

# The currency board and monetary stability in Bosnia and Herzegovina

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## 1. The transition economy of Bosnia and Herzegovina

When the Central Bank of Bosnia and Herzegovina (CBBH) started its operations in August 1997, the country faced, and largely still faces today, three major concurrent transition processes:

- the transition from war to peace;
- the transition from a socialist command economy dominated by the state to a market-oriented private sector economy; and
- the transition from being a part of a larger nation to being an independent country with its own democratic and administrative institutions.

Any one of these transition processes on its own is extremely challenging. Within this avalanche of change there is a need to provide some anchors or areas of economic stability at an early stage of the reform process. One such anchor, which the experience of Bosnia and Herzegovina (BiH) shows can be attained successfully and relatively quickly, is a stable currency.

What did the financial system in BiH look like in 1997 when the CBBH commenced its operations? There were four currencies being used in the country (BiH dinar, Yugoslav dinar, Croatian kuna and Deutsche mark). Of these currencies, only the mark was a 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, and in the main citizens did not use the banks. There were three payments bureaus, each of which had a monopoly on non-cash payments in the territory it covered. In short, it was a very weak and fragmented financial system.

## 2. Monetary policy in Bosnia and Herzegovina

The most important function of the CBBH is to “formulate, adopt and control the monetary policy of BiH”. The CBBH conducts monetary policy through a currency board arrangement, as stipulated in the CBBH Law and in the Dayton Peace Agreement.

The choice of a currency board had two main motivations. First, it provides a firm nominal anchor in the form of a fixed exchange rate. This was considered critical for the very uncertain postwar economic situation in BiH. Second, it is a rule-based approach to monetary policy that took into account the difficulty there would be in establishing institutions and making political decisions in the complex political environment that existed in BiH after the war.

The three essential features of the currency board, all of which are specified in the CBBH Law, are:

- Fixed exchange rate: the BiH currency, the convertible mark (BAM), was tied to the Deutsche mark (DEM) at a fixed exchange rate of 1:1. This exchange rate allowed the two currencies to be used together during the period in which citizens were building up their trust in the new currency. It has been tied to the euro at the same rate as the Deutsche mark (1.95583 per euro) since the euro was introduced in January 1999. We did not alter the exchange rate at the time of the euro changeover as we believed it was very important that the citizens of BiH (and potential foreign investors) continue to have complete confidence that the exchange rate will remain fixed against our anchor currency.
- Full foreign exchange backing: the domestic currency liabilities of the CBBH have to be fully backed with convertible foreign assets. At the end of December 2001, our BAM liabilities

were BAM 2.623 billion and our foreign assets were BAM 2.697 billion, so we had more than 100% coverage.

- Full convertibility: the CBBH had to be prepared to exchange BAM for DEM at any time for any amount. Now the BAM is convertible into euro. Since the establishment of the CBBH in 1997, we have issued BAM 8.1 billion and we have converted back BAM 5.9 billion. So it has been a fully convertible currency in practice as well as in name.

The CBBH has not had any special arrangements with the Bundesbank for the use of the Deutsche mark or now with the ECB for the use of the euro. The CBBH bears by itself the costs of handling the foreign currency, and invests the funds for the coverage of the local currency as deposits in foreign banks according to its own business policy on a commercial basis.

### 3. The performance of the Central Bank of Bosnia and Herzegovina

Linking the BAM to the DEM through a currency board was an easy choice for BiH because the DEM was already extensively used in the country and was the currency that people trusted. It proved to be a successful choice for the following reasons:

- The BAM has been a stable currency against the DEM and the euro since it was introduced.
- Inflation in BiH is low and stable. The latest figure is around 1% per annum and it is similar in both the Bosnian and Herzegovinian regions.
- BAM use has risen rapidly within BiH and it is now the dominant transactions currency in all parts of the country. Our BAM liabilities rose from an initial BAM 132 million in August 1997 to BAM 1,166 million at the end of September 2001. During the final four months of the euro introduction they more than doubled. The citizens of BiH took the large amounts of DEM banknotes they had been keeping under their mattresses to the banks and converted a lot of them either to BAM banknotes or put them on deposit in a BiH bank. By 31 December our BAM liabilities had reached DEM 2,623 million and they have stayed around that level during 2002 so far. This is a clear sign that the citizens of BiH trust the BAM and are beginning to trust the banking system too (see the box); and
- The BAM can now be traded in specified banks in a number of other countries in Europe.

There is no other type of monetary policy, other than the adoption of the DEM as the currency of BiH, that could have given a country like BiH a stable and trusted currency and low inflation this quickly.

#### Deposits with commercial banks

Total deposits with commercial banks at the end of March 2003 totalled BAM 3.7 billion, having more than doubled between 1997 and the end of March 2003. During this period, a significant increase was recorded in domestic currency deposits, a reflection of increasing confidence in the domestic currency. They rose from 16% of total deposits in 1997 to 45% by March 2003.

The proportion of time and savings deposits in total deposits decreased from 43% in 1997 to 41% in March 2003, with some increase in domestic currency time and savings deposits more than offset by a decline in foreign currency time and savings deposits.

Within these totals, deposits by BiH citizens account for an increasing proportion. They reached BAM 1.6 billion by March 2003, having risen fivefold between 1997 and the end of March 2003. By March 2003, 22.5% of citizens' deposits were in domestic currency accounts.

#### 4. Why has the currency board worked in Bosnia and Herzegovina?

There are four main reasons:

- First, people have faced many financial traumas. They therefore value a stable currency. The currency board consequently has a high level of public support within BiH.
- Second, people had complete trust in the anchor currency, the DEM. A strict currency board has allowed the CBBH, a new institution with no track record, to gain some of the credibility of the DEM and the Bundesbank. The changeover to the euro as the anchor currency does not appear to have weakened the credibility of the currency board in BiH.
- Third, the CBBH has a foreign governor. This has been important for establishing the political neutrality of the CBBH.
- But the major reason why the CBBH works well is the very good legal and institutional framework under which the CBBH operates:
  - (i) The *goal* of the CBBH is simple, clear and specified in the law.
  - (ii) The law *limits our activities* where there would be any potential conflict with the currency board requirements.
  - (iii) Within these statutory goals and limitations, the CBBH is *independent* of political direction.
  - (iv) How did the CBBH provide for its independence from political influences?

Article 3 of the CBBH Law states: “Within the limits of its authority established by this Law, the Central Bank shall be entirely independent from the Federation of Bosnia and Herzegovina, the Republika Srpska, any public agency and any other authority in the pursuit of its objective and the performance of its tasks. Except as otherwise specified by law, the Central Bank shall take no instructions from any other person. The independence of the Central Bank shall be respected and no person shall seek improperly to influence any member of a decision making body of the Central Bank in the discharge of his duties towards the Central Bank or interfere in the activities of the Central Bank.”

The important provision of the Law is that on the impossibility of extending credit and lending to the BiH government or government entities or banks. It is true that those criticising currency board arrangements consider this as an important shortcoming in the conduct of monetary policy.
  - (v) We have *sensible and sound internal decision-making processes*.
  - (vi) We are easily and firmly held *accountable*. A breach of the currency board requirements would be quickly obvious to all. To use the current economic jargon, it is a very *transparent* form of policy implementation.

#### 5. Conclusion

Monetary policy in the form of the currency board arrangement in BiH is achieving undoubted results. The stability of the local currency and transparency in CBBH operations are contributing significantly both to the development of the banking sector and also development of confidence in banking institutions. This opens the door for entry of foreign investments and international capital into BiH, which can speed up the process of development of a self-sustainable open economy in BiH on the way to the community of the European states.