

## UNDERSTANDING OF THE CURRENCY BOARD SYSTEM IN BOSNIA AND HERZEGOVINA

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### **ABSTRACT**

*Currency board system is as old as the central bank. Early currency boards were created out of concern for safety, the practice of Great Britain with Banc Charter Act of 1844, which are limited by some forms of banking competition. The peak in the application of the model currency board is culminated in the fifties years of last century. There are many differences in connection with this system identified by various conditions for introduction in various countries, and many are differences to maintain reserves, as well as the binding currency choice. Special conditions for the organization and functioning of the system currency board had our state. Establishment of economic development to macroeconomic stabilization with disregarding structural characteristics of the real economy has led us to the unacceptable state of the trap. We missed the years behind us from adopting the currency board system that dynamism economy, increase productivity and ultimately the competitiveness of the economy.*

**Keywords:** currency board, the conditions of establishing a system, measuring the effectiveness of the currency board, currency board in Bosnia and Herzegovina

### **1. INTRODUCTION**

Currency board system in the 50 - ty years of the last century was extended in some seventy countries, and this is his peak. With certain exceptions, the currency board system, is used in small, poorly developed economies, and emphasizes the view that the currency board system possibly suitable as a monetary system in Eastern Europe and the Third World. A currency board, which by their sense and meaning, is different from typical central bank, we can talk in aspects of: development in the period, reasons for the emergence and introduction of this system, maintenance of reserves and the extreme in aspect of its effectiveness. In terms of Bosnia and Herzegovina: economic, political, institutional, there are strong reasons for and against. When comparing systems of the central banks and currency board systems are commonly used indicators: rates of economic and inflation growth, and currency exchange rate, but it is debatable how comprehensive and acceptable to the considerations of macroeconomic stability.

### **2. UNDERSTANDING OF THE CURRENCY BOARD SYSTEM IN B & H**

#### **2.1. Currency board system**

Currency board system is as old as the central bank, and was adopted and there is a lot of countries. With the intent to encourage links between the country's colonizers and colonies of most currency board system was used in the colonies, but also with decolonization many of the newly sovereign

states, with intentions to raise power and prestige of his new currencies, issued currencies, are to choose for such systems. Early currency boards are keeping reserves in gold and silver coins, and later inspired by the experiences of the British community in India. States under the currency board in their local currency tied to various currencies. Key assumptions in his work are to: a) broadcast money (currency and demand deposits) must be fully covered with a convertible currency, a selected currency or basket of currencies, b) a fixed exchange rate to the chosen freely convertible currency, as a „monetary anchor“. Currency Board is system of fixed exchange rates and ensure full convertibility of the currency of the country in a reserve currency. The currency board has not discretion in monetary policy, because in this system occurs spontaneously change the volume of money supply and the impacts of market processes. Currency board system is only part of the monetary system in any country that has banks and other financial institutions. In countries with currency board<sup>1</sup> express the greatest confidence of the international banks with large extensive network of bank branches, including branches in countries with currency board. In the currency board in the past the Government had a balanced budget. Theoretically, the Government may have a budget deficit under the currency board system, if they can "sustain" borrowing to finance deficits. Currency board system provides the "hard budget" with constraint of the local authorities. This system can not be independent inflationary source of financing, although it can be transmitted inflationary pressure reserve currency country.

## **2.2 Currency Board in Bosnia and Herzegovina**

There are different conditions, factors, which are essential for the acceptance, introduction and functioning of the currency board system in many countries, and these are usually: 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. Bosnia and Herzegovina had the specific conditions for the introduction of this system. At the moment when the start with the work of the Central Bank of Bosnia and Herzegovina, 11 VIII 1997th, in the State of BiH was open multiple transition: the transition from war to peace, the transition of society towards an independent state with its own democratic and administrative institutions and the transition from state-directed economy to a market-oriented economics.

## **2.3. Efficiency of the currency board system**

Currency board arrangement in Bosnia and Herzegovina, observed with the institutional, operational and empirical aspects, it has its purpose and it is certainly good, but not the only system suitable for Bosnia and Herzegovina in the postwar period of reconstruction and development. It has the advantages of implementing a currency board, and they could be reflected in: simplicity in application, based on legal and institutional framework for the operation of CB BiH, and the currency board system, and the operational design and macroeconomic stability, which is implicit in the operational rules. Currency stability and transparency of operations CBBiH encourage the development of the banking sector and restore confidence in the banking sector, opening the door for foreign investment and international capital, and accelerate the development process. In the first five years of a Currency Board system - the deposits are doubled and rose to 3.7 billion (in local currency deposits have grown from 16 to 45% of the total), a registered foreign direct investment increased from 83.3 million KM in the period V 1994 - 1997. a total of \$ 7.6 billion at the end of June 2010<sup>2</sup>th year. The largest FDI realized in 2007. year and amounted to 31.5% of the total investment in this period. In reviewing the functioning of the currency board, institutions and individuals in institutions, presenting macroeconomic stabilization seen in: currency convertibility and fixed exchange rate, low inflation rate. Comparative performance views expressed by the growth of GDP, annual growth rate and% share of fiscal deficit to GDP, countries that have a central bank and currency board systems, are in favor of a currency board system<sup>3</sup>. The question is whether this is sufficient, and how it can be a realistic basis for proposing economic policies of the country.

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<sup>1</sup> currency board system gives freedom of movement of capital

<sup>2</sup> Ministry of Trade and Economic Relations, more information on foreign investments

<sup>3</sup> IMF Country Report No. 08/327; october 2008

Table 1. Data Series of real GDP growth, CPI inflation and foreign reserves<sup>4</sup>

year	real GDP growth %	CPI inflation %	foreign reserves (millions \$)
1997	29,9	5,6	80,4
1998	17,6	-0,4	174,5
1999	9,5	3,0	452,3
2000	5,2	5,1	496,6
2001	3,6	3,2	1.221,2
2002	5,0	0,3	1.321,4
2003	4,1	0,6	1.795,6
2004	5,8	0,3	2.407,9
2005	5,0	1,9	2.530,9
2006	6,0	6,0	3.371,6

year	real growth GDP %	CPI inflation %	foreign reserve (millions of euro)
2007	6,1	1,5	3.425,0*
2008	5,7	7,4	3.219,0*
2009	-3,1	-0,4	3.176,0*
2010	0,8	2,4	3.219,0*
2011	3,0	3,0	3.733,0*

Table 2 Changes in real GDP growth and CPI inflation during the period 1997 – 2010<sup>5</sup>

country	real GDP growth %	CPI inflation growth %
<b>Bosnia and Herzegovina</b>	<b>89,6</b>	<b>22,8</b>

On the negative relationship between trade balance that with - 2.1 billion € in 1997. increased to a maximum of - 4, 2 billion € in 2008. year (was - 2, 6 billion in 2010., then the current account balance was highest and amounted to - 1.8 billion € ) effects are scarce commodity funds and foreign markets for the poor competitiveness of BiH products<sup>6</sup>. The problem of the BiH economy is high, an unsustainable trade deficit, a serious problem is very large balance of payments deficit. The influence of foreign trade on GDP growth is important, but it is not achieved only through growth, but also change the structure, especially exports (% increase in goods with higher level of treatment). From 2008.th to today has been a strong reduction in growth rates of GDP and the economy of Bosnia and Herzegovina in 2009. year the fall into recession. In macro-economic considerations should be noted that the economic crisis in Bosnia and Herzegovina is neither cyclic, or imported, but is the political and structural. Political and economic crisis is reflected in the overall economy and the functioning of the market. Our crisis is a long time depreciated inflows from privatization in the period 1998 to 2002. and later influxes of increased inflow of taxes<sup>7</sup>. Privatization in the financial sector have lasted long. International economic aid and remittances from abroad have enabled growth in the period before the recession, but the value of GDP has not yet reached its pre-war level. GDP growth rate in the period before the global financial and economic crisis were between 5 and 6%. Real GDP growth is priced much lower than it should be not only as expected but as a necessary goal of reaching the post-war economy of the country (table 1). It is impossible with such growth rates as high levels of pre-war activities (table 2), and in particular the approximate lowest level of economic development in countries of the European Union. If we take the highest growth rates of 6.2 and an average GDP growth rate of 2.6% in the EU, we would need 32 years to close the gap to 75% of the average GDP of the European Union. Narrowed the expression of macro - economic stability leads us into a trap, the monetarist misleading, because it ignored the structural characteristics of the real economy<sup>8</sup>. The bottom line is that these macroeconomic indicators are not really sufficient, and those without stability, constructed suitable structure of the economy, should lead to the so called "trickle - down" effect<sup>9</sup>. This means that the existing fixed exchange rate, the level of inflation and growth rates should lead to economic efficiency and long-term growth and employment. In such a misguided monetary we not used the period since 1997. and we have not worked on the structuring of the economy and raising the efficiency and competitiveness. Certain, not even so much detailed research, indicating a problem regarding the level of overall competitiveness in society as well as a significant problem that comes from the structure of our economic activities of society. The duration of the currency board system, we

<sup>4</sup> Source: IMF, World Economic Outlook Database , \* Bulletin CB BiH 2010.

<sup>5</sup> Source: IMF, World Economic Outlook Database and authors calculations

<sup>6</sup> This is affected by nonuniform economic space, unfair competition, corruption, skid funding expensive banking services, a relatively high tax burdens, high costs of public services

<sup>7</sup> 2003 rd the-value - added tax - VAT

<sup>8</sup> sustainable economic growth, employment and the current liquidity - in BiH today we have over 8 billion of mutual claims - domestic insolvency

<sup>9</sup> „trickle down effect „,is absolutely nowhere recorded; In the long term, according to John Maynard Keynes - in everyone would be dead.

should actually serve as a useful period of preparation and execution of strategies as appropriate to the level of Bosnia and Herzegovina. Comparison of the same indicators at the territorial level of Bosnia and Herzegovina, under of the same monetary authorities, pointing to various levels of growth and inflation, and it certainly reduces the effectiveness of macroeconomic policy and Central Bank BiH. Strong political divisions between the entities of concern because they can propose and implement, in the absence of a unified strategy, different measures and instruments. External debt, which is estimated at 40% of GDP in 2010. she became a cause for concern.. Strong obstacles to progress lies in the potential of BiH political reasons, unfortunately, have a way to infiltrate the strong economic activity. The main handicap and lack of monetary and credit policy is offset by the influence and impact of the currency board achieved through stability of the domestic currency, the stabilization of the overall banking system and economic trends and providing conditions for the inflow of foreign capital. Yet in the long run it is necessary to consider the inclusion of monetary aggregates in the function faster, the programmed growth of the economy, providing the absolute sovereignty of the monetary authorities.

### **3. CONCLUDING REMARKS**

The considerations relevant to this text could be displayed the following conclusions:

- 1) Throughout the long history of societies, carried out and the organization of central banks and the currency board system. Factors organizing the currency board system vary by country. Recognize the diversity in maintain reserves, as well as the choice of binding rate.
- 2) Special conditions for the acceptance of this system was Bosnia and Herzegovina, and they were decisive in the organization and functioning of the currency board.
- 3) It is essential for establishing and implementing the necessary strategies and programs, understanding the factors of growth and development in an economy and society.
- 4) One of the key functions of the state's macroeconomic stability and ensuring growth and is always open important questions about the structure of the economy models of growth and macroeconomic stability, for whose resolution should be balanced choices of policies and measures at the state level.
- 5) Currency board system is suitable for B&H in the postwar period of reconstruction and development, but unfortunately nothing has been done on the structuring of the economy and raising the efficiency and competitiveness. In the long run, it is necessary to consider the inclusion of monetary aggregates in the function of rapid growth, economic development.

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