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THE ROLE OF THE CENTRAL BANK IN THE FUNCTION OF IMPROVEMENT OF LIQUIDITY OF BANKING SECTOR IN BOSNIA AND HERZEGOVINA

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Abstract: *The monetary policy of Bosnia and Herzegovina is rather limited because it is based on the principles of a currency board characterized by the impossibility of implementing the basic monetary policy instruments in comparison with the monetary policy of the European Union. However, the constant presence of European integrations should point the need for a more drastic change in the monetary policy of Bosnia and Herzegovina. By entering the European Monetary Union (EMU), the monetary territory of Bosnia and Herzegovina will become one of the branches of the European Central Bank (ECB). In addition, it is not difficult to conclude why the Law about the Central Bank of Bosnia and Herzegovina has been adopted with the first laws of the Dayton Agreement, if it is known that the largest part of the banking system, and therefore the financial market, is owned by foreign banks. This work will point out the significance of the Central Bank of Bosnia and Herzegovina, as one of the most important factors for maintaining the permanent liquidity of the banking sector in Bosnia and Herzegovina. The possibilities and limitations of the Central Bank of Bosnia and Herzegovina will be determined, with the assumption of macroeconomic sustainability over a longer period of time. The need of reforming the banking system in Bosnia and Herzegovina will be analyzed through the constant implementation of the Basel standards with the increasing participation of foreign banks in the Bosnia and Herzegovina. It will be determined the impact of the implementation of the Basel III in the banking industry in Bosnia and Herzegovina and its consequences on the banking and economic system.models, on the ways of financing the elimination of adverse consequences of natural disasters.*

Keywords: *Central Bank of Bosnia and Herzegovina, liquidity, banking sector.*

INTRODUCTION

The monetary policy of Bosnia and Herzegovina is based on a currency board characterized by the impossibility of implementing the basic monetary policy instruments in comparison with the monetary policy of the European Union. Consequently, the monetary policy of Bosnia and Herzegovina needs to change radically in the future considering the inevitability of the presence of European integrations. By entering the European Monetary Union (EMU), the monetary territory of Bosnia and Herzegovina will become one of the branches of the European Central Bank (ECB). The Central Bank as a comprehensive concept is oriented towards achieving economic objectives pursued. The main aims are full employment of resources, general price level stability and sustainable economic growth. The development of monetary policy in Bosnia and Herzegovina should be focused on the open market operations as the most efficient instrument of monetary management. Direct instruments of monetary management usually represent a hindrance to the efficiency of the financial system and particularly to the credit policy. The Central

Bank of Bosnia and Herzegovina can have a significant influence on the liquidity in the banking system, fund prices and an overall level of interest rates through open market operations with securities in the aftermarket. This instrument offers greater flexibility, and in the more developed market economies it is usually used as the monetary policy instrument. It is inevitable for the open market operations to be phased in as the basic instrument of the monetary policy of the Central Bank of B&H, and this is one of the ways of approaching the financial market to the monetary policy of the European Union. The implementation of this instrument creates many positive opportunities related to regulation and control of financial markets. (Source: Mirko Savić, Mladen Savić, Mjesto i uloga monetarne politike u Bosni i Hercegovini prilikom ulaska u evropsku monetarnu uniju, Bijeljina 2011)

1. THE ROLE OF THE CENTRAL BANK IN THE FUNCTION OF IMPROVEMENT OF LIQUIDITY AND FINANCIAL STABILITY

The most important function of the Central Bank of B&H is to formulate, adopt and control the monetary policy in Bosnia and Herzegovina. The Central Bank of B&H manages the monetary policy through the so-called Currency Board arrangement. This is stipulated in the Law on the Central Bank of B&H, as well as in the Dayton Agreement. There are two reasons for choosing a Currency Board. The first one is that the Currency Board provides a fixed, nominal foundation in the form of a fixed exchange rate. This was of the utmost importance for a very insecure, post-war economic situation in Bosnia and Herzegovina. The second reason is that the Currency Board took into account the difficulties that would arise when setting up institutions and making political decisions in a complex political environment, i.e. ambience that existed in Bosnia and Herzegovina.

There were three key features of the Currency Board when setting up, and which were defined in the Law on the Central Bank of B&H, as follows:

The currency of Bosnia and Herzegovina is the convertible mark (KM), with fixed rates related to the German mark (DEM). This fixed course is 1 KM = 1 DEM;

KM liabilities of the Central Bank of Bosnia and Herzegovina should be fully covered by convertible foreign assets.

The Central Bank of B&H should be prepared to change KM for DM at any time and in any amount. Linking the KM to the DEM through a Currency Board was an easy choice for B&H because the DEM was already extensively used in the country and was the currency that people trusted. Also, it can be stated that there is no alternative to the current monetary policy in Bosnia and Herzegovina, which so quickly secure a stable and trusted currency that is currently being followed by rather low inflation. The stability of the exchange rate and the inflation rate is of exceptional economic importance for one country. This gives citizens the opportunity to plan their economic decisions more safely. This is especially important for investments because the profit from any investment comes after a number of years. Therefore, the stability of inflation and the exchange rate is of critical importance for investment, especially when it comes to a small country such as Bosnia and Herzegovina, which requires significant private-sector investment. The stability of inflation and exchange rates is also extremely important for the development of the financial sector. Currently, the main risk that banks need to focus on is the credit risk of their clients.

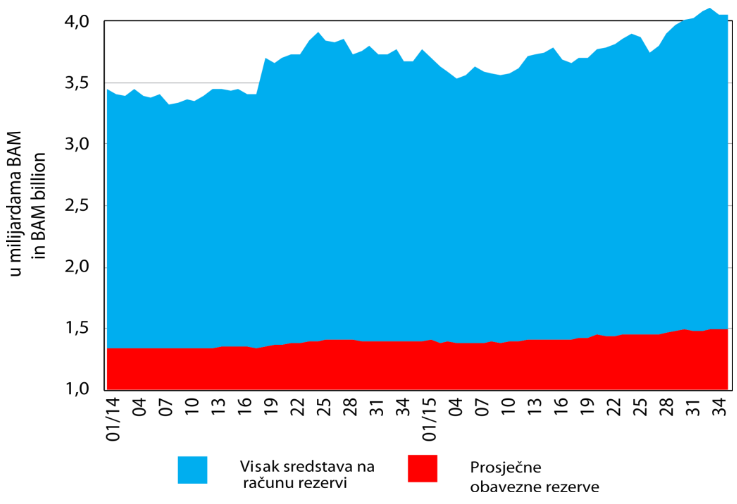
There is a big problem in Bosnia and Herzegovina, but since it is the main risk, it is possible to create the policy which will reduce that risk. It is important that the banking sector in Bosnia and Herzegovina has quite normalized. The advantage is certainly that banks in Bosnia and Herzegovina don't have to think about the risk of inflation and the risk of the exchange rate because such stability contributes to the development of the banking sector. (Source: Peter Nicholl, Uloga centralne banke u Bosni i Hercegovini, Prezentacija za studente Ekonomskog fakulteta u Banja Luci, Banja Luka 2001, p.2.)

The concept of required reserves in banking occurs at the beginning of the nineteenth century and secured the liquidity of the bank's liabilities in a way that banks made deposits with each other in the form of high-quality and quick-paying assets, most commonly gold. When defining a required reserve policy, the Central Bank proceeded from the defined monetary policy goals. Those goals were high employment, price stability, interest rate stability, financial market stability, all of that depending on the economic situation in the given circumstances, which explicitly stipulated by law. Different goals demanded a different structural policy of required reserves within the overall monetary policy instruments. A mandatory reserve can create stable demand for reserve balances and many Central Banks in developed countries use a mandatory reserve for these purposes. The Monitoring and Analysis Department of the Central Bank of Bosnia and Herzegovina has issued a text on a required reserve instrument. The use of required reserve instruments in the conduct of monetary policy can be seen through three basic functions: *(1) function of prudential control, (2) function of monetary control and (3) Liquidity management function.*

The prudential function is historically linked to the gold standard, where the gold reserves which banks held at each other (before the appearance of central banks) provide security of liquidity, i.e. payment obligation. With this system, banks secured their liquidity as well as solvency and at the same time they secured their business.

The monetary control function implies the direct control of the central bank over the monetary aggregates. By increasing the required reserve rate, the Central Bank can influence the reduction of the currency in circulation, i.e. the reduction of the required reserve rate, and directly it can influence an increase in the amount of currency in circulation. In this way, the Central Bank applies a restrictive, that is, expansive monetary policy. Both of these functions affect the level of interest rates, loans on one side, and deposits on the other. The Governing Board of the Central Bank of Bosnia and Herzegovina (CBBH) has passed the decision on determining and maintaining required reserves and as well as on defining the compensation of the Central bank of B&H to banks on the amount of reserves. According to this decision, the base for the required reserve calculation includes deposits and borrowed funds, regardless of the currency. Also, the decision defines the single rate of required reserve of 10% which is applied by the Central bank of B&H on the base for the required reserve calculation. In addition, the decision defines that the Central Bank of B&H calculates a certain amount of remuneration on the amount of required reserves. On the amount of funds exceeding the mandatory reserve, the Central Bank of B&H calculates compensation at the rate which is equal to 50% of the rate applied by the European Central Bank on the deposits of commercial banks. By passing the decision on introducing a negative interest rate of compensation on the amounts of excess funds above the mandatory reserve in reserve accounts, the Central bank of B&H wants to stimulate commercial banks to use the mentioned funds to extend loans to households and companies. Excess funds above the required reserves of commercial banks in reserve accounts with the Central bank of B&H have shown a continuous growth for a longer period of time, and the banks currently hold around KM 2.5 billion in the form of excess funds in reserve accounts. Finally, it is important to say that this decision has applied since 01 July 2016. (Source: The Central Bank of Bosnia and Herzegovina, Obavezna rezerva kao istrument monetarne politike, Sarajevo 2014.) In terms of liquidity management, the banking system is still unchanged. The large share of surplus funds at the Central Bank of Bosnia and Herzegovina is still evident and the average reserve requirement has been registered as an increase due to the growth of domestic sector deposits.

***Graph1.** Balance in Reserve Account with the CBBH*



Source: The Central Banka B&H, Bilten 4, Sarajevo 2016., p.57.

The amount of loan funds and deposits of the Government for development projects was KM 2.29 billion by the end of 2015. With the exclusion of these funds from the base, according to the decision of the Central Bank of Bosnia and Herzegovina, commercial banks were exempted by KM 176.3 million in 2015. Finally, it is important to point out that the business banks were more active in a loan placement, which was typical for the last quarter of 2015.

2. LIMITATIONS OF THE CENTRAL BANK OF B&H

According to the Law, the Central Bank of Bosnia and Herzegovina cannot deal with money market operations. Licensing and banking supervision activities are carried out by specialized Banking Agencies in Entities that are formed by a special law. The specific monetary system set out in the Central Bank Act allows the bank to issue paper money with equally smaller net foreign exchange reserves. Operatively, the above-mentioned rule allows domestic currency to be issued only with the purchase of a convertible foreign exchange currency with full coverage in net foreign assets. This means that the Central Bank cannot provide loans. It also cannot lend to the state, i.e. cover its budget deficit in any way. The Central Bank cannot perform the normal function of a creditor because it cannot approve a commercial bank's liquidity loan or loan for any other purpose. The law ensures the independence of the Central Bank. Required reserves are the only policy instrument of the Central Bank. Since it does not approve loans, the Central Bank does not set a discount rate nor in any other way can affect the level of interest rates in the economy. The high level of 10% of required reserves by commercial banks in the accounts of the Central Bank of Bosnia and Herzegovina speaks of exceptionally low economic activity. In addition, the overpayment of public companies prevented regular servicing of existing obligations, which led to more rigorous conditions when approving placements by banks.

Deficits in state and municipal budgets have also had a negative impact on the credit policy of commercial banks. This is particularly the case with the issue of short term bonds, that is, treasury bills by the state for servicing short-term liabilities. The fact that banks are buying so-called short-term bonds, i.e. treasury bills, with a discount of 5%, shows that there are particular uncertainties in the banking sector lately.

This discount is currently the higher interest rate charged by the state with respect to the loans of some commercial banks. Namely, certain commercial banks, with foreign equity, place commercial loans on good business entities (which have an adequate balance sheet position) at interest rates of 3%, which is as much as 2% less than the discount that the state borrows. Source: Novo Plakalović, Monetarna ekonomija, Istočno Sarajevo 2004)

Commercial banks and microcredit organizations in Bosnia and Herzegovina freely form interest rates which are not the instrument of monetary credit policy of the Central Bank of Bosnia and Herzegovina. The level of interest rates is different and it depends on whether they are calculated for the short or long term, and whether it is deposits or loans. Of course, short-term funds are collected and interest rates range from 10% to 20% annually, taking into account not only commercial banks and microcredit organizations, where interest rates are much higher than in banks.

Analyzing interest rate differentials between the active interest rates charged on the basis of bank loans and the passive interest rates for which interest on accumulated deposits and other assets are calculated, with short-term assets ranging from 10% to 30%. The question now arises as to why there are interest rates at this level and why there are so many differences in interest rates now. The conclusion is that banks as financial institutions do not need financial resources from the citizens (this applies to foreign banks) because it is obvious that they have the money needed by foreign banks and for this reasons, passive interest rates are so low. On the other hand, a high level of active interest rates is given as a result of the financial and country's risk. It is unjustified that a financial institution such as the Central Bank of B&H cannot influence this situation.

High interest rates are also the consequence of the closure of credit markets not only within the entity but also within the area where the banks operate. The demand for loans that is considerably higher than their offer as well as the general framework of the commercial banks' operation is not sufficiently regulated yet so it cannot be expected that the loans have a unique market price and that the interest rate policy by individual banks until the general framework is not regulated. In Bosnia and Herzegovina, there is a complete liberalization of interest rates and this has led to the formation of such high real interest rates. The liberalization of financial markets and interest rates in many developing countries has not been done for its own sake but in the context of a specific development strategy and according to the market-oriented development scenario of these countries.

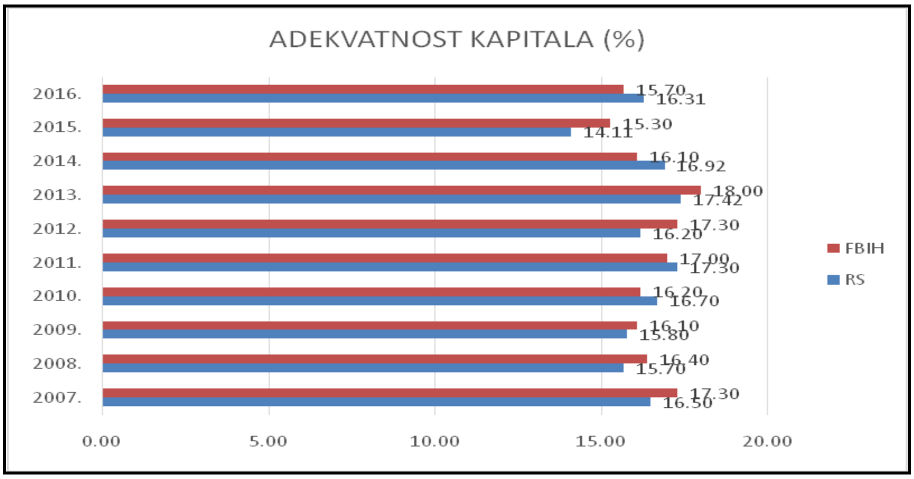
Therefore, the liberalization of interest rates in these conditions and their control in the first phase should be carried out in the context of the general macroeconomic policy and the corresponding strategy of the overall development of Bosnia and Herzegovina, which were not fully defined yet. (Source: Mirko Savić, Mladen Savić, Mjesto i uloga monetarne politike u Bosni i Hercegovini prilikom ulaska u evropsku monetarnu uniju, Bijeljina 2011). In addition to certain limitations of the CBBH and the presence of weak economic activity in Bosnia and Herzegovina, an analysis of the capital adequacy of the banking system in B&H was carried out. The data in Figure 1 give the values of the basic descriptive measures, on the basis of which can be concluded that the average capital adequacy in RS during the observed period was 16.296% and in FB&H that number was 16.540. Further analysis shows that the minimum value in RS is 14.11% and in FB&H it was15.30%, while the maximum values are 17.42% and 18.00%. What is even more interesting is that the coefficient of variation is only 5.6% or 4.8% meaning that there was no significant deviation of the data from the average values. The data in the Figure 1 are taken from the Banking Agency FB&H, Report on the condition of the banking system of RS and FB&H for the period 2007-2016.

Figure.1. *Capital adequacy of banks in RS and FB&H for the period 2007-2016*

Statistic	CAPITAL ADEQUACY OF RS	CAPITAL ADEQUACY OF FBIH
Nbr. of observations	10	10
Minimum	14,110	15,300
Maximum	17,420	18,000
1st Quartile	15,900	16,100
Median	16,405	16,300
3rd Quartile	16,865	17,225
Mean	16,296	16,540
Variance (n-1)	0,917	0,696
Standard deviation (n-1)	0,958	0,834
Variation coefficient	0,056	0,048

The following graph 2 illustrates the changes in the capital adequacy ratio as well as a comparative analysis for RS and FB&H by years.

Graph 2. *Capital adequacy ratio of banks in RS and FB&H for the period 2007-2016*



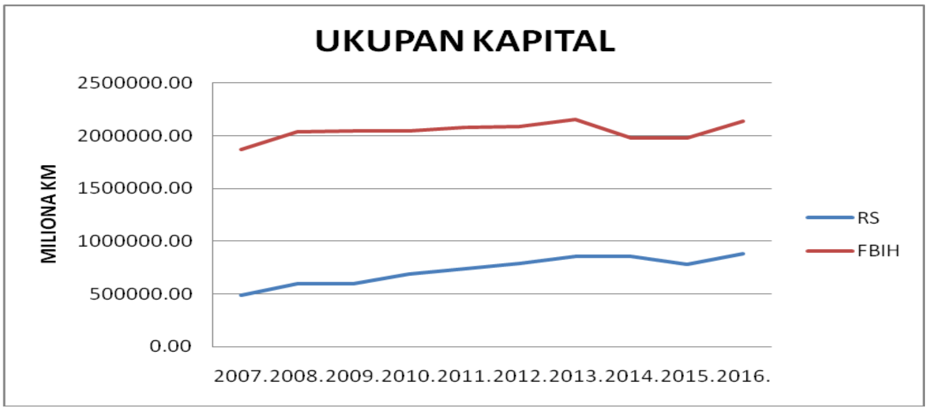
After capital adequacy ratio, the total capital of the banking sector of RS and FB&H was analyzed and data are presented in Figure 2. It can be concluded that the average value of total capital in RS is 728,708,60 million KM, while in FB&H, the amount was 2,043,980,40 million KM. The main cause of this difference is certainly the larger number of banks with headquarters in FB&H, and the greater number of residents. The minimum value in RS was 488.009,00 million KM and in FBIH it was 1.873.145,00 million KM. It is interesting that the minimum values are at the beginning of the observed period, and the maximum values are in the final years. Also, the coefficient of variation suggests that the variability of the data is much higher in RS, i.e. the data in FB&H are homogeneous in comparison to the arithmetic mean. The data in the Figure 2 are taken from the Banking Agency FB&H, Report on the condition of the banking system of RS and FB&H for the period 2007-2016.

Figure 2. The total capital of the banking sector of RS and FB&H

Statistic	TOTAL CAPITAL OF RS	TOTAL CAPITAL OF FB&H
Nbr. of observations	10	10
Minimum	488009,000	1873145,000
Maximum	882534,000	2157896,000
1st Quartile	622012,500	1995980,000
Median	763037,000	2046150,000
3rd Quartile	838550,250	2088915,500
Mean	728708,600	2043980,400
Variance (n-1)	17429401726,044	7004320554,711
Standard deviation (n-1)	132020,459	83691,819
Variation coefficient	0,172	0,039

The following graph shows the changes of the observed indicators by years.

***Graph 2**. The total capital of the banking sector of RS and FB&H for the period 2007-2016*



Generally speaking, it can be concluded that the banking sectors of the Republic of Srpska and the Federation of B&H are well capitalized since the adequacy ranges from 14 to 18%, which is significantly higher than the specified 12% of the adequacy by the agency. This will certainly be a good framework for the implementation of Basel III, which should have a positive impact on the banking sector by providing banks with a good basis for dealing with unexpected occurrences. One of the main goals of the Basel III standard is to contribute to the stability and growth of banking systems through the strengthening of the capital framework.

3. MEASURES AND ACTIVITIES OF CENTRAL BANKS OF B&H WITH AN EMPHASIS ON LIQUIDITY

The global crisis has had major changes in the monetary business and activities of the most important Central Banks in the world. Of course, it has also affected the Central Bank of Bosnia and Herzegovina, which operates under the Currency Board arrangement. This board has only a required reserve with a loan prohibition and with a domestic currency exchange rate fixed to EUR as an instrument of monetary policy. In order to relax the liquidity of the banking sector, the Central Bank of Bosnia and Herzegovina has issued certain monetary policy measures. Certain monetary policy measures were issued in the period from 2008 to 2011, and these are related to the decision to reduce the required reserve rate from 18% to 14%. These measures provided additional liquidity to commercial banks in the amount of 727 million KM. In addition, apart from the reduction of the required reserve rate, all credit lines from commercial banks from abroad have not entered the base for calculating the required reserve. These measures were introduced in order to stimulate inflow of foreign capital into the domestic banking sector and create additional impetus in terms of credit activities of commercial banks.

In addition, the Central Bank of Bosnia and Herzegovina also issued a decision to introduce a differentiated reserve requirement rate on commercial banks' deposits. At a differentiated rate reserve requirement on deposits entering the reserve base, whose maturity up to one year was 14%. The required reserve rate on deposits with a maturity of more than one year decreased from 14% to 10%. This decision further exempted some 370 million KM of additional liquid assets for commercial banks, which made banks significantly increase their credit potential. During 2009, measures taken to stimulate the real sector financing continued. Thus, a decision to reduce the required reserve rate on deposits with a maturity of more than one year, from 10% to 7% was made, while the government deposits required for development programs are out of the calculation base of the required reserve. In 2011, a new decision to reduce the obligatory reserve rate on deposits and borrowed funds with agreed maturity up to one year from 14% to 10% for commercial banks was issued. By this decision commercial banks were exempted from additional financial resources in the amount of about 300 million KM.

During the global financial crisis, a "panic" of a part of the population related to savings in commercial banks was registered, so that the population began withdrawing money from commercial banks based on their savings roles. Therefore, about 700 million KM was withdrawn over a short period of time, which certainly caused particular disturbances in banking business. Increased demand for foreign currency-effective households by commercial banks resulted in commercial banks having increased purchases by the effective side of the Central Bank of B&H, which made the transfer of foreign cash from abroad to their treasuries in order to facilitate the complete situation.

It is well-known that in times of crisis, there is an increasing mistrust in the banking system, and as a result, a rapid withdrawal of deposits from banks can be expected.. In addition, it is important to point out that there is enough cash in the vault of the Central Bank as a sign of readiness to satisfy the additional demand of commercial banks for foreign currency exchange in the crisis period. As an illustration, the CBBH only intervened to transfer EUR 300 million of cash from abroad into its treasuries in the fourth quarter of 2008, and of that amount EUR 200 million was delivered to commercial banks in order to satisfy demand for foreign currency. Central banks as institutions holding international reserves of countries need to manage foreign exchange reserves in a safe manner, taking into account the maximum rating in investing foreign exchange reserves and less on profitable investments. Central banks as specific monetary institutions do not have profit as their primary goal, but monetary stability and investment security. It is also important to diversify foreign exchange portfolios, especially in unstable periods. When it comes to the countries of the region and the activities of their Central Banks, it can be concluded that these are countries with small and open markets. They are mainly characterized by a strong exchange rate policy, regardless of whether it is fixed as with the Central Bank of B&H or the one with smaller fluctuations. Monetary policy is mainly based on the exchange rate of the domestic currency against the Euro as the nominal rate. This monetary regime is chosen because of the high level of euroization that is characterized by their economies, especially the financial sector, since most of the assets and liabilities of the banking sector are in Euro or indexed for Euro. Focusing on the stability of the exchange rate, monetary institutions partially lose the maneuvering space for running an active monetary policy. Similarly, the possibility of those Central Banks acting as a lender of last resort is significantly reduced and limited to the amount of their foreign exchange reserves because most of the liabilities of commercial banks are in foreign currencies. In such a situation, the Central Bank relies on administrative measures such as various regulatory requirements to ensure the stability of the banking sector and to have an impact on the domestic economy through banks. (Source: http:/www.nezavisne.com/ekonomija/tržište/mjere i aktivnosti-Centralne banke BiH u vrijeme krize)

In a monetary policy based on a stable course, monetary authorities are partly limited in their efforts to suppress the impact of foreign shocks and stimulate activities in the real sector. The reduction in regulatory burdens, which leads to increased liquidity of the banks with limited success, contributes to neutralizing the negative impact of "shocks" abroad. However, it is important to note that this partial success can be assessed in the context of highly euroized small open economies where the primary objective of their monetary institutions is the stability of the exchange rate. It would be wrong to conclude that monetary policy in such conditions did not have any effect on the activities in the real sector. Specifically, in the case of Bosnia and Herzegovina, it can be conclude that the Central Bank of Bosnia and Herzegovina, within the framework of the monetary policy it manages, has taken all measures in accordance with statutory authorizations for the period from 2008 to 2012, contributing to the stabilization of the situation. By using high reputation and confidence that it built in the domestic and international public, the Central Bank of B&H has preserved the confidence in the banking system, financial and monetary stability, which was the primary goal and the primary task of the central bank in each country.

CONCLUSION

Generally speaking, it can be concluded that the banking system of B&H is well capitalized since the adequacy ranges from 14 to 18%, which is significantly higher than the specified 12%. With this adversity, it can be concluded that the banking system of B&H is able to withstand certain macroeconomic shocks. This also contributed to the role of the CBBH with its control functions by reducing regulatory burdens and increasing liquidity with banks that could withstand external negative impacts. In addition, the CBBH, within its monetary policy, has taken all measures in accordance with statutory powers, contributing to the stabilization of the state. By using high reputation and confidence that it built in the domestic and international public, the Central Bank of B&H has preserved the confidence in the banking system, financial and monetary stability, which was the primary goal and the primary task of the central bank in each country. In addition, the Entity Banking Law in Bosnia and Herzegovina, the delegated and implementing acts of the Banking Agency and the Central Bank of Bosnia and Herzegovina should be aligned with the basic requirements of international, universal standards by the Basel Committee. Given the presence of the European integration that is inevitable, and by joining the European Monetary Union (EMU), the monetary area of Bosnia and Herzegovina becomes one of the branches of the European Central Bank (ECB). In addition, the direction of the monetary policy development of Bosnia and Herzegovina should focus on open-market financial operations as the most efficient instrument of monetary management. The gradual introduction of open market operations as the main instrument of monetary policy of the Central Bank of Bosnia and Herzegovina is inevitable and this is one of the ways of approaching the financial market for monetary policy of the European Union. However, in order for the Central Bank of B&H to manage an independent monetary policy, it is necessary, above all, to create an adequate political environment. Due to the dependent monetary policy, there is currently no proper link between certain macroeconomic and banking indicators. The reason for this is the controlled monetary policy of the Central Bank of Bosnia and Herzegovina (100% coverage of foreign exchange reserves in circulation), which, on the other hand, affects the insignificant low inflation. However, it should be emphasized that the stability of the foreign exchange rate and the inflation rate is of exceptional economic importance for one country.

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SUMMARY

Research in this work focuses on the role and importance of the Central Bank of Bosnia and Herzegovina and its influence on improving the liquidity of the banking sector. The possibilities and limitations of the Central Bank of Bosnia and Herzegovina in the implementation of the Basel's Standards have been determined in the conditions of increasing participation of foreign banks in the financial system of Bosnia and Herzegovina. The results of the research have shown that the banking system of Bosnia and Herzegovina, which is well capitalized, so it can be easier to withstand certain macroeconomic shocks. This also contributed to the role of the Central Bank of Bosnia and Herzegovina with its control functions by reducing regulatory burdens and increasing liquidity with banks that could withstand external negative impacts. On the other hand, the Central Bank of Bosnia and Herzegovina has fulfilled its primary task of strengthening confidence in the banking system, which has resulted with and in financial and monetary stability, and thanks to its reputation it has built in the domestic and international public. The well-running policy of the Central Bank of Bosnia and Herzegovina has influenced the existence of negligible low inflation rates and a stable exchange rate, which is of great importance for economic growth and development of Bosnia and Herzegovina