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**DARK AGE OF ECONOMICS OF TRANSITION: the case of  
BOSNIA&HERZEGOVINA ECONOMIC TRANSITION**

**Abstract**

Bosna&Hercegovina is in the process of transformation from a previously self-managed economy to a modern market economy since 1996. In this paper we analyze the Economic development strategy of the international institutions imposed on B&H from the point of view: how an economic idea may be counterproductive: economically, politically, and socially. Namely, political and ethnic division between Bosnians made up by Dayton Agreement has been additionally deepened by imposed economic strategy. The Strategy brought about such strange phenomena such is: ethnic privatization and inter-entity trade. Our attitude from the very beginning was that Imposed development strategy under Dayton's condition had to produce more divergence than convergence both between B&H and its neighbors and B&H and EU.

Key words: Transition, Failure, Imposition, Paradox

JEL classification: D, E, F, O

## **Motto**

The economic transition of a society is a thing to be accomplished slowly... We have a fearful example in Russia today of the evils of insane and unnecessary hate. The sacrifices and losses of transition will be vastly greater if the pace is forced...For it is of nature of economic processes to be rooted in time. A rapid transition will involve so much pure destruction of wealth that the new state of affairs will be, at first, worse than the old, and the grand experiment will be discredited « J.M.Keynes ,1933. In BHAGWATI, J. (2004),

### **1. Introductory Remarks**

Bosnia-Herzegovina is in the process of transformation from a non-market, previously self-managed economy to a modern market economy. The process was started at the beginning of 1996, immediately after the Dayton Peace Accord was signed. The transition package being implemented is based on the “rules of the game “of the Washington Consensus. At the international level, the IMF, the World Bank and USAID have led the transition.

When the transition began, there was the promise and expectation of a “blooming landscape”. Today it seems more like a mirage. Economic development has hardly started. It is becoming obvious that an alternative solution was needed for economic development of the country... This underscores the importance of supply side industrial policies for productivity, competitiveness and convergence, the element which has been missing from the package of the “Washington Consensus”. Exactly those element we have offered in Economic Development Strategy we had prepared under UNDP auspices in 1977.However,international community: the IMF, World Bank and the Office of High Representative (OHR) have rejected the Strategy with a pretext that is obsolete, that is the Strategy has been out of line with respect to main-stream neoclassical concepts of transition( see appendix) In this paper we a) we discuss two paradoxes developed by the Strategy that economic science has never seen before B&H transition: a)inter-entity trade and b) ethnic privatization. We conclude that the imposed economic strategy has heavily worsened already existing political division between Bosnian people along both entities and ethnic lines. The strategy has deindustrialized country and made it heavily dependent upon remittances from abroad, thus making the country almost unattractive for its population. Therefore, one should not be surprised by findings of Oxford Research Institute that great many of inhabitants of B&H prefer to leave B&H for ever. Such an economic reality begs for a new economic development beginning for B&H based on an alternative approach.

### **2. Methodological and theoretical background of the paper**

At the beginning of transition process there sill was a knowledge gap on subject how to transform former socialist economy into modern market economy. B&H case with triple transition was even much more complicated than “standard” one. Bing-bang approach prevailed between main-stream economists. As the author of this paper strongly disagreed with such an approach, particularly for B&H case, he was proposing an alternative gradual but aggressive approach which was supposed to respect first of all so- called “path-

dependency“theory. The author was one between tiny minority both politicians and economists who had argued against Dayton and economic transition package being sure that both will destroy B&H. The first such a paper has been presented at Paris conference 1995. (Stojanov, 1995). Next has come Vienna conference 1996(Stojanov, 1996). Under the auspice of UNDP we have gathered first relevant primary statistical data about the state of B&H economy, and we have proposed Economic Development Strategy for B&H based on a gradual but effective neo-Keynesianism(Stojanov,1997).The strategy has gathered a few domestic economists who shared author’s opinion(Čaušević,F;Vilgorac,S.,Papic,Ž.Hodzic.K.),and two distinguished foreign consultants Panic.M from Cambridge university and Mencinger,J,from Ljubljana. The Strategy has been rejected by the IMF and World Bank in 1997.with pretext that is obsolete. Instead, a neoliberal economic strategy has been imposed on B&H by these institutions. In year 2000 being in the capacity of chairman of Sarajevo’s cantonal agency for privatization together with members of the managing board author proposed privatization strategy with main idea first to restructure companies with eventual privatization at later stage of take off of the economy(Stojanov,2000). In the same time we proposed establishment of B&H Development bank. Interestingly, both ideas have been rejected by international institutions with a pretext that a) state is corrupt, and b) shock therapy is what B&H needs. Next research concerning economic development and economic policy relevant for B&H we did together with dr.C.Pitelis (Stojanov, 2000) pointing out necessity of reindustrialization of B&H economy and a useful role of cluster development. Important contribution to deliberations of economic, political, sociological and cultural effects of Dayton has been provided by the study of Soros foundation ”International Support Policies to SEEC: Lessons(not)Learned(20001).Under the auspices of World Banka and DFID we undertook new research project which did confirm negative economic process B&H’ economy was on (Stojanov, 2004). We did a monograph “Economic in Peacemaking: lessons from B&H” on behalf of the Portland Trust using statistical data available from official B&H statistics and Oxford Research International(Stojanov,2009).In that monograph we compare World Bank proposed strategy for B&H with actual data relying on comparative method and method of analysis and synthesis. The monograph de facto was a sort of crystallization of author’s research on B&H economy since 1995 All our effort to offer a domestic strategy or at least to amend proposed/imposed one have been rejected by international community. Therefore B&H economy and society have had underwent very strange process of transformation. That transformation of country from a normal one into Frankenstein has begun by the war and has been resumed by a) Dayton Peace Accord, and b) by Imposed economic development strategy.

### **3. The Economy since the War-on the Road to Economic Deconstruction**

When considering accepted/imposed the 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 have determining influence. The first is 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 other is the 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 ties the hands of the central state concerning the formulation of a uniform strategy for economic development, including industrial policy. In practice, Bosnia-Herzegovina lacks 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 is, in fact, impossible under the rules applied/imposed on the country by the World Bank and IMF.

The development prospects in such a poor country are remote since the starting position is so low. It has no developed market institutions and no strong government which might implement an alternative package for development and macro-economic policies. 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.

#### **4 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.”

Yet the evidence indicates otherwise. The “Frankenstein” economy simply does not perform as has been expected

#### **5. An Example of Frankenstein Economy: the role of trade both: Inter-Entity Trade and Foreign trade**

Inter-Entity trade (trade between republic Srpska and Federation of B&H) is relevant for B-H and its two entities for at least two reasons:

- A) Economic, because its expansion can contribute to the growth of the GDP of the entities and of B-H, as well as to the more effective functioning of the market, and
- b) Politically, because it acts or could act as an integrating factor of the political area of B-H, by stimulating cooperation between citizens and business people of both entities.

The significance of trade for economic growth and development of a country is beyond question. This goes both for domestic and foreign trade, especially in today’s global environment. It should be that way for B&H, too. It is therefore not surprising that some economists, entrepreneurs and politicians represent the position that trade is the integrating

factor of economic and political recovery of B&H. In that respect an OHR effort was undertaken concerning harmonization of special excises and taxes on the so-called "high-tariff" goods in the Federation (FB&H) and Republic Srpska (RS). With the same aims the office of the OHR has been pressuring ministers of trade of both entities to cooperate, to harmonize conditions for trade, to organize trade and finally, to exempt it from various formal and informal restrictions.

Until June 1998 inter-entity trade was regulated by the entities and was similar to, or even had more characteristics of international trade than of domestic trade. It is therefore perfectly normal that only a very modest volume of inter-entity trade was officially registered. Political policy bodies of both entities have had a more complete picture of inter-entity trade, since they monitor it closely in the given political circumstances.

Still, a logical, although (at first glance) paradoxical question is: would inter-entity trade have developed without pressure from OHR, and if so, to what extent? Similar relevant questions are the following:

Is trade in B&H really an integrating factor for B&H, at least to the extent expected by the politicians and the office of OHR?

Does favoring inter-entity trade stimulate greater trade diversion than trade creation?

Under which circumstances can inter-entity trade create (intensify) the trade creation effect in order to be an integrating factor of the economic and political area of B&H, and in order to play its standard (textbook) role in the interest of B&H citizens and entities?

Due to the war and the Dayton Accord, B-H has not been at 1966 even a firm customs union. The process of disintegration of the former Yugoslavia has led to creation of independent states, which have their own economies, and naturally, their own policies on economic relations with other countries. It is well known that, according to the Dayton Accord, B&H has special relations with its neighboring countries. These relations are so special that B&H for all practical purposes can hardly be said to have a unified customs system. B&H finds itself in the unusual position of having and not having of policy of economic relations with other countries.

Her entities cooperate with the neighboring countries based on the principles of free trade zone. Given the fact that there were no customs or other obstacles to trade with neighboring countries, and, on the other hand, given the existence of regulatory obstacles which obstructed trade between the entities until June 1998, it was completely natural that trade was created between the entities and their immediate neighbors, i.e. between Republic Srpska (RS) and Yugoslavia, and between the Federation (FB&H) and Croatia.

Aside from the reasons provided in Dayton, this process of creation of trade with neighbors and diversion of trade between entities has, to some extent, its "natural" reasons after the war. The rationale for developing the effect of trade creation with the neighbors is based on import needs of both RS and FB&H. The economy of B&H and its entities, devastated by the war, had to satisfy its needs with imports. An edge was given in this process by the very nature of things, both as a consequence of the previously formed interdependency of the republics of former Yugoslavia, and due to the Dayton Accord and Dayton provisions.

Leaving aside the political considerations (which are still significant under B&H circumstances), we come to the most important question concerning inter-entity trade. The question is the following:

Does inter-entity trade determine economic flows in B&H, or is inter-entity trade itself determined by:

- a) The state of the economy in B&H,
- b) Solutions provided by the Dayton Accord and the Neo-liberal economic development strategy prescribed by the IMF, the World Bank and supported heavily by the international community?

The economy of B&H is far less developed than the economies of the neighboring countries. In addition, the special relations make the import of goods into B&H from these countries a very simple matter. Under such circumstances, a rational entrepreneur has no logical reason for inter-entity trade. The trade diversion effect thus suppresses the trade creation effect!!! The Neo-liberal concept for development of the economy of B&H eliminates state intervention in the economy, the infant industry argument, and foreign trade policy. At the same time, the convertibility of currency and a liberal foreign trade sector (with deconstructed domestic production) provokes a rational entrepreneur to import products from third countries, thus increasing the balance of payments deficit of B&H and its entities respectively. The question is this: how long can this endure without support of the international community? What is the prospect for inter-entity trade without import from third countries? These questions lead us to the theses that B&H must have its economic borders, but only if the necessary precondition is achieved in the form of dynamic economic development. Dynamic economic development of an infant economy can hardly be achieved by the current development concept.

## **6. Ethnic and Entities Privatization**

Privatization was/ still is / the “alpha and omega” of all transition packages despite some questions as to its success in eliminating de facto state control. In the case of the B&H economy, there were additionally two “Frankenstein” issues concerning privatization. Privatization in B&H has been supported, even by the World Bank and the IMF experts as an Entity privatization. The property of B&H as a state has, thus, been partitioned into two parts: the property of the state of RS and the property of the state of the Federation. Such a solution has contributed seriously to the further division of an already divided B&H economic space. It has contributed to the development of Inter-entity trade and to the confusion between citizens. A huge company such was „Energoinvest“ covering all of B&H territory suddenly had to be divided into two parts: one that belongs to the Republic Srpska and the other one that belong to Federation of B&H The same destiny has been faced by all big B&H companies!! Furthermore, in the specific B&H case of having three ethnic groups (Croats, Bosnia and Serbs), privatization along the proposed lines has been contributing to „ethnic privatization”. That is, the Bosnia oligarchy gets the companies in the region dominated by Bosniacs, Croats in the region dominated by Croats. In RS, Serbs are anyhow the dominant part of the population. To add to this, employees are then selected on the basis of ethnicity!!! Consequently, economic idea had spilled oil over fire of ethnic division of B&H provided by Dayton Peace Accord. Additionally, the idea that state companies should be: a) first privatized, and then b) afterwards restructured has delayed the restructuring process indefinitely. In the meantime state-owned companies, waiting to be privatized by this most inappropriate and mostly impossible way, become: a) technologically more obsolete, b) unproductive and loss makers c) irresponsible both to the government and to themselves, d) “asset stripping” took place. State companies become a source of capital and profit for new private companies. Inter-company income distribution also takes place. Now state companies represent the problem that they cannot be easily sold, or even sold at all. Another serious question for both domestic authorities and the international community regarding privatization has become apparent: what to do with non-privatized companies, and how to reinvent unique economic space both politically and economically?

## CONCLUSION

What could we conclude after all? Let us mention what The Portland Trust suggests. Most B&H citizens see the situation in B&H as “bad“. Four in ten would leave B&H if given an opportunity. Two thirds of respondents aged between 18 and 30 say that they would like to move abroad. Nearly half of the Bosnian people believe they are first and foremost B&H citizens; most of the others subscribe to a dual identity. Critically, 14.2 per cent of 3,580 Respondents reject a B&H identity. Many experts believe that this feeling of social exclusion is a result of the poverty in Bosnia and Herzegovina. 31.3 per cent of households in the Federation of B&H and 22.5 per cent in the Republic Srpska have no apparent monetary income. Other studies found that 50 per cent of the population is generally socially excluded. On a long-term basis, 47 per cent of the population is excluded. (The Portland Trust, 2009)] After triple transition and many foreign prescriptions and advices B&H has become a Frankenstein state! Economy sometimes may be a strange science.

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## *Appendix 1,*

### *Some Excerpt form Rejected Economic Development Strategy 1997*

#### THE PRINCIPLES AND CRITERIA OF POLICY SELECTION

The last few years have witnessed epoch-making changes in the former socialist countries. Two concepts have emerged regarding the overall approach to transition: the "big bang" or "shock" approach and the gradualist approach. These differ substantially on the issues of time-frame, the speed at which implementation of economic measures (known as "hard budget constraints") are to be imposed within that time-frame and the role of governments in the transition process. Both approaches have strengths and weaknesses. By combining their respective strengths, we feel that the best conceptual approach is one of "aggressive gradualism". Obviously, the key word is "gradualism", suggesting that the time-frame we are looking at is a fairly long one and that the economic pressures to be applied within that time-frame should be phased in, rather than implemented immediately. This does not mean that all change must come slowly. On the contrary, certain actions must be carried out decisively within a very short period of time. Gradualism refers primarily to the method of gaining the momentum for change and is a much more gradual process than the "big bang" or "shock therapy" would allow for. While the economy needs to be galvanized by drastic action being taken in certain areas, such as eliminating inflation and its accompanying speculation, shock therapy would not be always appropriate in view of the effect it could have both on people and on enterprises. If the key word is gradualism, then the operative word is aggressive. The Strategy will suggest measures which will aggressively exploit the potential of certain situations by actively designing and implementing policies conducive to change. "Aggressive" means overturning the status quo. It refutes the argument that things will change on their own, that there is no need to drive change, that inaction and a lack of commitment are normal. Expecting abrupt solutions where they are not possible is economically counter-productive and politically harmful. Yet, delaying the implementation of measures which can yield quick results is inefficient and wasteful. The right time-frame for the implementation of changes is, therefore, one of the key problems to be addressed in this program. The transformation of the system must be as quick as possible but not unduly hasty. The task at hand is to confront simultaneously the many problems which arise in the following sequence:

Market creation -> stabilization -> liberalization -> restructuring -> privatization both theoretical economics and practical experience demonstrate the necessity of taking action on all these matters simultaneously as they are all interdependent. An intervention in one major area cannot be isolated from other areas; there is bound to be a spill-over of the positive and negative effects into other areas, activities or measures. It is therefore impossible for all the areas mentioned in the above sequence to be addressed simultaneously and for smooth and universally acceptable solutions to be achieved. Nevertheless, there is no alternative but to intervene in some way make in all of them.

Two criteria may be helpful in confronting this problem:

As managers of the transition process, the government must focus on what is important, not on what is urgent unless what is urgent is also important. This comment concerns not only creating priorities, but also preserving scarce governmental resources. The sequence of measures to be taken must avoid widening the existing gaps and "black holes" in the economy. Transition should be conducted in such a way as to create new opportunities which can be filled by individual and collective initiatives, not open gaps which will further exacerbate the situation. With these criteria in mind, we propose, as a first policy priority, the aggressive development and implementation of market institutions. There is absolutely no need, no reason and no excuse to delay this process. It does not require

physical or material resources, simply political will. At the same time, the market itself and the ability to create a market within a short period must not become an obsession. It must be recognized that the transition to a market economy is a period during which the market does not function well or fully.

Next on the agenda of priorities is the consolidation of ownership, ownership claims and transformation of property. The objective of this is to enable enterprises, as economic entities, to carry out the necessary restructuring and reorganization to enable them to respond adequately to market opportunities and pressures. An important element of ownership consolidation lies in the provisions concerning the functioning of private ownership. There must not be discrimination against the private sector; the enforcement of private contracts must be guaranteed by law and upheld in the courts; absolute security of private property must be declared and there should be no review of private property values and holdings; the tax system should not restrain private investment. At the same time, there should be no discrimination against other forms of property.

This leaves two large areas outstanding: macroeconomic stabilization and the restructuring of the economy (overhaul of production facilities, employment, investments and foreign trade structures). More than the others, these are beset by contradictions and mutual interdependences. Just to indicate a few examples of the tradeoffs that policy makers are currently facing: Price and current account stability require one set of measures to be implemented, while increased employment. Production and investment require another, sometimes opposite, set of measures. To halt the decline in productivity and stimulate recover fiscal measures, such as tax concessions and publicly financed investments, need to be introduced. Such measures. However, could further increase the budget deficit. To improve the fiscal balance and encourage financial discipline, a hard budget constraint needs to be observed in that subsidies for persistent loss-makers need to be removed. Such an uncompromising stance could, however, result directly or indirectly in higher unemployment, lower aggregate demand, and lower output or, in the short term, slower growth. Measures that will reduce budgetary spending, such as cuts in welfare, will at the same time significantly lower the living standards of many citizens and threaten their security. Balancing the budgets requires a reduction in public spending, while the rapidly deteriorating economic situation requires increased expenditure on welfare and social security. To resolve these contradictions and define acceptable and workable policies, the following principles are proposed:

The main emphasis must be concentrated on supply-side measures, in other words all the factors which will change the supply side of the economy in qualitative and quantitative terms. The old socialist habit of demand-management must be reduced to a minimum, in particular the notion that public works and government-directed investment cycles will stimulate stable and sustainable economic growth. The concept of macroeconomic stability must be understood and interpreted in its full and deeper meaning as a crowning achievement supported by a transformed and efficient economic base, not simply as the icing on a rotten cake. Although stable macroeconomic financial conditions are extremely important, they must not be treated as an end in themselves or be allowed to draw attention and resources away from other areas of transitional policy. Policies affecting income distribution must give the strongest possible incentives to those most able to contribute to the growth of the national income. This means to individuals as well as enterprises. A social and welfare policy will be conducted, but without prejudice to the overall effort to mobilize productive resources which, after all, are the providers of welfare and social well-being. Burden-sharing among the generations will, of necessity, show a strong bias against future generations so that present needs can be met. In other words, future generations will have to shoulder a disproportionately large share of the costs of transition. It is impossible to pay all the bills resulting from previous and current mismanagement at once or even in a short time-span. Though clearly unfair to future generations, this seems the only practical way of proceeding. The resources of existing generations have been so depleted that it would be difficult, indeed impossible, to involve people in yet another general and collective belt-tightening exercise.

As far as timing is concerned, the Strategy points to the wisdom of the old adage: "Do not put off till tomorrow what you can do today". This philosophy is consistent with aggressive gradualism. It is very important to evaluate the measures and their consequences by their inherent merits, both known and anticipated. They should not be judged by well-worn or even new prejudices. Nothing must, a priori, be discarded as a useless instrument of change simply because it happened to be part and parcel of a previous system which was undesirable and wrong.

A sense of realism is of utmost importance in the guidance and selection of policy. If credibility and political stability are to be maintained throughout the transition process. Expectations must not be allowed to develop wildly or to become out of touch with the hardships through which the transition process must lead. The old maxim that "we are capable of doing in two years what others have taken twenty to accomplish" is no longer acceptable. To these principles, we must add the following objectives, which will also guide the selection of economic policy measures and instruments: Quick revived of economic growth. The current economic situation is precarious. It can sustain neither further decline nor a continuation of the status quo. Rapid transformation of inherited production facilities. Sustainable economic growth can be accomplished only through the transformation of existing production facilities. The "flagships of growth" concept has to be abandoned since past history has shown that too many of the enterprises in question turned out to be "white elephants".

Integration into the world market in general, and the European market in particular, should be accomplished by a combination of the rational liberalization of trade and a modern industrial policy. Revived of a trading area and economic space among entities from the former Yugoslavia once political obstacles are removed, economic cooperation could expand very quickly, bringing considerable benefits to all involved.