with those enterprises not needing substantial capital or technology inputs (e.g., lower-technology industries which have sustained more limited war-damage) could be sold through the voucher system when the conditions were appropriate.
Dilemma 4: How to privatise in the Federation? (continued)

in terms of income levels, confidence, etc. This could (but need not necessarily) be done on a national basis for those enterprises with 51 per cent foreign ownership, as no ethnic group would be able to secure a controlling interest. If a decentralised approach were used, it would be preferable to wait until substantial resettlement of minorities had occurred, or until it was clear that this would not happen within a reasonable time-frame. Cash payments should be optional, and reflect the market value of vouchers.

The implications of this approach for the proceeds of privatisation (relative to government liabilities) are ambiguous. The sale of stakes in some enterprises to foreign investors, and the delayed sale of 49 per cent stakes, would increase the prices received; and the limitation of foreign exchange deposit liabilities would help. However, the indexation or payment of interest on vouchers, and the use of part of the proceeds to finance rehabilitation would act in the opposite direction. It is therefore possible that some liabilities would remain (or that a greater volume of liabilities would remain than under the current proposals) after completion of the privatisation process. These could remain as (or, if initially indexed, be converted to or refinanced with) perpetual notes, to be redeemed by the government when resources were available. However, this could be a significant financial burden on the government, which would be reflected in other components of government spending (with a direct one-to-one relationship while the currency board is in operation).

It should also be noted that the skewing of benefits to those currently in a relatively strong financial position would not be fully resolved, as they would almost certainly be able to purchase vouchers at less than their face-value in the short term.

However, the World Bank does not agree with this approach. The social funds are seen as too passive; individual investors are seen as too small to take an active interest in the management of firms; and the stake to be offered to strategic investors is seen as inadequate to provide them with an incentive to overcome the resulting inertia. In addition, the conditional sale of strategic stakes is seen as unnecessarily restrictive, unenforceable, and non-transparent.

The Bank would like to see the privatisation of the social funds, consolidation of their claims in individual enterprises, and the development of a more active role in enterprise management; the abandonment of conditions on strategic investments; and a greater role for foreign investment (EU/World Bank, 1996b, p8).

These differences are probably not insuperable, since the RS position appears to be negotiable. However, the process of negotiation and the passage of new legislation is likely to delay the process somewhat.

The pace of privatisation is again an issue. As in the Federation (if not more so), the current weak economic position will limit the proceeds from a rapid privatisation. Moreover, a slower pace of privatisation is arguably more viable in RS than in the Federation, because the problems of state-owned enterprises arise primarily from economic sanctions (which have now been lifted) rather than from war-damage. This suggests that rehabilitation costs (which arise mainly from lack of maintenance) should be relatively limited, so that the financial constraints on the government will not be such an important limiting factor; and that the financial situation of the enterprises (and thus the potential revenues from privatisation) should improve fairly quickly as recovery progresses.

There is also a significant political dimension to this issue. The exclusive focus of the privatisation programme within RS at the Entity level suggests a consolidation of RS as a self-contained economic unit. With an immediate 100 per cent privatisation, ownership of each enterprise can be expected to extend, to a greater or lesser extent, throughout RS, without crossing the boundary into the Federation, or therefore to non-Serb investors. Once again, this implies a step towards separation rather than reunification.
This effect could be moderated by a phased (51 per cent–49 per cent) approach, to be completed on a BH-wide basis if and when the political circumstances permit. The government's share of rehabilitation costs could readily be financed from the proceeds of the 51 per cent sell-off, since (according to the authorities) there are no competing government liabilities which need to be settled.

However, there are two critical obstacles to this option:

• Since the authorities' objective is separation from the Federation, they cannot be expected to adopt a policy aimed explicitly at reunification.
• In the absence of outstanding liabilities, the proceeds from the 15 per cent stake sold on the market or to strategic investors will contribute directly to government spending. In view of the high expenditure needs, the relatively weak revenue base, and the tight fiscal constraint imposed by the currency board, the authorities might well prefer to receive lower proceeds now rather than higher proceeds in the future. This incentive problem is much more acute because the second instalment would be conditional on a degree of national reconciliation which could almost certainly not occur until the current RS authorities had lost power.

D.4 Private sector development

The long-term development strategy envisaged for Bosnia is based on development of the private sector. This entails three broad components:

• privatisation of state-owned enterprises (as discussed in Section D3);
• promotion of small and medium enterprises (SMEs);
• rehabilitation and privatisation of the banking system (as discussed in Section D5).

The encouragement of SMEs is partly direct, through the provision by donors of lines of credit (World Bank and USAID) and equity funds (EBRD) in the Federation. In addition, the intention is to provide a favourable environment for private sector development through deregulation, particularly of the labour market (as discussed in Section D6). Rehabilitation and privatisation of the banking sector is also a part of this process, intended to allow the development of domestic sources of financing over the medium term.

SME development is seen as a major source of employment generation, together with the rehabilitation and privatisation of public enterprises. The promotion of SMEs is probably wise: while many of the management and financial skills required for a thriving SME sector are currently lacking, there was a significant level of small-scale private sector activity before the war; and in Sarajevo, at least, the SME sector has already recovered significantly. The management skills required should be developed in the future with the help of donor-supported training courses, although the process may take some time.

However, there are some caveats to the likely benefits of SME development. Firstly, there appears to be a strong sectoral bias in SME development so far, at least in the Federation, towards trading, retailing, and other services such as restaurants and transport, with much less activity in the productive sectors — especially the production of internationally tradeable goods. This may change over time, as some service-providers are reportedly diversifying into the production of goods; but it is also likely to be a slow process.

An SME sector based too heavily on non-tradeable services raises two important problems:

• It will be critically dependent on the state of the domestic economy; and if declining aid flows, coupled with the currency board system, lead to a severe recession within three to five years (as suggested in Section D1), the sector could be disproportionately affected, with knock-on effects on employment.
• It implies a substantial negative impact of enterprise development on the balance of payments: within the Federation, firms import 60 per cent of their inputs, but export only 3 per cent of their output* (EU/EBRD/World Bank, 1996, p81).

Secondly, at least some of the SME funds seem likely to be unduly biased in favour of the better-off. The requirement of the World Bank fund that an enterprise should have been operating for at least two years before receiving credit limits its use to those who have the resources needed to sustain an enterprise for two years without credit.28

Thirdly, there would appear to be a danger of a regional and ethnic bias in the support of
SMEs. This could arise both directly and indirectly. The focus of the SME support funds at present is strongly, if not exclusively, on the Federation; and some funds have an explicit regional focus even within the Federation, for example, the USAID programme in the (Bosniac) Tuzla area. The World Bank's two-year rule limits access to funds in areas where the private sector was worst affected during the war, most notably the enclaves and areas of conflict, where most enterprises are likely to have been established more recently; and in areas where the economy remains most depressed, so that few people have their own resources to sustain enterprises.

Overall, while SME development is appropriate as an element of employment generation, greater consideration should be given to what type of enterprises are being supported, in what areas, and who owns them. It is also important to avoid over-optimism: the potential of this sector to absorb labour is likely to remain relatively limited, at least over the medium term; and there is a real risk that many of the jobs created will be lost later if the sector is severely affected by the macroeconomic effects of declining aid flows, especially if this coincides with the period when credits are due to be repaid.

D.5 Financial sector rehabilitation

The banking system faces extremely acute problems; and this constitutes a major constraint to the rehabilitation of socially-owned enterprises, the development of the private sector, and economic recovery. An estimated 90-95 per cent of the assets of the banking sector are non-performing, and the sector is divided between large socially-owned banks virtually paralysed by this encumbrance, and small under-capitalised private banks with very limited experience of financial intermediation. The overall result is that very little commercial lending is available, and what there is is short-term and at very high real interest rates (2-6 per cent per month).

In view of the private-sector orientation of the current economic strategy, this makes banking sector rehabilitation a high priority. This is to be based on five main elements:

- the rehabilitation and restructuring of the large state-owned banks, including relieving them of their existing overhang of bad debts, with a view to putting them on a sound financial footing and privatising them where possible, or liquidating them where the situation is irredeemable;
- providing technical assistance and other support to existing small private banks;
- 'supporting the development and growth of new private banks' (EU/World Bank, 1996b, p9);
- opening the market quickly (by end-1997) to foreign competition; and
- developing effective mechanisms for banking supervision.

The first of these elements is clearly appropriate. The financial situation of the major banks is such that their ability to operate is seriously impaired; and this represents an important constraint on private sector development. In the long term, there is no good reason to retain the banking system within the public sector, although the appropriate pace of privatisation is open to debate (as discussed in Section D3). The last element — improving supervisory mechanisms — is clearly essential.

Support for existing small banks is less clearly a priority, but probably desirable. The small private banks are under-resourced and inexperienced, but they provide a useful alternative source of financial services. Their role will remain important at least until the larger banks are rehabilitated. However, encouraging the development of new private banks is more questionable. The banking sector is already over-populated, with a total of 49 banks operating in early 1996 (World Bank, 1996b, p52); and both new and existing private banks would probably be too small to compete effectively in the long term — most of the current private banks have less than DM2.5m of net capital (EU/World Bank, 1996b, p9). A shake-out of the system is likely over the medium term, through a combination of mergers and bankruptcies. The benefits of opening the banking sector to foreign competition — or at least of doing so immediately — are also debatable.

The World Bank (1996b, p58) presages a difference of view with the authorities on the nature of the financial sector. The Bank anticipates that the authorities will opt for a universal banking system, in which the same financial institutions provide the whole range of financial services (insurance, for example, as well as
Economic policies

Dilemma 5: Free Entry for Foreign Banks?

It is proposed that the banking sector should be opened to foreign competition as quickly as possible, as a means both of increasing the efficiency of the sector (through competition) and of improving access to credit and financial services for the productive sectors. At present, it seems very unlikely that the domestic banking sector would be able to cope with international competition — particularly if new entrants were to cross-subsidise their operations initially as a means of breaking into the market. Foreign competition during the rehabilitation and restructuring of the banking system could seriously weaken the domestic financial sector, to the detriment of development over the longer term. From the point of view of the banking sector, a more considered pace would seem preferable. This would provide a breathing-space for the large banks to re-establish themselves post-restructuring, and for the smaller banks to strengthen their operations (with donor support) and consolidate their market position (through mergers). Exposing banks to the full rigours of foreign competition before these steps were accomplished would raise the risk of widespread bankruptcies — especially among the small private banks — leading to a largely foreign-owned financial sector in the future. This is unnecessary, and less than ideal from a long-term economic perspective. The collapse of much of the small bank sector would also largely negate the benefits of donor support to small banks. There is an argument for a substantial delay, of perhaps three to five years, in opening the banking sector. However, this would reduce the availability and increase the cost of credit and financial services to productive sectors during the critical reconstruction phase, which in turn would have some negative effect on employment. There is no obvious answer to this problem. It is necessary to make a judgment between the short-term economic and social benefits of an immediate opening of the market (which would have longer-term knock-on effects through health, education, and political stability), and the more direct long-term benefits of deferment.

D.6 Trade policy

It is proposed that all administrative restrictions on imports should be abolished, and that import tariffs should be levied at a standard rate of 8 per cent. Apart from the usual arguments about removing economic distortions, the proposal is justified by the intention to join the WTO; and the objective of ultimate accession to the European Union. A potentially significant constraint on trade policy is the recent free-trade agreement with Croatia, which limits the scope for protectionist policies. The removal of administrative restrictions on imports is unproblematic (assuming that the basic requirements of health and safety are observed). However, the immediate reduction of tariffs to a standard 8 per cent raises important political issues. It is also less clear-cut in economic terms (because of the direct effect on government expenditure under the currency board system), and is arguably based as much on ideology and presupposition as on the realities of the Bosnian situation. The political dimension arises because the current level of tariffs appears to be significantly higher in RS than in the Federation. In RS, the average rate is 15 per cent, with substantially higher rates for imports classified as 'luxury goods' (RS, 1996, p100); in the Federation, rates vary between 0 per cent and 20 per cent (World Bank, 1996b, p25). If this is the case, the
unification of rates at a lower level would imply a greater fiscal cost to RS than to the Federation. In any event, the RS authorities appear to have little desire to reduce tariffs, in view of the current tight fiscal constraints. They also appear to envisage at least the possibility of introducing new trade barriers in some circumstances:

Restrictive measures and import limits, as well as customs tariffs will not be introduced without a detailed assessment of domestic costs and resources and effective protection levels.

(RS, 1996, p119)

The operation of different trade régimes between the two Entities would raise substantial problems. If there is free movement of goods, there will be a strong incentive for importers in RS to import goods through the Federation, in order to benefit from the lower tariffs; and unless distrust or national solidarity were sufficient to overcome this, the RS authorities would face a substantial loss of revenue as a result. They may be forced to match the Federation’s tariff levels; but, to the extent that they are able to, they may prefer the alternatives of obstructing the free movement of goods and fostering distrust and anti-Federation solidarity.

The immediate needs for low and uniform tariffs are relatively limited. The potential benefits of WTO membership are small; and, as discussed above, the prospect of even starting the laborious process of EU accession remains distant. There could also be some economic benefits from maintaining (temporarily) a moderate level of protection, on a selective basis, in the form of higher import tariffs — although there are some potentially important trade-offs involved.

Dilemma 6: Trade policy

Virtually the entire BH economy is at present made up of ‘infant industries’ and ‘convalescent industries’. This would suggest that there may be a case for the maintenance of a moderate level of protection through tariffs on non-essential consumer goods for a strictly limited period, to help the development of small and medium private enterprises in import-substituting sectors, and the rehabilitation of socially-owned and newly-privatised enterprises, by offering them a breathing-space before they face the full rigours of foreign competition.

Such protection would also provide an additional source of government revenue, helping to ease the very tight constraint on public sector spending and allowing a faster reduction in wage-based taxes and contributions. It could also help to ease a source of political dispute between the two Entities, by bringing Federation policies into line with those of RS. The potential for economic distortions could be limited by phasing out the tariffs over time, according to a rigidly-imposed schedule established at the beginning of the process, reflecting the expected timing of a return to full capacity-utilisation.

At first sight, this might appear to compound the problem of exchange-rate adjustment under the currency board, as discussed in Section D1. Trade liberalisation has an effect similar to a real appreciation of the exchange rate (hence the need for accelerated devaluation during trade liberalisation in countries facing serious balance-of-payments constraints); and a real appreciation is desirable, but not achievable, during the reconstruction phase. Conversely, to liberalise imports as aid flows are reduced over the medium term, when a real devaluation is desirable, would appear to be at odds with real exchange rate objectives.

In practice, however, the distinction does not appear to be so clear-cut. Significant real appreciation of the exchange rate would only occur during the reconstruction phase if the capacity constraint were reached, which appears unlikely. (See Section E1.) Even then, maintaining or increasing the level of protection would merely enable a faster rate of accumulation of foreign exchange reserves, or slow down the accumulation of external debt. Reducing tariffs over time would imply a (perverse) real appreciation of the exchange rate, as aid flows decline, and a real depreciation is required. However, this effect is mitigated by three factors:
Dilemma 6: Trade policy (continued)

• the level of the real exchange rate would throughout be lower (and thus the balance of payments stronger) than under the immediate liberalisation option, ending up at the same level at the end of the process;

• to the extent that producers benefited from the breathing-space offered by temporary protection, and thus achieved a higher level of production of import substitutes (or were in a stronger position to move into export production), the balance-of-payments position would be strengthened for a given real exchange rate, and a higher real exchange rate would thus be appropriate; and

• the reserves accumulated during the earlier part of the process would provide an additional cushion, to finance a current-account deficit; and any reduction in the accumulation of debt would improve the current-account deficit by lowering interest payments.

After the six-year period for which the currency board is mandated, if the political circumstances were conducive, it would be possible to adjust the exchange rate if necessary. The mitigating factors noted above should at least delay the point at which over-valuation of the real exchange rate occurs, reducing the likelihood of a financial crisis in the interim.

A second caveat is the argument that protection would give rise to a distorted set of economic incentives, encouraging production of goods which could be imported more cheaply, and discriminating against export production. However, while the economy is operating far below full capacity, over-production of import substitutes would do little economic harm, and could bring substantial benefits in the form of employment. The negative effect on exports generally associated with protection should be limited, as it arises largely from upward pressure on the nominal exchange rate, which cannot be reflected in actual rates under the currency board system. If there were thought to be a significant negative effect on exports, this could be countered by a system of export subsidies at a rate no higher than import tariff levels. Since the trade balance is likely to remain substantially in deficit for the foreseeable future, the net effect on the public finances should remain positive.

To limit the distortionary effect, it would be critical to ensure that higher tariffs were genuinely temporary, and the schedule for their reduction strictly adhered to. This often proves difficult; and in BH could be a particular problem if the benefits of protection were significantly skewed in ethnic terms. There appears to be a need for the schedule of tariff reduction to be embodied in entrenched (i.e., unchangeable) legislation. However, the general aspiration to membership of the European Union would represent an increasingly strong incentive for tariff reduction, as the prospect of accession came (at least slightly) closer.

There is a critically important caveat to any automatic process of import liberalisation through entrenched legislation. Whatever the merits of this particular case, allowing the authorities to pass entrenched legislation would create a precedent; and could allow the present nationalist leaderships to tie the hands of future moderate authorities. Even with the requirement of consensus, this could create serious obstacles to a long-term political solution, unless there were some form of external control or constraint.
D.7 Labour market deregulation

As noted above, part of the strategy for the development of the private sector and the creation of employment is the liberalisation of the labour market, so as to remove an obstacle to SME viability and to encourage enterprises of all sizes to take on more employees. Liberalisation is also intended to discourage the diversion of economic activity into the informal sector, which would both remove workers from even the most basic protection, such as health and safety provisions, as well as reducing the tax base.

This policy encompasses three main elements:

• the removal of restrictive regulations on employment contracts (eg those making it difficult and/or expensive to fire workers, requiring very favourable annual leave arrangements, etc);
• lowering minimum wage rates, or removing them altogether; and
• lowering tax rates on wages (including employer and employee contributions for state pensions, unemployment benefits and health services).

It seems fairly clear that some movement in this direction is necessary. Even before the war, the former Yugoslavia was widely seen (not least by some Bosnians) as 'living beyond its means'. Bosnia's means are now more limited than ever; and it is not realistic to expect the high wage-levels and long holidays which existed before the war to be reinstated. Neither is it realistic, in the current state of economic uncertainty and change, to expect employers to take on staff whom they cannot later shed (or only at a prohibitive cost); and, with the current exceptionally high level of unemployment, an artificially high minimum wage would merely add to the problem, making any kind of social safety-net unviable.

Lowering tax rates is probably also necessary. At present, well over 50 per cent of the gross wage is taken up by taxes and social contributions; and this is likely to be a significant impediment to employment. It is argued by some that a reduction in rates could actually have a positive overall effect on the public-sector finances, by encouraging more formal-sector employment (and thus broadening the tax base) and reducing the need for expenditure on unemployment benefits and other social safety-nets. However, this view is probably exaggerated.

In all three aspects, the question is how far to go; and the details of these policies are as yet too vague to assess whether they are likely to go too far.

Dilemma 7: Labour market deregulation

A case could be made for making the reduction of minimum wage levels and deregulation of contracts temporary, mandating a progressive increase in minimum wages (though to a lower level than pre-war) and a reintroduction of (less restrictive) regulations on dismissal, annual leave, etc over time. This would offer the prospect of a gradual restoration of living standards, subject to the inevitable constraints of political stability and economic performance.

To the extent that the two Entities (and the two parts of the Federation) continue to operate as largely separate, competing economic units, gradual re-regulation could limit the extent to which competition took place on the basis of bidding-down real wages and working conditions. In the short term, while unemployment remains exceptionally high, this would not be appropriate: the effect would simply be to increase unemployment in the poorest (ie RS and Bosniac) areas. Low wages will be necessary to off-set the costs to employers of the worse economic conditions. As unemployment falls to more normal levels, however, the risk of bidding-down would be increased; and there would be considerable scope for resentment in Croat areas at losing jobs to low-wage workers elsewhere in BH.

Ultimately, if Bosnia were to accede to the EU, it would need to accept the provisions of the Social Chapter. An appropriately-designed labour-market re-regulation could lead up to this gradually.
Dilemma 7: Labour market deregulation (continued)

However, there are some important caveats:

- Potential investors (foreign and domestic) could be deterred by the prospect of having to increase wages and improve contractual terms in the future. This risk could be reduced by limiting changes to newly-contracted staff, which would also provide a disincentive to shedding staff unnecessarily; but investors would still anticipate an increase in production costs, (albeit a more gradual one). The investors discouraged would be those who might otherwise make a long-term commitment to production in BH, rather than foot-loose industries ready to move on once real labour costs increased — although the latter may also be put off if they thought their window of opportunity would be reduced so far as to make investment unviable.

- If BH is to perform well in an increasingly globalised world economy, it will have to retain its international competitiveness over the long term. It will be important to ensure that any re-regulation of the labour market does not compromise this objective, either through its nature or through its rate of implementation.

- It would be very difficult to make a realistic estimate ex-ante of the rate at which minimum wages could realistically be increased, or contractual regulations reimposed. Since an automatic re-regulation would probably need to take the form of entrenched legislation passed at the outset (to overcome political inertia), over-optimism could be very damaging, unduly increasing unemployment.

- Since responsibility for labour-market regulation is held at the Entity level, and the labour market prospects of the two Entities (and of the two parts of the Federation) may be very different, the prospects of a satisfactory agreement on re-regulation being reached at the national level are limited. It is likely that this would entail a long process of negotiation, which would take up scarce administrative resources, as well as creating considerable potential for dispute. It is not clear that this is necessarily preferable to later arguments about low-wage competition.

- As in the case of trade, whatever the merits of this particular case, establishing a precedent for entrenched legislation would be unhelpful unless such legislation were subject to some form of external control.

All in all, this may be an issue worth considering; but it is far from clear that an automatic labour-market re-regulation is desirable. A more general commitment to move gradually towards provisions in line with the EU’s Social Chapter might be more appropriate; but the potential for dispute and thus for political inertia would again be considerable.

A third alternative would be to establish a non-entrenched schedule of changes, beginning in, say, three to five years’ time, leading progressively from the (post-deregulation) status quo to reach the standards of the EU’s Social Chapter at the (conservatively) expected time of accession. It would be preferable to allow some scope for delaying the start of the process and adjusting its pace after the initial grace period, in accordance with the economic circumstances of the time and revised expectations on the timing of accession. Allowing for more detailed amendment would probably not be desirable, as this would provide much greater scope for dispute.
D.8 Utilities and public services

Beyond physical reconstruction and rehabilitation, the intention is to reunify the public utility infrastructure between the Entities. Energy, water, and telecommunications systems were originally developed for Bosnia as a whole, and were intricately linked between the Entities prior to the war. They have now been effectively separated along the inter-Entity boundary, to the detriment of efficiency, service costs, and financial viability. Reintegration is highly desirable from an economic perspective, and would be a significant step towards reunification. However, precisely because of the latter aspect, there may be important political obstacles to movement in this direction.

A second, and more controversial, policy in this area is to develop and extend cost recovery for services such as water, sanitation, and solid-waste disposal, as well as for energy supplies (electricity, gas, and district heating). The proposed timetable for cost recovery is relatively quick: for water, sanitation, and solid waste, the objective is to recover all operations and maintenance costs in three years, with full cost recovery after five years. Social-pricing mechanisms (to limit the social impact) are regularly mentioned in Bank documents in this context, but only in passing. There is no discussion of the types of mechanism which could be used, or of issues in their design and application.

The desire to increase cost recovery is motivated primarily by the fiscal constraints on the public sector — no doubt considerations of economic efficiency are also at play, but these are not emphasised. It should be noted that cost recovery was well developed prior to the war, so the perception problem which arises when fees are introduced for previously free services should not be serious.

Nonetheless, there are potential concerns about the extent of cost recovery, the pace of its implementation, the potential social impact, and the regional/ethnic dimensions.

Dilemma 8: Cost recovery

There are three major concerns about the rapid and general application of cost-recovery policies in BH.

• While cost recovery for energy is fairly uncontroversial, for some other services the case is less clear. This applies particularly to sanitation and solid-waste disposal, as there are major public-good benefits arising from their use. From an economic perspective, this represents a strong case for subsidy.

• The social impact of increasing cost recovery is a matter of potential concern. The breadth of cost recovery envisaged, and the relatively rapid achievement of full cost recovery, suggest a major escalation of basic living costs over the next five years. While rapid economic growth is expected, at least initially, the benefits will by no means be universal, and will be critically dependent on BH’s success in employment generation, and the extent and effectiveness of safety-nets. There are serious concerns on both these issues, as discussed in Sections E1 and E2.

• There is also a potentially important regional dimension to this issue. While the existing regional disparities in income persist, the ability to afford services will vary considerably between RS, Muslim and Croat areas. Assuming similar levels of consumption, applying the same principles and targets in all areas would mean a much greater impact on real incomes in the poorest (generally Muslim and RS) areas.

These concerns would suggest a more limited and/or more gradual application of cost recovery. However, there would be a high cost to such a policy: because of the tight fiscal constraint, spending money on subsidising infrastructure services directly reduces the resources available for other uses. The potential benefits of subsidising infrastructure services therefore need to be evaluated relative to alternative uses of funds.

Social-pricing mechanisms of some kind will be critically important, especially over the medium term, as a means of limiting the social
Dilemma 8: Cost recovery (continued)

impact. If such mechanisms are not in place, it may well be necessary to moderate the rate of increase of charges, and to delay cost-recovery targets. It should be noted, however, that social pricing would reduce the revenues generated — it may well be necessary to subsidise the consumption of a large proportion of the population, at least initially. The administrative costs of social-pricing mechanisms may also be substantial.

In view of the regional dimension, it might seem preferable from a distributional perspective to apply more rigorous standards of cost recovery in higher-income (mostly Croat) areas, in effect cross-subsidising services in the poorer areas. However, this could create considerable resentment. Social-pricing mechanisms could ease the distributional problem without an explicit regional differentiation; but resentments could still arise if it became apparent that the costs and benefits of social pricing had a strong regional or ethnic bias.

There are no easy answers here. The benefits of not imposing full cost recovery for sanitation and solid-waste disposal should be carefully evaluated, and compared with alternative uses of government spending. Where cost recovery is introduced, social pricing should be included as an integral part of the policy, to protect poorer households; and it should be designed in such a way as to protect all those who would face an excessive financial burden. However, direct cross-subsidisation between the three ethnic regions should be avoided.

D.9 Agricultural policies

The proposed agricultural strategy is based on practical support for small private farms, including the provision of imported inputs, credit, livestock, and equipment. These policies include cost-recovery measures, and it is strongly recommended that subsidisation of agriculture should be avoided. The state-owned farms are to be privatised, as are support services and the production of agricultural inputs and processing industries. Food aid is to be phased out, to avoid undermining the incentives for domestic production and reducing producers' incomes. There is also a proposal for a land bank, to facilitate the departure of farmers from the agricultural sector, and to allow the enlargement of the remaining plots. A World Bank Agriculture Sectoral Adjustment Loan is expected in the near future to support these policies.

These policies appear to be somewhat at odds with the policies envisaged by the RS authorities (RS, 1996, pp 121, 123), which include, for example, direct state provision of veterinary services and credit, the possibility of subsidising producers in relatively undeveloped areas through direct grants, and 'protective prices' for priority products, including wheat, corn, sugar beet, oil-bearing crops, meat and milk. These represent a large proportion of RS's total agricultural production.

Pursuing different agricultural policies in the two Entities — particularly with regard to prices — would cause serious problems, and is not a viable option. This implies an urgent need to reconcile policies and priorities between the Entities, if this has not yet been achieved. This would be a prerequisite for a Sectoral Adjustment Loan.

The evolution of conditions affecting the agricultural sector over time will be critically important, and needs to be taken carefully into account in policy design. In the short and medium term, important constraints arise from landmines, and ownership disputes arising from population movements, as well as the lack of equipment and limited access to other inputs. Major concerns over this period will be to re-absorb as much as possible of the rural labour force into the agricultural sector at adequate income levels (to limit rural unemployment and poverty and excessive pressure for rural-urban migration); and to encourage an expansion of food production at affordable prices, to fill the gap left by declining food aid receipts. In the longer term, it will be necessary to improve farm incomes; to increase efficiency and international competitiveness; and to prepare the ground for ultimate accession to the EU.
These aims require very different policies in some respects; and it seems possible that policies directed towards longer-term objectives are being started too soon. For example, support for farm mechanisation (financing for tractors, for example), and the land bank will tend to increase the size and capital-intensity of farms, which implies a reduction in labour use. In some areas, population shifts from rural to urban areas have already occurred and are unlikely to be reversed in the near future. However, there may be other areas where the shedding of labour could contribute to rural unemployment, declining real wage levels, and rural-urban migration (adding to urban unemployment rates).

A long-term agricultural strategy is needed. However, uncertainties relating both to BH’s political future and to the prospects for EU accession make devising a strategy a complicated process. Creating the conditions for EU membership will be an important objective; but it will be important to be realistic about the likely time-frame of accession, and to ensure the viability of the sector in the interim.
E. Social dimensions

E.1 Employment and the Emergency Social Fund

The need for employment creation is well recognised in World Bank documents. Unemployment is described as 'an overwhelming economic and social problem' (EU/EBRD/World Bank, 1996, p94), and job creation as 'absolutely essential' (EU/World Bank, 1996a, p9), 'not only an economic necessity but...essential for peace' (World Bank, 1996b, p xvii), 'the most important challenge for the economic recovery programme' (World Bank, 1996b, p11), and 'an absolute priority' (EU/World Bank, 1996b, p10).

At present, unemployment is estimated at 50-60 per cent of the population of working age, although it is substantially lower in the Croat area of the Federation. It is estimated that the reconstruction programme created some 250,000 jobs at its peak in 1996 (EU/EBRD/World Bank, 1996, p94). This is equivalent to half of total employment in BH during that year. If the average level of employment generated by reconstruction during 1996 were half of this level, this would imply an unemployment rate without the reconstruction programme in the order of 60-70 per cent. Adjusting further for the effects of demobilisation during 1996-7 could increase the underlying rate post-demobilisation further to between 85 per cent and 95 per cent.32

As the reconstruction programme is completed, these jobs will disappear (hopefully to be replaced by jobs in running the rehabilitated infrastructure and services). At the same time, unemployment may be further increased by the return of refugees, and possibly by further demobilisation (as well as shifts in the geographical distribution of employment due to the return of displaced people).

The potential effects of population movements are enormous: there are between 1.0 and 1.4 million refugees; and a greater proportion of these people are likely to be of working age than in the settled population. If all refugees were to return, the demand for employment could increase by more than half. Excluding reconstruction-related employment, this would imply an unemployment rate of about 85-90 per cent. Reducing unemployment to a sustainable level (say 10 per cent), while allowing a return of the refugees, would require an increase in non-reconstruction employment in the order of 400-650 per cent from its current level. Even if no refugees were to return, non-reconstruction employment would need to be doubled or trebled.

The relationship between population movements and employment is a two-way one. A necessary (though not a sufficient) condition for the return of refugees and displaced people to their areas of origin is their expectation that they will have an adequate income. With pensions and social benefits likely to remain at minimal levels over the medium term, this will require the creation of adequate employment at reasonable wage rates to reabsorb the returnees into the economy. Unless and until this is achieved, displaced people are likely to remain where they are, and refugees will be returned only by compulsory repatriation. Moreover, compulsory repatriation will have a serious economic and social impact, not only leaving the returnees themselves (or those they displace from jobs) without a viable income, but also increasing the strain on the budget and potentially reducing overall real wages by adding to the excess supply of labour.

This suggests that the compulsory repatriation of Bosnian refugees from 'host' countries will be seriously detrimental (except in the case of people with substantial financial or valuable human capital). It will be economically damaging; it will have a substantial social impact; and, in consequence, it could be a significant obstacle to a viable and peaceful future. Donors should both avoid this option themselves, and put pressure on others to do so. They might also consider mechanisms for sharing the financial burden of refugees, to reduce the pressure for repatriation on the most important host countries.

As discussed earlier, the strategy for employment creation is based on private-sector development, through privatisation and the promotion...
of small and medium enterprises. However, it is recognised that this will not be achieved quickly; and that domestic social safety-nets will be inadequate to fill the gap in incomes for the immediate future. Thus the World Bank (1996b, p15) acknowledges that:

*A significant share of the population will continue to depend on assistance in the medium term...Temporary programs are required until pension, unemployment and social assistance systems are restarted.*

If the World Bank’s projections for output growth (World Bank, 1996b, Table 5.3) prove correct, and employment grows in line with output, unemployment would fall to somewhere between 6 per cent and 25 per cent in 2000 (assuming that no refugees return, but allowing for 0.6 per cent pa population growth). In other words, there would be no scope for reabsorbing refugees into the labour market without adding to unemployment until at least 2001. At the higher starting-point for unemployment, full employment of the current population would be reached only in 2004. If the projected growth rate for 2001–5 were continued thereafter, refugees could then be fully reabsorbed into the labour market by 2006 on the most optimistic scenario, or 2011 on the most pessimistic.

However, these projections are fairly sensitive to the assumptions on which they are based. Moreover, as noted above, the World Bank projections appear very optimistic; and extrapolating the projected 2001–5 growth rate (8.4 per cent pa) into the indefinite future is almost certainly not realistic. It also seems questionable that a 1 per cent increase in output would lead directly to a 1 per cent increase in employment. Apart from anything else, real wages are currently very low, and capital very scarce (at least in RS and Bosniac areas); and a one-to-one relationship between output growth and employment growth would imply avoiding any increase in either the real wage rate or the share of capital in total income. Apart from the question about its realism, the assumption of constant real wages would imply very high levels of poverty (and therefore a considerable need for social support) for employed workers and their families. (It should also be borne in mind that the jobs associated with externally-supported reconstruction will be lost by 2000 as the reconstruction programme winds down; and that demobilisation will further reduce employment from the 1996 level.)

A fairly limited adjustment to take account of these considerations would have a substantial effect on the results. If the growth rate of employment were one-third lower than the World Bank projections for output growth (by no means a pessimistic assumption), unemployment would remain between 24 per cent and 39 per cent in 2000; and full employment of the current population would be achieved only between 2006 and 2010. It would take until 2019–27 to reabsorb all of the refugees into the labour market.

At present, emergency food-aid is an important form of social support. However, it is largely an overhang from the war, and is being phased out by donors. The proportion of the population receiving food aid is officially estimated to have reached 80 per cent in 1995, although some informed observers believe the figure to be much lower. The Federation authorities expect food-aid recipients to decline to 40 per cent of the population in 1997, 20 per cent in 1998 and less than 5 per cent in 1999 (World Bank, 1996b, p15).

Apart from food aid, there are two main temporary programmes for income support:

- The Emergency Public Works (EPW) programme is intended to increase employment opportunities until private-sector employment generation takes over, by providing funds for small, labour-intensive rehabilitation projects.
- The Emergency Social Fund (ESF) is intended mainly to provide a minimum level of social support to the poorest households, in the form of monthly cash payments, until the pensions, unemployment benefit, and other social support systems are once again fully operational.

However, there are serious doubts about the size of these programmes relative to the scale of the problem; and their duration appears to fall far short of the likely time-frame for the restoration either of full employment or of benefit payments. Both of these problems are compounded by the major shortfalls in cofinancing for these two programmes, which will further reduce their scale and duration.

The EPW programme is, in principle, very helpful, although its scale is very limited. The total amount originally envisaged was $45m over two years, implying the creation of about 3,800 jobs for the two years of its operation — enough to reduce unemployment by less than 0.4 per cent. If the current financing gap for this project is not filled, this will be reduced to about 0.1 per cent.
The ESF is also very welcome, but limited in terms of its coverage, the level of payments provided, and its likely duration. Coverage represents less than half of the number of people unemployed (and is likely to include a large proportion of recipients not classified as unemployed, such as those above working age and dependent on pensions, orphans, and households with some employment but including members with war-related disabilities).

The ESF is supposed to provide monthly payments to households totalling DM5m (US$3m), spread between 150,000 poor households across the country, and 100,000 orphans and war disabled in four municipalities (World Bank, 1996c, pp 9, 93). The average monthly payment per recipient household would thus be DM20. Allowing for an average household size of three, this implies payments of about $0.13 per person per day, a fraction of the absolute poverty line ($1 per person per day at purchasing-power parity exchange rates).

The planned duration of the ESF is only twelve months; and this could be further shortened by the substantial financing gap. The funding gap has so far been filled partly by the Bank accelerating its own disbursements, and partly by the authorities diverting some of their balance-of-payments support to fill the gap. However, disbursements nonetheless seem to have been slowed down: as of mid-November 1996, eight months after the Emergency Recovery Project (of which the ESF forms a part) became effective, disbursements totalled only DM9.4m (World Bank, 1996c, p4). This represents a monthly rate less than one-quarter of that assumed in the last paragraph. Moreover, the Bank resources available for the ESF will soon run out; and, in view of the strict budget constraints imposed by the currency board, the diversion of balance-of-payments support puts additional pressure on other areas of government spending.

It seems clear that there is a considerable gap between employment and social needs and the current scale of assistance aimed at meeting them; and that the time-frame for reducing dependence on social safety nets, and for the return of refugees, is considerably longer than the World Bank appears to envisage. The statement quoted above, that 'a significant share of the population will continue to depend on assistance in the medium term' does not come close to reflecting the gravity of the situation. Coupled with the very short time-frame of the ESF and EPW programmes, and the rapid phasing out of food aid, this implies a choice between widespread and severe poverty, or an intolerable burden on the public finances to support safety-net programmes for the next 20-30 years.

There are also potentially serious implications in the shorter term. If, as seems quite possible, unemployment remains at 25-40 per cent in the year 2000, and specific employment creation and externally-supported social safety-nets have been phased out, the prospects for reconciliation or a shift towards political moderation could be seriously jeopardised. This could be compounded if there were a contraction in the economy due to the reduction of aid flows and the exchange rate rigidities associated with the currency board arrangement in 1998-9. Since the World Bank's growth projections (and thus the decline in unemployment) rest heavily on a return to pragmatism and moderation in the political sphere, there is a real risk that the whole political and economic future of BH could be irrevocably compromised.

It is not realistic to assume that the donors will continue to fund social programmes on the scale required over the next 20-30 years. However, it would seem essential that programmes such as the ESF and the EPW project are both substantially enlarged and extended over at least the next five years. Only if the decline in unemployment and poverty can be greatly accelerated can there be any hope of creating the political conditions for long-term economic growth. This raises some important questions about the economic strategy being pursued.

Dilemma 9: Employment creation and the economic strategy

A major part of the rationale for the current economic strategy is the rapid creation of employment opportunities. However, this is not being achieved at an adequate rate, and it is by no means obvious that it is likely to be achieved within a politically viable time-frame. The question is whether a fundamentally different economic strategy would be more
effective in reaching this objective, or whether potentially beneficial changes are limited to minor modifications to the current strategy.

It would be possible to envisage a rather different strategy, modelled in part on the Emergency Public Works programme. This would increase the emphasis on (and donor support for) labour-intensive reconstruction and rehabilitation work. There is clearly a very considerable amount of such work, only a fraction of which has, as yet, been done. The spending of those employed in such projects would generate additional demand in the economy, strengthening small and medium enterprises and creating more (hopefully sustainable) jobs.

However, there are some important limitations to this alternative:

- Increasing support for labour-intensive public works could only be achieved by increasing total aid (which would be difficult to justify), or by reducing support to other programmes. If other components of the reconstruction programme were substantially reduced (for example, institution-building, infrastructure rehabilitation, or support to the social sectors), there would be a danger of compromising long-term sustainability and other aspects of basic needs in the interests of short-term employment gains.

- The cost of employment generation under the EPW programme to date is very high—in the order of $5,500 per person-year. A rough estimate suggests that this may be only slightly lower than the equivalent figure for the overall aid programme. Based on this estimate, transferring the entire financing for the reconstruction programme in 1996 would have led to a net reduction in unemployment of only about 3 per cent.

- The potential for labour-intensive public works is much greater in the Federation (where there is substantial war damage) than in RS (where the main damage has been done by economic sanctions). An EPW-based strategy would therefore have more limited scope in RS, so that shifting the emphasis towards this type of programme could inhibit any correction of the regional imbalance in aid.

- The jobs created directly by EPW schemes would be temporary, lasting only as long as there was appropriate work to be done and adequate donor funding to pay for it. The longer-term benefits would be limited to the secondary effects on employment, through increased demand.

In practice, an approach centred on labour-intensive public works is therefore unlikely to be viable as a basis for sustainable long-term growth. To have any significant positive effect, it would be essential to reduce the cost of EPW projects substantially. At present the cost per job seems unnecessarily high—150 per cent more than the average net wage in Croat areas, and nearly five times that in Bosniac areas. However, a detailed assessment of how the cost could be reduced is well beyond the scope of this paper.

Even at a much lower cost, the argument for increasing support for EPW is essentially political: as long as unemployment and poverty remain at their current very high levels, this will be a serious impediment to the creation of a political climate conducive to peace, stability, and economic growth. It is possible—but only possible—that greater employment creation could shift the political process in the direction of moderation andconciliation; and that this would substitute for the effects of those projects which would need to be forgone to finance a major EPW programme.

A more limited shift in this direction (coupled with a substantial cost reduction) would be more viable. This would entail a detailed appraisal of the whole aid programme, to identify those components which are, on the whole, less beneficial than support to EPW.

However, employment creation based on public works can be no more than a temporary palliative; it is no substitute for an economic policy programme designed to generate employment. The alternative approaches to privatisation and trade policy outlined in Dilemmas 4 and 6 might help to strengthen and accelerate job creation under the current private-sector-led strategy.
E.2 Pensions and benefits

In time, it is hoped that domestically-financed social safety-nets, such as pensions and unemployment benefits, will take over from the ESF. However, this is a very long way off, and movement in this direction will be very slow.

Pensions have fallen dramatically since the beginning of the war, and at times have not been paid at all in the Federation, reflecting the extreme pressures on public sector finances. In 1996, average pensions in Croat areas were DM65 (US$38) per month, slightly above the absolute poverty line. In Bosniac areas, however, they were only one-fifth of this level, and in RS, while the authorities claim that there are no payments arrears, they were 'at a very minimal level'. As a result, many pensioners were (and still are) living in 'conditions of extreme poverty' (World Bank, 1996b, p48).

A major contributory factor is the exceptionally high dependency ratio. Because of the disproportionate number of people of working age who left BH as refugees, coupled with the very high rate of unemployment, there are nearly as many pensioners as there are people in employment to pay for their pensions. Moreover, there is a strong regional pattern, in that pensioners represent a substantially larger proportion of the population in Bosniac areas and RS than in Croat areas (Table 6). This is a particular problem because unemployment is also substantially higher in these areas: the ratio of pensioners to those in work is roughly three times as high in RS and Bosniac areas as in Croat areas.

Taking account of the high proportion of workers in the informal sector, who are likely not to be paying wage contributions, makes the situation considerably worse. In RS, only 30,000 people were employed in the formal sector in 1995, one per 5.5 pensioners. While figures are not available for the Federation, the situation is likely to have been broadly similar in Bosniac areas, but substantially better in Croat areas, where the formal sector represents a much greater proportion of total employment.

The problem is of a similar order of magnitude in the case of unemployment benefits: with unemployment at 50–60 per cent, there are at least as many, and up to 50 per cent more, people out of work than in work, overall. Again, the ratio of unemployed people to those in formal employment is considerably worse: assuming a 60 per cent unemployment rate, there would have been 7.5 people unemployed for every person in formal employment in RS in 1995. This implies that, for a pension/benefit system fully paid for from formal sector wages, each wage-earner would have had to pay for 5.5 pensions and 7.5 unemployment benefits. Again, the situation is likely to be considerably better in Croat (though not Bosniac) areas.

The ratios for Bosniac areas and to a lesser extent RS are likely to have improved significantly since 1995, to the extent that formal-sector employment has increased. However, the situation remains serious. Even on the optimistic assumption that half of the workers in the informal sector in 1995 have been

### Table 6: Estimated number of pensioners relative to population and labour indicators

<table>
<thead>
<tr>
<th></th>
<th>Bosniac areas</th>
<th>Croat areas</th>
<th>Rep. Srpska</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of pensioners</td>
<td>200,000</td>
<td>52,000</td>
<td>170,000</td>
</tr>
<tr>
<td>as % of:</td>
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<tr>
<td>population</td>
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<tr>
<td>labour force</td>
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<td>115</td>
</tr>
<tr>
<td>formal employment</td>
<td>n/a</td>
<td>n/a</td>
<td>550</td>
</tr>
</tbody>
</table>

Sources: Numbers of pensioners and of formal sector workers in RS (in 1995) are taken from World Bank (1996b, pp 24, 26, 26). Population and labour force are the author’s estimates: overall population is based on estimates of the total pre-war population (4.4m) and numbers of refugees (1.14m); and the overall labour-force (1.1m) is taken directly from EU/EBRD/World Bank, 1996, p93. These figures are combined with the pre-war ethnic composition of the population (from Crnobmja, 1996, p22, with self-identified Yugoslavs and other ethnic groups divided pro rata between the three areas). Total employment is based on the resulting labour-force figures, combined with rough estimates of regional unemployment rates (Bosniac areas and RS 60 per cent; Croat areas 20 per cent). It should be noted that all the percentage figures are very approximate.
reabsorbed into the formal sector, increasing the formal sector's share of total employment from around 20 per cent to 60 per cent, each formal-sector worker in RS would be paying for 1.5–2 pensions and 2.5 unemployment benefits.

The situation in the Federation is somewhat better overall, because of the more favourable circumstances in the Croat areas. On similar assumptions (60 per cent formal-sector employment, with unemployment of 60 per cent in Bosniac, and 20 per cent in Croat areas), each formal-sector worker would have to pay for around 1–1.5 pensions and 1.5–2 unemployment benefits. However, if the benefits system were operated on a uniform Entity-wide basis, the inequality between Bosniac and Croat areas would imply a considerable transfer of resources between the two areas: taking account also of wage differentials, Croat areas would make about 60 per cent of total contributions, while receiving only about 20 per cent of pensions and 12–15 per cent of unemployment benefits. This could raise serious political problems.

In view of the very low wage-levels, especially in Bosniac areas and RS, the high dependency ratio and unemployment rate means that payroll contributions are very high, even at the current very low levels of pensions and benefits — 17.5 per cent of wages in Croat areas and 24 per cent in Bosniac areas for pensions alone. The current situation also makes for a very acute trade-off between formal-sector incomes and pensions/benefits: increasing pensions by DM1 would require an increase in the cost to formal-sector workers of DM1.50–2.00 in RS and DM1.00–1.50 in the Federation, while a similar increase in unemployment benefit would cost around DM2.50 per worker in RS and DM1.50–2.00 in the Federation. Since the average net wage in Bosniac areas is DM160 pm (about US$3 per day), any household with three or more members and only one (average) wage is already on or below the absolute poverty line. This means that poverty among pensioners or those dependent on other domestically-financed benefits can only be reduced by increasing poverty among people in employment.

The problem is not likely to be resolved in the near future. As noted in Section E1, unemployment could well remain at 25–40 per cent in 2000, even without any return of refugees. Even if the share of the formal sector in total employment could be increased to 80 per cent over this period, this would reduce the ratio of pensioners and the unemployed to those in formal employment to perhaps 1–1.25 in the Federation and 1.75–2 in RS. This would be a substantial improvement, but the ratio remains very high: in the order of 2.5–3 times that in the UK for the Federation, and 4.5–5 times for RS. It would also be greatly increased by any significant return of refugees; if all the refugees were to return during this period, the ratios for unemployment benefits would be at least doubled.

The problem of inequality between Croat and Bosniac areas would also be moderated in this scenario, but would remain serious even without the return of any refugees. On the same assumptions, and allowing for a halving of income differentials between the two areas (from 50 per cent to 25 per cent), Croat areas would make about 40 per cent of contributions, while receiving around 20 per cent of pensions and perhaps 15 per cent of unemployment benefits.

The donors recognise the existence of this problem. The EU/EBRD/World Bank (1996) paper observes with reference to 1997 that ‘there are still significant gaps between the needs for protecting vulnerable groups and the revenues that can possibly be generated by the domestic economy’ (op. cit. p.145). However, the donors appear to under-estimate (or at least they under-state) the extent of the problem; and they give little consideration either to its likely duration or to its regional dimension.

In the short term, the gap is to be filled by donors. However, the level of donor support envisaged appears to be grossly inadequate even to bring pensioners and the unemployed in RS and Bosniac areas up to the absolute poverty line. For pensioners alone, this would cost something in the order of $80m; and the amount needed for the unemployed might be of a similar order of magnitude. By comparison, the amount deemed necessary in the EU/EBRD/World Bank paper is $20m in 1997. This is roughly $20–25 per unemployed or pensioned person, making no allowance for other potential recipients. This would represent an average additional income equivalent to about 6 per cent of the absolute per capita poverty income. Taking account of dependents would reduce this figure still further.

In the medium term, the intention is to shift towards a self-financing, pay-as-you-go pension and benefit system, wholly financed from payroll contributions. Pensions would be based on a three-tiered model, with a universal minimum pension, supplemented by earnings-
related pensions (operated at the cantonal or inter-cantonal level in the Federation) and private pension schemes. The minimum pension would be based initially on a fixed contribution per employee, and supplemented by donor funding (World Bank, 1996b, p49), then shifted to a proportional rate, which would be increased in 1997–8, as donor support is phased out.

A ceiling of 15 per cent is envisaged for payroll contributions to the minimum pension. By 2000, even with unemployment at 25–40 per cent, this should be sufficient to provide pensions above the absolute poverty line in the Federation. In RS, however, this may well not be the case: with unemployment at 25–40 per cent, even if 80 per cent of employment were in the formal sector, pensions would reach the absolute poverty line only if real wages were increased by 150–200 per cent from their current level (Table 7). Such changes in unemployment and real wages would almost certainly require considerably faster growth even than the very high rates currently envisaged by the World Bank.

Four further points should be noted in this context:

• The initial use of a fixed contribution per employee is wholly inappropriate. This is highly regressive, in that low-wage earners would pay a much greater proportion of their income than those on higher incomes. The absolute amounts are very large — about $3–400 per employee per year for pensions at the absolute poverty level — and even the average net wage in Bosniac areas is already on the absolute poverty line for a household of three.

• The proposed rate of 15 per cent is not far below the current rate of 17.5 per cent in the Federation, which is described by the Bank as 'extraordinarily high' (World Bank, 1996b, p 48), suggesting that there may be strong pressure to keep wage contributions well below this level in both Entities. This would imply a commensurate reduction in pensions below the levels shown in Table 7.

• It seems unlikely that pensions and benefits at absolute poverty levels would be politically viable for more than a very short period.

• Once again, it is important to note that a uniform Federation-wide system would imply a substantial net transfer of resources from Croat to Bosniac areas, which could be a source of political tension. The alternative of separate arrangements for the two areas might well imply pensions below the poverty line or wage contributions in excess of 15 per cent in Bosniac areas.

In the long term, a system based on individual accounts is envisaged. However, it seems unlikely that this will be feasible for some decades. The transition from a pay-as-you-go system to a system based on individual accounts requires pension payments to continue, while contributions are set aside for future payments. The resources for pensions thus need to come from somewhere else; and it will be a very long time before additional resources are available on the necessary scale. There seems little point in even considering this option at this stage.

No explicit ceiling has been proposed for contributions to unemployment benefits. However, these will need to remain very high until substantial improvements in wages and employment have been achieved (Table 8). In 2000, with unemployment at 25–40 per cent, contributions in the Federation would remain at around 10–25 per cent even if there were a 50 per cent increase in real wages and 80 per cent of employment were in the formal sector. In RS, the situation is again much worse: this scenario would leave contributions at around 35–70 per cent of wages, which would clearly be at odds with the objective of reducing wage deductions. Only if unemployment were reduced to about 10 per cent and real wages doubled could contributions be reduced below about 10 per cent of wages in RS.
### Table 7: Pensions at alternative levels of unemployment and real wages (US$ pm)

#### a. Federation

<table>
<thead>
<tr>
<th>Unemployment (%)</th>
<th>60</th>
<th>50</th>
<th>40</th>
<th>25</th>
<th>10</th>
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<tr>
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<td>38</td>
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<td>92</td>
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<td>138</td>
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#### b. Republika Srpska

<table>
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<th>Unemployment (%)</th>
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<td>52</td>
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Notes: Author's estimates, assuming 1.1m work-force (one-third in RS), 0.42m pensioners (0.17m in RS), wage contributions at 15 per cent, and administrative costs equal to 10 per cent of the total amount collected. The shaded area represents pensions less than $1 per day. Base-line wages are estimated on the basis of the net monthly wage figure given in Table 5, assuming current taxes and wage contributions of 50 per cent.
Table 8: Wage contributions required for minimum unemployment benefit coverage (% of wages)

<table>
<thead>
<tr>
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<th>Unemployment (%)</th>
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<td></td>
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<td><strong>a. Federation</strong></td>
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<tr>
<td>0</td>
<td>230</td>
</tr>
<tr>
<td>25</td>
<td>183</td>
</tr>
<tr>
<td>50</td>
<td>153</td>
</tr>
<tr>
<td>100</td>
<td>112</td>
</tr>
<tr>
<td>150</td>
<td>92</td>
</tr>
<tr>
<td>200</td>
<td>77</td>
</tr>
</tbody>
</table>

Notes: Author's estimates, assuming unemployment benefit of $3 per day ($1 per person per day for a three-person household). Other assumptions are as in Table 7.
E.3 Health and education

The health strategy for BH is based on a shift away from the top-heavy pre-war structure, and towards a system based more heavily on primary health care (PHC). Within the Federation, the intention is to shift towards a three-tier, insurance-based system, comparable to that for pensions. The first tier would be an Entity-wide package of uniform basic services, and the second a supplementary package specified by each Canton, both financed from payroll taxes and administered at the cantonal level. The third tier would be voluntary private health insurance. It remains unclear whether co-payments (i.e., additional payments made at the point of service delivery) are envisaged for either or both of the first two tiers. Health financing arrangements within RS remain unclear.

The shift towards PHC is wholly appropriate, and the insurance approach should be viable in the Bosnian context, provided appropriate arrangements are made for non-wage-earners. However, co-payments should be avoided for the foreseeable future, as they would risk excluding a substantial proportion of the population from access to health services, while leaving them to pay part of the cost of services for the better-off through wage contributions. Some caution is also needed with respect to private health insurance, as there is a risk of underpaid health professionals being lured away from the public sector by much higher incomes in private practice. In the long term, this problem should be eased to some extent by increasing salary levels in the public sector, provided sufficient financing is available for recurrent expenditure. The return of health professionals who have left as refugees would also help considerably; but it remains far from clear that they will in fact return on a substantial scale.

The administration of health services at the cantonal level could cause significant regional disparities in health sectors, with more limited services, fewer or lower-quality staff, more supply shortages, and possibly higher co-payments in poorer areas. The need for 'some mechanism...to provide for cross-cantonal subsidies as required' is recognised by donors (EU/World Bank, 1996b, p12). While this inevitably raises the issue of inter-ethnic resource transfers, such a mechanism would seem to be essential. (See Dilemma 3.)

Financial constraints, particularly on recurrent expenditure, are a critical factor in the health sector in both Entities. In Croat areas of the Federation, health services are currently funded primarily through an insurance fund, financed through wage contributions at a rate of 12.5 per cent, which pays mainly for salaries. In Bosniac areas and RS, similar insurance funds were effectively merged with the general government finances during the war. In all areas, the bulk of recurrent expenditure goes to salary payments; but even so, salaries fell drastically in real terms, and substantial arrears were accumulated.

The programme of donor support to the health sector, designed by the World Bank and WHO, includes as one of its six objectives to provide support for recurrent expenditure, to be phased out over three years. However, only $5m was firmly committed for this purpose in 1996 (equivalent to about $1.40 per capita), partly reflecting the 43 per cent shortfall in overall commitments to the health sector (EU/EBRD/World Bank, 1996, pp 132-3). This is a very small amount relative to the shortfall in resources for recurrent spending on health; and if the planned reduction in support goes ahead from this level, support will become increasingly inadequate.

As well as the overall level of donor support, its composition is also a problem. Despite the arguments put forward by the World Bank for salary support, in practice aid has been mainly for essential drugs and other medical supplies, while 'no significant support has been provided for complementing health workers salaries' (EU/EBRD/World Bank, 1996, p134).

The government has tried to fill the gap (overall and for salaries) from general balance of payments support; but this again increases pressure elsewhere in the budget. While this has permitted some increase in salary levels, it is still the case that 'most health workers are paid insufficient salaries' (EU/EBRD/World Bank, 1996, p140). More generally, it is acknowledged that 'budgetary resources for the operating costs of health facilities will most likely remain insufficient in 1997' (EU/EBRD/World Bank, 1996, p137). However, this again appears to be a serious under-statement of the extent of the problem.

Yugoslavia’s pre-war public expenditure on health was around $120 per person per year (in 1987, based on data from UNDP, 1992). A return to this level of funding through pay-roll taxes would give rise to very high rates of wage contributions: 30–40 per cent in the Federation and 100–120 per cent in RS at present, declining
only to 15–20 per cent and 40–50 per cent in 2000. In the long term, assuming real wages 100–200 per cent above current levels and 0–10 per cent unemployment, the rate would become sustainable in the Federation, at 5–10 per cent. In RS, however, the rate would remain in the order of 15–25 per cent, which is clearly unsustainable (Table 9).

These figures are probably somewhat exaggerated. Costs should be reduced to some extent by the proposed shift towards primary health care; and (in the short and medium term only) by low salary levels. Nonetheless, even allowing for a halving of per capita health spending from the pre-war Yugoslav level, together with the costs of minimum pensions

| Table 9: Wage contributions required to restore pre-war per capita health expenditure (% of wages) |
|---------------------------------------------------|---------------------------------------------------|---------------------------------------------------|---------------------------------------------------|---------------------------------------------------|---------------------------------------------------|---------------------------------------------------|
| a. Federation | Unemployment (%) | 60 | 50 | 40 | 25 | 10 | 0 |
| wages: | 0 | 40 | 32 | 27 | 22 | 18 | 16 |
| real % change from 1996 | 25 | 32 | 26 | 22 | 17 | 14 | 13 |
| | 50 | 27 | 22 | 18 | 14 | 12 | 11 |
| | 100 | 20 | 16 | 13 | 11 | 9 | 8 |
| | 150 | 16 | 13 | 11 | 9 | 7 | 6 |
| | 200 | 13 | 11 | 9 | 7 | 6 | 5 |
| b. Republika Srpska | Unemployment (%) | 60 | 50 | 40 | 25 | 10 | 0 |
| wages: | 0 | 119 | 96 | 80 | 64 | 53 | 48 |
| real % change from 1996 | 25 | 96 | 76 | 64 | 51 | 42 | 38 |
| | 50 | 80 | 64 | 53 | 42 | 35 | 32 |
| | 100 | 60 | 48 | 40 | 32 | 27 | 24 |
| | 150 | 48 | 38 | 32 | 25 | 21 | 19 |
| | 200 | 40 | 32 | 27 | 21 | 18 | 16 |

Notes: Author’s estimates, based on 1987 health expenditure of $120 per person per year. Other assumptions are as in Table 7 (excluding administrative expenditure, which is included in the $120 figure).
and unemployment benefits, this would leave tax and contribution rates on wages at very high levels, in marked contrast with the objective of reducing the rates of wage taxes and contributions. (See Table 10.)

Despite the very conservative assumptions used in Table 10 (including the absence of any form of taxation on wages for any other purpose), the short-term levels of wage contributions are clearly unrealistic in both Entities — around 100 per cent of gross wages in the Federation, and 3-400 per cent in RS. In the Federation, a moderate reduction from current levels might be possible in the medium term (ie by about 2000), a sustainable level of 10-20 per cent being reached only in the long term (ie when unemployment is reduced to 10 per cent or less and average real wages at least doubled from their current levels. In RS, the situation remains clearly impossible until well after 2000, and even the very optimistic assumptions of the long-term scenario leave wage contributions for these three purposes alone at 31-54 per cent, suggesting that a significant reduction is likely to be impossible.

In the education sector, financial support has been concentrated on school reconstruction (more than 80 per cent of funding), with smaller-scale support for institution-building, teacher training, educational materials, and support for students whose education was disrupted by the war, traumatised children, and children with special needs. The future direction of education policy remains unclear, partly as a result of uncertainty about the roles of different levels of government and limited capacity for policy-making at the cantonal level.

As in the health sector, teachers salaries are a serious problem; and this is ‘a fundamental threat to education in the future’ (EU/EBRD/World Bank, 1996, p122). This is again partly due to uncertainty about government roles, largely as a result of inadequate administrative capacity (and in most cases financial resources) to plan and manage education effectively at the cantonal level. However, in view of the importance attached to this issue, it is far from clear that this is an adequate reason for the complete absence of donor support to teachers’ salaries.

### Table 10: Wage contributions required for minimum pensions, unemployment benefits and health expenditure (%)

<table>
<thead>
<tr>
<th></th>
<th>Pensions</th>
<th>Unemployment Benefit</th>
<th>Health</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federation:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996:</td>
<td>15</td>
<td>51-78</td>
<td>16-20</td>
<td>82-113</td>
</tr>
<tr>
<td>2000:</td>
<td>11-13</td>
<td>11-23</td>
<td>7-9</td>
<td>29-45</td>
</tr>
<tr>
<td>long-term:</td>
<td>4-7</td>
<td>0-3</td>
<td>5-9</td>
<td>9-19</td>
</tr>
<tr>
<td><strong>Rep Srpska:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996:</td>
<td>45-56</td>
<td>153-230</td>
<td>96-119</td>
<td>294-405</td>
</tr>
<tr>
<td>long-term:</td>
<td>15</td>
<td>0-9</td>
<td>16-27</td>
<td>31-54</td>
</tr>
</tbody>
</table>

Notes: Author’s estimates, based on Tables 7-9, assuming unemployment of 50-60 per cent in the short-term, 25-40 per cent in the medium-term and 0-10 per cent in the long-term; and real wage increases of 0 per cent, 50 per cent and 100-200 per cent respectively. Pension contributions are assumed to be 15 per cent, subject to a minimum pension of $30 pm and a maximum of $60 pm. Unemployment benefit is set at $90 pm throughout. Annual health expenditure is set at $60 pc, half of the 1987 Yugoslav level.
There is a proposal to develop cost recovery for higher education. There is likely to be less resistance to this in principle than in some countries, as cost recovery was well established prior to the war. However, there is a risk of skewing the benefits of higher education towards those better able to pay; and in the Bosnian context, this would almost certainly entail an ethnic bias towards the Croats and better-off returnees, at least over the medium term, due to current income differentials. This would tend to compound and entrench inter-ethnic inequalities, and could also generate an ethnic imbalance among decision-makers over time. It is also important to avoid any substantial reduction in overall attendance of higher education, as the disproportionate number of graduates and professionals among refugees is likely to leave an increasing shortfall in the supply of human capital as the economy recovers, unless there is a large-scale return (which is not expected in the near future).

If the option of cost recovery for higher education is to be pursued, it should at least be delayed until the bulk of the population can afford to pay, and then be phased in gradually, in line with ability to pay among the poorer ethnic groups. Donors should fill most of the gap between the costs of higher education and the available government resources and fee revenues. They should also finance a scholarship fund for those who are academically able to continue with their education, but unable to bear the financial cost (including forgone income) of doing so. Explicit ethnic targeting should, however, be avoided.

The World Bank also appears to be promoting the idea of private provision of education and health services at the primary level. A recent Bank publication on Bosnia noted that 'a combination of direct provision and regulated private provision has generally been adopted' elsewhere, although it stops short of recommending this as a policy (World Bank, 1996b, p47). This option should be approached with great caution.

- In the health sector, there is a risk that competition among private providers (with at least partly public funding) could bid up the costs of health inputs — particularly the salaries of health professionals — relative to a system based on a public sector monopoly or near-monopoly. This could substantially increase the cost of publicly-funded health services in the longer term. There is also a danger of perverse effects on incentives, reducing the quality of health services.

- The education sector is critically important to the development of the political environment over the long term. If, as seems likely, education were provided by organisations motivated by nationalist agendas, in the absence of extremely rigorous monitoring and regulation, this could seriously jeopardise progress towards national reconciliation.

It seems unlikely that there would be substantial long-term benefits in the private provision of health services. In the case of education, this could be positively dangerous from a political perspective. It would be better to avoid any movement towards private provision in either case.
F. Conclusion

There are no easy options in Bosnia and Herzegovina. The situation is both very difficult economically and extremely complex socially and politically. Economic policy has to be formulated and implemented within three interlocking sets of very tight constraints, political, social/ethnic, and economic, which seriously limit the available options. Where alternative approaches to those currently proposed can be envisaged, they often raise as many problems as they resolve.

In consequence, this paper has focused on exploring dilemmas, and the options they suggest, rather than recommending specific policy changes. Nine such dilemmas have been discussed:

1 Political conditionality is necessary to achieve any progress against the background of extreme political inertia in BH. However, it raises the risk of skewing the allocation of aid, jeopardising economic recovery in RS, and compromising the donors' neutrality. A carefully designed, graduated approach is suggested, avoiding conditionality on factors beyond the control of the authorities.

2 The currency board arrangement is probably necessary in a highly decentralised political system with a high level of political conflict and inertia. However, it seriously constrains economic policy, and raises the risk of a serious financial crisis after 1998-9. Two options are proposed for further consideration:
   • a self-financing system of import tariffs and export subsidies, to achieve effective exchange rate adjustment within the currency board system; and
   • a temporary support facility for the Central Bank, to be activated in the event of a crisis beyond the authorities' control.

3 Regional inequality is a particular problem because of the political obstacles to inter-regional resource transfers. It is suggested that part of the anticipated balance-of-payments support could be allocated between Entities and Cantons on the basis of an explicit formula measuring needs, for use in support of recurrent expenditure.

4 Privatisation in the Federation raises a number of issues relating to the role of foreign investment, the pace of privatisation, and the proposed level of decentralisation. A possible alternative approach is outlined, which would be more gradual and more closely related to the needs and circumstances of individual enterprises, with a greater role for foreign investment where there is a substantial need for capital inputs and/or imported technology.

5 Free entry for foreign banks could help to improve the availability and reduce the cost of financial services, but, in the current circumstances could give rise to a heavily foreign-dominated financial sector in the future. Delaying this process could reduce this risk, but could also have a negative effect on economic recovery in the short term.

6 The trade policy envisaged for BH is based on a rapid reduction of tariffs to low, uniform levels. A case could be made, on both political and economic grounds, for delaying this process, to allow a breathing space for the development of 'infant' and 'convalescent' industries. This would also ease financial constraints on government spending. However, further consideration is needed of the interaction of trade policy with the constraints on exchange-rate policies imposed by the currency board system.

7 Labour market deregulation may be helpful to employment creation in the short term, but a gradual and flexible restoration of employment standards (for example, to bring standards into line with the EU's Social Chapter) may be both feasible and desirable over the long term.
8 Rapid movement towards full cost recovery for public services and utilities fails to take account of public goods, and could give rise both to a substantial social impact and an increase in regional disparities. This suggests the need for a more selective and gradual approach, and for social-pricing mechanisms. However, this would take resources away from other uses and entail potentially problematic inter-ethnic resource transfers.

9 Employment creation is recognised by donors as a fundamental objective, essential to social and political stability. However, the reconstruction process to date has had a limited impact. There might be a case for a limited and selective shift of external resources towards job-creation through public works projects, particularly if their cost could be reduced from the current very high level. More generally, the implications for employment should be a key factor taken into account in assessing the alternative approaches to privatisation and trade policy outlined in Dilemmas 4 and 6.

A further serious problem arises from the cost of minimum pensions, unemployment benefits, and health services. These cannot be adequately financed from wage contributions in the short term, or, in RS, in the medium term. Even with a reduction of unemployment to 10 per cent and a doubling of real wage levels, the wage contributions required to sustain pensions and unemployment benefits on the absolute poverty line and half the pre-war level of health expenditure would be more than 50 per cent in RS. This is clearly at odds with the objective of reducing wage-based social contributions and taxes.

Greater donor support for safety-nets and recurrent expenditure on health and education is essential in the short term, extending well beyond 2000 in RS. Such support has been totally inadequate so far, and will become progressively more so if the donors’ plan to phase it out over three years is implemented. Further consideration needs to be given to the establishment of a sustainable system of financing for social expenditures over the long term.

Clearly, the economic, social, and political problems of BH are intractable in the extreme; and they are compounded by the critical tensions which remain among the various ethnic groups, and particularly their political leaders. The current institutional arrangements have prevented these tensions from turning into renewed physical violence; but they have neither resolved the tensions nor allowed them to be set aside so that normal political processes and policy-making can be resumed.

Any progress towards resolving the problems will require a great deal of effort and pragmatism on all sides. This includes the donors (and NGO advocates) as well as the authorities and political agents within BH itself. At present, the movement of the authorities (or at least the Serb and Croat authorities) towards moderation and pragmatism remains limited. There also seems to be a question-mark over the pragmatism of the donors, in that the policies they are advocating for BH closely resemble the free-market model which conforms to their ideological position. These policies are not necessarily wrong, but nor should it be automatically assumed that they are necessarily right.

The need for pragmatism extends well beyond the realm of economic policy, in particular to the long-term political future of BH. There is a tendency on the part of the major donors — and international NGOs — to assume that the long-term solution to the Bosnian problem is a reunification of the country as a single multi-ethnic state. This is neither valid as an assumption, nor defensible as an objective in itself. If the ultimate objective is a peaceful and prosperous future for the people of BH, the country’s political future must be subject to critical and objective evaluation.

This raises the most fundamental and intractable dilemma of all: how many countries should Bosnia-Herzegovina be?
The IMF, the World Bank and economic policy in Bosnia

Dilemma 10: Reintegration or partition?

The international community appears to be firmly committed to the notion of a single BH, with the ethnic integration of the pre-1991 period restored. There are a number of possible reasons for this, some of which are better than others.

a. Accepting partition would amount to an official endorsement of the results of ethnic cleansing. This would not only be very difficult politically and raise major moral issues, but could also provide an incentive for ethnic cleansing elsewhere.

b. More generally, the concept of ethnic partition is at odds with Western liberal preferences for coexistence and multiculturalism.

c. Reunification and ethnic reintegration may be seen as providing a more acceptable (and expeditious) basis for the return of refugees. Germany, for example, in repatriating refugees, has accepted the principle that people should not at present be returned to areas where they would be members of the ethnic minority. A successful transition to multi-ethnicity would remove this constraint, and allow a faster (and less politically embarrassing) repatriation. This might also be possible with partition; but would require a very explicit acceptance of the results of ethnic cleansing. It could also result in disputes about the morality or legality of forcing people to return to ethnically-defined areas rather than areas of origin; and it would leave no clearly-defined destination for a substantial proportion of the refugee population (for example, people of mixed parentage, mixed couples, and members of other ethnic groups).

d. A single, unified Bosnia may be seen as more economically viable than two or three separate states: even with the return of all the refugees, the total population would be only 4.5m.

e. Bosnia’s economy and infrastructure are based on the concept of BH as a single entity within the Yugoslav Federation; and the current boundary between RS and the Federation is, from this point of view, essentially arbitrary. Partition would therefore be potentially disruptive in economic terms.

f. The complex pattern of the country’s ethnic division would make separation complicated: RS is virtually divided into two parts, linked only by the Brecko corridor (and only subject to the results of arbitration38), while the Federation is a complex patchwork of Croat and Muslim areas. Separation would mean a choice between non-contiguous Croatian and Bosniac territories, and at best a very tenuous link between Western RS and the rest of an enlarged Serbia; or further ethnic relocation. The former would entail considerable administrative complexity, and would require a high level of cooperation between the states (with a serious risk of renewed conflict if it failed). The ethnic relocation option would almost certainly be unacceptable internationally.

g. In the case of RS, unification with Serbia would raise particular problems, as the western half of the Entity has closer economic ties with Croatia than with Serbia (or with the rest of Bosnia). Coupled with existing political differences between the two halves of RS and the tenuous geographical linkage between them, the prospect of partition could give rise to serious political divisions between the two areas (and within the western area), which could undermine the stability of BH as a whole.

h. If control of the Croatian port of Ploce were retained by the Croatian component of a partitioned BH, the Muslim rump would become land-locked, weakening its strategic and economic position, and leaving it critically dependent on Croatian goodwill.

The practical issues (e-h) carry some weight, as does the concern about endorsing ethnic cleansing (a). Other aspects, however, are less clear-cut. The refugee issue (c), in
Dilemma 10: Reintegration or partition? (continued)

particular, is primarily a matter of political convenience to donor governments. There is some basis for the 'small country' argument (d). However, there are a number of limitations to this view.

- It has been argued (by The Economist, for example) that the process of globalisation makes smaller countries more viable than has been the case historically.
- If the alternative to reunification of BH were the accretion of RS to Serbia and of Herceg-Bosna to Croatia, the 'small country' argument would apply only to the remaining Muslim area.
- Economic viability depends to a great extent on political stability and the effectiveness of public institutions; and it would at best take some time to re-establish these conditions in a reunified BH. It is relevant to consider whether this could be achieved more quickly by partition.

There is also some danger in seeking to impose fashionable Western views of multi-ethnicity and multiculturalism (b) in a very different context where these concepts may be inappropriate. The fact that BH was a successful multi-ethnic entity before 1991 does not mean that it necessarily can be again. The war, by its very nature, has had a profound effect on the relations between the ethnic groups. A return to multi-ethnicity can only be achieved to the extent that the resentments generated are resolved; but these resentments are acute, and their resolution will take a considerable time.

There are some factors which could contribute to this process — for example a more independent media, the replacement of nationalists with moderates in the political leadership, and a rapid and broadly-based economic recovery. However, these developments are not within the donors' control, and are by no means assured.

Even if the media were more independent, they would almost certainly continue to be organised on an ethnic basis, in terms of both editorial control and audience. Given the depth of the resentment, and the cumulative effects of nearly a decade of strident nationalist propaganda, it can by no means be assumed that greater independence would mean greater moderation.

A change in political leadership would require a shift in popular opinion; and as long as the media remain nationalistic, any shift towards moderation will at best be slow. The current political dominance of nationalists will further impede this process, as they will have ample opportunity to find or create sources of conflict with other ethnic groups. The current nationalist authorities will remain in power for some years; and the extent of movement in popular opinion required to remove them is considerable.

As discussed earlier in this paper, a rapid economic recovery cannot by any means be taken for granted; it could be reversed in three to five years (ie roughly at the time of the next elections), as international support for reconstruction winds down; and it is far from clear that employment generation and social safety nets will be adequate to provide a substantial improvement in the standard of living for much of the population. Improving living standards are in any case only a necessary, and by no means a sufficient, condition for reconciliation.

Ultimately, reunification will only be successful if it is actively endorsed by an overwhelming majority of all ethnic groups; and the factors considered above will be major impediments to such endorsement. It will at best be some time — possibly measurable in decades rather than years — before reunification can be achieved.

If reunification can be achieved at all, it will require an immensely difficult balancing act. On the one hand, the institutional arrangements adopted must be popularly acceptable in an environment of ethnic mistrust and hostility; and be able to function effectively in an environment of ethnic separation. At the same time, however, they must lead towards reconciliation and moderation, rather than polarisation and nationalism; and foster identification with former ethnic enemies in the same country rather than with members of the same ethnic group in neighbouring countries.
Dilemma 10: Reintegration or partition? (continued)

To be politically acceptable, the structure must allow the members of each ethnic group to remain more or less autonomous at the level of effective power. At present, the variable decentralisation enshrined in the Dayton arrangements secures this. To function effectively, however, the institutional arrangements require a high level of cooperation between the separately elected ethnic leaderships. To ensure cooperation, the Dayton arrangements rely to a great extent on sanctions against non-compliance — primarily the withholding of financial support.

There is a potential contradiction here. Ethnic autonomy directly reinforces ethnic rather than national identity; and it entails an almost complete separation of political systems. Rather than fostering cooperation or reconciliation, it reinforces the tendency towards ethnic and political polarisation (as demonstrated by the September 1996 election results). This in turn weakens cooperation and thus impedes the operation of institutions (as amply demonstrated by the current problems, both between RS and the Federation and within the Federation itself).

This goes to the heart of the Bosnian dilemma. Successful reintegration requires conditions which cannot realistically be expected in a segregated society with a high level of mutual distrust between ethnic groups (or at between their elected political leaders). In other words, while it is possible to envisage a reintegrated society which would be stable and sustainable, it may well not be possible to engineer the transition from the current situation to that ideal within a time-frame which would be politically acceptable to the donors.

Further problems may arise from attempts to enforce cooperation within this framework. The failure of cooperation requires the application of the available sanctions — that is, the withdrawal of external support. However, by their nature, these sanctions impede economic recovery in the recalcitrant areas; and this will exacerbate tensions. In other words, the mechanism for achieving cooperation may itself compound any failure of cooperation over the long term. However, even if conditionality can enforce cooperation, in the absence of genuine political will, cooperation is likely to occur only at the formal level. This will make at best a limited contribution to the effective operation of the institutional arrangements.

This implies a need for political conditionality to be closely targeted, carefully graduated, and designed on the basis of a clear understanding of the political dynamics. (See Dilemma 1.)

At the same time, the reliance on donor conditionality to enforce cooperation may jeopardise the donors' (perceived) neutrality, in that it requires them to associate themselves clearly and explicitly with the principle of reunification — in other words, to align themselves closely with the Muslim objective, in opposition to those of the Serb and Croat leaderships.

Thus it is by no means clear that the present arrangements fulfil all of the conditions necessary to reintegration. Nonetheless, they may be the best that can be achieved, to the extent that the problems noted above are largely inherent, and may well be insoluble. In any event, reopening the process to redesign the institutions is not a realistic option.

It is also unrealistic to expect the donors to adopt partition as an ultimate objective. While this would be an internally consistent position, to the extent that donor support would almost certainly result in partition, it would be in direct contradiction to the principles underlying the whole process of mediation, and would represent a clear, though implicit, endorsement of ethnic cleansing. This is neither likely nor desirable.

Neither is neutrality a viable option, so long as donors are seeking to influence policy. The design of institutions and policies, and of the whole process of reconstruction and rehabilitation, is critically dependent on the nature of the future BH which they are to serve. They need, to a great extent, to be designed on the basis either of reunification or of partition. In the current state of political inertia, opting out of the policy-making and institution-forming process would merely be a particularly messy way of bringing about partition.
Dilemma 10: Reintegration or partition? (continued)

This leaves the international community with two viable alternatives:

• to design their interventions with the specific objective of pushing BH towards reunification, and/or on the assumption that the country will ultimately be reunited; or

• to design policies in this way, while planning explicitly for the possibility of ultimate partition.

At present, donors appear to be following the former approach, with little outward sign of contingency planning: to the extent that there is a contingency plan, it appears to take the form of a withdrawal of support. (If contingency planning were taking place, however, it is unlikely that it would be overt, since openly planning for partition would risk legitimising and encouraging separatist tendencies, ultimately making partition more likely.)

The impression created by this single-minded pursuit of reunification is of a rather superficial and patronising view of the divisions generated by the war, like parents telling squabbling children to be friends again. This is not obviously helpful, and could itself alienate nationalist leaderships and/or their supporters.
Notes

1. This is a very brief and grossly over-simplified account of the war and the factors leading up to it. Readers are referred to the substantial number of books on the subject, such as Malcolm (1994), Bennett (1995) and Crnobrnja (1996).

2. There were some tensions before this, e.g. Croat fears of Serb expansionism under King Alexander in the 1930s, which was an important factor motivating the Ustašas. According to Bennett, the notion of centuries of animosity between Serbs and Croats is a 'historical myth', based on media propaganda rather than actual history: 'until this century, most Serbs and Croats had virtually no contact with each other' (Bennett, 1995, p.6). Bosnian Muslims were at most collaborators with the Serbs' actual enemies (the Turks), rather than there being any direct conflict between them. The Second World War was not the beginning of ethnic tensions in the region; but it represented (with the benefit of hindsight) the point of no return.

3. The figures in this paragraph and the next are taken from Crnobrnja (1996), pp.22-3.

4. Fox and Wallich (1997, p.3) give very different figures for population: 0.7m in RS and 2.9m in the Federation (2.5m in Bosniac and 0.4m in Croat areas). However, these figures seem difficult to account for in terms of the pre-war ethnic distribution of the population. According to Crnobrnja, pre-war census data (based on self-identification) show 44 per cent of the population (1.9m people) to have been Muslims, 31.5 per cent (1.4m) Serbs, 17 per cent (0.7m) Croats, leaving 7.5 per cent (0.3m) other ethnic groups and self-identified Yugoslavs. If the Muslim share of deaths and refugees is equivalent to their pre-war share of the population (which is probably a conservative assumption), the Fox and Wallich figures would be correct only if there were 1.2m refugees from other Republics and members of non-Muslim ethnic groups resident in Bosniac areas that is, if these groups constitute roughly half the current population in these areas. Since the total number of refugees entering BH is estimated at 2-300,000, and there were about 300,000 Yugoslavs and members of other ethnic groups pre-war, this would imply that, at the very least, 25 per cent of the current population of Bosniac areas would be Serbs and Croats; and, since the difference between the pre-war Croat population and the estimated current population of Croat areas is only 300,000, at least half of these people would be self-identified Serbs. These implications seem implausible.

5. Following the de-collectivisation of agriculture in 1953, private land holdings were limited to 10 ha.

6. GSP (gross social product) is the nearest equivalent to GDP in the national accounting system used in most socialist countries, including the former Yugoslavia.

7. This Section is based mainly on EIU (1996a, 1996b, 1997a, 1997b), supplemented by various articles from The Economist.

8. The US, in particular, has linked the FRY's reentry to the IMF to progress on the extradition of war criminals and its policy towards Kosovo. Progress on both has so far been limited.


10. As the name suggests, the final beneficiary principle means that the debt is divided up according to which Republic, Entity, etc was the ultimate recipient of each individual loan.

11. The HIPC Initiative phases debt reduction over a period of six years, each phase being conditional on a favourable track-record of structural adjustment policies. The other complication of the HIPC Initiative with regard to BH is that, while its per capita income is currently low enough to qualify, if economic recovery proceeds at the rate currently hoped for, it would exceed the income threshold before the final stage was reached.

12. An agreement-in-principle, in this context, is an agreement between the government of a country and an appointed committee of its
commercial bank creditors. The agreement cannot be finalised until the terms agreed in principle have been accepted by creditors holding a specified percentage of the debt — typically about 95 per cent.

13 Strictly speaking, this would almost certainly be illegal without a formal waiver by the banks of the negative pledge clauses and sharing provisions in their loan contracts; and the FRY would once again have a sufficient share of the debts to block such a waiver. However, mechanisms are readily available to purchase debts informally; and some Latin American governments are believed to have undertaken such transactions during the 1980s. While the FRY could make a legal challenge, it would be difficult to prove the offence, if it were well executed.

14 It should be noted that the following discussion is entirely speculative in nature.

15 Net present value (NPV) is a measure of debt which takes account of its terms as well as its absolute amount. For a loan at the market rate of interest, the NPV is the same as its face value, but it becomes progressively smaller as the interest rate declines. Increasing the repayment period of a loan at a concessional interest rate also reduces its NPV, as the benefits of the lower interest rate are enjoyed for longer.

16 This and the figures in the next two paragraphs are the author's estimates, based on World Bank (1996b), Tables 5.2 and 5.3. Because of the rather unhelpful presentation of the Bank's projections, the figures given should be regarded as very approximate.

17 A conspicuous exception is Brunei, which pledged only $2m, but committed $18.7m, of which $16.7m had been disbursed by October 1996.

18 World Bank financing was limited to $8m mobility aids and training for the disabled and $2m for institutional and implementation support.

19 Compared with current salary levels. This estimate is based on World Bank estimates of staff requirements (World Bank, 1996a, Annex II Appendix 2), assuming a 50–50 split of staff between Bosniac and Croat areas, and a 900 per cent increase in salaries of those from Bosniac areas.

20 As noted above, however, that this assessment is based on population figures very different from those used elsewhere in this paper (0.7m in RS and 2.9m in the Federation, as against 1.2m and 2.3m respectively). See footnote 5.

21 This is illustrated by the dispute between Bosniacs and Croats in Mostar following the September 1996 elections: the EU's ability to secure a favourable outcome was seriously compromised by the fact that virtually all its aid had already been disbursed, so that the Croats had nothing to lose by intransigence.

22 This is proposed by the World Bank (1997b, pp xxv, 37, 42), although they appear to envisage subsidies from domestic resources rather than aid receipts. The current status of this proposal is unclear.


24 The cost of the EPW programme per person-year of employment is estimated at $5,440. (See Section E1.)

25 The Fund for War Veterans, Invalids and Families of Deceased (20 per cent); the Fund for the Protection of War Veterans (8 per cent); the Retirement Fund (7 per cent); the Education Fund (5 per cent); the Family Planning Fund (5 per cent); the Population Resettlement Fund (5 per cent); and the Restitution Fund (5 per cent).

26 Current and former soldiers are important holders of public sector liabilities, in the form of salary arrears.

27 A bond which is never repaid, but on which a constant stream of income is paid.

28 This problem is much less serious in RS, where 69 per cent of inputs are imported, but 53 per cent of output is exported.

29 The SME funds were 'almost the only sources of cash resources for enterprises in 1996' (EU/EBRD/World Bank, 1996, p83).

30 As discussed in Section B2, there is a risk that the World Bank's balance of payments projections will not be achieved, which could seriously damage BH's external debt situation. Strengthening the balance of payments through changes in trade policies could help to avert this problem.

31 The likely ethnic locus of pressure for continued protection in unclear: the relative strength of producers in the Croat areas suggests that they would be best able to take advantage of the resulting opportunities in the short term; but equally, if this approach were successful in promoting local production, producers in RS and Bosniac areas might be more dependent on the maintenance of tariffs for their continued viability.

32 According to EU/EBRD/World Bank (1996, p93), 'About 425,000 soldiers have been or are being demobilized.' If, say, 300,000 were
demobilised at a constant rate during the course of 1996, the average employment figure for the year would need to be adjusted downwards by 150,000. This would leave a further 125,000 jobs to be shed by further demobilisation, so that employment would be reduced by 275,000 (25 per cent of the labour-force) from its 1996 level overall.

33 Up to mid-November, 38 sub-projects had been financed at a total cost of $2.96m; and 6,530 person-months of employment had been created. This implies an average cost of $5,440 per person-year. The total value of the project is $41.4m, spread over two years, implying the creation of an average of 3,800 jobs over that period, from a labour force of 1.1m. At that time, three months after the project had come into operation, none of the non-World Bank-managed funds had been identified, leaving a financing gap of $31m, or three-quarters of its total value (World Bank, 1996a, p15).

34 Aid disbursements up to October 1996 were $720m (EU/World Bank, 1996a, Table 3), an annual rate of $864m. It is estimated that the reconstruction programme created 250,000 jobs at its peak (EU/EBRD/World Bank, 1996, p94). Again assuming an average level of employment-creation for the year as a whole of half this level, this implies an average cost per person-year in the order of $7,000.

35 In Croat areas, no pension payments were made in 1992-3; in Bosniac areas, payments were six months in arrears in early 1996 (World Bank, 1996b, p48).

36 These figures are affected significantly if the population figures in Fox and Wallich (1997) are used. Assuming that the numbers of pensioners in World Bank (1996b) remain valid, this would increase the pension levels in Table 7 by about 10 per cent in the Federation, but reduce them by about 40 per cent in RS.

37 The Fox and Wallich (1997) population estimates would increase the cost of a given level of wage contributions in the Federation for a given level of unemployment benefit by about one-eighth, because they imply a substantially greater share of population in the (lower-income) Bosniac areas. The RS figures are unaffected.

38 The conclusion of the Brčko arbitration has been deferred until February 1998.
References


EIU (1996a)

EIU (1996b)

EIU (1997a)

EIU (1997b)


