

*Željko Marić<sup>1</sup>*

## **Currency Board Policy and Economic Development of Bosnia and Herzegovina in the Context of European integration**

### **Политика валутног одбора и економски развој Босне и Херцеговине у контексту европских интеграција**

#### **Summary**

*Bosnia and Herzegovina is a small and open economy in transition with great distrust in local authorities and institutions. The country applies a currency board as the only acceptable and optimal exchange rate system in order to protect its monetary policy from political influences. The strict rules of the currency board provide monetary stability and confidence in the domestic currency, but disable the pursuit of discretionary monetary policy and limit autonomous fiscal policy for the purpose of stimulating an investment cycle and economic development without coordinated accompanying support of monetary policy.*

*The subject of this paper is an analysis of the short-term and long-term effects of the currency board application in Bosnia and Herzegovina in conditions of increasing liberalization through the process of European integration. Given the negative consequences and limitations of the currency board system, this paper analyses in particular the possibility of introducing a central bank with discretionary monetary policy instruments, as well as other measures that can influence the overvaluation of the domestic currency exchange rate.*

*The scientific methods used in the paper are: inductive-deductive method, descriptive method and statistical method. The conclusion and recommendations are*

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<sup>1</sup> University of Mostar, Faculty of Economics, zeljko.maric@sve-mo.ba

obtained by using inductive-deductive method and descriptions of current economic trends based on numerous secondary statistical data presented in the tables and charts.

**Key words:** currency board, (un)real exchange rate, devaluation vs. deflation, internal adjustment, Bosnia and Herzegovina.

## Резиме

Босна и Херцеговина је мала и отворена економија у транзицији, с великим неовјерењем у домаћу власт и институције, те примјењује валутни одбор као једини прихватљив и оптимални систем девизног курса, како би се монетарна политика заштитила од политичких утицаја. Сврха правила валутног одбора осигуравају монетарну стабилност и повјерење у домаћу валуту, али онемогућују вођење дискреционе монетарне политике и ограничавају аутономну фискалну политику у циљу држег инвестицијског циклуса и економског развоја, без координиране пратеће монетарне политике.

Предмет овог рада јесте анализа крајкорочних и дуорочних ефеката примјене валутног одбора у Босни и Херцеговини у условима све веће либерализације кроз процес европског интеграционог процес. С обзиром на неадекватне последице и ограничења валутног одбора, у раду се посебно анализира могућности увођења класичне централне банке с дискрецијским инструментима монетарне политике и друге мјере којима се може утицати на превладавање инфлационог курса домаће валуте.

**Кључне ријечи:** валутни одбор, (не)реалан девизни курс, девалвација, дефлација, интерно прилагођавање, Босна и Херцеговина.

## Introduction

A currency board was developed by the colonial policy in 19<sup>th</sup> century with the aim of limiting the economic development of less developed countries (colonies) and preventing them from becoming competitive. In modern times, transitional countries autonomously introduce a currency board, which serves as a starting point for maintaining monetary stability and creating a development strategy in the world of global competition. It is a system in which the domestic currency is only issued if fully covered with the reserve currency and if it is possible to substitute it in unlimited amount and at any time for the reserve currency at the fixed exchange rate. In addition, the rules of a currency board prohibit lending of

a “central bank” to any sector of the economy (the state, banks, enterprises and population), as well as performing any transactions on the money and capital markets. The currency board system allows a country with great political and economic problems to rapidly introduce its own currency, create the confidence of all entities in the domestic currency, stabilise prices and the banking system.

A currency board was introduced in Bosnia and Herzegovina as the best solution for the Central Bank to distance itself from the political influence on the creation of money circulation. The strict rules of the currency board imposing restrictions on both monetary and fiscal policy<sup>2</sup>, enabled, in the short-term, the acceptance of the domestic currency BAM (convertible mark) throughout Bosnia and Herzegovina, the price stabilisation and the financial (banking) sector development in the country. But, analysing the determinants of long-term exchange rate movements (international competitiveness, labour productivity, protectionism, consumer preference, etc.), it can be concluded that in conditions of fluctuations in foreign exchange rates, BAM would surely depreciate (Mishkin, 2010, pp. 437-438). In all reports of the World Economic Forum on international competitiveness, BiH has been ranked behind all its most important foreign trade partners<sup>3</sup>. Bosnia and Herzegovina is significantly lagging behind the EU member states, and its productivity was at the level of 31% of the EU average in 2015<sup>4</sup>. This is a consequence of low technological capability, weak economy of individual economic entities and a lack of an institutional framework for entrepreneurship promotion. In addition, huge administration and costs (fiscal and parafiscal) imposed by the state on the economy/society as a whole are the reason for low productivity and uncompetitive nature of the BiH economy.

Very low labour productivity in BiH, consumer preferences in favour of foreign goods<sup>5</sup> and excessive liberalization in the context of European integration (CEFTA, Stabilization and Association Agreement) have a long-term impact on the depreciation of the domestic currency. But, given the long-term implementation of the currency board and the fixed exchange rate, it is clear that the “convertible mark” is nominally overvalued currency. From the stability instrument,

<sup>2</sup> Since a currency board prohibits lending to the state from the primary emission, public spending can be financed exclusively from taxes, contributions and instruments of commercial borrowing.

<sup>3</sup> According to the World Economic Forum’s Global Competitiveness Report for 2016-2017, which includes 138 countries, BiH is ranked as 107th, Serbia as 90th, Croatia as 74th, Macedonia as 68th, Slovenia as 56th, etc. (Retrieved on 21 January 2017, from <https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1>)

<sup>4</sup> Source: Federal Institute for Development Programming, Labour Productivity in BiH – a Condition for Strengthening Competitiveness, Sarajevo, April 2016, p. 6; [www.fzzpr.gov.ba/](http://www.fzzpr.gov.ba/)

<sup>5</sup> The impact of ethnocentrism in BiH is very strong, because domestic population, such as Serbs and Croats, consider products from neighbouring countries (Serbia and Croatia) domestic, and therefore prefer their consumption to the products produced in BiH. This, of course, affects the movement of imports and exports in foreign trade.

the exchange rate has turned into an instrument for limiting economic growth. This is the result of an irresponsible overall economic policy, especially fiscal policy, which, due to high public spending, imposes high taxes and prevents greater productivity. Direct consequences of non-competitiveness, liberalization, the currency board policies and the overvalued domestic currency are continuous and high foreign trade deficit, external debt growth, low production, unemployment and de-industrialization.

Due to the restrictions, the domestic currency in the currency board system does not have the function of stimulating investment cycles in the long term, but serves only as transactional asset. Instruments for encouraging economic development should be sought within other economic policy measures. A currency board can only be positive in the short term, because it allows price stability. In the long run, a currency board disables economic development in transitional countries, due to the overvalued exchange rate, unless other measures of economic policy and structural reforms are taken to prevent it. The replacement of a currency board with the introduction of a classical central bank requires a number of economic preconditions, for which small, open and import-dependent economies have very little chance. In the case of BiH, this also implies many other non-economic conditions (political pressures, corruption, etc.) as well as the economically efficient and rational behaviour of the state. Until that happens, the currency board serves as a barrier to an even more costly behaviour of the state.

The initial intention was to have a currency board for up to 6 years. However, the currency board has still been applied since the establishment of the Central Bank of Bosnia and Herzegovina in 1997. It is the longest case of the currency board implementation in history.

## **1 Consequences of the currency board implementation and the overvalued currency**

The economic policy in BiH is based on neoclassical theory or monetarism, known as the Washington Consensus, whose settings are also contained in the IMF arrangements. The essence of functioning of the BiH economy can be explained within the framework imposed by the rules of the currency board, EU accession and the level of economic development.

Due to the low level of competitiveness, labour productivity and liberalization of foreign trade in the context of European integration, BiH has long-standing, high foreign trade deficits that dominate the structure of its balance of payments.

**Table 1:**  
*Foreign trade in goods (in thousands of euro)*

<b>Year:</b>	<b>Volume of trade</b>	<b>Export</b>	<b>Import</b>	<b>Balance</b>	<b>Coverage rate of imports by exports %</b>
2006	8,463.456	2,640.463	5,822.993	3,182.531	45.3
2007	10,141.385	3,035.327	7,106.058	-4,070.731	42.7
2008	11,761.864	3,431.633	8,330.231	-4,898.599	41.2
2009	9,145.160	2,828.057	6,317.103	-3,489.046	44.8
2010	10,589.745	3,627.873	6,961.872	-3,333.999	52.1
2011	12,142.311	4,203.925	7,938.386	-3,734.461	53.0
2012	11,816.662	4,017.905	7,798.757	-3,780.852	51.5
2013	12,041.266	4,284.880	7,756.386	-3,471.506	55.2
2014	12,721.464	4,438.904	8,282.559	-3,843.655	53.6
2015	12,700.070	4,595.141	8,104.929	-3,509.788	56.7

Source: Agency for Statistics of Bosnia and Herzegovina

Longstanding high trade deficits are a direct consequence of the low international competitiveness of BiH and the excessive liberalization of foreign trade.<sup>6</sup> Although commodity deficits are partially covered by the surplus of the foreign trade in services and transfers as the most significant surplus item in the country's balance of payments, current account deficits are still high. Also, the share of foreign direct investment in the coverage of the current account deficit is very low. This is a consequence of the complex organization of the country and excessive administration, which results in high taxes that reduce domestic investment potential and create insufficiently stimulating environment for the inflow of foreign investment. The final consequence is the growth of external debt as the most important source of financing the current account deficit.

**Table 2:**  
*Trends in external debt of Bosnia and Herzegovina*

<b>External debt of the government sector</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
In millions of BAM	4,240	5,236	6,291	6,663	7,212	7,563	8,442	8,691
In percentages of GDP	16.6	21.1	24.8	25.4	27.5	28.3	30.9	30.9

Source: Central Bank of Bosnia and Herzegovina, Annual Report 2015, p. 111

<sup>6</sup> BiH has recorded a slight growth in export-import coverage in recent years. The main reason for the trends in exports and imports is business cycles in the international market, rather than "major reforms" and economic policy of BiH. For example, in times of financial crisis and the global recession of 2007 and 2008, the foreign trade deficit increased, and then decreased as a result of overcoming the recession in the EU and stimulating measures of the ECB. In BiH export, base metals and their products (aluminium and steel), whose value is increasing due to the price growth in the international market and other low value added goods, have had the largest share in BiH export. On the other side, imports are dominated by consumer goods, while there is less capital goods.

When a state or banks borrow in foreign currencies abroad, they have to convert the foreign currency into the domestic currency issued by the central bank, thus creating the primary money that can be further multiplied into deposit money. All budgets (state and entities) are predominantly consumer-social, and banks are dominant in providing consumer credits. Therefore, the primary emission of money does not go into production, but the final consumption which is settled from the foreign trade deficit. The foreign trade deficit must be financed in the foreign currency purchased from the central bank. In this way, in most cases previously emitted money is withdrawn. So, the current account deficit is financed from the purchase of the foreign currency from the central bank. This withdraws domestic currency previously issued by the foreign currency purchase from foreign borrowing. The results of this process are stable prices, overvalued currency, very low production and employment, with the constant rise in the foreign debt.

The currency board creates an illusion of price stability and confidence of foreign investors. Namely, prices are stable as there is no depreciation and import inflation due to legislative provisions of the currency board (fixed nominal exchange rate), and domestic producers cannot increase prices because of foreign competition, as this would increase the overvaluation of the domestic currency. Therefore, we are talking about administrative, rather than market price stability.

Foreign debt and foreign transfers still maintain a sufficient level of foreign exchange reserves and the money supply and create an illusion of financial stability.

**Table 3:**

*Trends in foreign exchange reserves of Bosnia and Herzegovina*

<b>Gross foreign exchange reserves</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>
In millions of BAM	6,296	6,212	6,458	6,424	6,509	7,068	7,826	8,606
In millions of US dollars	4,710	4,416	4,372	4,569	4,274	4,797	5,309	4,883

Source: Central Bank of Bosnia and Herzegovina, Annual Report 2015, p. 111

Social peace and financial stability will be maintained as long as it is possible to borrow abroad. When the borrowing limit is reached, all higher foreign debt repayments in the future will become key constraints to financial sustainability. Long-term functioning of the economy on the principles of the currency board in the future will be possible until foreign exchange reserves and the money supply begin to decline significantly. When this happens, the government will have to sell state-owned enterprises and natural resources, completely lose its economic sovereignty and go into bankrupt in economic terms.

## **2 Is Bosnia and Herzegovina over-indebted?**

When assessing the burden of BiH external debt, apart from economic characteristics, one should bear in mind the poor demographic characteristics of the population (emigration of the young population, the change in age structure of the population, adverse relations of employees/pensioners, etc.). However, the sustainability of the external debt will mostly be determined by the economic development level of the country. The two the most important indicators of indebtedness indices (External Solvency Indicators), used by the World Bank, are the ratio of external debt/GDP and the ration of external debt/exports of goods and services.

The ratio of external debt/GDP indicates the risk of a country's insolvency. According to the World Bank, the increase in the external debt/GDP ratio above 30% indicates a relatively high risk of future insolvency of the country. Bosnia and Herzegovina has a steady deterioration in the external debt/GDP ratio and has reached the defined nominal limit (29.08% by the production method of measuring GDP or 27.62% by the expenditure method of measuring GDP).<sup>7</sup> This is a consequence of long-term and large current account deficits, and low rates of economic growth,<sup>8</sup> even lower than interest rates on borrowed loans.<sup>9</sup> However, the real situation is much more difficult. Due to the overvaluation of the domestic currency, this indicator is not realistic, because the external debt denominated in the foreign currency is undervalued, and GDP measured in the domestic currency is overvalued. If the real foreign exchange rate was used, then the actual, considerably higher foreign indebtedness for the amount of overvaluation of the domestic currency would be seen. Secondly, it is very important to consider not only quantitative but also qualitative side of GDP. The structure of the BiH economy has significantly changed from the dominant industrial to the dominant service economy. This is partly a result of the war destruction and poorly conducted privatization, as well as poor economic policies (large non-production public spending, high fiscal burdens and overvalued exchange rate). Comparing the structure of employment by sectors before and after the war, it can be seen that both the number and the structure of employees are constantly deteriorating.

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<sup>7</sup> Source: Ministry of Finance and Treasury, Information on the State Debt of Bosnia and Herzegovina on 30.6.2016, p. 15

<sup>8</sup> Real GDP growth rates (in %) were: 2.77 (2015); 1.05 (2014); 2.4 (2013); -0.9 (2012); 0.9 (2011); 0.8 (2010); -2.9 (2009), etc.; Central Bank of Bosnia and Herzegovina - Annual Report 2015, p. 112

<sup>9</sup> The average weighted interest rate is 1.6% on the total debt, 1.4% on the external debt and 2.9 % on the internal debt. Source: Mid-Term Debt Management Strategy of Bosnia and Herzegovina, Ministry of Finance and Treasury of BiH, March 2016, p. 7

**Table 4:**  
*Total number and the structure of employees in BiH*

Sector:	1990		2008		2016	
	Total	%	Total	%	Total	%
Agriculture	19,392	1.9	183,000	20.6	144,000	18.0
Industry	856,232	83.4	289,000	32.5	251,000	31.3
Services	150,630	14.7	418,000	47.0	407,000	50.8
Total	1,026,254	100.0	890,000	100.0	801,000	100.0

Source: Agency for Statistics of Bosnia and Herzegovina (<http://www.bhas.ba/tematskibilteni/>)

A decrease in industrial production, which primarily creates export potential, and expansion of the service sector reduce the overall economic capacity of the country and the ability to repay the foreign debt. For example, in the analysis of public indebtedness of the Euro-zone countries, Italy, which is highly indebted but an industrialized country, is considered to be less risky than Greece or Portugal, which are less industrially developed, i.e. tourism as the most sensitive economic sector is much more represented in the structure of their GDP.<sup>10</sup>

Another indicator, the ratio of external debt/export of goods and services shows the indebtedness of the country per unit of goods and services. It is a good indicator of the current debt repayment capacity, as export represents the source of funds for the external debt repayment. The ratio of external debt/exports of goods and services is more stable indicator than the ratio of external debt/GDP, as it is not affected by the change in the real exchange rate. The ratio of external debt/exports of goods and services was 85.84% in 2015.<sup>11</sup> This is not a high amount because the creditworthiness of the country becomes questionable when the ratio exceeds 200%, i.e. when the external debt exceeds twice the value of annual export of goods and services. But, this applies to economies with a classic central bank that can manipulate the exchange rate and interest rate in order to encourage exports and investment.<sup>12</sup> This indicator should be considered critical at a significantly lower level for a de-industrialized economy with a currency board, precisely because of the lack of discretionary monetary policy and poor

<sup>10</sup> The indebtedness of the EU countries in 2015 was (measured as the public debt/GDP): Greece 177.4%, 132.3%, Italy, Portugal 129%, etc.

([http://ec.europa.eu/eurostat/statistics-explained/index.php/Government\\_finance\\_statistics](http://ec.europa.eu/eurostat/statistics-explained/index.php/Government_finance_statistics))

<sup>11</sup> The ratio of external debt/export will increase significantly in 2017, 2018 and 2019, due to repayments to the IMF based on the IV Stand-by Arrangement; Source: Mid-Term Debt Management Strategy of Bosnia and Herzegovina, Ministry of Finance and Treasury of BiH, March 2016, p. 8

<sup>12</sup> This problem is also evident in the Eurozone countries that have come into the debt crisis (e.g. Greece, Portugal). However, the policy of solidarity and EU funds allow Eurozone members much easier to overcome the debt crisis, than they would for BiH that is not the member of the EU and the EMU, nor does it have a discretionary monetary policy.



export capacity that would provide foreign exchange earnings for the external debt repayment.

Among the external debt flow indicators, it is important to consider the ratio of debt repayment/export of goods and services. If this ratio is less than 10%, it is considered that the country is not at a risk of insolvency, and if it exceeds 20%, it is considered to be a high risk of insolvency for the country. Foreign debt servicing of BiH has not been a big problem so far, but in the coming years, due to the obligations under the IV Stand-by Arrangement, this ratio will exceed 10% which can be a problem, especially because of the limitations of the currency board.<sup>13</sup>

### **3 Currency board – winners and losers**

The currency board, with low labour productivity and liberalized foreign trade, has created overvaluation of the domestic currency. The overvaluation of the domestic currency has the same effect for domestic, export-oriented producers as the linear introduction of export duties on everything that is exported or subsidies for foreign companies that export to our country for the amount of overvaluation. All export-oriented enterprises that produce domestically have costs (salaries, material costs, taxes and social contributions, etc.) in domestic overvalued currency, while revenues are generated by exports abroad in undervalued foreign currencies. Therefore, the biggest losers, due to the overvaluation of the domestic currency, are domestic export-oriented companies, which are uncompetitive on the international as well as on the domestic market, as domestic consumers buy cheaper imported goods. In this way, the overvalued domestic currency encourages the process of economic de-industrialization, bankruptcy of the company and very high unemployment. For these reasons, banks, as the most developed sector of the economy, mainly provide loans for final consumption of the population that is settled by import, while lending to the economy is insufficient and unprofitable.

Unlike the industry, which has gone through a huge digression, the service sector, primarily banking and trade, has experienced prosperity. Trade has developed because it is profitable to buy and import foreign goods in undervalued foreign currencies and sell them domestically in overvalued domestic currency. Anyone who appears on the demand side of the foreign market and on the supply side of the domestic market, benefits from an overvalued domestic currency. That is why a number of shopping malls, mainly in foreign ownership, have been developed aimed at selling foreign goods. In addition, the imported goods are

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<sup>13</sup> In September 2016, the IMF approved a three-year Extended Credit Facility of EUR 553.3 million with an interest rate of 1.05%, a grace period of four and a half years and a repayment period of ten years. Funds will also be used for repayment of previously taken loans.

intended for final consumption rather than for investments. All this has contributed to long-term and high foreign trade deficits.

The overvalued domestic currency is also favoured by the banking sector and its development. Privatized and predominantly foreign-owned banking sector places available funds in consumer loans for the purchase of imported goods rather than investment loans for domestic production. The banking sector in BiH borrows in foreign undervalued currencies (e.g. in the euro) and realizes interest revenue in the overvalued domestic currency (in convertible mark) at relatively high interest rates.<sup>14</sup> Thus, the banking sector is one of the most profitable sectors, while the BiH economy is in a chronic recession.

Both the trade and banking sector in BiH are in the function of the foreign trade deficit, external indebtedness and poverty of the domestic population. Therefore, the banking and trade sectors are predominantly foreign-owned, because, in conditions of overvalued domestic currency, they are the most profitable businesses for foreign direct investment. Foreign capital has been more used through take-over investment in the tertiary sector (banks, trade, etc.) that is more profitable compared to green-field and brown-field investments in the real sector (industry) which a small and open economy should be based on. All employees whose salaries are administratively, and not market determined benefit from the overvalued currency. Due to the reduction in the industrial sector there is less production and more interest in the services sector (banks, trade and the public sector), which results in greater social differences.

Finally, the Central Bank of Bosnia and Herzegovina can be considered a loser because of the currency board. As a public or state institution, the Central Bank has four ultimate macroeconomic goals: price stability, economic growth and development, full employment and the balance of foreign trade. It is clear that the currency board has only provided the price stability at the expense of achieving three other macroeconomic goals. Essentially, the job of the Central bank of Bosnia and Herzegovina is reduced to the currency conversion and statistics management.

#### **4 Currency Board or Classic Central Bank**

Due to the limitations of the domestic market, development of a small transition country should be based on export-oriented production. To achieve this, it is necessary to guide the policy of the undervalued exchange rate of the domestic currency, which would enable employment of domestic factors of production,

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<sup>14</sup> BiH has borrowed abroad at higher interest rates, due to the political and systemic risk as well as because of the very low credit rating of the country.

profitable exports and all advantages of economies of scale (average cost decrement, new technology and management, etc.).

According to all economic trends (foreign trade deficit, external debt growth, de-industrialization, etc.), Bosnia and Herzegovina has an overvalued exchange rate and should take measures of a real depreciation, which will lead from overvaluation to the undervaluation of its currency exchange rate. Theoretically, this is possible in three ways:

- increase in prices in the foreign trade partners
- nominal devaluation/depreciation of the national currency and
- reduction in prices of domestic goods in the country (deflation).

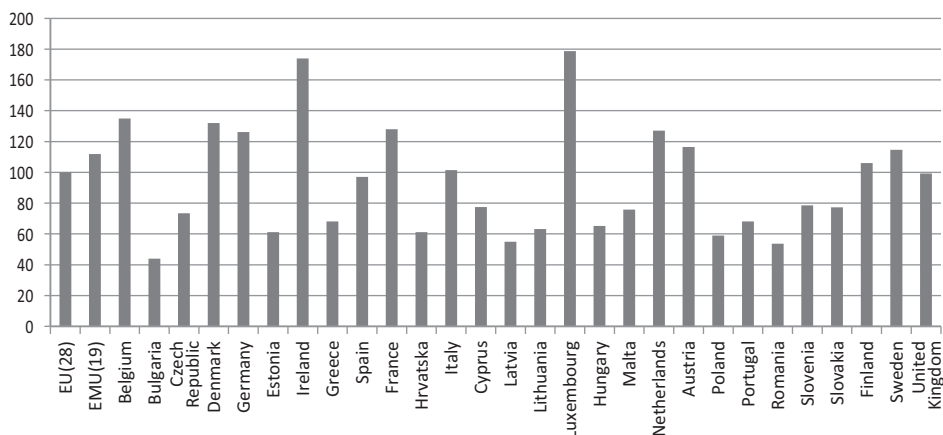
Price stability, i.e. the preservation of the euro, is the primary monetary goal in the EMU. The ECB regulates the money supply and thus sets the interest rates for the eurozone, in order to keep inflation below, but close to 2% in the medium term. Price stability is the most important contribution of monetary policy for the economic growth and job creation which are the two main goals of the EU.<sup>15</sup> Given that the EU is the most important foreign trade partner for BiH, it is not realistic to expect that the overvaluation of the exchange rate will be reduced by faster price growth in foreign trade partners compared to the domestic price level.

BiH has a choice between two alternatives, devaluation or deflation. Both solutions are risky and have negative and positive consequences.

Devaluation is only possible when a currency board is replaced with a classic central bank with discretionary monetary policy instruments. In the specific political and economic conditions in Bosnia and Herzegovina, devaluation is not a realistic option, because certain preconditions (full political independence and trust, a developed financial market and a stable banking system, etc.) have to be fulfilled for a classical central bank. Transformation of the currency board into a central bank with discretionary monetary policy instruments cannot be effectively implemented in conditions of systemic corruption, dysfunctional state, insufficient independence from political influences, a lack of trust in institutions (including the Central Bank), high openness and import dependence, currency substitution, only entity securities and not the state ones, etc. The majority of small countries (Croatia, Montenegro, etc.), especially BiH, which are burdened with various problems (political and legal complexity of the country, corruption, etc.) are simple unable to have a classical central bank with discretionary monetary policy instruments.

<sup>15</sup> The best way for long-term price stability is moderate inflation of up to 2%, which is in the function of investment and economic growth. Therefore, since March 2015, the ECB, as well as other major central banks before it, has launched a quantitative easing process (QE) in order to depreciate the euro against the US dollar and other world currencies, reduce interest rates and stimulate economic growth.

The autonomous introduction of the euro, as it was the case in Montenegro, is not a solution for Bosnia and Herzegovina. Namely, the introduction of the common currency is justified if countries are at an equal level of development and competitiveness.<sup>16</sup> For example, within the European Monetary Union, a certain nominal amount of the euro will actually be more valuable in countries with higher labour productivity (mostly old EU members) and thus undervalued, while in countries with lower labour productivity (mostly new EU members) the euro will actually be less valuable and thus overvalued.<sup>17</sup> That is why less developed countries are increasingly borrowing and losing economic sovereignty.



**Figure 1:** Labour productivity per hour (EU28 = 100) in the EU countries; 2015  
 Source: Eurostat (<http://ec.europa.eu/eurostat/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=tesem160&language=en>)

In conditions of monetary union and significant differences in labour productivity in member states or regions, liberalization of foreign trade on the principles of comparative advantages leads to unfair competition, even greater polarization to industrially developed and underdeveloped countries and social stratification. The European Union is decreasingly becoming the integration of economically independent countries, and increasingly becoming functional integration of large-scale capital of multinational corporations. In this sense, the Nobel Prize

<sup>16</sup> The first chief economist of the European Central Bank and one of the creators of the euro, Professor Otmar Issing has warned that the eurozone is a “house of cards”, that euro cannot survive in the existing form and it is only a matter of time when it will collapse. (Retrieved on 20 January 2017 from <http://www.independent.co.uk/news/business/news/eurozone-euro-collapse-house-of-cards-ecb-single-currency-a7364826.html>)

<sup>17</sup> Due to the high labour productivity and undervalued euro policy, Germany has steadily expanded its exports and economic growth, and at the end of 2016 it reached a record of 44 million jobs in history.

winner for economics in 2016, British economist Oliver Hart believes that the introduction of the euro was a mistake. According to him, the EU has to give up the trend of centralization, and he proposes partial decentralization, including monetary policy, i.e. the return of national central banks and national currencies. He believes that EU members are not sufficiently homogeneous to form a single entity, and that further centralization leads the EU to ruin and decentralization to prosperity.<sup>18</sup> Bosnia and Herzegovina has very low labour productivity (around 30% of the EU average). Therefore, in the case of the autonomous introduction of the euro, Bosnia and Herzegovina would have overvalued euro from the start, which would continue to affect the deterioration of the economic situation and the loss of economic sovereignty.

As a small and open transition country, with the de-industrialized economy and growing external debt and in conditions of imposed liberalization and economic integration, BiH has minimal opportunities to apply development policy in a way that other developed countries did in the past (customs, quotas, monetary policy, etc.). As a member of CEFTA and the country that implements the Stabilization and Association Agreement, BiH is not in a position to run an autonomous customs policy and monetary policy with the currency board and real constraints. In current circumstances, BiH can only use fiscal policy measures to reduce domestic prices (deflation). The socio-economic and related reforms that are implemented through the so-called “Reform Agenda for Bosnia and Herzegovina” and the structural adjustment measures imposed by the IMF through stand-by arrangements are replacing the state of lawlessness (tax evasion, corruption, etc.) and administrative economies with the rule of law and the market economy.

In that sense, there are a number of internal adjustment measures:

- harmonization of domestic legislation and standards with the European Union
- reform of the public sector and reduction of costs and number of employees
- reduction of the pay gap in the public and private sector<sup>19</sup>
- creation of the necessary market institutions
- privatization of state-owned enterprises

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<sup>18</sup> The Nobel Prize-winning economist Oliver Hart argued that “the euro was a mistake” and that Britain has acted rightly when it did not accept the introduction of the euro. He also argued that it would be a good thing if Europe abandoned a single, currency in the future, i.e. euro, while keeping free trade and free movement of labour. (Retrieved on 19 January 2017 from <http://www.euractiv.com/section/euro-finance/news/economic-nobel-prize-winner-the-euro-was-a-mistake/>)

<sup>19</sup> The greatest difference between average salaries in public administration and the private sector in Europe is in BiH (57% in FBiH and 44% in RS), Romania 28%, Bulgaria 26%, Slovenia 21%, Serbia 19%, Latvia 16%, Croatia 10 %, etc. In Slovakia, for example, public sector wages are lower by 17% than in the private sector; (Retrieved on 18 January 2017 from [www.cci.ba](http://www.cci.ba))

- reform of labour legislation
- reform of the pension and health system
- coordination of entity banking agencies and deposit insurance agencies, etc.

Public sector reform and spending cuts<sup>20</sup> would help to reduce the private sector's fiscal burden and create a stimulating business environment.<sup>21</sup> This would not necessarily reduce the revenue of the state budget if the basis for the taxation of production increased. This is known from the theory of Arthur Laffer's taxation curve. However, although the actions aimed at fiscal and financial sustainability and other socio-economic reforms are necessary to create "...the rule of law and the fight against corruption; and to strengthen administrative capabilities and increase efficiency in public institutions at all levels of government ..."<sup>22</sup>, they cannot solve the problem of overvalued exchange rates and deep recession. Creating a more favourable business environment with lower fiscal charges and deflation is not enough to ensure development.<sup>23</sup> The reduction of the fiscal burden in the real sector in order to create deflation would further discourage production and consumption and lead to an even greater recession. Deflation is a process that leads to bankruptcy, increases unemployment, etc. It is not the way competitiveness and exports are increased. Also, the policy of negative interest rates on deposits above the reserve requirements with the Central Bank of Bosnia and Herzegovina has not given positive results. Namely, due to an overvalued exchange rate and insufficient investment demand, commercial banks placed the funds mostly in treasury bills and bonds to finance budgetary non-productive consumption. Production and employment have not increased, but internal and total public debt has.

BiH must change the concept of neoclassical development (the so-called Washington Consensus), in which free market competition and the foreign direct investment play a key role as drivers of economic development. But, such concept of development is appropriate for developed economies close to the state of full employment. Foreign direct investment, as well as EU funds, cannot be

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<sup>20</sup> The public expenditure (in % of GDP) in BiH was 42.6 (2015), 45.8 (2014), 44.8 (2013), etc. Source: Central Bank of Bosnia and Herzegovina. (Retrieved on 17 January 2017, from [http://statistics.cbbh.ba:4444/Panorama/novaview/SimpleLogin\\_cr.aspx](http://statistics.cbbh.ba:4444/Panorama/novaview/SimpleLogin_cr.aspx))

<sup>21</sup> In that sense, within the framework of the "tax reform" in 2016, the abolition of the only incentive measure in FBiH was an absurd, whereby companies that export more than 30% of their production were exempt from paying income tax.

<sup>22</sup> Reform Agenda for Bosnia and Herzegovina 2015 - 2018 (Retrieved on 20 January 2017, from <http://europa.ba/wp-content/uploads/2015/09/Reform-Agenda-BiH.pdf>)

<sup>23</sup> The Laffer curve and the *supply economy*, i.e. reduction of tax rates aimed at stimulating production and investment in the past, was not effective in solving economic problems (budget deficits, inflation and unemployment) because of the low elasticity of production and investment. This was demonstrated by the US example, during the two mandates (1981-1989) of President Ronald Reagan and in the UK during the presidency of Margaret Thatcher (1989-1990).

the key, but only additional sources of economic growth. In the context of internal adjustments, BiH should apply Keynesian economic policies, in which public investment is the main measure of economic development. In a recession, when total aggregate demand decreases, the most effective way to encourage the overall economic growth is productive public expenditure (capital investment) as an autonomous component of aggregate demand, initiated by the state regardless of the national income. The state should initiate investments (especially in infrastructure) from the part of the funds which are collected in different ways and irrationally spent, thus creating projects that would be acceptable to banks as well, as it would be less risky. Also, the privatization of strategic public companies is not a solution. However, it is necessary to change the method of electing members of the board of directors, to choose professionals rather than political figures. The current government should ensure the absence of any politicization in choosing management in public companies (electric power companies, telecom companies, development banks, etc.), because it shows what form of management they want in the economy and society.<sup>24</sup> In addition, these are companies with the highest creditworthiness, which can be used as collateral in issuing government bonds for capital investments, not for public non-productive consumption. In this way, Bosnia and Herzegovina, in present circumstances, should reduce the overvaluation of the domestic currency, so that everyone can pay the real price of the business. All those that were previously subsidized due to the overvaluation of the domestic currency (traders, banks and employees in the public sector with administrative salaries) would have negative consequences of real depreciation, and all newly-employed workers and export-oriented industrial companies would benefit from real depreciation of the domestic currency. In the long-run, the reduction of overvaluation and the creation of the undervaluation of the currency will create the growth of net exports, foreign exchange revenue for repayment of external debt, revenues to the state budget and new investments. Also, long-term economic growth is the best way to prevent inflation.

BiH is not able to lead an autonomous expansive monetary policy in order to encourage investments and economic development. This is justified by a number of economic (size and openness of the economy, import dependence, currency substitution and a lack of money illusions, currency speculation, etc.) and non-economic (political influences and distrust in institutions, corruption, psycho-

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<sup>24</sup> For the purpose of better functioning of the entity development banks, a "Letter of Intent" of the government of BiH envisages measures such as: banking agencies should take the supervision over the national development banks instead of the entity governments, remuneration of board members should be linked to the realized effects, external audit reports must be publicly available, etc. The aim is to prevent the affairs of the past (for example, lending to members of the supervisory board and employees, although the law prohibits lending to individuals, lending to favourable enterprises based on political and private interest criteria).

logical influences, etc.) factors. It is realistic to assume that such a policy would lead to high inflation and the capital outflow from the country. If a detailed cost/benefit analysis shows that it is not possible to introduce a classical central bank, Bosnia and Herzegovina can leave the currency board and autonomously introduce the euro. It would be technically simple to do, but would not significantly resolve the economic problems.

Discretionary monetary policy is appropriate for much larger, less open and politically stable economies, such as the Eurozone. In such countries, the primary emission of money (lat. *ex nihilo*) and direct financing of public investments could be an effective measure of getting out of the recession, with significant multiplicative effects without necessarily causing inflation. As long as the primary emission of money is covered in new production and employment, it will not cause inflation. In economically and politically stable countries, it is possible to have low inflation that stimulates investment in the long-run and maintains price stability through economic growth. In addition to the quantitative easing policy, it is necessary to create a real transmission mechanism, i.e. a national development bank, which will ensure that the primary money emission is invested directly, not through banks, in the public-infrastructure projects and new production.<sup>25</sup> Because “... the central banks have the power to prevent a bank or non-financial corporation from failing by lending it money needed to pay its workers and suppliers, but they cannot oblige companies to invest or households to consume, and they cannot compel the economy to resume its growth” (Piketty, 2014, str. 649-650). In the case of large and successful economies (the US, the EU, China, etc.), the exchange rate can become a flexible instrument of monetary policy instead of a fixed nominal anchor, and the role an anchor is replaced by targeted inflation with pre-programmed and precise devaluation in order to allow adaptation of market entities and prevent destabilizing speculation.

## Conclusion

The currency board, as the strictest form of the exchange rate system without any discretionary rights in monetary policy, allows nominal stability of the exchange rate and prices. Monetary stability is a fundamental precondition for a transition period in which structural reforms have to be implemented. But monetary stability without the necessary structural reforms, for small, open and insuffi-

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<sup>25</sup> In the UK, British economist Jeremy Corbyn proposes a policy of “People’s Quantitative Easing (PQE)” by investing in public infrastructure (energy, transport) directly, rather than through banks. The investments would be made through the National Investment Bank set up to invest in new infrastructure, etc. Corbyn, J., *The Economy in 2020*, p. 5-6. (Retrieved on 17 January 2017, from [http://www.solidariteetprogres.org/IMG/pdf/theeconomyin2020\\_jeremycorbyn-220715.pdf](http://www.solidariteetprogres.org/IMG/pdf/theeconomyin2020_jeremycorbyn-220715.pdf))



ciently competitive economies, is not sufficient and will not lead to real economic convergence. On the contrary, the process of divergence dominates the process of convergence, both between EU members and potential members. Structural and pre-accession EU funds can only mitigate this. With the entry of new member states with insufficient levels of real economic convergence and facing unfair competition of multinational corporations in much more developed old members in the free market of the EU, the EU has become increasingly less integrated union of politically and economically equal sovereign members, and increasingly more integrated market of unfair competition dominated by a large capital of multinational corporations.

BiH, as a small, open, deindustrialized and indebted economy with its early entry into the EU, will have less chance for reindustrialisation and autonomous management of economic development policy. BiH must undertake economic policy measures in order to implement real depreciation, i.e. reduce overvaluation and undervaluation of the domestic currency, which would lead to the improvement of real economic convergence towards the EU. Therefore, BiH should, as soon as possible, initiate a process of major structural reforms of public expenditure reduction and restructuring, in order to create more a favourable business environment for domestic and foreign investment and mobilise investments from public funds through development banks exempted from any form of political influence. The currency board in BiH has provided nominal stability, but in the long run, without the necessary structural reforms, it limits economic development. It is absurd in which the nominal stability of the exchange rate and prices is insured, the currency becomes more overvalued and production and employment are decreasingly lower. By implementing structural reforms, that is creating legality and the rule of law, providing a better business environment and implementing a Keynesian investment policy in the context of internal adjustment, Bosnia and Herzegovina has a chance to change the negative economic trends. Otherwise, BiH will become increasingly de-industrialized and indebted, sell the most valuable state-owned enterprises and completely lose its economic and probably political sovereignty.

Discretionary monetary policy and a classic central bank is not an option for Bosnia and Herzegovina. Namely, given the overall political and economic situation in BiH, it is realistic to assume that such a policy would lead to huge inflationary pressures as a result of the emission of money and devaluation. The primary money emission (known as quantitative easing – QE policy) aimed at depreciating the exchange rate, reducing interest rates and consequently stimulating economic growth, in contemporary conditions of the globalized world, is the privilege of only large economies (the USA, the EU, China, Japan, etc.).

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