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**CURRENCY BOARD IN BOSNIA AND HERZEGOVINA
Course: Finance**

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What is the currency board system?

The currency board is arrangement with a fixed exchange rate that is tied to the currency so called "anchor", gold or even to a basket of currencies, where all the money in circulation can be freely converted into the reserve currency, and where the main action of the central bank is clearly defined in the law about the central bank. It is based on following strong rules:

- Cover of emissions of the national currency is stable foreign currency (reserve currency) in minimum amount of 100%;
- At any time, the national currency must be convertible to a stable foreign currency, to which it is attached;
- Maintaining the stability of the currency is the first and primary objective of currency board system and all other objectives have to be subordinated to the primary objective.

Currency board and monetary policy in Bosnia and Herzegovina

Currency board system started in Bosnia and Herzegovina in 1997 when the Central Bank of Bosnia and Herzegovina (further CBBH) started its operations. For the acceptance, introduction and functioning of the currency board system in many countries there are different conditions, factors such as: the economic and political instability, a very soft budget constraints and the prospect that the instability continues and intensifies with repeated and with the effect of permanent growth of inflation. At the moment when the CBBH started working, in August 1997, there were four currencies in the state (BiH dinar, Yugoslav dinar, Croatian kuna and Deutsche mark). Only the Deutsche mark was generally accepted transaction currency across the entire country. There were around 75 commercial banks but most of them were very small, none of them operated over the whole country. There were three payments bureaus, each of which had a monopoly on non-cash payments in the territory it covered. All this shows that financial and monetary system were very fragile but main reason why currency board was needed in Bosnia and Herzegovina was that country was in the hardest transition ever. Bosnia and Herzegovina was facing transition from: 1. war to peace; 2. socialist command economy dominated by the state to a market-oriented private sector economy; and 3. being a part of a larger nation to being an independent country with its own democratic and administrative institutions.

Also, introduction of currency board had two motivations. First, it provides a firm nominal anchor in the form of a fixed exchange rate which was crucial for the very uncertain post war economic situation. Another thing is that currency board is a rule-based approach to monetary policy that took into account the difficulty of establishing institutions and making political decisions in the complex political environment that existed after the war.

Currency board was the most appropriate tool for CBBH to control monetary policy and because of that there are three crucial features of the currency board which are specified in the CCBH Law. Those features are: 1. fixed exchange rate (the convertible mark (BAM) was tied to Deutsche mark at a fixed exchange rate of 1:1 and now it is tied to the Euro at the same rate as the Deutsche mark has been- 1.95583 per Euro); 2. full foreign exchange backing, which means that the domestic currency liabilities of the CBBH have to be fully backed with convertible foreign assets; 3. full convertibility, so the CBBH has to be prepared to exchange BAM for Euro at any time for any amount.

Is the currency board in Bosnia and Herzegovina efficient?

From today's perspective can be said that the CBBH has achieved significant results in the period of its existence. In 1997, when the CBBH introduced convertible mark (BAM) was as the

national currency in Bosnia and Herzegovina economic space was divided, connection between entities broken, and the economy devastated. CBBH managed to implement a unified monetary system and to suppress the use of the currencies used in cashless payment transactions. After that, BAM became the only legal currency. Another important success has been achieved in the area of price stability. Inflation dropped from 13.4% in 1998, to 3.7% in 2005 and from the end of 2013 Bosnia and Herzegovina has deflation as a numerous countries in the world. Also, in the first five years of the currency board deposits have doubled and participation of domestic deposits in total deposits went from 16% to 45%, while foreign direct investments have been increased significantly. Registered foreign direct investment in the period from 1994 to 1997 were 83.3 million, and at the end of June 2010, the Ministry of Foreign Trade and Economic Relations has recorded a total of 7.6 billion US dollars of foreign investment. Because of this, foreign exchange reserves went from 127 million BAM, in August 1997, to 7.7 billion BAM, in August 2014. During all this time, the CBBH fully committed one of its core functions, achieve and preserve the stability of the domestic currency, while the external stability was ensured with successful maintenance of a fixed exchange rate and regular servicing of external debt of Bosnia and Herzegovina, where the CBBH performs the role of fiscal agent.

Currency board achieved undoubted results but still opponents of the currency board in Bosnia and Herzegovina believe that country should abolish the limitations of the currency board and establish a classical central bank in addition to use other monetary policy instruments, not only obligatory reserves, including the ability to create money without backing in foreign currency or gold. They believe that the currency board is a key problem of economy stagnation and that the classic bank would provide better solutions for economic development.

On the other hand, there are arguments for preserving the status quo until further notice. First, is the fact that the banking sector does not have liquidity problems because commercial banks hold required reserves and additional two billion marks in the CBBH so that in absence of quality projects they can place these funds without high risk. Another thing which supports keeping the currency board is difficult economic situation with budget deficits at all levels of government, which are mainly covered with loans from the IMF and emissions of short-term securities, and an unbalanced balance of payments and the high rate of unemployment which increases demand for social welfare from the state. In these circumstances, the central bank with discretionary powers would be under pressure to finance government and social needs by creating money.

The transition from the existing model of the classical central bank would enable the manipulation of the money supply and nobody can guarantee that the country would not enter into a phase of uncontrolled growth of inflation, which could further jeopardize the already low standard of living. There is a possibility of correction rate of BAM in relation to the euro and a possible decline in value of BAM would certainly lead to an increase in external debt. Therefore, the decision to change the existing model is big and delicate.

Conclusion

From the appearance of currency board until today there have been global debates about should it be abandoned or not. Attitude of CBBH is that it is not time for Bosnia and Herzegovina to abandon it, but it does not mean that there should not be debates about it. Also, examples of Estonia, Bulgaria and Lithuania show that the currency board is not an obstacle to European integration, which is one of the main goals for Bosnia and Herzegovina. In the end, efforts should be directed towards creating a climate for accelerated growth through appropriate reforms in the area of fiscal policy and other reforms aimed to encouraging investment in the real sector.

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