

*Paper prepared for the Second Euroacademia International  
Conference*

*The European Union and the Politicization of Europe*

*Budapest, 6 – 8 December 2012*

*This paper is a draft*

*Please do not cite*

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## **EU Perspectives between Politics, Economics and Ethnicity**

### **(Are There Lessons to Be Learned From the Cases of Former Yugoslavia and B&H?)**

#### **Abstract**

The future of the EU seems foggy at the end of 2012. The EU might eventually prove efficient and able to survive discovering its own and new way out of crisis. Practically speaking survival of the EU and Euro begs for creation of a political union. Political Union asks from members of the union to surrender a part of both economic and political sovereignty. The USA has become first political union and consequently monetary union. Former Yugoslavia used to be political and monetary union. B&H is a sort of monetary union, and likewise the EU, B&H is not political union. Yugoslavia has got disintegrated. B&H is on verge either of disintegration or eventually integration. In this paper we try to draw some lessons from both former Yugoslavia and B&H past that might be useful to be considered in the context of EU future.

Key words: EU, development, disintegration, ethnicity, diversity  
JEL: F15, F59, O10

#### **Introduction**

Treaty of Maastricht (1992) and the Stability and Growth Pact (1997) have saddled Europe with such an institutional framework which remind deeply on bastion of neoliberal macroeconomic orthodoxy. Great experiment of creating monetary union (1999) without having political union promised success in time of fine-weather condition that prevailed in the meantime and until 2007 crisis.

Since time of A. Smith and D. Ricardo nation was the space within which Pareto optimum was supposed to be reached by free functioning of market forces. Keynes's „General Theory...“ was focused on nation state much more deeply. Keynes's macroeconomic management deals with the issue how to improve market imperfections and market failure in order to increase well-being of a nation and nation state citizens. Globalization at work, particularly that one which is described by Krugman's Economic geography or Summers's New Economy is nation-less process without a proper global economic management. Many distinguished economists were convinced that international Pareto optimum, relevant for EU

enlargement, was quite realistic achievement just if one (country or region-EU) follows dictate of strong radical free market reform.( Frankel,1999) Therefore, creation of unique economic market within Europe ,the formation of European economic space without political union was quite feasible and promising future.

As far as functioning of Euro zone is concerned, Keynes's economy was taken as useless. Likewise, enlargement process was dictated by Maastricht criteria and promising Euro zone benefits were expected by newcomers.

However, crisis of 2007 on has raised question: how Europe may respond to serious economic crisis? Is Europe fine-weather union or may survive heavy economic storm?

Prime Minister Ferenc Gyurcsany of Hungary has already warned „We should not allow that a new Iron Curtain should be set up and divide Europe“(New York Times, 4, 24, 2009). Urgent call from Hungary for a comprehensive bail out of all Eastern Europe has firstly been promptly rejected by madam Merkel.

National interests are inserted in the heart of Europe. Tomas Klaus; Paris director of the European Cancel on Foreign relations pointed out „This crisis affects the political union that backs the euro and of course E.U. as a whole and solidarity is at the heart of the debate“(International Herald tribune 4.24.2009)

EU is defined by: Maastricht treaty, Stability and Growth Pact, monetary union...However, the EU is place of variety of: fiscal policy, tax policy, industrial policy, social policy. Europe has social democratic part of itself (Scandinavian countries) with well developed welfare policies, corporatist states such as Germany and France and Netherlands plus whole bunch of new members which try to emulate free market liberalism. Exactly those last mentioned are in deep economic turmoil. Adding to them Ireland, Greece, Portugal, Spain and Italy we get half of the E.U. already entrapped by economic crisis. And all of these countries are devoid of any serious Keynesian macroeconomic management.

European Central Bank is obsessed with price stability, and national governments of the members of euro-zone are devoid of monetary policy .Therefore, in the absence of political union compromises might be harder reached in case of bad weather. In time of crisis multiethnic society become a serious obstacle for further unification of EU, particularly if member countries are unequally developed. In this paper we start from platform that between EU and B&H there is not such huge formal difference. In fact, there are some important similarities which merit to be considered for benefit of EU future. The similarities are:

- both parties a monetary union,
- both parities are not political union,
- both parties do have not common fiscal policy,
- both parties do not have common social policy,
- both parties prefer monetary stability,
- both parties are multiethnic societies
- both parties are confronted with economic crisis,
- both parties aim to become federal, that is more functional state.
- both parties are on crossroad between integration and disintegration.

## **I the Case of former Yugoslavia and B&H**

### **The Economy of B&H Before 1991**

Between the Second World War and 1991, when Bosnia&Herzegovina was one of six republics of the former Yugoslavia, it achieved significant economic transformation. Economic growth averaged 5 per cent a year. In 1991 per capita income was \$US 2,400,

excluding the service sector from BDP calculation, as was the practice in former socialist economies. Twelve big companies produced 35 per cent of the gross domestic product (BDP), and four of them generated more than 40 per cent of total exports. Companies were organized as self-managed companies of associated labor, in accordance with the principle of a self-managed market economy, which was half way between a centrally planned and a modern market economy. In 1990-1991, Bosnia's main foreign trade partners were the former USSR, Germany and Italy. It had a surplus in its trade with the EEC countries in 1991. Main exporting sectors were chemicals, ferrous metallurgy, metal processing, leather shoes, electrical appliances, finished wood, timber and panels, and finished textiles.

#### Pre-war position of Bosnia and Herzegovina

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

See for more details: Stojanov, (2004).

## II the Economy since the War-on the Road to Economic Deconstruction

B&H and former Yugoslavia were faced with the war from 1991 up to 1995. Consequently, when the war ended issues how to organize and start up the B&H politically and economically has become dominant question. When considering the selection of development strategy and its effects so far, one has to take into consideration relevant external and internal factors of both an economic and a political nature. Two external factors did have determining influence. The first was the process of globalization of the world economy, and the "Washington Consensus" which provides the basis for the treatment of transition countries and their transformation into "small open economies."

The second was 1995 Dayton Peace Accord. While the Accord placed banking and customs regulation at the central state level, fiscal policy was transferred to the entities and cantons, and no instruments were provided for shaping country-wide macro-economic policy. This has been tying the hands of the central state concerning the formulation of a uniform strategy for economic development, including industrial policy. In practice, Bosnia Herzegovina has been

lacking the power to formulate and implement independent monetary, fiscal, price and foreign exchange policies, and policies regarding privatization, incomes, and social welfare. Moreover, industrial policy-making was, in fact, impossible under the rules applied/imposed on the country by the World Bank and IMF. The policy package coming from, and implemented by, the IMF and the World Bank is seen as the only way of achieving stabilization, preparing the ground for privatization, and developing macro-economic policy under more favorable political circumstances. Yet the evidence indicates otherwise. The “Frankenstein” economy simply does not perform as has been expected. Unemployment rate is as high as 43% in 2012.

#### ----- Causes and effects

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

### III. The “Washington Consensus” in the B-H Economy: A Basic Strategy for Recovery

In the chapter “Towards Establishing a Market Economy” in the document “B&H Towards Economic Recovery”(1996) prepared by the World Bank, European Commission and EBRD, a basic strategy for recovery and the role of government was set forth. The World Bank document states:

“The basic strategy for economic recovery should rest upon the private sector as a main starting device of the growth of the economy and employment. Further, most of medium-term economy growth will have to come from the extension (the development) of the service sector and the development of light industry on the basis of private enterprises. The property now held by state firms which do not operate can be used by the private sector. What is needed here is to identify the useful parts of the state firms and to sell them through a simple and quick mechanism of privatization.”

Therefore, a quick privatization, the dismantling of state firms, the development of SMEs along with light industries and the service sector were supposed to be levers for the growth of the B&H economy in the coming period. The World Bank continues:

“The role of the state in the economic and development strategy which is governed by the private sector is not unimportant, but it is of shifted focus. It should concentrate on the maintenance of healthy macro-economic conditions, on the establishment of a relevant legal and institutional framework, which motivates uninterrupted functioning of a free market and provides basic public goods and social services, such as defense, public order, education, and health service.”

The reform of banks and firms is a major project which must be implemented in B&H. Sizeable inherited bad credits, as well as old foreign currency accounts must be excluded from the balance sheets of banks. At the same time, large and inefficient state firms must be closed or restructured.”

Regarding the institutional structure of the B&H state, the World Bank has argued that the most appropriate approach may be a flexible process for the restructuring and privatizing of firms and banks on a regional basis. In line with this approach, the privatization programs should have been applied regionally (i.e. on the level of Republic Srpska and on the level of a cantonal group, an individual canton or on local levels, within the Federation)

### III.1. Macro-economy of the Economic Recovery of B&H

The World Bank has stated that at the beginning the stimulus for economic growth will come from the reconstruction process, and not from exports, as has been the case in East Europe. The macro-economic policy of the 2-3 year transitional period must be different, therefore, from the standard one. World Bank experts were of the opinion that the main macro-economic challenge of the transitional period (reconstruction period) is management of the great influx of donations and favorable credits, the removal of bottlenecks during the reconstruction period, and control of inflationary pressures. Maintaining macro-economic stability, however, is considered a key issue for successful recovery and for progress and development later on. (World Bank, European Commission, EBRD, Bosnia and Herzegovina on the Road to Recovery, 1996)

Under the World Bank and the IMF program, the Central Bank of B&H was supposed to have a foreign governor for the next 6 years. Monetary policy was to be restrictive and carried out by a currency board regime. B&H was supposed to be integrated into international markets as a “price taker” with a fixed exchange rate of national currency pegged to the DM. In practice, this meant that the prices in B&H could not deviate from the German (world) price level. The country is, thereby, losing the potential advantages of the effects of the so-called “Philips curve”. Monetary policy, one between the strongest instruments of macro-economic policy, has virtually being taken out of hands of the B&H authorities, since: the exchange rate of the national currency is fixed. However, in time, some problems of national currency management will appear as a result of price increases on the one hand, or the large influx of capital, on the other hand. For the time being, from the time the Dayton peace accord was signed, that question had to be put aside, particularly as the country did not have a single currency, but rather four different currencies: the Dinar, Kuna, Serb Dinar and DM. Additionally, at that time, no-one could trust the domestic nationalist-oriented politicians. The “hard budget constraint” is a rule which B&H authorities had to accept in the package. A budget deficit cannot become a source of inflation.

## IV The Future of B&H

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

Transition to the future in Bosnia and Herzegovina

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

PRSR is term for Poverty Reduction Strategy Paper

To resolve the economic and political issues as far as possible, the international community (notably the OHR) offered Bosnia and Herzegovina in 2004 a second best solution that might turn out to be the first best under the pertaining circumstances. The circumstances are still the Dayton 'skin', which allows only a limited role for the state in the economy. The decentralized (1+10+1) community in Bosnia and Herzegovina, as second best solution, promotes economic reintegration by creating economically viable regions. It might be said that from the point of view of the process of Transition to the future in Bosnia and Herzegovina in the process of EU accession, the best idea would be to have Bosnia and Herzegovina as one region. But reality suggests it would be politically more acceptable and still economically viable for Bosnia and Herzegovina to consist of more than one region. In terms of economic efficiency, two regions could be preferable as a solution to three regions, and so on. Regionalization of Bosnia and Herzegovina along the lines of the EU regionalization concept is not devoid of risk. Look, for instance, at the ethnic composition of the Sarajevo macro region in 1991 and in 2002. The Serb populations are concentrated in one part of the region, while the Bosnian population lives in the other. The centre of the Sarajevo macro region is the city of Sarajevo, the wealthiest part of Bosnia and Herzegovina. If applied uncritically in Bosnia and Herzegovina, the 'new economic geography', as a concept of economic development, could exaggerate the imbalance of economic growth in a region, with predictable dire consequences.

**V Connection with Former Yugoslavia: parallel approach**

Here it is worth quoting from Woodward at some length, while adding some comments in square brackets: 'The remedy proposed by domestic economists and required by the International Monetary Fund (IMF) in exchange for credits in 1982 to Yugoslavia was a harsh austerity program of domestic contraction and export promotion, accompanied by

decade long series of economic and political reform. While the critical reform arts were liberalization of foreign trade and domestic prices, the creation of institutions necessary to implement such a policy mandated a radical change in the locus of political power over domestic and foreign currency. This was not the first IMF-financial effort to reform the Yugoslav socialist economy, but in all previous programs, the advice has been to decentralize..... The result, by the early 1980s when the debt crisis hit, was a central government with almost no authority over the economy and unable to act without the consent of all republics. Decentralization has gone too far, the market promoters concluded. A true central bank had to be created; authority over monetary aggregates, debt repayment, and foreign exchange policy had to be reunified; barriers to the flow of capital and labor across republics had to be removed; and a state administration capable of performing the functions necessary to an open, market economy had to be restored. 'The resulting reform program ... that was adopted by parliament in 1982 triggered three destabilizing shocks to the Yugoslav system....

**'The first shock was the challenge to revise the 1974 constitution....** By 1974, the balance of power lay with the republics [entities and cantons today in Bosnia and Herzegovina], and federal government had responsibility only for the common defense, veterans, setting guidelines on foreign trade-oriented investment policy [as in Bosnia and Herzegovina] legislating standards for wage and labor policies in the separate republics, and managing the federal fund for regional development, which taxed the wealthier northern republics for redistribution to the south..... 'Liberalization required the recreation of a single market over the entire Yugoslav area (as in Bosnia and Herzegovina today), and this in turn required the reunification of monetary and foreign exchange policy, including administrative apparatus necessary to such policy. The level of decentralization achieved by the mid-1970s, however, meant that the reform was a direct attack on the economic power of the republican governments (on the entities of Bosnia and Herzegovina today)....**Those who believed in the re-creation of a single market were "unitarists" as well as "federalists"....** By using the term "unitarism", they cast the **centre-republic fight in ethnic-cum-national terms**. They implied that this new threat from from Belgrade was from Serbs (as with Bosnians in today's Bosnia and Herzegovina). Such obfuscation always was possible because Belgrade was the capital of both the federation and the Serbian republic (as Sarajevo is in Bosnia and Herzegovina today). Their alternatives were the decentralized status quo or creation of confederation (a striking similarity with Bosnia and Herzegovina today and, and former Yugoslavia in that respect).

A suitable concept for achieving faster growth in Bosnia and Herzegovina could be developmentalism. A strategy for economic upswing and a complementary macroeconomic policy would contribute to economic prosperity provided it contributes to 'real convergence' with the EU. The only way to achieve this in the medium term through a differential increase in productivity, and thus competitiveness:' Macroeconomic policy can contribute to Bosnia and Herzegovina prosperity only in the short run. The nominal convergence with EU, almost attained in Bosnia and Herzegovina, can contribute to macroeconomic stability by putting things into place. However, it is insufficient, virtually by definition. Within such an approach to economic growth and prosperity, the economic paradigm termed here developmentalism seems the best suited to attaining the goals desired. 'Developmentalism(Murakami,1996) is an economic system that takes a system of private property rights and a market economy as its basic framework, but that makes its main objectives the achievement of industrialization (or continuous growth of per capita product) and, insofar as it is useful in achieving this objective, approves government intervention in the market from long-run perspectives. Developmentalism is a political-economic system established with the state as its unit.'Developmentalism consists of market competition, a government-implemented industrial



policy, export oriented manufacturing industries, development of SMEs, a search for a new **mass class** with importance attached to **equitable income distribution** and domestic centered demand, particular importance for comprehensive education, and creation of a fair and competent modern bureaucracy.

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

## VI EU complication: Mega –region, convergence and economic policy

Besides standard issues concerning the relations between the role of state and economic development, an extant EU reality complicates the matter even more. Namely, Krugman, Lancaster and others (Soderstein-Reed, 1994) works on economy of increasing returns under imperfect market condition seems has been confirmed by contemporary data. Main economic actors on global scale are no nation state any more, particularly so if one thinks about small or underdeveloped nation state. The main actors are firms-transnational corporations. (TNC). TNC locate activities where skill, capabilities and market cluster; capital flows where the returns are greatest and highly skill people move where opportunities lies.

The data prove that high-knowledge activities are produced primarily in increasing return to scale environments that are dependent on urban agglomeration, while low-intensive activities are produced more in environment of constant return to scale (Mc Cann, 2008)

New economy consequently contributes to economic divergence between countries. More developed country is more mega-regions might be found either in the country or across the border with another reach country.

„Europe's largest mega-region is the enormous economic composite spanning Amsterdam-Rotterdam, Ruhr-Cologne, Brussels-Antwerp and Lille. Housing 59, 2 million people and producing nearly \$1.5 trillion in economic output, this mega-region production exceeds Canada's and as well as China's or Italy's.“ (Florida, R., Mellander, C. 2008)

A mega-region asks for mega-regional economic policy, **not a national economic policy**. A poor mega-region asks for centrally- driven economic policy. The more poor regions in a country the more country has needs for centrally managed economic policy. Additionally a sort of economic policy needed by a poor region is different from a sort of economic policy required by reach region let alone reach-mega region.

## Concluding Thoughts

E.U. is economic union, but not completes one. E.U. is not a political union.

In time of fair-weather condition the E.U. may function well both on behalf of its citizens and national state members.

However, in bad-weather conditions (economic crisis) E.U. (particularly some of the members) might need to resort for Keynesian type of economic policy. Keynesian's sort of economic policy might not be effective without proper management of monetary and fiscal policy. Such effective Keynesian policy seems far from reality on the level of the EU. Applied nationally, such an economic policy might contribute to economic divergence between members and might dilute the efforts necessary for achievement of political union in the future. On top of that the reality of mega-region contributes to economic divergence between richer and poorer part of EU.

Taken altogether only one conclusion seems pertinent at this moment, and that is that EU is in the midst of economic policy fog. Great challenge for EU politicians is how to reconcile a)

different interests between nations which need an efficient economic and developmental policy, and b) that of big companies having its own profit making motive and demanding state- less economic space? Is an EU as space of regions instead of a space of sovereign states feasible in near future? What is EU going to look like in near future if it is not feasible? Shall we witness another Balkan syndrome developing itself within EU? Here are we find the points of great similarity between former Yugoslavia and extant B&H, and reasons for a great precaution in building up new EU.

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