

The Role of Monetary Policy as the Foundation of Economic Development in Bosnia and Herzegovina

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Abstract: *Macroeconomic stabilization of every country depends largely upon the conduct of appropriate economic policy, which comprises both fiscal and monetary policy; therefore, it is of great importance to choose the most adequate and productive ones. Many countries across the board have employed monetary policy in their attempt to ease the consequences of economic crises in the aftermath of global financial meltdown, and in the search for sustainable economic development. This paper was confined to the monetary policy in Bosnia and Herzegovina specifically, and its aim was to address the current Currency Board Regime along with the available monetary policy instruments and to determine whether an opportunity for the improvement of economic growth and consequently economic development lies within it. The importance of Central Bank was stressed out, as it represents the anchor of the monetary system. The paper comprises the analysis of the implemented CBR, its brief history, monetary policy instruments available and its consequences on the economy of B&H and based on that, the recommendations for exit-strategy which, ceteris paribus, represent a key to achieving higher levels of development. The economic indicators suggested that macroeconomic performance under CBA is not advantageous for B&H; therefore, it is thought that abandoning the arrangement either by joining the EMU or by making the Central Bank more independent is necessary.*

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Introduction

Every country, in order to achieve macroeconomic stability, full employment and improved living standards for its citizens, faster economic growth and consequentially economic development needs to conduct appropriate economic policy. Government has three instruments to achieve objectives of economic policies in a certain nation, namely investments, direct government and by state owned enterprises, as well as fiscal and monetary policy. An important part of every country's economic policy is therefore monetary policy, whose aim is, by influencing the availability of credit and cost, to stabilize the prices, exchange rate and amount of money in circulation, to control inflation and maintain equilibrium of balance of payments.

Monetary policy actions need to adjust to changes in the financial systems of countries, which happen regularly. Therefore, the model of managing the monetary policy has to be chosen with a lot of care.

The use, influence and objectives of monetary policy have changed in the aftermath of the global financial crises and consequent global recession. One of the heritages of the seventies was the fear of high inflation that devours the value of everything in a single economy. This fear was multiplied in countries of the region by hyperinflation of the eighties. The terror of inflation has left much of the world with the primary concern with general increase of prices for monetary policy. However global crises caused triggering the concept of easy money through what was later called monetary easing, with primary goal of revitalizing stumbled economic activities without any fear of overheating the economy with possible inflation. The paradigm has hence changed; monetary policy no longer targets levels of price at least not as its primary concern, but unemployment and other economic malaise produced by economic crises and attempts to assist together with other instruments of economic policy in achieving economic development.

The subject of this paper is the monetary policy and its instruments, especially in Bosnia and Herzegovina, and it being the potential for achieving economic development. Throughout the paper, the importance of Central Bank will be highlighted as it represents the pillar of monetary system and is the holder of monetary policy. The method which will be used to serve the aim of the paper is a combination of modelling method, inductive method and Delphi method.

Furthermore, the task of the paper is to address the Currency Board and to present possible changes in monetary policy that potentially could be the key to achieving faster growth and enabling the country to become economically stable.

Literature review

The topic of Currency Board Arrangement (CBA) has been used as a main research topic for many years, since many countries, at either same time or at different points in time, have experienced currency fluctuations and consequently financial instability and since currency boards have been existing for more than 150 years. The CBA was also the cover topic of most prominent economic newspapers, including *The Economist*. The most prominent study of currency boards was by Hanke and Schuler (1994) who provided with a comparison of currency boards versus central bank regime, highlighting benefits and disadvantages of each. Comparative statistics and formal econometric analysis of Gosh, Gulde and Wolf (1998) confirmed that, historically, currency board arrangements have achieved better performance and better results than any other fixed exchange rate regime (Fabris & Rodić, 2013). In addition, it has been found, through statistical and econometric analysis of Gulde, Julia and Keller in 2000, that the performance of inflation has been significantly better, meaning lower, and higher growth has been achieved under currency boards than under floating exchange rate regimes (Gulde, Julia, & Keller, 2000). Holger C. Wolf in his book “Currency Boards in Retrospect and Prospect” gave a synthesis of many different studies on this topic, focusing on the early forms of currency boards, the example of Argentina, stating that its disinflation success could be because of the CBA, but at the same time the CBA, with the lack of fiscal discipline, was the cause for financial crisis that happened afterwards. The third part of the book was devoted to explaining the most recent currency boards, including B&H’s CBA as the youngest, i.e. the last one implemented. It has been argued that despite different reasons for its implementation, European currency boards had the same objective of eventually abandoning it in order to be accepted into Eurozone membership (2008). As regards to the CBA in B&H topic, not much literature is available. The former Governor of the Central Bank B&H Kemal Kozarić presented an overview of the monetary policy regimes, with the review of the CBA currently implemented, and thereby stressing its advantages out (Kozarić, 2007). In addition, both Kovačević Dragan and Ivona Kristić have the same view on the effects of CBA on B&H’s economy, thereby emphasizing the stability achieved with the fixation of local currency. However, other literature, including the paper “Understanding of the Currency Board System in Bosnia and Herzegovina” by Ferizović Mersud and

Ferizović Naida accentuate that CBA has been beneficial in the immediate postwar period for B&H, but however it needs to be restructured so that the increased competitiveness of the country can be achieved.

Current Monetary Policy of B&H: The Currency Board Regime (CBR)

Bosnia and Herzegovina has the Currency Board implemented as the monetary policy regime, and it limits the authorities of the Central Bank.

Currency Board is an arrangement in which the domestic currency is with a fixed exchange rate tied to another currency which represents the “Anchor”, gold or to a basket of currencies where all the money in circulation can be freely converted into reserve currency and where the functioning of the Central Bank is clearly prescribed by the Law on the Central Bank. Currency Board functions by the rules of passive monetary policy and it lacks the ability of implementing basic monetary policy instruments. However, it is known by its simplicity, transparency and precise rules (Kozarić, 2007).

Brief History of the Currency Board in B&H

Establishment of the Currency Board was built as Annex 4: Constitution into the Dayton Peace Agreement, which was initiated and concluded in Dayton, Ohio, United States on 21st November 1995 and it was officially signed 14th December 1995 in Paris (Fabris & Rodić, 2013).

Article VII of the Constitution appointed Central Bank of Bosnia and Herzegovina (CBBH) as the only authority for conducting monetary policy throughout Bosnia and Herzegovina and with the approval to issue currency. In addition, it is stated that only Parliamentary Assembly could give the authority to Central Bank to extend credit by crating money, but only after six years since the adoption of the Constitution pass (OHR, 1995).

Main motivation behind the implementation of Currency Board was the complex political situation in B&H, which made decision-making on political issues, on a single level, very difficult (Kozarić, 2007). Moreover, other reasons that contributed for adoption of such regime were: great division of the society, two entities and four currencies in circulation: Yugoslav Dinar, Croatian Kuna, Bosnian Dinar and German Mark.

However, Currency Board, as a model of managing the monetary policy, was not immediately adopted, because the Bosnia and Herzegovina was in a transition period from war to peacetime economy, from planned to market economy and from the status of the former Yugoslav Republic to an independent state with its monetary sovereignty, territorial integrity and political independence, which took time to happen (Kovačević, 2003). Therefore, the implementation occurred on 20th June 1997 under the assistance of International Monetary Fund (IMF), when the Central Bank of Bosnia and Herzegovina was established. In addition, the Convertible Mark (KM) was formed as a domestic currency, which was convertible on demand first into Deutsche Mark and after the adoption of Euro, into Euro (Gedeon, 2009). The fixed exchange rate by which KM was converted into Deutsche Mark and is now converted into Euro is set by the Law on the Central Bank of B&H. Article 32 of that Law states that the official exchange rate for the currency of Bosnia and Herzegovina is going to be one Convertible Mark per Deutsche Mark, or as of 1st January 2001, KM is pegged to the Euro at the exchange rate: one Convertible Mark for 0.511292 Euro, or one Euro for 1.955830 Convertible Marks (CBBH, 2002). The KM exchange rate against its anchor currency has not been altered since when it was first set by Law in 1997, and it is fixed nominal variable which influences inflationary expectations of the public (Centralna Banka Bosne i Hercegovine, 2015). The fixed exchange rate was important for the implementation of Currency Board, since its aim was to ensure economic stability in an extremely disordered postwar economic environment for Bosnia and Herzegovina, by providing solid nominal exchange rate of the domestic currency and by establishing the credibility of the Central Bank.

Main Elements of the Currency Board

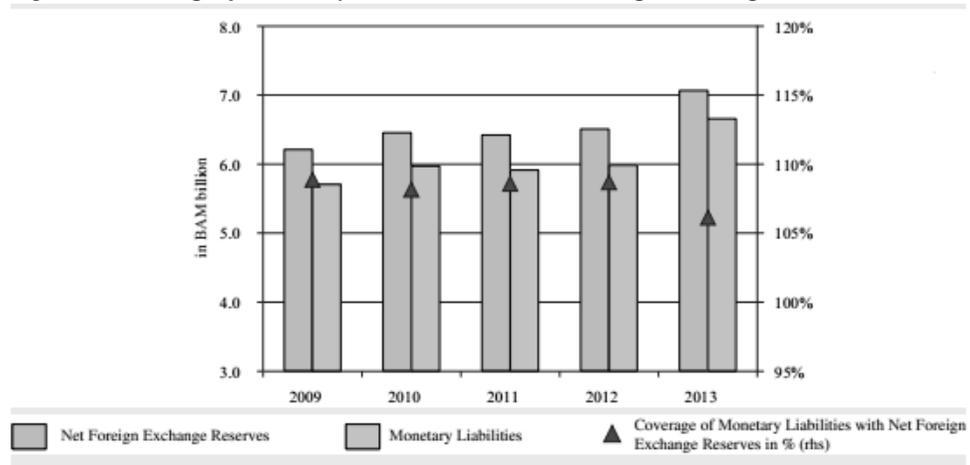
Currency Board in B&H is very transparent and is characterized by four main elements: automatism, convertibility of the domestic currency, political and financial stability and credibility.

Automatism refers to endogeneity of money supply and the self-regulation of monetary system. It is thought that domestic money supply is going to endogenously adjust to changes in the balance of payments (BoP), which represents imitation of self-regulatory mechanism of the gold standard.

Moreover, convertibility of the domestic currency means that the domestic currency is always ready to be exchanged for the anchor foreign currency at a fixed exchange rate, and also for other foreign currencies as well. In addition, KM is fully backed up

by foreign assets reserves. Therefore, any increase in the money supply can be solely provided by increasing reserve currency in the same amount. This means that the Central Bank needs to hold reserves, which are high-quality, interest-bearing securities denominated in reserve currency, of at least 100% as set by Law; however, the Bank usually holds 105-110% as to be protected in the case of interest-bearing securities losing value.

Figure 1. *Coverage of Monetary Liabilities with Net Foreign Exchange Reserves.*



Source: CBBH

Figure 1 represents the coverage of monetary liabilities with net foreign exchange reserves in the period from 2009 to 2013. During the period, the rule that net foreign exchange reserves, which include foreign currencies, gold or securities issued abroad and denominated in foreign currency less foreign liabilities of CBBH, need at all times to fully cover monetary liabilities in Convertible Marks, which include all bills and coins in circulation, the balances in commercial banks' reserve accounts and other deposits with the CBBH, has been respected. The coverage in 2013 was approximately 106%.

Since the Central Bank under CBR cannot create inflation, is protected from political pressures, makes interest rates to be lower and provides currency stability, the Currency Board Arrangement (CBA) establishes political and financial stability of the country. In the case of Bosnia and Herzegovina, it imports monetary policy from the European Central Bank, and interest rates as well as inflation closely track those in the anchor country.

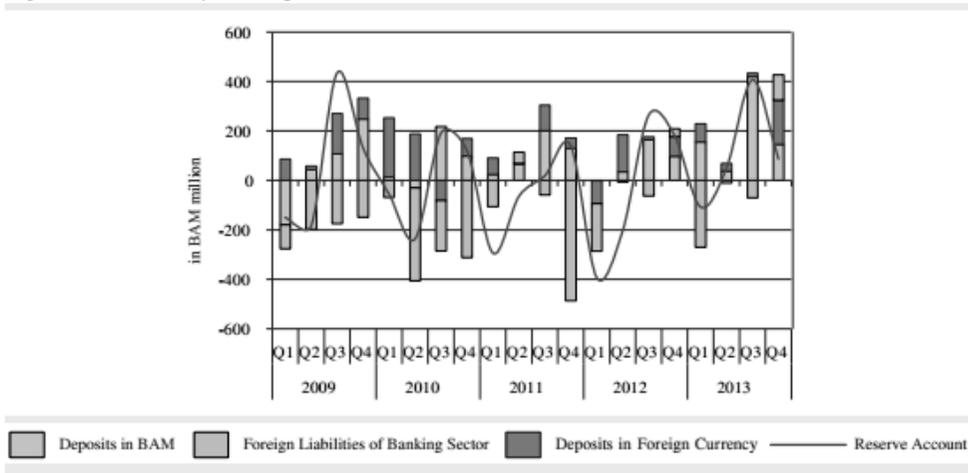
However, Currency Board, although an efficient measure for stabilizing the level of inflation in short-term, limits monetary authorities to finance budget deficit and their possibilities to give support to banks that have liquidity problems. Therefore, the Central Bank of B&H could not and still cannot act as “lender of last resort” and cannot use the exchange rate as means for recovery from economic shocks (Savić & Savić, 2011).

Monetary Policy Instruments of CBBH

As stated in the Law on the CBBH a under chapter IV on Monetary Functions and Operations of the Central Bank, The CBBH is not allowed to engage in any money market operations which involve securities of any type (Monetary Functions and Operations of the Central Bank, 1997). In addition, it takes over the monetary policy of the European Central Bank and acts as a passive agent in order to achieve its primary task of obtaining the stability of EURO-KM parity. However, the Central Bank of Bosnia and Herzegovina has one monetary instrument available to carry out economic policy goals and influence monetary movements, and that is the level of required reserves. The Governing Board of the Central Bank requires that banks hold the deposits with the Central Bank at minimum level of between ten and fifteen percent of their deposits and borrowed funds. Required reserves are calculated as average daily reserves over ten days period. Moreover, the amount of funds in the reserve account with the CBBH determines the amount of money in circulation.

The first time that CBBH used mandatory reserves as monetary policy instrument was in June 2003, when it decreased required reserve rate from 10% to 5%. However, in the next year the CBBH increased the rate up to 7.5% in September and to 10% in December and kept increasing it in order to eliminate high current account deficit as well as high credit growth (Kristić, 2007). Furthermore, since the effects of global financial crisis were also felt in B&H banking sector in 2008 and 2009, especially in terms of banking sector liquidity, the CBBH Governing Board decreased the required reserve rate from 18% to 14% in late 2008, and again it was reduced in 2009 to 10% for liabilities with a maturity over one year aiming to improve overall liquidity and economic activity by encouraging lending (CBBH, 2009). In 2010 the rates did not change; however, in 2011 the required reserve rate for maturities over one year was reduced to 7% as well as the required reserve rate for maturities up to one year, which then was set at 10%. From the base for calculating reserve requirement the value of government deposits for calculating development projects was excluded. Moreover, during 2011 significant loosening happened, which created conditions for monetary expansion (CBBH, 2011).

Figure 2. *Quarterly Changes in Bank Liabilities and Reserve Account with the CBBH.*



Source: CBBH

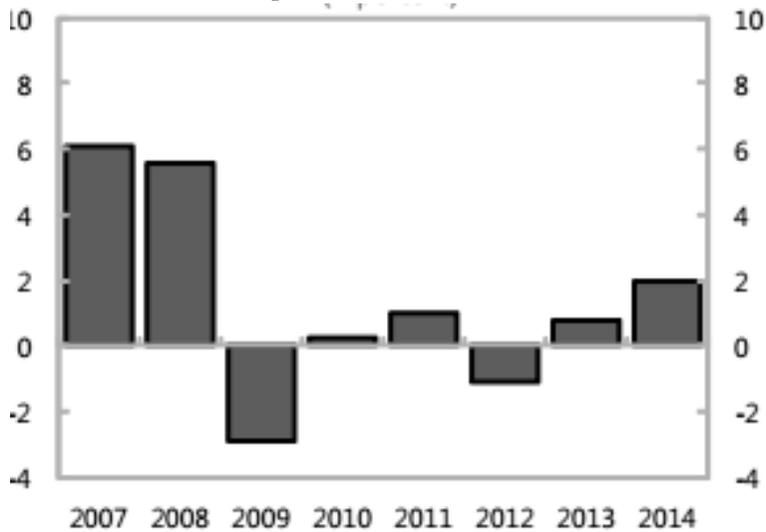
Figure 2 above represents the changes in reserve account, resident deposits and liabilities to non-resident over the 5 year period. It can be observed that deposits by residents have increased significantly as an aftermath of the growing public debt, whereas liabilities to non-resident have been reduced. In 2013, when B&H's economy experienced slight recovery from previous shocks, the base for calculating reserve requirement has been raised, and the surplus funds held with the CBBH that exceed the required reserve were also increasing (CBBH, 2013).

Selected Economic Indicators in B&H under the CBR

As previously mentioned, Currency Board Arrangement has roots in classical paradigm and it is assumed that domestic money supply adapts endogenously to changes in the balance of payments, meaning that maintenance of financial equilibrium and restoration of full employment and the balance of payments occurs through self-adjustment of national price level and the free flow of specie. It is thought that when consumers trade domestic for foreign currencies, the current account deficit will reduce the monetary base. This further causes an increase in the interest rates, a decline in the aggregate demand and a depreciation of the real exchange rate. The contraction in the money supply also reduces labor demand and the demand for other factors of production and that in turn reduces country's prices relative to other prices (Gedeon, 2010). This indicates that macroeconomic performance under CBR is not beneficial for the development of B&H.

Recent data suggests that economic activity in B&H modestly continued to increase; however the growth in 2013 was very low and it counted almost 1 percent, which can be observed in Figure 3. Because of the limitations of the CBR, and the Central Banks' inability to act as a "lender of last resort" and to influence the exchange rate, the growth in 2014 was projected by the IMF at around 2%, but based on the unofficial data it is even smaller than in 2013, namely 0.7% (International Monetary Fund, 2014).

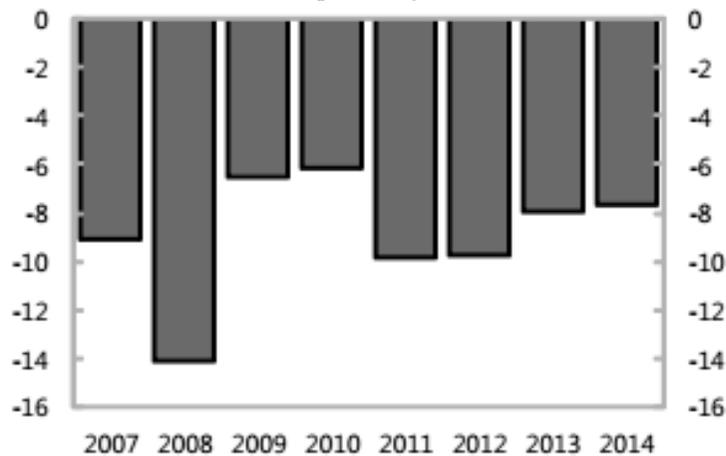
Figure 3: *Real GDP Growth (in percent).*



Source: IMF

Furthermore, the current account balance remains negative throughout the years, reflecting the fact that Bosnia and Herzegovina, because being unable to print money on its own and collect revenues through open market operations, is net borrower from the rest of the World, especially from the IMF. The negative current account balance can be seen in the figure below (International Monetary Fund, 2014).

Figure 4: *Current Account Balance (in percent of GDP).*



Source: IMF

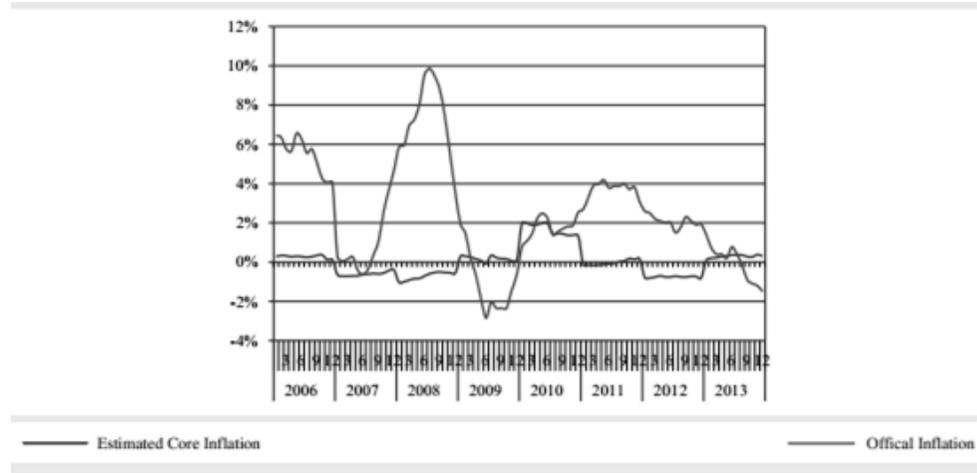
Figure 5 is a graphical representation of the official and estimated core inflation, measured by the consumer price index, in the period from 2006 to 2013. The data was extracted from CBBH reports, with the cooperation of Bosnian Agency for Statistics (BHAS). Fluctuations in the official inflation can be observed; however, from 2011 slowdown trend in inflation is present due to the deflationary pressures. In 2013, Bosnia and Herzegovina experienced deflation; although, because of the low purchasing power of consumers, domestic demand was very weak.

Monetary Policy as the Key Foundation for Economic Development in B&H

Although the Currency Board Regime provides financial as well as political stability to the country by prohibiting the interference of the politicians and by curbing the inflation, it is at the same time disadvantageous for Bosnia and Herzegovina. Its benefits and efficiency could be seen in the period since its introduction; however, after continuous implementation of this arrangement researchers concluded that it is extremely harmful for the country since it leads to overvaluation of the domestic currency and the current account deficit is double that of countries with floating exchange rates (Fabris & Rodić, 2013). In addition, it does not give the authority to the Central Bank over monetary policy instruments, except for the required reserves. The present deflation is beneficial neither for the suppliers nor for the consumers, since it reflects low purchasing power and weak domestic demand and it could even

lead to the deepening of the recession. Moreover, as previously seen, Bosnia and Herzegovina is having difficulties in achieving even modest growth rate. Although, there is widespread understanding that discretionary monetary policy is not the best sustainable option for countries in transition. Further, CBA mechanism cannot prevent crisis in the banking sector, so consequences of such event can have disastrous effects on a country's economy. Frederic Mishkin (2007) stated that: "The longer the currency board stays in existence, the greater the likelihood that there will occur a sufficiently large shock that leads to its collapse."

Figure 5: *Official and Estimated Core Inflation.*



Source: *BHAS and CBBH*

Having this in mind, in order for Bosnia and Herzegovina to achieve economic growth, and consequently economic development, it should develop exit strategy from the Currency Board Arrangement.

The CBA is considered as a gold-standard in modern monetary system. Furthermore, it served as a stabilization device. However, since it was supposed to remove immediate causes of financial instability, now its abandonment represents the foundation of economic development in B&H. Delphi method, combined with previously used method of analysis, were used to present how changing the current monetary policy regime of B&H could help it achieve better level of economic development.

B&H could theoretically exit from CBA by imposing a central bank regime with autonomous monetary policy and the ability to conduct open market operations or by joining European Monetary Union in order to achieve progress in its economic performance. One has to bear in mind that whatever monetary policy is chosen, in order to provide positive results, appropriate fiscal policy should as well be conducted (Avramov, 2000).

Abandoning Currency Board as a monetary policy of B&H could involve two or three stages, as was the case with Lithuania and Argentina and should be done in times when things are going well so that the smooth transition is feasible (Kozarić, 2007).

First, it is necessary that the monetary conditions for the monetary reform are created, and that can be done by intervening in the primary market for securities. This means that the possibility of transaction of securities between commercial banks should be introduced, as well as the possibility of issuing notes and Lombard loans which were not in use (Kozarić, 2007). In addition, money market would be transparent and the communication between its operations would be prompt. Improving inter-bank communication, designing money market instruments and infrastructure represent essential precondition for introducing open market operations. Open market operations are significant as they steer interest rates, signal monetary policy viewpoint and manage liquidity.

Second, the Central Bank needs to replace Currency Board system and it has to be sufficiently independent so to pursue long-run objectives such as price stability and monetary policy, and instruments other than required reserve have to be introduced. It is important that the Central Bank is independent and isolated from political pressures in order to efficiently achieve its goals and conduct its operations (Mishkin, 2007). This aspect of independency from shortterminism by politicians can be achieved by introducing member in the Board from ECB with veto rights in voting. Operational decision making would be left to domestic actors. Important advantages that B&H could have from independent central bank are the possibility of monetization of deficit and the CBBH having the function of “lender of last resort”. If B&H’s central bank gains the right to print money, then quantitative easing could be chosen. Given the assumption that CBBH could print and create money, it could buy bonds from financial institutions which would reduce the interest rates, further leading people, as well as businesses to borrow more which means they will spend more, create more jobs and thereby boost the economy.

With the independence of the Central Bank, which already is in force, B&H could choose a somewhat complex way of conducting monetary policy, and that is inflation targeting. In order to adopt inflation targeting, B&H should develop its financial markets and establish a reliable system of measuring inflation. Monetary instruments that would be used in conducting the monetary policy are short-term interest rates and control of the credit. This would further lead to changing fixed exchange rate with floating one, so that CBBH would be able to intervene in the market when it is necessary to ensure stability and avoid inflation (Kozarić, 2007). Floating exchange rate is more efficient than a peg and more important in determining the long-term value of the currency and for creation of the equilibrium in the international market. A gradual move from the almost orthodox CBR to a central banking system would return full monetary sovereignty to CBBH.

In addition, great importance in the development of financial markets should be devoted to repurchase agreements. By establishing this money market instrument the way to a broader market development would be alleviated. Monetary instruments available to CBBH must be efficient in controlling overall monetary trends and they must improve, or at least allow, the establishment of market-oriented financial system. These instruments need to be compatible with the financial system within which they will work (Savić & Savić, 2011).

For example, CBBH decides to target inflation at a certain low level in order to achieve sustainable economic growth. This could be done by a monetary policy decision which lowers interest rates and therefore also lowers the cost of borrowing. The result of such action would be higher investment activity as well as consumer spending. The expectation arising from lower interest rates that economic activity will strengthen, may cause banks to ease lending policies. Stocks become more attractive for purchase and they raise households' financial assets. This in turn boosts household and business spending. In addition, with lower interest rates, domestic currency depreciates, imports become more expensive so the domestic demand increases. Combining these factors lead to an increase in output, employment and consumer spending, helping country to achieve higher level of economic development.

On the other hand, if the abandonment of CBA is done in order to join the European Monetary Union, benefits are fewer than when imposing a central bank regime, yet still significant. By joining the monetary union, B&H would not have to give up independent monetary policy, since it already has given it up and it imports

one from the European Central Bank. However, there would be no more exchange rates between the members of the Union; therefore competition would be higher, prices would be lower and because of the greater price transparency international trade and investment would increase, causing B&H to move up on the latter of economic development. This would in turn lead to greater global status as well as greater political integration and influence in international affairs (Dolphin, 1995).

If Bosnia and Herzegovina abandons Currency Board Arrangement, it could gain control over its monetary policy, and by having all monetary instruments at disposal it could substantially achieve greater level of development.

Conclusion

There is no universal model of monetary policy that could bring benefits and economic development for all the countries of the world. Monetary policy's main goal is to achieve price stability, full employment and to balance the BoP.

In Bosnia and Herzegovina particularly, the monetary policy under the Currency Board Arrangement has helped the country to achieve price, financial and political stability; however it seems like in the current stable environment it does not help it develop. Therefore, the importance of this research lies in the fact that if the proposals were implemented, B&H could move forward and become more economically stable country. Current situation of the state of monetary policy seems much outdated especially since dominant paradigms across the board have changed targeting economic development. Therefore, the key foundation for B&H's development might be the abandonment of the CBA and moving toward central bank regime with the authority to conduct open market operations. It is very important for B&H to move away from the currently implemented monetary policy regime, since it only holds the country back from progressing. In that sense, this paper can serve as a useful guideline for policy makers when discussing and forecasting which path and which type of monetary policy to pursue to yield higher economic prospect.

The process of transformation towards effective use of open market instruments in policy implementation doesn't happen overnight and usually involves two or three stages of market development. The transition to indirect instruments of monetary policy causes the operational activities of the central bank and the treasury to become more connected than before.

Creators of the monetary policy need to closely follow the level of development of the country's financial system and to, in a timely manner, adjust their monetary activities to those changes.

Though it has to be emphasized that transformation of monetary authority into one that has actual instruments at its disposal, should by no means happen at the expense of established independence of monetary pillar of the economy.

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