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From Defective to Effective BiH Development Policy

Од дефектне до ефектне развојне политике БиХ

Summary

After 21 post-war years Bosnia and Herzegovina (BiH) found itself in a “middle-income trap”. It is not classified into low income countries because workers and citizens do not accept low wages and low standard of living, nor does it fit into high income countries because those workers do not produce sophisticated products that ensure competitiveness, export and the basis for high wages and the standard of living. The development vision of BiH is to become a high income country. However, the state has neither suitable strategy nor policy.

This paper represents a detailed research of multifaceted secondary sources (i.e. journal articles, government publications, internet sources, etc.), conducted in a cross-sectional time manner. By utilizing secondary sources of data we conducted our own calculations based on data from the World Bank, the Central Bank of Bosnia and Herzegovina and Agency for Statistics of Bosnia and Herzegovina.

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We hold that key sectors which would provide return to pre-crisis GDP growth rate of 6-7 percent per year, should be: financial system, diaspora and digitalization of industry (with the introduction of suitable strategies and policies), each of which would contribute to GDP growth of two percent per year. The key agents of change should be the leaders of value chains (large-scale companies), cities-regions, gazelle companies (fast growing small and medium size companies) and micro digital companies.

Key words: Macroeconomics, economic growth, savings, upper middle income

Резиме

Двадесет и једну годину након рата Босна и Херцеговина (БиХ) се нашла у „заци средњих прихода”. Она не припада групи земаља са ниским приходом јер радници и грађани не прихватају мале плате и низак стандард живота, нити сада у земље са високим приходом јер радници не производе софистициране производе који омогућавају конкурентност, извоз и основу за велике плате и висок стандард живота. Визија развоја БиХ јесте да постане земља са високим приходом. Међутим, држава нема одговарајућу стратегију, нити политику.

Овај рад представља детаљно истраживање вишеструких секундарних извора (односно часописа, владиних публикација, извора са интернетом, итд.), сprovedено у пресеку времена. Користећи секундарне изворе података, извршили смо власитиу калкулацију на основу података добијених од Свјетске банке, Централне банке Босне и Херцеговине и Агенције за статистику Босне и Херцеговине.

Смајрамо да би кључни сектори за повратак на предратну стању раста БДП-а од 6 до 7% годишње требали бити: финансијски систем, дијаспора и дигитализација индустрије (са увођењем одговарајућих стратегија и политика), од којих би сваки допринио расту БДП-а од 2% годишње. Кључни носиоци промене би требали бити лидери ланца вредности (велика предузећа), градови-региони, дрзорастуће компаније (мала и средња предузећа) и микро дигиталне компаније.

Кључне ријечи: макроекономија, економски раст, штедња, изнад просјечни приход.

Introduction

After recovering from the post-war renewal and transition shock, BiH entered the “middle- income trap”, due to numerous reasons: (i) non-existent vision, the strategy and development policy, (ii) a lack of rule of law (i.e. non-functioning of

legal rules, especially the execution of unfulfilled contractual obligations) due to which the economic transactions with built-in rents slowly and scarcely perform, (iii) suppression of entrepreneurs (i.e. disabling the formation of the 'bottom up' market economy (whereby basic prerequisites for taking people out of poverty, inactivity and unemployment were not achieved)), (iv) very-open economy (exposing weak local producers to strong external shocks), (v) not introducing financial institutions and instruments coupled with non-adequate regulation and surveillance of financial markets, (vi) no renewal, or support for development of the research and development (R&D) sector (e.g. BiH is the lowest ranked country in Europe regarding per capita investment basis for research and development); (vii) utilizing an orthodox currency board, (viii) by keeping an educational system of closed ethno-national societies instead of developing an educational system which would meet regional and global needs, BiH is ranked as the last country in Europe, according to DHL index of global connection, (ix) a lack of support for knowledge-based reindustrialisation of the economy, (x) total domination of non-productive (social and administrative) over productive public expenditures (research and development and physical infrastructure, primarily the information and communication infrastructure), and (xi) a lack of support for development of value chains and production clusters (e.g. through public procurement, support packages for companies, etc.), (xii) failure to implement adequate pricing policy, especially the stabilization through stockpiles, etc.

BiH will not be able to achieve high rates of economic growth and employment until it has clear vision, strategy and development policy. The vision can only be *becoming a high-income country*. Other goals, such as becoming a member of the EU can only be an operational aim, but not a strategic goal of BiH policy. On its way of development BiH does not need to become a member of the EU but it has to become a high-income country. Therefore, it is important to make a radical turn in development policies. The focus must be shifted from the last development wagon's support (by applying subsidies, tax expenditures, credits of development banks, etc.) to unrestrained locomotive of the economic development.

The basic problem of BiH economy is that its main economic engine is exemplified in the public sector while the private and civil sectors are secondary. The inefficient public sector surpasses the weak private sector, as the main and the most prestigious employer in BiH economy. It is followed by the informal agriculture as the second largest employer. The Government takes a half of the country's GDP and spends it primarily on socio-administrative expenses and providing service.

The development must be based on foreign direct investment (FDI) as much as possible. Generally, this cannot be a plentiful source of investment financing.

However, a small country can hardly achieve strong development if it does not ensure technology transfer that is best encouraged by FDI inflow.

Because of the long term improvement of competitiveness of BiH economy it is necessary to conduct its second reindustrialization.

Industrialization of BiH economy was conducted by the Austro-Hungarian Empire. The first reindustrialization was conducted by the Socialist Federative Republic of Yugoslavia (SFRY), and the current BiH government should conduct the second reindustrialization of BiH economy (i.e. digitalization of its economy).

BiH has a low share of value added from manufacturing in its GDP. It needs to double the share to reach the most appropriate economic comparators (e.g. Switzerland, Austria, Slovenia and Slovakia). BiH is encountering the transition of the existing low-technology exports to knowledge intensive export.

I. Defective BiH policies

I.1 Deep internal and external disequilibria

The introduction of the currency board in 1849, in the island of Mauritius, Africa, and furthermore in Southern Asia and Caribbean was to ensure that British colonies have stable currency supported by monetary reserves in British pounds. There was neither need nor space for monetary policy in the colonies - money supply was gathered or shrunk according to pound reserves. The colonial governments agreed on that because they maintained interests in monetary reserves abroad. After the WWII most independent colonies established their central banks and abandoned the currency board. The currency boards appeared at the beginning of 1990s after the fall of communism and/or the appearance of hyperinflation. Here we are interested in how this youngest, the most orthodox form of all regimes of currency board(s) functions in Bosnia and Herzegovina?

Great and unused advantage of the currency board is a mechanism of adjusting current account of balance of payment, as the one which existed in the conditions of the gold standard (described in 1752 by David Hume, the father of economic science), and which the currency board is the most similar to.

If the country has a trade deficit the money supply shrinks causing interest rates growth and the withdrawal of foreign capital. High interest rates translate into deflationary pressure which leads to reduced imports, enlarged exports and improvement of foreign trade balance. This in turn leads to reduction in prices (if they are flexible) and makes exports more attractive. This causes the production to grow to its full employment level, export to increase and the elimination of current account deficits, which makes economy balanced internally and externally.

This mechanism does not function in BiH, as shown by the long term internal and external disequilibria. There is a high unemployment rate, low rate of economic growth and a high current account deficit, etc. The only positive result of the existing currency board is that there is no inflation.

According to views of those who advocate the currency board, the foreign exchange reserve should grow in parallel with external surpluses (i.e. recede with deficits causing changes in prices and interest rates). However, BiH is experiencing something quite different: there are current account deficits and the growth of foreign exchange reserves (and money supply at the same time). The Central Bank of BiH celebrates (just as the Indirect Taxation Authority which is proud of increased collections) without wondering who pays the ultimate price for it.

Since there are no policies to correct the external disequilibria that have marked the entire post-war period, net international investment position of the country (of what BiH invests abroad minus what foreigners invest in BiH) is -53 percent of GDP, hence, lower than the acceptable -35%. Fortunately for BiH, this disequilibrium is not financed only with credits, but also with non-credit resources, such as foreign exchanges from the non-observed economy's export, pensions, remittances to relatives in BiH, diaspora's investments in BiH, FDI and portfolio investments in BiH economy.

Table 1:

Importance of personal remittances; BiH, 2009-2015 (in billions of BAM)

Variables	2009	2010	2011	2012	2013	2014	2015
Nominal GDP	24,78	25,35	26,21	26,19	26,74	27,30	28,21
Final consumption expenditure	25,87	26,79	27,64	27,46	27,48	28,56	
Gross domestic savings	-1,09	-1,44	-1,43	-1,27	-0,74	-1,26	
Gross domestic savings (% of GDP)	-4,39	-5,68	-5,44	-4,84	-2,77	-4,61	
GNI	25,74	25,76	26,42	26,40	27,08	27,49	28,48
Final consumption expenditure	25,87	26,79	27,64	27,46	27,48	28,56	
Net current transfers from abroad	3,34	3,53	3,54	3,68	3,69	3,97	3,56
Gross savings	3,22	2,50	2,33	2,61	3,30	2,89	
Gross savings (% of GDP)	12,98	9,87	8,88	9,98	12,33	10,57	
Personal transfers (Current transfers between resident and non-resident households) - credit	2,01		2,01	2,09	2,17	2,31	2,38

Source: authors' calculations based on the World Bank, the Central Bank of Bosnia and Herzegovina and Agency for Statistics of Bosnia and Herzegovina

The main sources of personal remittances are (i) relatives' remittances and (ii) remittances with sources in the non-observed economy (the Central Bank treats them as typical remittances but they are de facto primary income that stays non-observed for the Central Bank, and statistic agencies in BiH that have a gap between the size of income by expenditure approach⁵ and production/income expenditure).⁶ Thanks to diaspora remittances and foreign exchanges of international financial institutions (e.g. MMF, the World Bank, and EBRD), that are given as a credit or a grant, BiH manages to survive.

In 2014 BiH⁷ had a GDP of 28.2 billion BAM. That GDP contained personal consumption (23.38 billion BAM), government final consumption (6.08 billion BAM), investment (5.02 billion BAM), and net export (-6.28 billion BAM) export (9.26 billion BAM) and import (15.54 billion BAM). Therefore, it is visible that domestic savings are negative. If we deduct consumption (private sector consumption of 23.38 billion BAM and government final consumption of 6.08 billion BAM) from the income of 28.2 billion BAM we have negative domestic savings of 1.26 billion BAM or -4.5% GDP.

Today, we can raise the question "who is being spread too thin". The answer is the government since it constantly runs budget deficits. In 2014, the government had a budget deficit of 0.61 billion BAM, which means it spent more than 610 million BAM than it collected in revenues. The private sector (e.g. households, non-profit organizations and companies) spent 650 million BAM more than it had in income. Thus, total domestic savings was minus 1.26 billion BAM (see Table 2).

It is necessary to differentiate between national (total) savings and domestic savings to understand how BiH managed to finance the aforementioned five billion BAM of investment. When domestic savings increase by the size of net personal transfers this provides us with the total size of national savings. The BiH national savings rate is 10.5% of GDP. Net transfers from abroad are taking BiH out of negative zone of -4.6% of GDP into the positive zone of 10.5% of GDP. As for other countries from the zone of negative values, Kosovo and Moldova are

⁵ What is recorded as a transfer in the balance of payments of the Central Bank represents the official remittances that are 40% less than actual remittances. Around 80% of remittances (formal and non-observed) are put into official channels through consumption, causing gaps in national system accounts.

⁶ There is a large gap between the data on remittances flows provided by the Central bank of BiH and much lower amount reported by households in household budget surveys (Oruč, 2011). We estimate that a half of these personal remittances have the origin in the non-observed economy. It should also be noted that 47.7% of the BiH diaspora live in Croatia and Serbia. This requires detail account on who, how much, where from and what remittances are sent to BiH. There is a large gap between the data on remittances flows.

⁷ Still, there is no detailed data for 2015, so illustration is based on 2014 data. There are no significant differences between these two years.

saved by remittances to an even larger extent reaching +17.7 and +17.0% of GDP respectively. In short, their diaspora sends more than BiH diaspora. The personal foreign remittances of BiH are around 2 billion BAM, and in 2014 they were 2.3 billion BAM (World Bank, 2016).

Table 2:
Savings, investment; 2014

Income	Domestic savings	National savings
<ul style="list-style-type: none"> • $Y=28.20$ • $C=23.38$ • $G=6.08$ • $I=5.02$ • $E=9.26$ • $Im=15.54$ • $Y=C+G+I+(E-I)$ • $28.20=23.38+6.08+5.02+(9.26-15.54)$ 	<ul style="list-style-type: none"> • $S=Y-C-G$ • $S=28.20-23.38-6.08$ • $S=-1.26$ • $S=-4.5\%$ 	<ul style="list-style-type: none"> • $S=I+CA$ • $-1.26=5.02+(9.26-15.54)$ • $-1.26=5.02-6.28$ • $S-CA=I$ • $-1.26-(9.26-15.54)=5.02$ • $-1.26+6.28=5.02$
Government savings	Private savings	
<ul style="list-style-type: none"> • $Sg=T-G$ • $-0.61 (=2.2\% Y)$ • $-0.61=T-6.08$ • $-0.61+6.08=T$ • $5.47=T$ 	<ul style="list-style-type: none"> • $S=Sg+Sp$ • $-1.26=-0.61+Sp$ • $-1.26+0.61=Sp$ • $-0.65=Sp$ 	<ul style="list-style-type: none"> • $Sp=Y-T-C$ • $Sp=28.2-5.47-23.38$ • $Sp=-0.65$
<ul style="list-style-type: none"> • $S=Sp+Sg$ • $-1.26=-0.65-0.61$ • $-1.26=-1.26$ 		

Source: authors' calculations based on the World Bank, the Central Bank of Bosnia and Herzegovina and Agency for Statistics of Bosnia and Herzegovina

When inflows of foreign exchanges weaken (or they are stopped by putting BiH on the black list), BiH economy is threatened by chaos or collapse. One source of those inflows, mother-bank loans to daughter-bank loans, dried out. Before the global crisis of 2008, it was a plentiful source of foreign exchange and financial sources of credit and in turn it had strong aggregate demand increase and economic growth of almost 7 % of GDP. With global crisis the economic growth of BiH virtually collapsed and since then it has had a growth rate of 1-2% per year.

If one or two larger banks were to withdraw from BiH it would cause a strong contraction of the money supply for which BiH has no antidote. Actual behaviour of foreign banks that are strengthening more non-interest income than interest bearing ones, acts as a brake on the economy.

BiH has effectively lost control over its monetary and financial system. When pounds from Mauritius are relocated to London, the foreign exchange reserves of 10 billion BAM are outside BiH (and serve only to discipline the local politicians). In addition, the banks are not under the (efficient) supervision of the BiH government. They are controlled by two banking agencies that have become mere

instruments of banks, just one step lower than their Bank Association, a pure lobbying organization. When banks whose deposits originate to a large extent from the public company's deposits decide to buy treasury bills they engage in that activity (or decide not to buy in order to corner the government, as it was the case recently).

I.2. Middle-income trap

Many countries have developed rapidly after the WWII and have become middle income countries. Few of them continued to develop and became high income countries.⁸ According to the World Bank, certain countries are stuck in “the middle-income trap”.⁹ Resources that enable high growth of countries with low income (e.g. natural resources, cheap labour force and easily absorbed technology) do not enable growth of countries with high income.

A journey from a middle income country to a high income country requires the direction of resources into highly-productive, skilled and knowledge intensive activities. The production of higher value-added goods seeks qualified workers who need to have higher wages. Due to the increase in wages the manufacturing companies in upper middle income countries often deal with the situation of not being competitive in the export markets where more efficient producers operate.

Journey from a middle income country to a high income country is based upon export-led development (i.e. the exploitation of global demand at deep elastic markets for their products). In this way four “small tigers” (i.e. Hong Kong, South Korea, Taiwan and Singapore) increased export of industrial products from 4.6 billion in 1962 to 715 billion US dollars in 2004 (US\$ in 2000). In 42 years they increased their exports by 155 times. Domestic markets could not secure that. When in 1950 South Korea followed the strategy of substitution import (“buy domestic”), it had the economic growth rate of 2-3% per year. Since the use of “export domestic” strategy in 1960s, the growth rate has jumped to over 7% per year or more in 41 years and the country has become an economic miracle (Commission on Growth and Development, 2008).

The ratio of exports to BiH's GDP is one third of GDP, while the ratio of imports is almost 60% of GDP. BiH export is twice lower than simple average of

⁸ After the WWII only 30 countries managed to pass the way from a middle income to a high income country. Five of them succeeded by 1950 and 25 after 1950 (Felipe, Kumar and Galope, 2014). In 1961 there were 101 countries with middle income, and by 2008 only 13 became countries of high income (Larson, Loayza and Woolcock, 2016).

⁹ This term was first introduced by Gill and Kharas 2007 in a study “An East Asian Renaissance: Ideas for Economic Growth.” Since then, there has been a debate about the concept which here in the case of BiH is used for diagnostic purposes while the therapy is based upon viewpoints of Commission on Growth and Development (2008) – discussed in detail in the third part of this work.

the small European transition countries. BiH export per capita is ten times lower than the export of Slovenia, Slovakia and the Czech Republic. The simple averages for European transition countries are 54% for exports and 57% for imports. It is a common sense that values of imports and export should be equal in the long run, but it is not normal and it is unsustainable to have imports double the size of exports which is the case of BiH (the World Bank, 2016). BiH has low exports due to a lack of tradable goods. Globally looking, modern economies are service-based with the aggregate production dominated by the production of services, but the international economy is based on goods trading - the total export of goods and services consists of four-fifths in goods, and the remaining quarter in services export. Those who do not have tradable goods drop out of international trade and the international capital market.

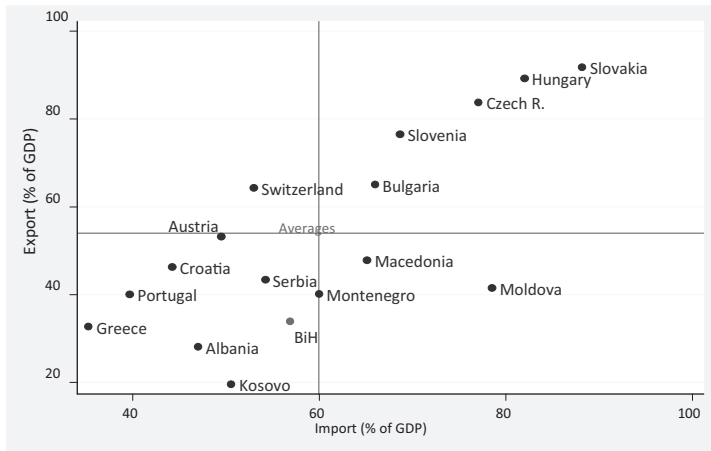


Figure 1: Export and import; BiH and comparators, 2015.

Source: authors' calculations based on the World Bank (2017)

“The middle-income trap” country is the one that stays in that state for more than the average time of retention. In the school terminology, a student who stays longer than one year in a class is a bad student, and needs to repeat the class. Argentina and Greece are the most famous repeaters in the class of higher middle income. It took Argentina 40 years (1970-2010), and Greece 28 years (1972-2000) to become high income countries. According to the World Bank, the transition from an upper middle income to a high income country lasted on average 14 years and in the case of South Korea, Taiwan and Hong Kong it lasted seven years. For 18 years BiH has been a middle income country. After two post-war reconstruction years, for 18 years now, BiH has been an upper middle income country. Undoubtedly, BiH is not going to be a good student but it is still far from being the worst one (i.e. to have Argentina and Greece syndrome).

II. How to reach effective BiH policies

Five main ingredients of high and stable development, based on the experience of countries that have become economic miracles, are: (Commission on Growth and Development 2008; Jones and Romer, 2009; Stiglitz, 2012; Lin, 2012):

1. Involvement in international economy (openness)
2. Macroeconomic stability
3. High rates of savings and investment
4. Market allocation of resources, and
5. Small, determined and capable government.

In addition, during the last three decades the prevailing view has been that the best strategies of development for small middle income countries, such as BiH, are export-led development strategies. Their main characteristics are: high investment and savings, high foreign investment, and high export of industrial products. Specifically, what high-growth Asian small tigers, which have also become economic miracles, have in common is: high saving and investment rates, rapidly improving education level, relatively moderate inflation rates and if not free trade, then at least a high degree of openness and integration with the world markets (Krugman, Obsfeld and Melitz, 2015).

Therefore, it is necessary to bring export-led strategies to all levels of BiH government. Their existence is like a light bulb in a dark room. The room can be crossed without the light but it will take time and bring along some painful bruises. Foreign trade policy of BiH must facilitate foreign trade transaction of companies and be connected with the biggest socio-economic questions of the country (i.e. unemployment, rural development, inactivity, poverty and inequality) in order to secure jobs.

Incentives for export rather than for exporters, have to be short-term (what is the purpose of a country's comparative advantage if it should be supported limitlessly!) and agnostic (country must support export without specific *benefits for* some companies).

In 1955 a development economist Arthur Lewis said that “governments are failing because they are doing too little or too much”. During the promotion of sustainable economic development the government must focus on creating the environment for economic activity which will easily introduce new undertakings.

In the most adequate way the government will adhere to market functioning and create conditions to introduce new economic activities if its intervention is adjusted to the country's comparative advantages, defined by the structure of available production factors in the current period, among which knowledge and entrepreneurship are (Lin, 2012, Stiglitz, 2012).

BiH policy makers do not support the development of competitive market. They strongly support the existence of moral hazard because it helps non-effi-

cient public companies to stay in the market¹⁰ even when they are making a loss. Some public companies are in privileged position and extract rents. For example the prices (and profits based on them) of telecom operators are high which prevents development of entrepreneurship through unaffordable production inputs and distancing telecoms from the global production frontier and it damages their legal privatization.¹¹

Policy makers should resist demands to protect activities, companies or jobs. Instead, they should protect people. The best protection that a government can offer is education and training (acquiring skills that enable people to become employed) and creating the environment which secures jobs and helps people find jobs. By respecting the solidarity principle people need to be supported when they are between two jobs by the social security. That is why the unemployment benefit exists.

In BiH the economic growth rates of less than 7% per year are not acceptable. It is necessary to increase production to improve competitiveness by 3% per year (in order to achieve Copenhagen's criteria to enter the EU) and to increase employment by 4% per year (in order to reduce mass inactivity and unemployment to prevent the collapse of health and retirement funds). Over the last 21 years no significant level of government of BiH has made clear strategies and productivity policies. Some levels of government had an employment strategy but today there is none.

BiH was on the threshold of those high growth rates in 2007 with the growth rate of 6% and in 2008 it was 6, 8%. In those successive years BiH was even close to 7%. With 7% growth rate it could reach income of 9.400 US\$ in 10 years. This would overpass today's global average, with income larger than Romania's. By increasing the growth rate to 10,5-11,0% in ten years BiH would ensure income per citizen of 12.196 US\$ (entering the group of countries with high income) (Domljan, 2014).

¹⁰ There is no study on tax expenditures in BiH (what the country will lose due to tax exemptions, exceptions, etc., because of supporting certain sectors, regions or social groups and what it will get with it), nor a consolidated balance sheet of the public sector to see when and how many losses it creates and to whose account.

¹¹ Economic privatization was carried out when the public companies became political party holdings. The profits of these "public companies" are stripped by managers and employees through payroll and uncontrolled employment, through public procurement and by the government through taxes. Citizens do not participate in business results through lower prices and better quality services. Thus, the economic situation is the same as it was in communism: working class and people do not get anything - a piece of fruit is taken by the privileged social groups. Only the terminology has changed: the company is not a "social" but "public" property.

II.1 Cities-regions and value chains, engines of economic development

BiH needs to focus on supply-side economics¹² and find engines for export and development. These could be cities-region and value chains (VCs), or even better value chains of cities-regions. Policy makers need to analyse global niches and decide where it is easiest to become technological leader and achieve economies of scale.

Cities-regions are current pockets of excellence from which excellence needs to be spread to country-wide and support BiH's fitting into the space of South-Eastern Europe and Mediterranean and gradually to the EU space. In cities-regions (Banja Luka, Bihać, Bijeljina, Mostar, Sarajevo, Tuzla, Zenica) it is necessary to support VCs where BiH has traditional comparative advantage, and where it needs to acquire that advantage, primarily in the areas of software production and creative goods.

Even though the total share of BiH economy in global export is 0.028 %, the country is struggling for global niches where the share of its leading companies is 0.10-0.70%. It takes the 20th-30th place among 100-130 countries exporters of certain products. BiH has a chance to become a leader of certain global niches.

This can be achieved with development of VCs based on large-scale companies as leaders of VCs and inclusion of large number of micro, small and medium enterprises (MSMEs) where some of them function as locomotives and others as wagons. At the same time government's support policies can grow out of policies of VCs into cluster policies. Based on the EU countries' experience the cluster policy is conducted at the regional level, even in constitutionally unitary countries (Italy), and especially in federal countries (Switzerland, Belgium). The cluster policy is conducted in BiH at the regional level.

BiH's cities-regions have rich cultural diversity which is an excellent basis for development of creative economy. Multiculturalism encourages creativity. In BiH creative economy's production and export have minor significance causing foreign trade deficit even in this field. Creative economy is an important part of knowledge economy. It has strong economic growth and employment growth in comparison to the total economy, and it is an important component of cultural identity and development of cultural diversity as a basis for modern development. Primarily based on ideas, not on capital, the creative economy leans on unlimited resources, not on optimization of limited resources such as manufacturing.

¹² It is very difficult to conduct demand side economic policy in BiH under the currency board (renunciation of monetary policy and exchange rate policy) and with a lack of institutions and instruments, and above all political interests of policy-making at the country level. Only indirect tax policy could be conducted at the macro level - direct tax policy is led at the lower (mezzo) levels.

Therefore, BiH, which neglects the export of intangible goods, needs to focus on export of creative services, business services and financial service and above all export of software and software services.

II.2 Aggressive knowledge production

Observed from contemporary industrial society's viewpoint let alone from knowledge based society and digital economy's viewpoint, BiH has an insufficiently skilful work force. Only 5.7% of citizens older than 25 have a university degree (150.000). All regional and economic comparators have relatively more educated citizens with tertiary education (both high and higher). Without the acquisition of knowledge there is no removal of the technology gap in BiH in comparison with high income countries. Insufficient number of students in BiH, especially at the Faculty of Natural Sciences and Mathematics and the Faculty of Technology, makes a fragile basis for recruitment of research-development personnel. Research-development centres are scarce in the companies (in the EU countries 60% of total number of researchers are employed at the centres of this type), so there are no preconditions for companies to be successful in product development. Globally observed BiH is among countries with the lowest innovation capacity (Nair, 2008). Due to small investments into R&D, the production and dissemination of knowledge are low (see Figure 2). Out of all comparators only Albania has the lowest knowledge production.

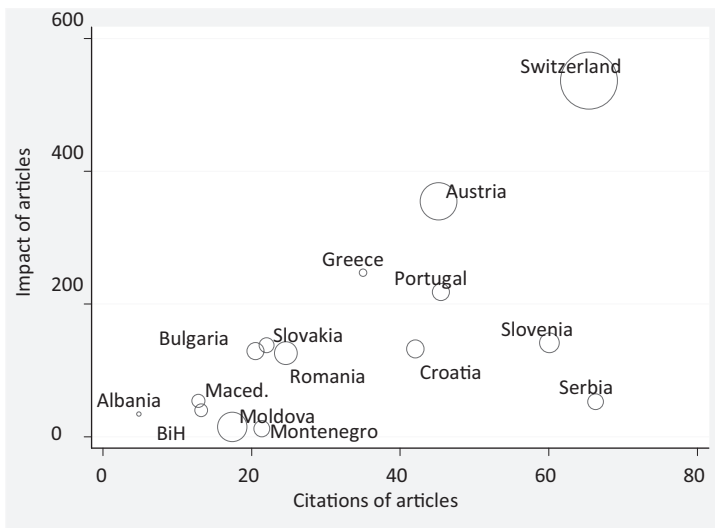


Figure 2: Knowledge production; BiH and comparators, 2013

NB: a bubble marks the county's total patent activity

Source: authors' calculations based on Dutta and Lanvin (2013)

The number of patent resident applications reported to the BiH patent authorities is lower than any economic or regional comparators and the simple average for all forms of country income groups except for low-income countries. Globalisation in BiH is lagging behind because of poor physical infrastructure (and promotion of closed society). As for the physical infrastructure, primarily it is behind comparator countries on ICT infrastructure (Domljan and Domljan, 2014). The world is becoming physically and economically more remote for citizens and companies from BiH, as it is more difficult, more expensive and more distant to travel. As the time and economic distance in Europe are decreasing, for example, in an hour or two you can get to the end of Europe. In BiH you can hardly arrive to Mostar from Sarajevo by road – but not by rail or plane.

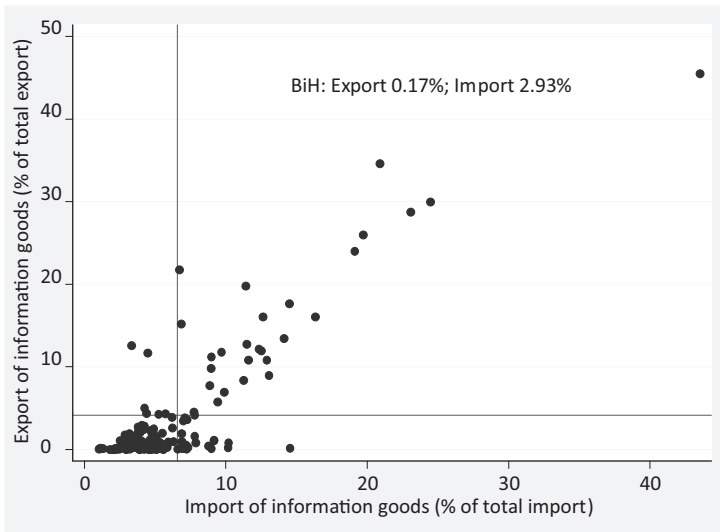


Figure 3: Export and import of ICT goods; World, 2014
Source: authors' calculations based on the WB (2017)

Today there are over 400 science parks in the world, which are already passing the third generation of development. Of course, most of them are in the United States (150), Japan (111) and China (100), which began to develop in the mid-1980s, and there are dozens in Africa. Thus, according to the International Trade Centre (ITC), e-commerce in Africa amounted to 8 billion US \$ in 2013, and it will amount to 50 billion US \$ in 2018.

The question is no longer how to ensure internationalization of SMEs, because micro-enterprises are born as global firms from the start. They use “plug and play” Internet infrastructure platform, so they can reach a global customer base and become exporters without any problems. According to the World Bank (2010), there are 125 million MSMEs, while Facebook (2016) estimates 50 mil-

lion MSMEs which use this platform, out of which 30% are foreign MSMEs. BiH must work, as quickly as possible, on the establishment of digital platforms for many reasons, and one is overreaching, namely, a very small BiH market.

II.3 Increasing savings and investment

One of the lessons from the experiences of countries that have strongly developed and become world miracles, is that there was no high economic growth without high rates of savings and investment. For example, China saved each year more than a third of income for more than a quarter of the century, but in recent years it has saved about a half of gross domestic product.

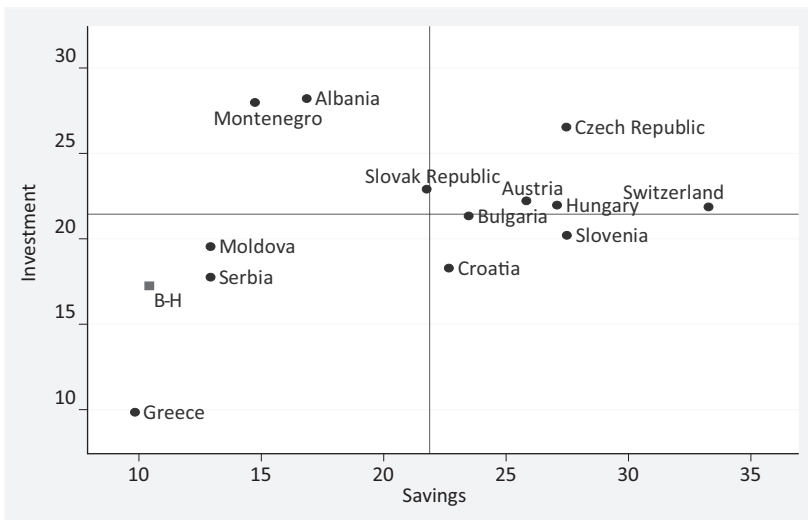


Figure 4: Saving and investments; BiH and comparators, 2014 (in % GDP)
Source: authors' calculations based on IMF (2017)

BiH has a negative rate of domestic savings, spanning from -3 to -6 percent of GDP and the low rate of overall national savings, which is about 9-13% of GDP. Global average of domestic savings is about two tenths of GDP, while BiH is among ten countries on the globe that save least. Only two European countries (Kosovo and Moldova) save less than BiH. On the other hand, BiH invested around 15 percent of GDP in the period after the outbreak of the global recession, which was significantly below the global average of nearly a quarter of GDP.

BiH has a higher rate of investment than the savings rate, which means that it is 'importing' foreign savings and the inflow of foreign capital in the size of these differences. As long as import is higher than export of goods and services, investments are financed with 'imported' savings.

II.3.1 Introduction of non-bank depository institutions

The main reason for the low savings rate and consequently the rate of investment and growth rate of GDP is the underdevelopment of the financial system of the country. There is no variety of financial institutions and financial instruments capable of mobilising resources ranging from a few BAM (micro institutions that accept deposits - in BiH it is prohibited by law) to several billion BAM (through infrastructure bonds issuances). There is no law in BiH on mutual guarantee funds, savings banks, savings and loan associations (there is a law in the Republic of Srpska), financial holding companies and credit guarantee funds for over two decades.

The World Bank research shows that reform of the financial markets provides GDP growth of two percentage points. Simply put, only a reform of the financial system and attracting diaspora funds (which, to a large extent, can mean one stone hits two birds, but in BiH it means one stone missing two birds) can beat glum rates of GDP growth of 1-2% per year (we do not know for sure what the growth rate was in 2015) to minimal 5%.

The creators of economic policy in BiH did not develop the financial system. They reduced it to five-six foreign commercial banks whose aim is (quite legitimate, there is nothing to complain about) making profit and not funding the development of BiH.

About 90% of the financial system of BiH is controlled by commercial banks, the only existing banks, with the exception of development banks that are nothing but a pocket bank of the ruling elite. Insurance companies control a half of the remaining 10% (due to mandatory car insurance), and the other half is controlled by the leasing companies and microcredit organizations.

There is a complete dominance of foreign commercial banks in the financial system of BiH. Worst of all - which did not exist even in the former communist countries of Eastern Europe, let alone in the communist BiH - is what exists in the capitalist BiH: *The law on banks prohibits non-bank financial institutions, because no institution other than a bank can collect deposits and grant loans.* There is no doubt that with the transfer of the EU legislation BiH and especially FBiH shall abolish this civilization's shame on the soil of Europe.

The Banking Act should regulate banks and abandon any mentioning of non-bank depository institutions in the law (especially regulated by banking agencies). Other deposit taking and credit approving institutions should be regulated by other, respective laws, in which, on the other hand, operation of banks should not be limited. It would be unreasonable, by using law on savings banks or savings-credit cooperatives, to limit the work of commercial, investment, development and other types of banks.

High real interest rate can be lowered only by creating competition in the financial market and inflows of funds from abroad. Extremely difficult task is to lower the interest rate, one of the most difficult in economic policy. Since 1995, in the capitalist BiH we have not seen any measure of economic policy makers aimed at lowering interest rates. What should the government do in this regard? *The correct way of pushing banks towards reducing interest rates is to reduce systemic risk and increase competition in the financial market.*

In developed economies the financial system relies on two legs - mobilizing capital by taking deposits (commercial banks, savings banks, etc.), and mobilizing capital through the capital market (investment banks, development banks, mutual funds, etc.). In BiH, the book is reduced to *an institutional letter, i.e. the commercial banks*. No savings, no development banks (in BiH called the Entity Development Bank) have ever been engaged in mobilizing resources before waiting for the funds to be allocated to them in a way funds and agencies function. Therefore, these so-called development banks cannot be called development banks because they are not bank institution at all, neither collect nor place funds through market mechanisms and instruments, etc. How is it possible to have high saving rates in BiH?

The banking mediation in BiH was effective (and banks considered it 'the best part of BiH economy', which is quite wrong, as the situation with the banking system in the Republic of Srpska clearly shows) when the mother-bank sent money to subsidiary banks, and they traded with it. In the era of Great Recession mother banks do not send money (they are committed to *the Vienna Initiative* that asks them not to withdraw) - which is not the worst part. The problem is that these subsidiary banks have almost no one to credit and they are swimming in liquidity (with a share of risky loans due to asymmetric information, an increasing number of good companies are "engaged with the enemy" while bad companies do not have the similar problem), and business sectors in insolvency.

The unfavourable general and business environment, particularly high fiscal and parafiscal burdens, are forcing the private sector to emigrate (underground or abroad) or (hopefully temporarily) to close the firm. 'Corporate-cows', organically grown and with no support, are long lasting and poorly developed while the citizens-clients can still be found in some public monopoly enterprises. But there the situation is more difficult, because the authorities succeed in putting these monopolies into losses (as Elektroprivreda and Telecom companies clearly show). Such companies, whose profits are the *spring of economic life of economy, precisely of savings and investment*, are decreasingly generated.

Competition in the banking market must be sharpened with the introduction of non-bank deposit taking financial institutions, such as savings banks. The threshold for the establishment of commercial bank should be increased to 20

million BAM, while the savings banks could be established with 10 million BAM. This would help in the further consolidation of the banking system, while the remaining banks could be transformed into savings banks.¹³

In Bosnia and Herzegovina, savings banks could be established in cities-regions, which would serve the needs of citizens and MSMEs. They could acquire 20-30% of the credit market, as in the case of the economic comparators, that is to say at least five billion BAM, thereby employing about 5,000 workers.¹⁴

According to available statistical data, today it is possible to have the savings and credit unions in 109 countries on six continents.¹⁵ Movement of credit cooperatives began with a simple idea: individuals can improve their own and other people's standard of living by putting their savings in the common pile and lending it to neighbours and colleagues.

This year, on the World Day of the credit, the first credit union in (F)BiH, Spark 1 was formed. It is called Spark 1 because it is expected that the Spark 1 will be joined by Spark 2, 3, and it will be possible to form a league of credit cooperatives, like the one developed by Desjardins in Canada. We should recall that credit unions in the country were developed by the Austro-Hungarian Empire in the early 20th century, when they had strong growth, which weakened in the era of the Kingdom of Yugoslavia and the Socialist Yugoslavia, while in the capitalist BiH they were not only extinguished but also forbidden by law.

II.3.2 Development of government bonds market

No matter how good they are, foreign banks are not able to mobilize large amounts of capital, while BiH development banks are not interested in dealing with it. The securities market is not developed. The number of potential issuers of attractive

¹³ Savings Bank, a financial institution over 300 years old, is strongly developed in Europe, but not in BiH. Modern societies adorn regional and responsible 3R retail. They are involved in retail banking (payments, savings products and loans and insurance for citizens and SMEs), since commercial banks are distinguished by the fact that they focus on the local and regional markets.

¹⁴ According to the World Institute of Savings (World Savings Banks Institute, WSBI, operating since 1924), with its members from 92 countries it shows countries where there are savings from those with low income (Burkina Faso, Guinea, Ivory Coast, Namibia, Uganda, Togo), the communist countries (Cuba, China), transition countries (Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Poland, Romania, Slovakia, Ukraine, etc.), and those 'rich countries' (Austria, France, Germany, Italy, Spain, Portugal, Japan, UK, USA, etc.).

¹⁵ It began in 1844 in Rochdale, England, and in 1849 in Germany. Today it is possible to see them in 25 African countries, 21 Asian countries, 19 Caribbean countries, 14 European countries, 15 Latin American countries, 2 North American countries and 14 countries in Oceania. They can be seen from Burkina Faso and Uganda, through Myanmar, Albania and the Netherlands to Canada and the United States. There are a total of 60,500 credit cooperatives, with assets of 1.8 trillion US \$, serving 223 million people.

securities (shares, bonds, etc.) is small. None of the other domestic players has an interest in the pump priming finance and *the government remains as the solution*.

Firstly, infrastructure bonds with maturities of 5, 10, 15 and 20 years could be purchased by BiH citizens. Citizens now have nearly five billion BAM of savings in BiH banks. There are no other possibilities, except to keep the money under 'the mattresses' as a dead capital or abroad as a placement (or, at least some of them become business angels or loan sharks). The yield on government bonds would be safer and more profitable (higher yield of bonds than from interests on bank savings). And it would be very liquid, because it could be traded in the bond market. Objectively, calculations could be intertwined by inflation, but it is nowhere in sight, nor will it be as long as the currency board functions as orthodox.

For instance it is clear that public pension funds in BiH could face a collapse unless deep structural reforms are undertaken, since citizens need security in their old age. By purchasing bonds a person can do more for his/her (healthy) child than to provide a good education, through the purchase of bonds. And as the child gets to the college and receives education, bonds will come for collection.

Investing in bonds is not only a good and safe investment for citizens, both at home and abroad, but also a good opportunity for domestic financial institutions (savings banks, which make long-term placed assets in these bonds, insurance companies, public companies, private companies and banks, etc.), which would address issues of over/under current assets by selling and buying bonds.

The infrastructure bonds would be bought, for example, in the part of the 20% of issuance, by banks, insurance companies, pension funds, mutual funds and citizens. *Banks would hold the respective bonds as a first-class, 100% secure placement, hence the provision of them would be 0%*. Also, a regulation could be adopted according to which a part of the foreign reserves at the Central Bank in excess of the coverage of 110% could be held in these bonds. In this way secondary bond market could be developed. Banks and other institutions could release excess liquidity with profitable, secure and liquid placement. This would contribute to the strengthening of the credit system because the banks, savings banks and credit unions could accept these bonds as security for loans.

II.3.3. Powerful mobilization of diaspora funds

With the appropriate policies, BiH can make significant use of its diaspora community which includes emigrants and their descendants - to support the economy. Mitra et al (2016b) found that diaspora can help raise long-term economic growth, on average, by 0.6 percent of GDP in emerging and developing home countries (Mitra, 2016a), while in emerging Europe diaspora can contribute with 1.4 percent of GDP (Mitra et al, 2016a). In the post-global crisis BiH has had

GDP growth rate oscillating around 1-2 %. Accordingly, tapping into diaspora's resources could double the GDP growth rate, which BiH desperately needs.

Table 3:
GDP; BiH, 2014-2021 constant prices (in %)

	2014	2015	2016	2017	2018	2019	2020	2021
GDP growth rate	3.2	3.0	3.2	3.7	3.9	4.0	4.0	3.2
Diaspora's potential contribution to GDP growth rate	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4

Source: Mitra (2016) and authors' calculations

IMF research shows that central and eastern European countries can increase GDP growth by 1.4% percent if they manage to attract diaspora funds. BiH could provide a higher GDP growth rate than the average for central and eastern European countries due to the abundance of its diaspora and the size of sent remittance.

II.4 Cutting public expenditure by one third

BiH must implement fiscal consolidation, i.e. remove the fiscal disorder, fiscal deficits and reduce public debt. Also, it must reduce *all types of public expenditures and introduce R&D expenditure*, increase them (at once 1%, over the next two years 2% and over another two years 3%) and strive to maintain this rate.

In particular it is necessary to review *public expenditure on social programs*. A set of measures is needed to support, starting from the introduction of ID cards (to determine who, how, how much and from whom it is received, both from BiH and outside, and to put the whole social security system under control), to political and legal review of the basis for granting aid.

It is necessary to act on public revenues (diverting taxation and contributions from labour and exports to consumption, property and imports, i.e. to implement fiscal devaluation), especially *to expand fiscal space*.

In the existing circumstances it should be necessary to pass a law that would *ban state borrowing for current consumption*. If despite everything loans are taken, this should at least prevent money from going into non-productive expenditures. Thus, the debt offspring will have infrastructure and skills.

Measurement of the effectiveness and efficiency of the public sector (of public expenditure and public companies) is very limited in BiH. It is necessary to start benchmarking the activities of these institutions, i.e. to simulate operation of the market in non-market activities.

II.5 Reduction of non-observed economy and tax evasion

Last year Association of Employers of FBiH published a Grey Book, which is based on primary research seeking to establish what drives the informal economy in the FBiH. According to employers, the main driver is fiscal burden. It comprises of 26.8% of the informal economy, followed by tax morale (23.2%), regulation (labour and other regulations) (16.5%), the quality of state institutions (14.2%), social support (6.1%) and political protection (7.9%).

In other countries, the order of drivers is almost identical: fiscal burden (35-38%), tax morale (23.2%), regulation (7-9%), the quality of state institutions (10-12%), social support (5-7%) and political protection (0%, respectively in studies for other countries this driver is not recognized as valid, while in FBiH it has some significance).

When it comes to taxes, it should be noted that in the case of FBiH the problem is the size of social contributions and the procedures for paying taxes. A large number of procedures and the number of payments require immense time and administrative work.

The tax morale is the driver as it was recently included in the survey of the grey economy. People are aware that the market can produce private goods, but not the public whose production has to be funded by the country.

The country must treat the taxpayer as a contracting party. Government is on one side and the taxpayer is on the other. If the government treats the taxpayer fairly, and if he/she sees that the government produces public goods efficiently and distributes them equitably, he/she will duly pay taxes. And it is tax morale that FBiH employers understand and appreciate as a driver of the grey economy. The calculations show that in some countries tax morale amounts to 30% of the grey economy. Reducing the tax by 1% increases the grey economy by 0.20%. Simply put, if the taxpayer does not respect the government, he/she will “manage” in a variety of ways to avoid paying taxes and at the same time will have no remorse, quite the contrary.

If the grey economy accounts for a quarter of the income of the country and a quarter of the work force, as in (F)BiH, it is clear that it cannot be eradicated overnight. BiH would achieve a great result if it managed in the mid-term to reduce the grey economy by a fifth, i.e. force it from a quarter to a fifth of GDP.

Sequence of moves must be clear, starting from the one which would cause the least social and political tensions. Firstly, it is necessary to reduce the grey payment, then to reduce the grey income and ultimately to reduce the grey employment. Few people understand that in BiH the government creates the grey economy. Everyone knows there are a number of public institutions and companies (mines, railways, hospitals, etc.) that do not pay contributions for workers. If taxes and contributions are not paid, the public entity and its workers are auto-

matically considered grey employment, grey sector and the grey economy. Also, within a range of organizations, both public and private, the part of the salary is paid as a minimum wage, and it is a formal sector to that extent. Another part of the salary is paid in cash and to that extent it is a shadow economy.

Around 3.3 billion of cash is outside the Central Bank and banks. There is no doubt that at least in part, cash payments are used in the grey economy. These flows should be stopped. It is necessary to introduce electronic payment of social benefits, to determine the maximum amount that can be paid in cash (which already exists in Bulgaria, the Czech Republic, Croatia, Slovenia, Slovakia, etc.), to use POS terminals for certain types of sectors and types of companies (which exists in South Korea), a lottery for those who picked up the bills for which VAT is paid, tax incentives for buyers and merchants who use electronic payment (e.g. the return of 0.02% VAT) which will probably be hard for the Indirect Taxation Authority, which alarmed the BiH VAT system and does not want to implement it (as seen in South Korea and Uruguay). According to EY if BiH started this way it could further increase tax revenues in the amount of 4.2 % of GDP. This is 1.2 billion BAM, which is even more than the latest arrangement with the IMF.

Note on the statistical basis for the design of policies

Superficial views of Figure 5 show that there is something wrong with BiH statistics (the strong money supply growth of 5-10% per year, accompanied by the price drop of about 1%). It would not be surprising if there were strong income growth, which is not the case: it grew at the rate of 1-3% per year.

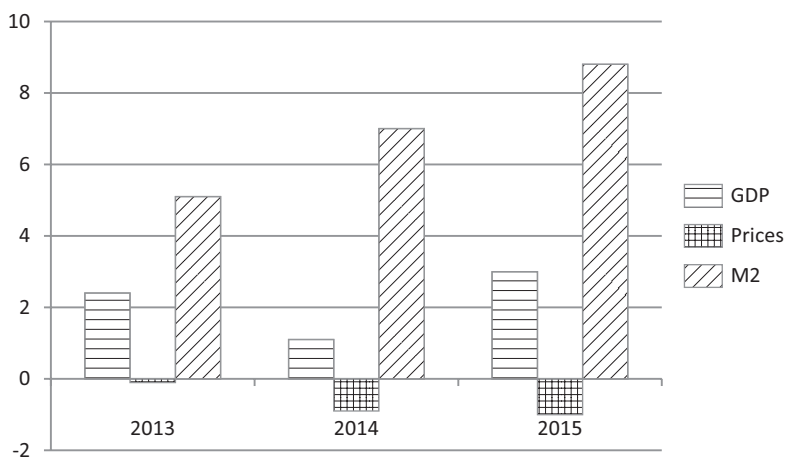


Figure 5: Real GDP, prices and money supply (in %); BiH, 2013-2015

Source: authors' calculation based on the CB BiH (2016)

One thing is certain: the statistical agencies are doing their job poorly. To what extent, we can only assume. It is possible that this is a bad calculation of *the growth rate* (i.e. the actual growth rate is higher than statistically shown), a bad calculation of gross domestic product (there is a great non-observed economy) or a simultaneous bad calculation of price and income, which is likely the case. If we accepted that the statistical calculation of the price was correct, income growth would have to be far greater than statistically shown (there is a theoretical possibility of changing the speed of velocity of money, but the economic circumstances in the short period do not change, and it is difficult to work with the strong slowdown of the velocity of money).

It should also be noted that the growth in money supply results from an increase in foreign exchange reserves at the Central Bank, because it is a currency board arrangement. Purely theoretically observed, an increase in foreign exchange reserves may happen because the country has a surplus in its relations with foreign countries. However, since 1995 BiH has had a deficit in its relations with foreign countries.

Theoretically speaking, if the country has a trade deficit, the money supply of the country is shrinking (because the country needs to pay, and in the case of BiH the import is almost double the export of goods). This should lead to rising interest rates and attracting foreign capital (in BiH it happens that interest rates are high, and despite this there is no inflow of foreign capital, nor any action of this mechanism to establish equilibrium).

Furthermore, high interest rates should cause deflationary pressure which should lead to the decrease in imports and improve the balance of payments. Reduction of the pressure of buying funds to selling funds would lead to reduced prices and the depreciation of the real exchange rate, which would lead to the growth in exports and reduction in imports. All this should lead to an increase in production to the level of full employment and an increase in exports. Finally, the current account deficit should be eliminated and the economy achieves an internal and external equilibrium.

Only something of this happens in BiH in practice. Enormous unemployment and inactivity of the work force means that there is no establishment of internal equilibrium, economic growth rates are low and the current account deficits are high. No one knows how big the deficit of the public sector is since there is no consolidated balance sheet. There is no doubt that it is vast, because the moral hazard is equal to the communist times (as seen in the vast and uncovered losses of public companies). However, the price level is stable (at least there is no statistically expressed rise in prices) and that is the result of the currency board in BiH.

According to the currency board system, foreign exchange reserves need to grow with foreign trade surpluses and to fall with deficits, leading to price chang-

es and interest rates changes. However, in BiH foreign exchange reserves grow along with the deficits in the current account. Now the question could be raised whether the balance of payment given by the Central Bank of BiH is correct. It is obvious that it is not, and the reason is simple: the official balance of payments greatly underestimates the foreign currency inflow. Primary and secondary incomes are much higher than it is officially stated. The export of goods and services is higher than it is officially presented (the non-observed economy is high) and personal remittances are higher than officially reported.

It has already been shown that, due to personal remittances, the negative rate of domestic savings turns into the positive overall (national) savings rate. Now it can be said that these savings, both local and national, should be increased, especially when connected with the investment, which greatly exceeds the savings and there is no abundant inflow of funds from abroad.

In this work, we cannot go into the discussion on these issues, but we indicate them, because they are of a great importance for the evaluation and the design of economic policies.

Conclusion

To solve the problems BiH economy is facing, fundamental reforms which require wide participation of citizens are necessary. Reforms will have its losers (privatizers of social ownership, public sector employees, and recipients of public support) and winners (exporters, the unemployed, etc.).

The reforms are not implemented because political rulers do not change the existing institutional arrangements with a consensus (i.e. do not build unity without imposing). Therefore they rely on ‘institutional doubt’, (i.e. the right of veto when they are a minority) and thus block the organized (institutional) induction of institutional arrangements. Ruling parties act in the interest of the parts of the ethnic groups, and not in the interests of the broader social classes. They deal with issues of distribution, not the production. The period from 1995 to 2017 has been the period of defective economic policies.

Effective policy, the one that is able to mobilize the factors of production, must be based on the creation of enterprises. Only that can save from the “curse of unemployment” (Keynes). Development is associated with high rates of appearance and disappearance of enterprises, (i.e. with high rates of turbulence and related reallocation of resources from unprofitable to profitable activities and companies).

The Dayton peace agreement does not inconvenience the regional authorities to develop an entrepreneurial economy. For the development of traditionally managed economy the key level of national economy and modern economic

management is crucial to regional development, especially in BiH where (volens-nolens) central institutions and central instruments are non-existent or ineffective.

BiH will only be on its way of becoming a high income country if it activates the chain of knowledge production: *the production of ideas - conducting research (testing ideas) - increase in knowledge stock - the commercialization of knowledge (i.e. innovation) - increase in productivity - increase in competitiveness - export increase in higher added value - increasing the standard of living.*

BiH needs to radically cut parts of public expenditures rather than those in the R&D and productive physical infrastructure. It must introduce an aggressive innovation policy because it ensures the production of products with high technological content. Currently, their share in total exports of BiH industrial products is 2% or US \$ 21 per capita. Among European and transition countries only Albania has worse result (though for 10 of them there is no indication).

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