

CHAPTER 5

EUROISATION AND MONETARY POLICY IN BOSNIA AND HERZEGOVINA – SITUATION AND PERSPECTIVES



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Abstract

The Central Bank of Bosnia and Herzegovina is an independent monetary institution established by the Constitution of Bosnia and Herzegovina as the sole authority for conducting monetary policy at the state level. Its powers and organisational structure are regulated by the Constitution of Bosnia and Herzegovina (Annex 4 of the Dayton Peace Agreement) and the Law on the Central Bank of Bosnia and Herzegovina. In accordance with these acts, the Central Bank functions as a currency board, where the convertible mark is officially tied to the euro (EUR). This paper provides an overview of the regulatory framework for the operation of the Central Bank of Bosnia and Herzegovina, presents the management of foreign reserves and mandatory reserves, and discusses the suitability of the currency board in Bosnia and Herzegovina, which has led to a semi-official euroisation, facilitating the path to EU membership.

Keywords: currency board, euroisation, Central Bank of Bosnia and Herzegovina

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1. Introduction

A currency board is a form of fixed exchange rate that involves complete and automatic linkage of the domestic currency to a foreign currency. The foreign currency serves as an “anchor” for the value of the domestic currency and is often one of the “leading” world currencies with high stability and convertibility. The basic principle of a currency board dictates that the central bank must maintain foreign reserves in a precise proportion to the amount of domestic currency in circulation. This means that the quantity of domestic currency in the economy automatically adjusts to changes in foreign reserves. The introduction of a currency board has several advantages, such as exchange rate stability, reduced inflation, lower foreign exchange risk, increased investor confidence, etc. Economic history shows that countries that have implemented a currency board typically lack experience in conducting independent monetary policy, have underdeveloped financial systems and markets, or have experienced severe economic crisis with the collapse of the monetary system.

Euroisation is a process in which a country officially adopts the euro (EUR) as its legal tender, replacing its own domestic currency. This means that citizens, businesses, and other institutions in the country use the euro for their financial transactions instead of the domestic currency. The decision to euroise can be motivated by a desire for stability, ease of business, or political alignment with the European Union. Euroisation poses certain challenges, and countries intending to pursue euroisation, regardless of the form it takes, must carefully assess all aspects before deciding to adopt the euro. Euroisation usually occurs when a country becomes a member of the eurozone or simply decides to unilaterally adopt the euro as its currency, often for various reasons (e.g., Montenegro, Andorra, Kosovo). Bosnia and Herzegovina (BiH) experiences a partial official euroisation that began indirectly through the introduction of the currency board and the efforts of the monetary authorities to maintain it until BiH achieves EU membership status.

The currency board, based on whose principles monetary policy in BiH is conducted, is established by the provisions of Articles 31 and 32 of the Law on the Central Bank of Bosnia and Herzegovina. These articles specify the official exchange rate for the currency of BiH (convertible mark at 0.511292 euros). In practice, this means that the purchase of convertible marks is conducted at a fixed exchange rate of 1.95583 convertible marks to one euro. For the currency board to function, foreign currency reserves must be sufficient to enable anyone holding convertible marks, including funds in reserve accounts of banks with the Central Bank of Bosnia and Herzegovina and deposits of depositors with the Central Bank, to convert them into the foreign currency. In simpler terms, each issued convertible mark has coverage in foreign currency. In the Bosnian-Herzegovinian scientific and political milieu, there is a debate about the justification of the existence of the currency board. Do the reasons that justified the introduction of the currency board in BiH still hold? Would abandoning the currency board contribute to the economic growth of BiH? The currency board in BiH is sometimes the target of criticism from some economists

who believe that the currency board represents an obstacle to the economic growth of BiH because it has negative implications for the export of the Bosnian-Herzegovinian products. However, the problems of BiH are not of a monetary nature but real, and if the exchange regime in BiH were to change, Bosnian-Herzegovinian exports might not necessarily increase because the Bosnian-Herzegovinian economy is less competitive than countries that produce the same or similar products. Simply put, production costs, for various reasons, are too high, and the use of monetary policy instruments would not have a significant effect. At the same time, questions arise about the advantages of tying the convertible mark to the euro and acquiring EU membership status, i.e., entering the European Monetary Union. In this integration path, the Central Bank of Bosnia and Herzegovina has its role. The Central Bank participates in the work of coordination structures established on the basis of the Decision of the Council of Ministers of Bosnia and Herzegovina on the EU coordination system to monitor the implementation of the contractual obligations stemming from the Stabilisation and Association Agreement (SAA). To answer these questions, this paper presents the legal basis, goals, and tasks of the central bank, an analysis of the quality of management of foreign reserves and mandatory reserves as the only instrument of the monetary policy of the central bank, and presents the views and findings of the European Commission and the International Monetary Fund in the context of the work of the Central Bank of Bosnia and Herzegovina.

2. Central Bank of Bosnia and Herzegovina – legal basis, goals, significance and organisational structure

BiH is a country in transition and development, which has recently acquired the status of candidate for EU membership, with a GDP in 2021 of 39,107 million KM¹, whose index of volume of consumption per inhabitant is significantly lower compared to the countries in the region. GDP per capita in 2021 was 33% of the EU 27 average, while real individual consumption per inhabitant in SKM (purchasing power standard) was 41% of the EU 27 average.² In addition to a small, open economy, BiH is characterised by an extremely complex state structure that has implications for its economic system and market, which is still not unique in a large number of segments.

According to Annex 4 of the Dayton Peace Agreement, which represents the Constitution of Bosnia and Herzegovina, and the decision of the International Court of Arbitration, in the administrative-territorial sense, BiH is composed of two Entities (the Federation of Bosnia and Herzegovina and the Republika Srpska) and the Brčko

1 Agency for Statistics of Bosnia and Herzegovina, 2023.

2 Agency for Statistics of Bosnia and Herzegovina, 2022.

District. The Entity Federation of Bosnia and Herzegovina is divided into 10 cantons, while the Entity Republika Srpska is unitary. This complex state arrangement results in economic federalism, i.e. the distribution of responsibilities between the State of Bosnia and Herzegovina, the two Entities and the Brčko District. Within the Federation of Bosnia and Herzegovina, jurisdiction is divided between the Federation and 10 cantons. Annex 10 of the Dayton Peace Agreement stipulates that the institution of the Office of the High Representative (OHR) in BiH supervises the civilian implementation of the agreement, representing the countries involved in the Dayton Peace Agreement through the Peace Implementation Council (PIC). In 1997, the PIC gave additional significant powers to the OHR, in order to avoid delays and obstructions in the implementation of the Dayton Peace Agreement. Under the so-called Bonn powers, the OHR can make binding decisions in cases of violations of the Dayton Peace Agreement and legal obligations in general.³

The Constitution of Bosnia and Herzegovina in Art. 1 prescribes freedom of movement throughout BiH in the sense that BiH and the Entities will not hinder the full freedom of movement of persons, goods, services and capital throughout BiH. No Entity shall exercise any control at the border between Entities. This guarantees the single market of BiH.

In Art. 3 of the Constitution of Bosnia and Herzegovina, the competences of the institutions of BiH and its Entities are determined in such a way that the following issues are within the competence of the institutions of BiH: foreign policy, foreign trade policy, customs policy, monetary policy, financing of institutions and international obligations of BiH, policy and regulation of regarding immigration, refugees and asylum, enforcement of international and inter-entity criminal law regulations, including relations with Interpol, establishment and functioning of joint and international means of communication, regulation of inter-entity transport and air traffic control.

Art. 7 of the Constitution stipulates that the Central Bank of Bosnia and Herzegovina is the only authorised institution for printing money and monetary policy in the entire territory of BiH. Its competence is determined by the Parliamentary Assembly of Bosnia and Herzegovina. Also, the Constitution stipulates that, within a period of six years from the entry into force of this Constitution, the Central Bank will not be able to grant loans by printing money, nor function as a currency commission; after that period, the Parliamentary Assembly can give this authority to the Central Bank.

The aforementioned constitutional solution ensured that BiH has its own central monetary institution, which became a constitutional category, and represents the outcome of the activities undertaken until then by Narodna banka B&H, the Institute for Payment Transactions and commercial banks in preserving the monetary sovereignty of BiH.

3 Marković Bajalović and Imamović Čizmić, no date, ip.

In addition to the Constitution, as the highest legal act, the most significant source of monetary law is the Law on the Central Bank of Bosnia and Herzegovina (Official Gazette of Bosnia and Herzegovina, no. 1/97, 29/02, 8/03⁴, 13/03, 14/03, 9/05, 76/06, 32/07), which has undergone seven amendments to date. This Law regulates the following issues: establishment, goals and tasks of the Central Bank, organisation and administration of the Central Bank, financial provisions, monetary functions and operations of the Central Bank, monetary unit, banknotes and coins, foreign exchange policy, foreign exchange reserves and foreign exchange control, relations of the Central Bank with banks, accounts, financial statements, audits and reports of the Central Bank, various provisions regulating the special rights and obligations of the Central Bank.

The Central Bank is an independent institution with legal personality whose goals and tasks are prescribed in Art. 2 of this Law. According to the mentioned article, the goal of the Central Bank is to achieve and maintain stability of the domestic currency (convertible mark) by issuing domestic currency under an arrangement known as currency board. The basic assignments of the Central Bank are: (a) to define, adopt and control the monetary policy of BiH through the issuance of domestic currency (convertible mark) at the exchange rate determined by this Law with full coverage in freely convertible foreign currency assets, (b) to keep and manage the official foreign exchange reserves of the Central Bank in a safe and profitable manner; (c) to support or establish and maintain appropriate payment and accounting systems; (d) to issue regulations for the implementation of the activities determined by the provisions of this law; (e) to coordinate the activities of the agencies responsible for issuing banking licences and supervising banks in the Entities in a manner determined by the Central Bank's Governing Council, including monthly meetings of the heads of these agencies with representatives of the Central Bank and the submission of monthly reports by these agencies to the Central Bank on their activities and movements in financial institutions under their jurisdiction; (f) to implement monetary policy; (g) to receive deposits from BiH and commercial banks in order to fulfil the requirements for mandatory reserves. The Central Bank can also hold deposits of the Entities and other public institutions, as well as other reserves of commercial banks, if they so wish; (h) to review the information forwarded to the Central Bank by the Entities' Banking Agencies on the basis of the Law on the Banking Agency of the Federation of Bosnia and Herzegovina and the Law on the Banking Agency of the Republika Srpska; (i) to put into and withdraw from circulation domestic currency (convertible mark), including banknotes and coins of legal tender, strictly adhering to the rules of the currency board; (j) to implement actions to help combat money laundering, support anti-terrorist measures and measures against obstruction of the implementation of the General Framework Agreement for Peace in Bosnia and Herzegovina, which relate to banks.

4 This amendment is imposed by Office of the High representative, 2003.

Duties, tasks and obligations of the Central Bank are carried out through its headquarters, main units and other branches. The basic tasks of the Central Bank should be performed under the authority of its Governing Council, which has exclusive jurisdiction over tasks related to defining and controlling monetary policy of BiH, issuing currency, managing foreign exchange reserves, establishing and maintaining payment and accounting systems, and coordinating the activities of the Banking Agencies. The remaining tasks should be performed by the headquarters, main units and other branches of the Central Bank.

According to Article 5 of the Law on the Central Bank of Bosnia and Herzegovina, the organisation and administration of the Central Bank is based on the Governing Council, the management board consisting of the Governor, three Vice-Governors and the staff.

Article 8 regulates the constitution of the Governing Council. This article stipulates that during the first six years of operation of the Central Bank, the Governing Council consists of the Governor appointed by the International Monetary Fund with prior consultations with the Presidency of Bosnia and Herzegovina and three members appointed by the Presidency of Bosnia and Herzegovina. The Governor appointed by the International Monetary Fund is not a citizen of BiH or any other neighbouring country. The three members appointed by the Presidency of Bosnia and Herzegovina are one Bosniak and one Croat from the Federation of Bosnia and Herzegovina and one Serb from the Republika Srpska.

After the first six years of operation of the Central Bank, the Governing Council of the Central Bank consists of five members appointed by the Presidency of Bosnia and Herzegovina. After the appointment of the aforementioned members of the Governing Council, the Governing Council elects the Governor from among its members for a period of six years.

According to Article 17 of the Law on the Central Bank of Bosnia and Herzegovina, the management board of the Central Bank consists of the Governor and Vice-Governors, who, with the approval of the Governing Council, are appointed by the Governor. Members of the Governing Council can be appointed as Vice-Governors only with the unanimous decision of the Governing Council. The Governor may, with the approval of the Governing Council, assign temporary tasks to other members of the Governing Council. He can also give long-term assignments to the members of the Governing Council, if such assignments are unanimously approved by the Governing Council.

Art. 18 of the Law on the Central Bank of Bosnia and Herzegovina confers on the Governor the powers of the administration of the Central Bank, making him/her chief executive officer of the Central Bank in charge of the day-to-day operations of the Central Bank. If the Governor is absent, or is unable to perform his duties, the Vice-Governor, chosen by him with the approval of the Governing Council, acts as the chief executive officer of the Central Bank. The Governor is responsible to the Governing Council for the execution of their decisions, as well as for the management and control of the administration and activities of the Central Bank.

Based on Art. 2 of the Law on the Central Bank of Bosnia and Herzegovina, the Central Bank has adopted a large number of acts in the form of regulations, decisions and instructions. Most of these acts refer to the issuance of banknotes, while the following can be distinguished from other acts: (1) Regulation on the conditions, procedure, and documentation for registration in the Register of banks, subsidiaries, branches, and representative Offices in the Brčko District of Bosnia and Herzegovina. Rulebook on the conditions, procedure and documentation for registration in the Survey of banks, subsidiaries, branches and representative offices in the Brčko District of Bosnia and Herzegovina (Official Gazette of Bosnia and Herzegovina, 16/03)⁵; (2) Decision on the method and deadlines for submitting reports on total open foreign exchange positions of banks (Official Gazette of Bosnia and Herzegovina, 16/99); (3) Decision on the establishment of the Branch of the Central Bank of Bosnia and Herzegovina in Brčko (Official Gazette of Bosnia and Herzegovina, 10/00); (4) Decision repealing the Decision on determining compensation to commercial banks for withdrawing convertible mark banknotes from circulation (Official Gazette of Bosnia and Herzegovina, 16/05); (5) Decision on organising the clearing method for calculating international payments (Official Gazette of Bosnia and Herzegovina, 42/07); (6) Decision on repealing the decisions of the Central Bank of Bosnia and Herzegovina regulating electronic signature (Official Gazette of Bosnia and Herzegovina, 88/07); (7) Decision on taking over and converting monetary gold (Official Gazette of Bosnia and Herzegovina, 28/09); (8) Decision on establishing operational rules for gross settlement in real time (Official Gazette of Bosnia and Herzegovina, 31/16 and 37/19); (9) Decision on the establishment of the Branch of the Central Bank of Bosnia and Herzegovina in Banja Luka (Official Gazette of Bosnia and Herzegovina, 24/98 and 3/99); (10) Instructions on the structure and use of the international bank account number (IBAN) (Official Gazette of Bosnia and Herzegovina, 43/09); (11) Instructions on the procedure, activities and measures of the Central Bank of Bosnia and Herzegovina when a commercial bank fails to fulfil its obligation regarding the establishment and maintenance of mandatory reserves and in case of status changes of a commercial bank (Official Gazette of Bosnia and Herzegovina, 31/14);

- 5 The Brčko District functions within Bosnia and Herzegovina's unified monetary system, which is overseen by the Central Bank. The Central Bank ensures the stability of the currency board, issues the convertible mark (BAM), and regulates the country's monetary policy. There are no bank headquarters located within the Brčko District; instead, all banking institutions operate through branches or representative offices that are registered either in the Federation of BiH or Republika Srpska. All banks and their affiliated organizational units must be registered in the official Register of Banks, Subsidiaries, Branches, and Representative Offices in the Brčko District, with oversight provided by the local authorities in accordance with established regulations. The Regulation on the Conditions, procedure, and documentation for registration in the Register of banks, subsidiaries, Branches, and Representative Offices in the Brčko District of Bosnia and Herzegovina is a normative act that governs the conditions, procedure, and documentation required for the registration of banks, their branches, representative offices, and other legal entities in the official register of the Brčko District, maintained by the Branch of the Central Bank. Registration in the register is mandatory and a necessary condition for the commencement of banking operations in the Brčko District.

(12) Decision on the establishment of the main units of the Central Bank of Bosnia and Herzegovina (Official Gazette of Bosnia and Herzegovina, 7/98, 3/99 and 8/01); (13) Decision on the guaranteed convertibility of the convertible mark (Official Gazette of Bosnia and Herzegovina, 27/98); (14) Guidelines on rounding the amount for payment in cash payment transactions (Official Gazette of Bosnia and Herzegovina, 94/07); (15) Decision on the purchase and sale of effective foreign currency for foreign currency funds to commercial banks (Official Gazette of Bosnia and Herzegovina, 64/18 and 22/21); (16) Decision on the purchase and sale of convertible stamps to commercial banks (Official Gazette of Bosnia and Herzegovina, 64/18 and 22/21); (17) Decision on operational rules for the giro clearing system (Official Gazette Bosnia and Herzegovina, 37/19); (18) Decision on the Central Register of Credits of Business Entities and Individuals in Bosnia and Herzegovina (Official Gazette of Bosnia and Herzegovina, 44/19 and 77/21); (19) Instruction for operating the Reserve account of commercial Banks (Official Gazette of BiH, 2/15) Instructions for working on the reserve account of commercial banks (Official Gazette of Bosnia and Herzegovina, 2/15)⁶; (20) Decision on determining the tariff of fees for services provided by the Central Bank of Bosnia and Herzegovina (Official Gazette of Bosnia and Herzegovina, 10/21, 53/22 and 81/22); (21) Decision on monitoring the functioning of payment systems (Official Gazette of Bosnia and Herzegovina, 76/22); (22) Decision on the Unified Register of Accounts of Business Entities in Bosnia and Herzegovina (amended text) (Official Gazette of Bosnia and Herzegovina, 26/23)

In addition to the above, the Central Bank of Bosnia and Herzegovina has adopted a number of other acts and regulations with the aim of improving the functioning of the organisational system of the Central Bank of Bosnia and Herzegovina, relying on the good practices of central banks in developed countries. Moreover, the Central Bank of Bosnia and Herzegovina has continuous communication with the European Central Bank (ECB), the central banks of the Eurozone, and other central banks of different countries, including the most important monetary institutions in the world, such as the WB and the IMF, in order to improve its functioning. The Central Bank of Bosnia and Herzegovina participates in the work of various forums and bodies in which the governors and finance ministers of the most developed countries of the world and the region take part.

6 This Instruction the procedure for opening, maintaining, and closing reserve accounts of banks with headquarters in Bosnia and Herzegovina at the Central Bank of Bosnia and Herzegovina on which the bank holds funds for the purpose of fulfilling the mandatory reserve. It also outlines the procedures, activities, and measures to be taken in cases where the bank fails to meet the mandatory reserve requirements, as well as in the event of the revocation of the operating license or changes in the bank's status. Additionally, it covers other rights, obligations, conditions, and the manner of operation between the Central Bank and the bank.

3. Currency board and euroisation in Bosnia and Herzegovina

The Central Bank of Bosnia and Herzegovina operates according to the principle of currency board, and apart from defining the reserve requirement rate, it does not have other functions typical of central monetary institutions of market economies that represent instruments of monetary policy.

A currency board is a monetary regime based on an explicit legal obligation to replace the domestic currency with a specified foreign currency at a fixed exchange rate. This means that the domestic currency is only issued if it is fully covered by the foreign currency.⁷ The currency board is an arrangement with a fixed exchange rate that is tied to the “sirdo” currency, gold or even a basket of currencies where all money can be freely converted into the reserve “anchor” currency and where the basic functions of the central monetary institution – the bank – are limited and strictly prescribed by law. Foreign currency is most often one of the world’s currencies, with high stability and convertibility, which guarantees the security of the domestic currency with its credibility.

Economic history indicates that currency boards were most often introduced:⁸ (a) after gaining colonial independence (British colonies), (b) after a period of marked macroeconomic instability, (c) after the first transitional reforms and the opening of economies.

Considering the macroeconomic determinants, i.e. the environment at the time of the introduction of the currency board, the countries can be divided into two groups. The first group consists of countries where the need to introduce a currency board arose as a result of monetary and currency instability, and the second group includes countries with a small open economy that do not have enough experience in conducting monetary policy. The common determinant for both groups of countries is that they are countries in transition with a relatively low level of economic development.

The application of the currency board model, bearing in mind the experience of the countries that introduced it, has its advantages and disadvantages. In the literature, the following are mentioned as advantages:⁹ (a) Financial discipline is ensured and monetary balance is established automatically and constantly, without exceptions or reasons of a “special nature”; (b) Full convertibility and a fixed exchange rate are provided, which means that conversion costs and currency risk are effectively zero, and transaction costs are reduced to a minimum; (c) The regime of free movement of capital is ensured; there can be no restrictions regarding the raising of

7 Jakovčević, Lovrinović and Radošević, 2011, p. 461.

8 Kozarić and Fabris, 2012, p. 210.

9 Savin, 2003, pp. 123–141.

reserve currency funds on any basis. The currency board is obliged to exchange any amount of convertible money into domestic money and vice versa.

In addition to the loss of the monetary sovereignty of the central government and the possibility of conducting a discretionary monetary policy, two main disadvantages can be mentioned: (a) ban on granting loans (institute of last resort) to commercial banks and other institutions, (b) inadequate protection against speculative shocks.

There are at least three justified reasons for the introduction of a currency board in BiH, which existed and which are still valid today. Namely, in the 1990s, BiH began the process of transition to a market economy with private ownership as the dominant form of ownership over the capital of business companies, which was interrupted by the aggression against BiH. A successful transition process meant the creation of macroeconomic stability, the backbone of which is stable domestic money, which rests on a real basis and provides a solid basis for realistic calculations of private investments in the economy. Another reason for the introduction of the currency board is related to general social conditions, i.e. the need for general social stability in BiH after the aggression (1992-1995) which resulted in war destruction and post-war trauma, administrative complexity and asymmetry, national divisions, lack of mutual trust within ethnic groups, and different types of discrimination in the domestic and international context.

In such social conditions, it was not acceptable to establish a central monetary institution with absolute authority in conducting “discretionary” monetary policy. At the same time, there were additional economic reasons for introducing a currency board. To understand the economic reasons for introducing a currency board in BiH, several facts need to be mentioned. After the dissolution of the Socialist Federal Republic of Yugoslavia (SFRY), the Bosnian-Herzegovinian dinar (BHD) was introduced in BiH in 1992 as the means of payment in the payment system of BiH. The conversion of the Yugoslav dinar (YUD) to BHD was carried out at a rate of 1 BHD to 10 YUD. Deposit money was replaced through conversion at the given rate through the Social Accounting Service. During that period, due to the prevailing political situation, three currencies were in circulation in the territory of BiH (BHD, YUD, and the Croatian kuna). Since there were difficulties in securing BHD and its pegging to neighbouring currencies, from the second half of 1994, the former German mark (DEM) began to be used as means of payment. According to the exchange rate, BHD was pegged to DEM, where 1 DEM was equivalent to 350 BHD. In conditions of economic collapse and hyperinflation, there was a need for additional cash, which could not be printed to such an extent, so DEM was increasingly used as a payment currency.¹⁰ The macroeconomic situation was characterised by high inflation, a decline in economic activity, and problems in the functioning of the fiscal system, leading the government to borrow from the Central Bank of Bosnia and Herzegovina to finance public expenditure. In order to address such a situation, in mid-1994,

¹⁰ Marjanac, 2013, p. 113.

the monetary authorities of BiH took certain measures (BHD confirmed as the definitive means of payment, denomination of BHD by removing four zeros, introduction of a dual currency payment system BHD/DEM, fixed official exchange rate of 1 DEM – 100 BHD, reduced borrowing of the government and commercial banks from the Central/National Bank of Bosnia and Herzegovina).¹¹

The currency board, which was introduced in 1997, establishes KM as the only valid and legal means of payment in the entire territory of BiH, while all other monetary units that circulated in legal and economic traffic until then are abolished and prohibited as such.

Its influence and results differ depending on the aspect being observed. Two aspects are most often mentioned in the literature. The first aspect is the management of monetary policy, where the currency board proved to be a good solution, because it fulfilled the main goals, primarily the establishment of a healthy and stable monetary system and the prevention of political influence on the autonomy of the Central Bank when issuing money. Taking into account the experiences of the Federal Republic of Yugoslavia (FRY) and Croatia, and their monetary authorities, which stimulated hyperinflation during the greatest crisis by issuing money without cover, it can be said that this purpose of introduction has been fully fulfilled. Namely, by analysing the effects of the application of this regime during the past years of implementation, in order to ensure monetary stability, the currency board successfully achieved other objectives of the monetary policy to a greater extent:¹² (a) strengthening financial stability and discipline, (b) low inflation rate, (c) attracting foreign investments, (d) continuous growth of foreign exchange reserves, (e) development of the financial market, (f) servicing of the external state debt, (g) political independence.

Another aspect of observing the effects of the currency board is the achievement of economic policy goals, the achievement of economic development and the stimulation of economic growth through boosting domestic exports by devaluation of the domestic currency. Some analyses show the absence of a positive effect, which is expected due to the tight peg of the convertible mark to the euro. At this point, it is necessary to explain the reasons for the absence of those effects that are not related to the currency basket. Namely, taking into account the theoretical assumptions, the effect of devaluation on the stimulation of exports, which is of a short-term nature, also depends on the productivity, quality and competitiveness of domestic production on the foreign market. If the above considerations are put into the context of the economy of BiH, which is still characterised by an insufficiently high level of technical and technological development, accompanied by an insufficient level of competitiveness of domestic production, it can be concluded that the existence of a currency board, which prevents the use of monetary policy instruments, is not the only obstacle to economic growth. The reasons are much deeper and are found in the real sector, which affects all three dimensions of international competitiveness

11 Kozarić and Fabris, 2012, p. 223.

12 Marjanac, 2013, p. 114.

(price, structural and living standards). The analysis of international competitiveness in all these dimensions indicates that there is considerable room for action in order to improve the position of the economy of BiH on the international level. For example, the competitiveness of the industry represents a key challenge in order to increase the aggregate supply and achieve economic growth, which would ultimately lead to raising the standard of living of the citizens of BiH to a level that could rival the EU27 countries. In relation to the neighbouring countries, after the dissolution of Yugoslavia and the acquisition of independence, BiH had a much worse starting position due to the damage caused by war events during the aggression, which is reflected in the loss of human capital through expulsions and genocide, the destruction of production capacities and infrastructure, and the loss of export markets also due to the inherited modest, undifferentiated, labour- and resource-intensive industry with low productivity. In addition to these factors, a significant handicap for the economy of BiH was the inefficient and still unfinished process of privatisation in BiH as well as the slowness in the implementation of economic reforms in general. This results in high costs of the products from BiH. Before the crisis in 2008, BiH recorded growth of up to 10% on an annual basis, but this was not enough to significantly improve the overall industrial base and raise capacity utilisation to a higher level.¹³

Therefore, if the currency board regime were to be abandoned, Bosnian exports would not necessarily increase, because domestic products are less competitive in terms of price and structure than the products of countries that offer the same or similar products on the international market. Production costs, for the above and other reasons, are too high and no amount of monetary intervention can help much. It should be borne in mind that the weakening of the KM exchange rate would certainly have negative effects on debtors with loans indexed or issued in foreign currencies. The value of the debt would increase in case of devaluation. If the policy of targeted inflation were to be used, it is acceptable in stable circumstances in the world food and energy markets and in countries that have a significant influence on the world prices of these goods. This is because BiH is a significant importer of food, oil, and gas, which affects price shocks in the country. Therefore, for the transition from the regime of the currency board to the discretionary monetary policy in BiH, which implies the use of instruments for achieving economic growth, there should be favourable economic conditions, the completion of economic and structural reforms, which has not yet been done.¹⁴ The currency board, if a favourable regulatory environment for business would be created, puts the domestic economy and businesses in the right position related to the level of competitiveness without any artificial intervention of a monetary financial type, which in the long term creates conditions for sustainable economic development on a realistic basis. What does a favourable regulatory environment for business mean? In the simplest terms, a favourable regulatory environment is one that ensures the ease of doing

13 BiH Directorate for Economic Planning, 2021.

14 Central Bank of B&H, 2021.

business in a country. Namely, it is of crucial importance how easy it is for a local entrepreneur to open a small or medium-sized enterprise and do business according to the current legislation of the country. It does not include all issues that are important to the enterprise, but it covers important areas that are under the control of policy makers. According to the Association of Employers of Bosnia and Herzegovina, in order to create conditions for better business, it is necessary to change the laws at the level of BiH as well as at the level of the Federation of Bosnia and Herzegovina. Laws refer to taxes, contributions, working conditions and other additional things.¹⁵

There is considerable room for action in creating a favourable environment for business and it is transferred to the tax policy with the aim of reducing taxes and other levies that burden economic operators and affect the level of product prices and the accumulation of investments. Therefore, the priority of the fiscal policy would be the implementation of the tax reform in BiH, which should be revenue neutral. However, if taxes were to be reduced, the problem of filling the budget and creating a budget deficit would arise. Generally speaking, the budgets in BiH have the financing of a complex administrative apparatus conditioned by state regulation, which ultimately leads to the issue of constitutional reforms in BiH.

The foundations of the currency board in BiH, in addition to the Constitution of Bosnia and Herzegovina, are prescribed in Chapter IV titled 'Monetary functions and operations of the Central Bank' of the Law on the Central Bank. According to Art. 31 of this Law, which provides for the rule of issuing domestic currency or currency board, the Central Bank is obliged to ensure that the total amount of its monetary liabilities never exceeds the equivalent amount (expressed in the currency of BiH) of its net foreign exchange reserves. This Law establishes the rules according to which: (1) the total amount of monetary liabilities of the Central Bank is always the sum of: (a) all banknotes and coins put into circulation by the headquarters, main units and other branches of the Central Bank and (b) credit balances of all accounts kept in the books of the Central Bank and its organisational units by resident account holders; (2) the net foreign exchange reserves of the Central Bank represent at all times the difference between the fair market value of the assets and liabilities of the Central Bank listed below.

Article 32 stipulates that the official exchange rate for the currency of BiH is one convertible mark for 0.511292 euros, that is, one euro equals to 1.955830 convertible marks. The binding of the convertible mark to the euro leads to restrictions, the most important of which is the conditionality of the primary emission based on the euro reserves as an "anchor currency", i.e. the indirect influence of the monetary policy of the ECB on the monetary system of BiH. In practice, this means that it is a monetary regime based on the rule that the domestic currency is 100% covered by a certain foreign currency. In order for the arrangement of the currency board to function, the foreign exchange reserves must be high enough to ensure that all owners of KM, including deposits of resident banks with the Central Bank of Bosnia and Herzegovina

15 Udruženje poslodavaca Federacije BiH, 2022.

as well as the funds of the government, government institutions and agencies that hold KM deposits with the Central Bank of Bosnia and Herzegovina, are enabled to convert to foreign means of payment whenever they so wish. All issued KM, both cash and giro, are covered by foreign currency, i.e. the complete issued monetary liabilities of the Central Bank of Bosnia and Herzegovina are covered by held foreign exchange reserves.¹⁶ Bearing in mind these indications and the reports of the Central Bank, it can be concluded that the Governor and the Governing Council of the Central Bank of Bosnia and Herzegovina lead the policy of the currency board very responsibly, and based on the reports it can be seen that the coverage of monetary liabilities is 3-6% higher than the prescribed 100% which additionally strengthens the trust of both citizens and business operators, as well as foreign investors and international institutions in the domestic currency KM in BiH.

The arrangement of the currency board for certain countries is a stage in the introduction of full “euroization” and when it is implemented, the country still retains the central bank and the national currency. The currency board is then seen as a transitional form towards further EU integration in the form of eurozone membership.¹⁷ Eurisation is a term that appears as a counterpart to the term dollarisation¹⁸ and in the broadest definition it means a situation in which one country uses the euro as means of internal payment. A more concrete definition would imply ‘several different monetary systems that are very different from each other, but have the common characteristic that in formal or informal transactions foreign currency is widely distributed, as a means of payment.’¹⁹ Eurisation is most often associated with ‘small currency areas, it is open and sensitive to international capital flows.’²⁰ In the literature, the following factors are cited as factors that lead to euroisation:²¹ (a) in the long term, macroeconomic imbalance, manifested as ‘high and volatile inflation, stronger depreciation of the domestic currency and unsustainable economic growth’; (b) “underdeveloped capital market” in the country; (c) disruption of the macroeconomic balance, that is, “market imperfection”; (d) incomplete institutional structure, i.e. “currency blind regulatory framework.”

The aforementioned factors can be linked to the reasons for the introduction of the currency board in BiH and the aspiration to establish and maintain a stable monetary system in BiH, an underdeveloped institutional structure and an underdeveloped capital market.

There is no universal form of eurisation, so different types have appeared in practice that affect independence in the conduct of monetary policy in different

16 Hodžić and Gregović, 2017, p. 109.

17 Hodžić and Gregović, 2017, p. 111.

18 The term “dollarization” emerged as a result of the frequent substitution of unstable national currencies with the dollar. It most commonly occurs in less developed countries where there has been a loss of confidence in the domestic currency, which has been unstable for an extended period.

19 Fabris, 2006, p. 9.

20 Tomić, 2009, p. 3.

21 Ivković, 2011, p. 82.

ways:²² (a) Full official euroisation – implies a situation in which the foreign currency (euro) is the only legal tender and the domestic currency does not exist. (b) Partial official euroisation – implies a situation in which both foreign currency (euro) and domestic currency are used as legal tender. (c) Unofficial euroisation – refers to the situation when, due to the lack of trust in the domestic currency, a foreign currency (euro) is used as means of payment, means of calculation or – means of preserving value, and at the same time the foreign currency is not recognised as legal tender in the country. It is not possible to precisely determine in which countries unofficial euroisation is present, given that statistics of this type are almost impossible, but this form of euroisation is much more widespread than official euroisation. (d) The European Monetary Union refers to the situation when several countries use the euro as a common currency, resulting in the absolute transfer of monetary sovereignty to the central monetary institution of the EU. There is a partial official euroisation in BiH, which started indirectly through the introduction of a currency board and the efforts of the monetary authorities to maintain it until the acquisition of EU membership status of BiH. By signing the Stabilisation and Association Agreement in 2008, BiH fulfilled the institutional prerequisite for joining the European Union, including the assumption that in the long-term process of meeting the convergence conditions for admission, official euroisation will occur. The introduction of the euro into the monetary system of BiH, as a variant of euroisation, as was said earlier, was achieved by establishing the currency board regime of the Central Bank of Bosnia and Herzegovina.²³

In Art. 87 entitled 'Economic and trade policy' of the Stabilisation and Association Agreement it is foreseen that the Community and BiH will cooperate and thus facilitate the process of economic reform in order to improve understanding of the fundamentals of their respective economies as well as the formulation and implementation of economic policy in market economies. Furthermore, it was established that at the request of the authorities of BiH, the Community can provide assistance that supports the efforts of BiH to establish a functional market economy and to gradually harmonise its policies with the policies of the European Economic and Monetary Union, aimed at stability.

The aforementioned cooperation will also aim at strengthening the rule of law in the business area through a stable and non-discriminatory trade-related legal framework. Cooperation in this area shall include informal exchange of information concerning the principles and functioning of the European Economic and Monetary Union. The activities of the Central Bank of Bosnia and Herzegovina in this integration process of BiH are realised through participation in the work of coordination structures, established on the basis of the Decision of the Council of Ministers of Bosnia and Herzegovina on the EU coordination system, for the purpose of monitoring the implementation of contractual obligations stemming from the

22 Fabris et al., 2004, pp. 10–12.

23 Hodžić, 2020, p. 34.

Stabilisation and Association Agreement. Bearing in mind the last paragraph of Art. 87 SAA, the Central Bank of Bosnia and Herzegovina prepares attachments and information within its jurisdiction, including regular reports on the progress of BiH and the Economic Reform Program (ERP) of BiH. In the context of convergence towards EU standards, the Central Bank of Bosnia and Herzegovina applies a proactive approach, introducing the necessary functional changes in accordance with the challenges and requirements of the EU accession process. In the aforementioned activities, the Central Bank has great support from the ECB and the European System of Central Banks, which have been helping the Central Bank of Bosnia and Herzegovina through technical cooperation since 2007 in preparations for harmonisation with the EU and international standards.²⁴

4. From the perspective of joining the European Union

In June 1999, activities were initiated within the framework of the Stability Pact for South-Eastern Europe, the strategic goal of which is stabilisation in South Eastern Europe by bringing the countries of the region closer to Euro-Atlantic integration, and strengthening regional cooperation. This opened up the possibility of integration of BiH, as well as other countries of the Western Balkan region, into the EU. In the chronology of events and the development of relations between BiH and the EU, in the last phase before giving the opinion or conclusions of the Council on the Opinion of the European Commission on the request of BiH for EU membership, answers to the questions from questionnaire predisposed by the European Commission were prepared and submitted. Chapter 17 related to economic and monetary policy issues, where there were 23 issues from the domain of monetary policy that related to ensuring the independence of the Central Bank, the implementation of the currency board, the banking sector and its supervision, legislative reform and harmonisation with the *acquis* and other areas.

The progress or degree of preparation of BiH for EU membership is monitored through Commission Reports. When it comes to chapter 17 and the monetary policy segment, what the EU insists on is the independence of central banks and the ban on financing the public sector.

In the Report on Bosnia and Herzegovina of the European Commission for 2020,²⁵ it is stated that BiH is in the early stage of preparation in the field of economic and monetary policy. There was no progress in improving cooperation and coordination of macroeconomic and fiscal policies. The recommendations from 2019 were not implemented and remain in force. Monetary policy supports economic stability, but

²⁴ Central Bank of B&H, 2023a.

²⁵ European Commission, 2020.

the full independence of the Central Bank of Bosnia and Herzegovina remains to be ensured. The recommendations for 2020 mainly related to the elements of economic policy and the implementation of the Economic Reform Program and the political responsibility for it, which should be visible and coherent. In the monetary policy segment, it was stated that the objective of the Central Bank, defined as ensuring the stability of the domestic currency, is in contrast to maintaining stability as the basic objective of the EU's monetary policy. It was also pointed out that the Law on the Central Bank does not ensure the unconditional functional independence of the Central Bank of Bosnia and Herzegovina. Namely, according to the Law on the Central Bank of Bosnia and Herzegovina, the Central Bank of Bosnia and Herzegovina is obliged to submit reports on audited annual financial statements to the Parliamentary Assembly of Bosnia and Herzegovina and a preliminary financial report to the Presidency of Bosnia and Herzegovina. The European Commission believes that the submission of the preliminary report to the Presidency can especially affect its independence.

In the Report, it is stated that the fragmented competences of banking supervision, which implies that the supervision of the banking system is carried out by the Entities' agencies over banking, affect the effectiveness of its implementation.

In the Report on Bosnia and Herzegovina of the European Commission for 2021,²⁶ it is again stated that BiH is in the early stage of preparation in the area of economic and monetary policy. There was no progress in improving cooperation and coordination of macroeconomic and fiscal policies. The recommendations from 2020 have not been implemented and remain in force. Monetary policy supports economic stability, but the full independence of the Central Bank remains to be ensured. Recommendations for the year 2022 were given. Some of the recommendations coincide with the recommendations for 2021 in the segment of implementation, political responsibility, visibility and coherence of the Economic Reform Program. As a special recommendation, the preservation of the independence of the Central Bank of Bosnia and Herzegovina and the integrity of the currency board, as well as the appointment of members of the Governing Council of the Central Bank without further delay are stated. In the domain of monetary policy, the Report states that the existing regime of the currency board ensures monetary stability within the complex institutional environment of the country. It is stated again that the goal of the Central Bank, defined as ensuring the stability of the domestic currency, is in contradiction with the maintenance of stability as the basic goal of the EU's monetary policy, as well as the fact that the Law on the Central Bank does not ensure the unconditional functional independence of the Central Bank of Bosnia and Herzegovina. In this Report, the compliance of the appointment of the members of the Governing Council with the *acquis* is stated. However, the problem that arose due to the fact that after the mandate of the members of the Governing Council, expired in August 2021, new members were not appointed because the Presidency of

26 European Commission, 2020.

Bosnia and Herzegovina did not adopt a decision on the appointment. In order to enable the work and functioning of the Central Bank of Bosnia and Herzegovina, one day before the end of the mandate in August 2021, the members of the Governing Council, adopted a decision on the principle of continuity, which created the assumption that they will carry out activities until the appointment of a new member of the Governing Council. The Report stated that the Serbian member of the Council proposed on several occasions the use of Central Bank reserves for fiscal purposes, which would undermine the arrangement of the currency board. This confirmed the importance of maintaining the currency board model and the independence of the Central Bank. It was also reiterated that the fragmentation of the banking supervision system affects its efficiency.

The Report on Bosnia and Herzegovina of the European Commission for the year 2022²⁷ does not differ in many respects compared to the previous two presented. What is particularly emphasised and what is worrisome is that there has been a setback in this area because the new Governing Council of the Central Bank has not been appointed, and the insufficiency of coordination and cooperation of the bodies of different authorities, which was reflected in the preparation and implementation of the Economic Reform Program. It was stated that the recommendations were followed, but to a limited extent, and that they are still valid. As a recommendation for 2023, the need to maintain the independence of the Central Bank was emphasised. It is stated again that the objective of the Central Bank, defined as ensuring the stability of the domestic currency, is in contradiction with the maintenance of stability as the basic objective of the EU's monetary policy, but also that the Law on the Central Bank of Bosnia and Herzegovina is not fully harmonised with regard to the prohibition of monetary financing and that it does not ensure a functional independence of the Central Bank. The problem of appointing members of the Governing Council due to the blocking of decision-making at the state level by representatives coming from the Entity Republika Srpska was described again. In the context of supervision of the banking system, the position of the Commission remained unchanged.

When looking at the findings from the above-mentioned European Commission Reports, it can be concluded: (a) The economic and political situation in BiH confirms the necessity of maintaining the currency board regime, that is, it has not acquired the prerequisites for the application of discretionary monetary policy, (b) that political and ethno-national determinism enables blocking and influencing the efficiency of the work of the Central Bank of Bosnia and Herzegovina, i.e. ultimately its functional independence, (c) that the existing mechanism of supervision over the banking sector is not efficient enough.

27 European Commission, 2022.

5. Management of foreign exchange / currency reserves in the Central Bank of Bosnia and Herzegovina

Foreign exchange reserves represent claims of the central monetary institution abroad on the basis of effective foreign money, deposits with foreign banks and securities denominated in foreign currency. The reasons for holding foreign exchange reserves of individual countries are different.²⁸ Central monetary institutions manage foreign exchange reserves. Quality management of foreign exchange reserves is essential because it can increase the elasticity and resistance of the economy to shocks. For the management of foreign exchange reserves to be of high quality, it is necessary to adopt modern management policies and practices that can follow, for example, the Guidelines of the International Monetary Fund on the management of foreign exchange reserves, in which the basic principles of good management of foreign exchange reserves are given.²⁹

Chapter VI of the Law on the Central Bank of Bosnia and Herzegovina regulates the exchange rate policy, foreign exchange reserves and foreign exchange control. According to Art. 50 of the Law, the Central Bank of Bosnia and Herzegovina creates and maintains a certain foreign exchange reserve, which consists of all or part of the assets of the said Central Bank. The Central Bank of Bosnia and Herzegovina uses foreign exchange reserves to support the domestic currency, which results from the provisions of the currency board arrangement as the chosen model of monetary policy, in accordance with the Law on the Central Bank. The law stipulates the principles of good management of foreign exchange reserves in such a way that it is determined that the Central Bank of Bosnia and Herzegovina invests foreign assets in accordance with the principles and practice of sound investment and only in liquid securities issued by the Government or the central bank of the country in whose currency the securities are denominated.

Considering the importance of foreign exchange reserve policy, it is crucial to establish a chain of responsibility, authority and delegation of authority. In the Central Bank of Bosnia and Herzegovina, this was done in the following way. The Governing Council approves broader guidelines that determine the type and level of risk that the Central Bank of Bosnia and Herzegovina can assume. The Investment Committee acts within the framework of these guidelines and adopts operational rules for the

28 Some of the reasons include: supporting and maintaining confidence in monetary policy and exchange rate policy, including the capacity for intervention to support the domestic currency; limiting external vulnerabilities by maintaining liquidity in foreign assets to absorb shocks during periods of crisis or when the economy has limited access to borrowing; ensuring a certain level of market confidence that the economy can meet current and future external obligations; supporting the domestic currency through foreign assets and assisting government policies in meeting financial needs and debt obligations; foreign exchange reserves can be used in the case of natural disasters or urgent interventions. International Monetary Fund, 2014, p. 4.

29 International Monetary Fund, 2014.

Banking Department, which, respecting the guidelines and operational rules, based on the analysis of information on the financial markets, taking into account the types of risks given in the guidelines, and on the basis of the stress tests that have been developed within the framework of the Financial Sector Assessment Program for BiH (Financial Sector Assessment Program - FSAP), makes decisions on the investment portfolio.³⁰

Bearing in mind Art. 50 of Law on the Central Bank of Bosnia and Herzegovina foreign exchange reserves shall be invested only in liquid securities with the highest credit rating, issued by the Government or the central bank of the country in whose currency the securities are denominated. Given that KM is tied to the euro as a reserve currency, foreign exchange reserves shall be invested in government bonds and bank deposits of Eurozone member countries. The foreign exchange reserves of the Central Bank are therefore mostly held in EUR currency. The composite credit rating, which is taken as a criterion for investing foreign exchange reserves, represents the average level of existing credit ratings assigned to a certain issuer by at least two of the three renowned credit rating agencies Standard & Poor, Fitch Ratings or Moody. Investment of foreign currency reserves in instruments that imply exposure of the Central Bank of Bosnia and Herzegovina to a high level of credit risk is not allowed. In the above sense, the Central Bank of Bosnia and Herzegovina, in accordance with international investment standards and practices, treats a composite credit rating of AA- or higher as exposure to medium-level credit risk, a composite credit rating between BBB- and A+ as exposure to medium-level credit risk, and a rating lower than BBB as exposure to high level credit risk. The Central Bank of Bosnia and Herzegovina manages this type of risk by limiting the scope of financial instruments, by limiting contractual parties and issuers to those with an acceptable credit rating, by defining limits regarding investment concentration with each individual contractual party, by limiting the maximum amount that can be invested in individual types of financial instruments, by limiting the size of the issuance of individual securities and by limiting the maturity of the investment.³¹

According to the currency board regime and the provisions of Article 34 of the Law on Central Bank of Bosnia and Herzegovina, the Central Bank cannot invest more than 50,0% of the total unreduced capital and reserves in currencies other than the anchor. Based on this provision, the Central Bank invests more than 95,0% of its foreign exchange reserves in financial instruments denominated in EUR. In accordance with the aforementioned, the Central Bank has a very strict investment policy regulated by various internal acts with the involvement of highly sophisticated and professional internal bodies that monitor and evaluate it daily, and based on the above, continuously work on optimising the investment portfolio according to clearly defined criteria. All of the above is done with the aim at minimising the exposure of

30 Most commonly, there are four types of risks: foreign exchange risk, credit risk, liquidity risk, and interest rate risk.

31 Central Bank of B&H, 2022, p. 37.

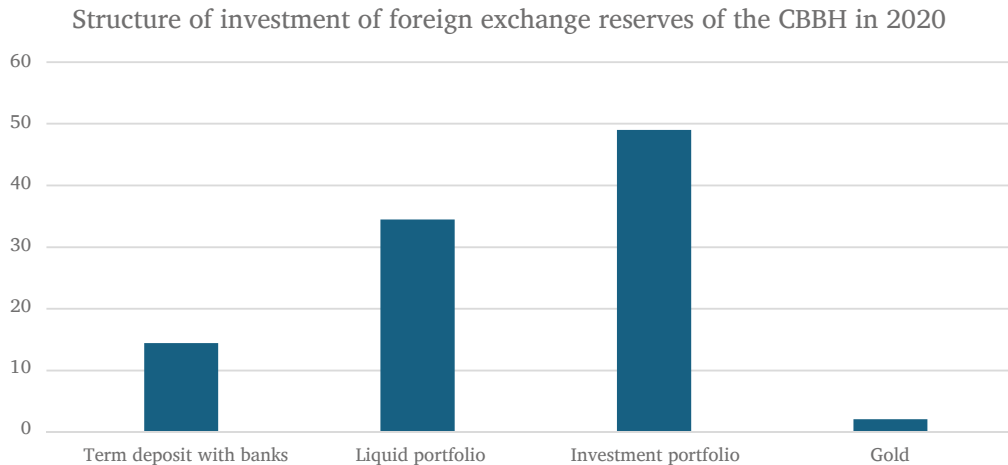
the Central Bank of Bosnia and Herzegovina to credit risks of an unacceptable level, i.e. with the aim at optimising the relationship between risk and return on invested funds in order to protect and stabilise the currency board and maintain the bank's key financial indicators at an optimal level, which results in the stability of the overall monetary system of BiH. In this sense, the Governing Council of the Central Bank of Bosnia and Herzegovina, together with other organisational parts involved in this process, ultimately take care that the net foreign assets of the Central Bank of Bosnia and Herzegovina, which are calculated by deducting monetary liabilities from the net foreign exchange reserves, is at an acceptable level because it represents the main financial indicator achieving and maintaining the stability of the domestic currency (KM), as part of the official foreign exchange reserves, i.e. net foreign exchange reserves in BiH, represent the basic measure of the success of the Central Bank of Bosnia and Herzegovina operations, so that the net foreign exchange reserves should always be at least a few percent above the monetary liabilities, which shows that the monetary liabilities, that is, the total amount of money in domestic currency, covered by more than 100% net foreign exchange reserves, which is actually the legal minimum.³²

According to the Annual Report of the Central Bank, the structure of foreign exchange reserves at the end of 2020 consisted of: time deposits with banks (excluding overnight deposits), with a share of 14.42%; liquid portfolio, with a share of 34.47%; investment portfolio (securities with more than one year left to maturity), with a share of 49.01%, and; gold, with a share of 2.1%.³³

32 Central Bank of B&H, 2022, p. 31.

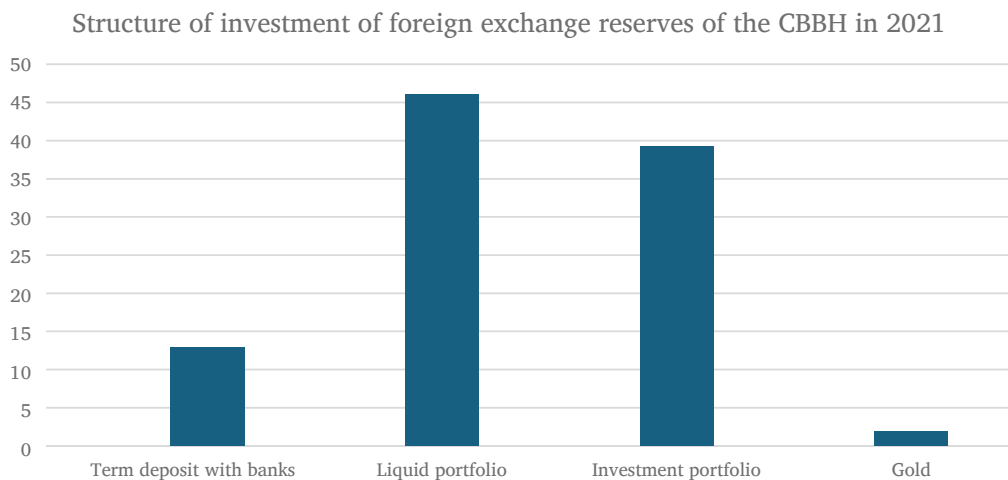
33 Central Bank of B&H, 2020.

Graph 1. Structure of investment of foreign exchange reserves of the Central Bank of Bosnia and Herzegovina in 2020



According to the Annual Report of the Central Bank, the structure of foreign exchange reserves at the end of 2021 consisted of: time deposits with banks (without overnight deposits), with a share of 12.87%; liquid portfolio, with a share of 46.01%; investment portfolio (securities with more than one year left to maturity), with a share of 39.27%; and gold, with a share of 1.85%.

Graph 2. Structure of investment of foreign exchange reserves of the Central Bank of Bosnia and Herzegovina in 2021



According to the Annual Report, the structure of foreign exchange reserves at the end of 2022 consisted of: time deposits with banks (without overnight deposits) with a share of 37.98%; liquid portfolio with participation of 39.71%; investment portfolio (securities with a maturity of more than one year remaining) with a participation of 14.02%; securities (Business model 1) with a participation of 7.30% and; gold with a participation of 1.00%.

Graph 3. Structure of investment of foreign exchange reserves of the Central Bank of Bosnia and Herzegovina in 2022

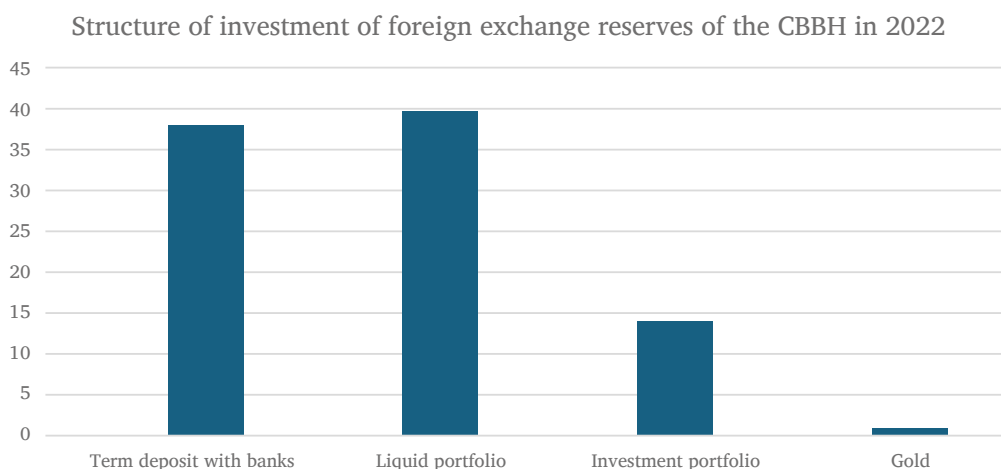


Table 1. Structure of investment of foreign exchange reserves of the Central Bank of Bosnia and Herzegovina in 2020, 2021 and 2022

Year	Term deposits with banks	Liquid portfolio	Investment portfolio	Gold
2020	14.42%	34.47%	49.01%	2.10%
2021	12.87%	46.01%	39.27%	1.85%
2022	37.98%	39.71%	14.02%	1.00%

Taking into account the interest rate, credit and foreign exchange risk, the Central Bank restructures investments of foreign exchange reserves in order to achieve the maximum net effect of the investment of foreign currency funds on the income statement.

Table 2. Presentation of the net effect of investing foreign exchange reserves of the Central Bank of Bosnia and Herzegovina in 2020-2022

Year	Total net effect	Effective rate of return ³⁴
2020	7.3 million KM	0.06%
2021	7.12 million KM	-0.05%
2022	11.15 million KM	0.07%

In 2021, a negative yield was expressed for the first time. The reasons are the current events on the EU financial market and the policy of negative interest rates led by the ECB. Namely, as a result of such ECB policy, there was a drop in yield rates on investments in convertible foreign currency, which is a consequence of negative interest rates on short-term deposits in euros and investments in securities with negative yield rates when purchasing in the last few years. Due to the ECB's quantitative easing, negative interest rates were applied in the eurozone countries from 2014 until 2021, which discouraged savings and stimulated consumption and investment. In order to get rid of excess liquidity reserves in their accounts with the ECB, on which they pay negative interest, many commercial banks in the Eurozone have introduced a negative interest rate on large deposits of their clients. The period of negative interest rates on the Eurobond market also lasted for a number of years, and the result was lower returns on investments of foreign exchange reserves of the Central Bank of Bosnia and Herzegovina in government bonds of the Eurozone countries.

Taking into account the legal assumptions for the management of foreign exchange reserves and the data from the Annual Reports of the Central Bank, it can be concluded that the management of the Central Bank, taking into account all risks, ensured the profitability of investments and did not call into question the marginal value of the coverage coefficient, i.e. that the marginal value of coverage was always above 100% which is the lower limit. The coverage rate of the currency board at the end of 2022 is lower than at the end of the previous year and was 102.89%.

34 'The effective yield is calculated by dividing the net effect of investing foreign reserve funds by the average level of foreign reserves observed during the period. When calculating the overall net effects of investing foreign reserve funds, all net interest income on securities and deposits in foreign currency are taken into account, as well as realized net capital gains/losses from the sale of securities from the portfolio of foreign reserves of the Central Bank of Bosnia and Herzegovina (CBBiH)' – Central Bank of Bosnia and Herzegovina, 2020, p. 35.

6. Management of mandatory reserves of the Central Bank of Bosnia and Herzegovina

The basic instrument of the monetary policy of the Central Bank of Bosnia and Herzegovina, which affects the overall stability of the banking system and its liquidity, is the mandatory reserve.

The required reserve is a percentage of the bank's asset base that is calculated and kept in specially opened accounts with the Central Bank. The reserve requirement is, along with open market operations and the discount rate, one of the three standard instruments of discretionary monetary policy.³⁵ The popularity of using this instrument of monetary policy depends on the level of development of countries, so for example, developed countries use open market policy more, because they have developed financial markets or a discount rate in relation to the reserve requirement rate, which in the case of open market operations is used as an alternative or supplement. By determining the mandatory liquidity reserve, the Central Bank influences credit conditions and the interest rate, controls the amount of money in circulation and controls the amount of bank reserves. The required reserve rate determines the amount of funds that a commercial bank should set aside from its deposit potential in favour of required reserves at the Central Bank.³⁶ It means that a part of demand deposits is placed outside the credit potential and cannot be used for loans.³⁷ With the reserve requirement, the Central Bank limits and directs the growth of deposit money.

Mandatory reserve in BiH is calculated on deposits and borrowed funds of the bank. Regardless of the currency in which they are expressed, deposits and borrowed funds together form the basis for calculating the required reserve. The Central Bank of Bosnia and Herzegovina, together with the Decision determining the mandatory reserve, also delivers a methodological scheme to commercial banks, of what is included in the deposit basis. The balance of these items is determined at the end of each working day in the period of ten days preceding the reversal of mandatory reserves. Banks are obliged to regularly submit reports on the balance of their deposits. Article 36 of the Law on the Central Bank of Bosnia and Herzegovina regulates the issues of mandatory reserves in terms of the competence to determine the level of the rate of mandatory reserves, the amount of compensation that the Central Bank pays to banks for the amount of reserves, the responsibilities and actions of monetary institutions in the event that the bank does not fulfil its obligation in terms of mandatory reserves.

Since the beginning of its operation in 1997, the Central Bank of Bosnia and Herzegovina has constantly adjusted the basis for calculation and the amount of

³⁵ Marić, 2021.

³⁶ Mišlov, 2016.

³⁷ Kešetović, 2007, p. 157.

compensation for holding excess reserves on accounts with the Central Bank, depending on the trend in the liquidity of commercial banks and their credit policy. Since the beginning of its operation, the Central Bank of Bosnia and Herzegovina has determined a percentage of 10% of deposits of commercial banks as a basis for calculating the required reserve. The fee rate on the mandatory reserve is 0.0%.

Table 3. Movement of the mandatory reserve rate

Year	Mandatory reserve rate-MRR
2012	Differentiated MRR rate: 10% on a short-term basis and 7% on a long-term basis
2013	Differentiated MRR rate: 10% on a short-term basis and 7% on a long-term basis
2014	Differentiated MRR rate: 10% on a short-term basis and 7% on a long-term basis
2015	Differentiated MRR rate: 10% on a short-term basis and 7% on a long-term basis
2016	Until July 1, 2016, differentiated: 10% on a short-term and 7% on a long-term basis, from July 1, 2016, a single 10%
2017	10%
2018	10%
2019	10%
2020	10%
2021	10%
2022	10%
2022	10%

Banks have the possibility to keep excess cuts above the mandatory ones, which they manage themselves, ensuring their own liquidity, for which a special fee can be calculated by the Central Bank of Bosnia and Herzegovina. Banking agencies, in order to maintain the liquidity and safety of the banking system, by their regulations order commercial banks to keep part of the reserves above the required reserve level.

The remuneration policy of the Central Bank of Bosnia and Herzegovina implies a policy towards monetary assets (obligatory reserves and excess over mandatory reserves), i.e., remuneration that is calculated at a certain rate on the mentioned reserves and the level of the remuneration rate on monetary assets itself affects the asset structure of the balance sheet of commercial banks. Although excess reserves are included in the available credit potential of commercial banks, banks keep their liquidity reserves in a reserve account they have opened with the Central Bank of Bosnia and Herzegovina and for which they receive a certain fee. This compensation is equal to the weighted average of the interest rates that, during the period of maintenance of the mandatory reserve, the Central Bank of Bosnia and Herzegovina

achieves on the market on deposits invested for up to one month. The approximately symmetrical level of that rate, on these placements, essentially represents risk-free placements for banks and is an incentive to keep funds in the reserve account with the Central Bank of Bosnia and Herzegovina.³⁸

Table 4. Movement of mandatory reserves and surplus above mandatory reserves of commercial banks in BiH (average of 36 decades within a year)

Year	Total Base	Average MR	Surplus above MR
2012	14,755,574,233.67	1,257,850,162.62	1,453,163,038.68
2013	15,162,241,323.62	1,290,757,911.83	1,813,107,490.09
2014	15,999,278,159.62	1,370,136,562.86	2,207,687,503.20
2015	16,664,524,694.40	1,432,593,008.05	2,337,906,719.91
2016	18,494,243,296.51	1,734,081,448.93	2,323,531,837.46
2017	21,224,852,629.71	2,122,485,262.99	2,180,855,031.97
2018	23,537,084,216.16	2,353,708,421.63	2,851,699,301.13
2019	25,752,967,935.80	2,575,296,793.60	3,013,723,746.89
2020	26,964,789,467.59	2,696,478,946.77	2,713,271,703.25
2021	28,677,192,430.04	2,867,719,243.02	3,434,762,484.06
2022	30,175,606,190.72	3,017,560,619.08	3,676,739,061.35

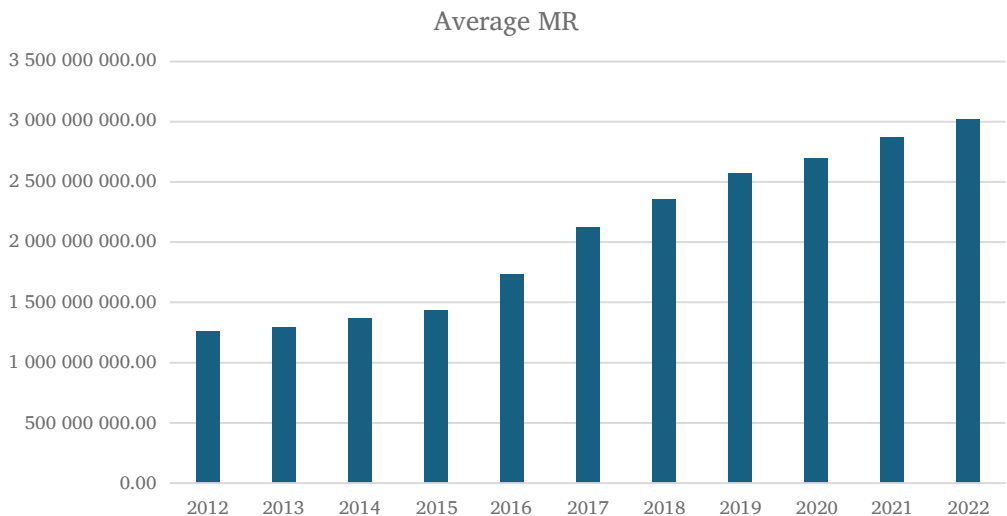
Regarding the currency structure of the base for the calculation of the required reserve, it can be stated that in the observed period the highest percentage of the base is in the domestic currency, ranging from 50 to 52%. So in 2020, it amounted to 52,6%. A certain level of liabilities of banks in foreign currencies, as well as assets in foreign currencies, is natural in BiH due to the arrangement of the currency board, the structure of banks' sources of financing and regulatory requirements related to banks' foreign exchange risk management. Slight changes in the wave structure in the observed period are the result of the impact of the COVID 19 pandemic and the war in Ukraine. What international institutions insist on, specifically the International Monetary Fund, is greater deeurisation. However, deeurisation in existing conditions, when the population and business entities still remember the financial collapse and the loss of their deposits and savings in Yugoslav dinars that occurred after the breakup of Yugoslavia, is not popular. The population believes in the currency system and the euro, and it is difficult to persuade them to keep deposits exclusively in KM.

38 Zupur and Tomić, 2014, p. 88.

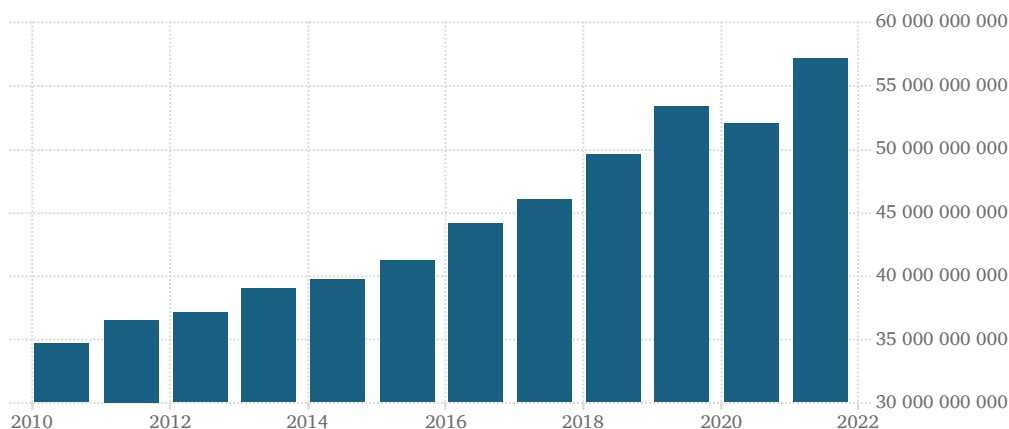
Data on the movement of mandatory reserves indicate that commercial banks in BiH are extremely liquid, which makes the banking system of BiH safe. The growing trend of mandatory reserves is a reflection of economic trends in BiH.

When observing the average size of required reserves, which is obtained as an average of the new 36 decades, that is, ten-day measurements, during the year one can clearly see the same growing trend during the last ten years, as can be seen in graph 4.

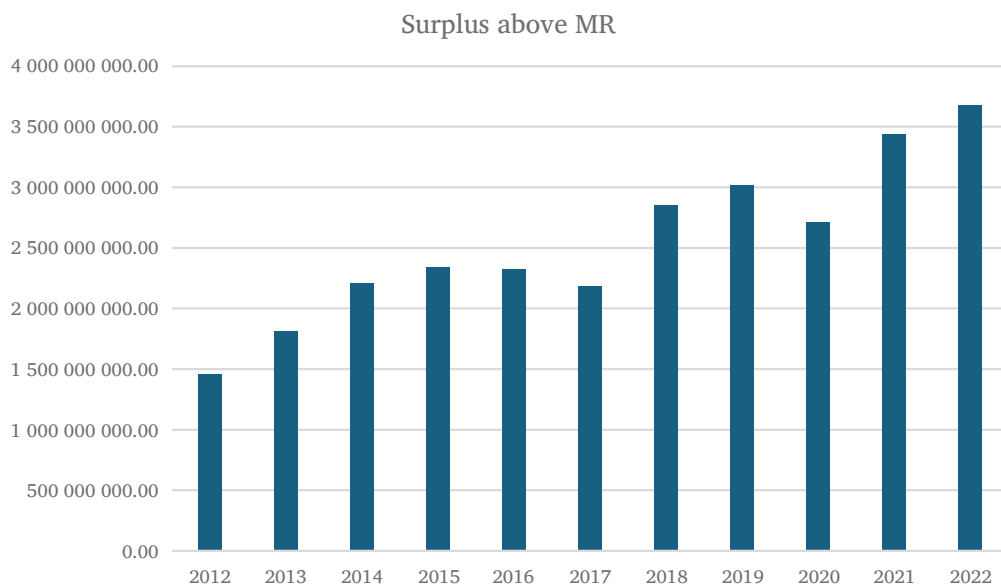
Graph 4. Average MR trend in period of 2012 to 2022



It is clear that more intense growth has been observed since 2016, when the rate on the long-term basis of 7% stabilised at the level of 10%, but the growth can also be explained on the basis of the economic growth in the mentioned period, which can be expressed through the PPP size of GDP with the fact that in both cases certain stagnation can be seen in 2020 during the pandemic (graph 5).

Graph 5. PPP-adjusted GDP of BiH (current international \$)

When observing the average annual level of excess over the required reserves, a similar trend can be observed, with the fact that in this case, during 2020, a decrease in the same level can be observed because the banks resorted to the same in order to maintain liquidity during the pandemic period with the aim at avoiding panic among the population which produced good effects and preserved the monetary stability of BiH (chart 6).

Graph 6. Surplus above MR trend in period of 2012 to 2022

Based on the aforementioned trends, it can be said that the Central Bank of Bosnia and Herzegovina fulfils its mission and monitors the national economy in the context of the needs of its development and growth, regardless of the fact that it does not have the competences and instruments to implement a full discretionary monetary policy. The aforementioned trends show that the Central Bank of Bosnia and Herzegovina in its current capacity and powers represents a real support for the economic development of BiH based on competitiveness as a criterion and does not represent any limiting factor, but on the contrary a factor that strengthens the integrity of the domestic economy and its monetary system on a permanent basis.

7. The operation of the Central Bank of Bosnia and Herzegovina from the point of view of the International Monetary Fund

After the dissolution of the SFRY, upon gaining independence, BiH inherited membership in the Bretton Woods institutions, and the Central Bank of Bosnia and Herzegovina has the status of a depository. Since 2002, the Central Bank of Bosnia and Herzegovina has assumed the role of fiscal agent of BiH to the IMF from the Ministry of Finance and Treasury of Bosnia and Herzegovina.³⁹ In the context of the arrangement with the IMF, BiH had and still has a debt relationship according to the following models:⁴⁰

- 1) “Stand-by arrangement” – Financial assistance is provided from General Resources Account (GRA) up to a certain amount and in a certain period of time, provided that the member complies with the provisions of the agreement. A stand-by arrangement is usually realised in a period of one year and it is usually approved in four tranches. At the request of the member, it can be extended (up to three years) The arrangement is repaid with a grace period of two years and three months, after which repayment occurs in eight equal quarterly installments. The drawdowns of tranches are purchase transactions, while repayments are repurchase transactions in the domestic currency.⁴¹
- 2) “Extended fund facility” – an extended financial arrangement is being developed to remedy for the disturbance in the balance of payments based on the Memorandum on Economic and Financial Policies and the Letter of Intent.
- 3) “Rapid financing instrument” – it is an arrangement of rapid financial assistance needed to mitigate the consequences of the pandemic caused by COVID

³⁹ Central Bank of B&H, 2023c.

⁴⁰ Central Bank of B&H, 2023b.

⁴¹ Radaković, 2016, p. 147.

19, where the approved amount is allocated once upon approval by the IMF Executive Board.

In the context of the “stand-by” arrangements, which have existed until now, BiH has repaid 10,456,800 (SDR) debts and closed that engagement. When it comes to the “extended fund facility” arrangement (2016-2019), the planned and committed amount of funds is 126,825,000 (SDR) and 36,990,625 has been repaid, so the debt of BiH to the IMF based on this arrangement is 89,834,375 (SDR). Funds in the amount of 265,200,000 (SDR) were committed on the basis of the “rapid financing instrument” on April 22, 2020, but so far not a single instalment has been returned.⁴²

Every year, the IMF publishes its opinion on BiH and makes recommendations. The IMF Report for 2022 (IMF Country Report No. 22/167) comprehensively covers the latest developments, perspectives, risks, and discussions on policies – reforms to support recovery. Within the framework of the reforms, a special place is dedicated to the arrangement of the currency board. The Report states that during the pandemic, and more recently the war in Ukraine, the arrangement of currency agreements contributed to ensuring macroeconomic and financial stability by maintaining public confidence in the currency. The mission welcomed the reforms of the Central Bank of Bosnia and Herzegovina aimed at strengthening the mandatory reserve framework by applying a differentiated fee rate to the reserves of commercial banks. These reforms will help achieve greater profitability of the Central Bank of Bosnia and Herzegovina, and thus a higher coverage rate of the currency board. The members of the mission also welcomed the commitment of the Central Bank of Bosnia and Herzegovina to implement the remaining recommendations from the report of the technical assistance mission for 2019.⁴³

8. Concluding considerations

Today, twenty-five years after the establishment of the Central Bank, the conditions for abandoning this model have not yet been met. Political pressure, administrative and ethnic division of society and little progress in terms of economic recovery are still present. In addition, the globally present economic challenges caused by the Covid-19 pandemic, the war in Ukraine and inflationary pressure, as well as the introduction of digital currencies and the impact of digitalisation on economic flows justify the existence of the currency board in BiH. Namely, in such challenging circumstances, the Central Bank of Bosnia and Herzegovina managed to maintain

42 Central Bank of B&H, 2023b.

43 International Monetary Fund, 2023.

the monetary stability of the country as one of the key factors of macroeconomic stability.

The paper analyses the Annual Reports of the Central Bank of Bosnia and Herzegovina covering the period of 2020 to 2022 aimed at confirming the assumption that the existing model of the currency board, along with good management of foreign exchange and mandatory reserves by the monetary authorities in BiH, enabled the maintenance of monetary stability and strengthening of confidence in the domestic currency (KM). In other words, that in BiH, which has acquired candidate status, the currency board that ties the KM to the euro is paving the way to the fulfilment of the master conditions for entry into the European Monetary Union. Viewed from that angle, taking into account the existing economic and political situation in BiH, the introduction of discretionary monetary policy is not an acceptable solution. The reports of the European Commission and the International Fund support this. On the other hand, the population that faced financial trauma after the breakup of Yugoslavia and appreciates the stability of the currency, gives great support to the currency board that ties the KM to the euro. In addition, the strict rules of the uniform currency established by the Law on the Central Bank are the basis of a stable banking system, which is a prerequisite for the functioning of the real sector.

The currency board model is not an obstacle to stimulating economic growth in BiH, there is currently a lot of space in which to act in order to improve the business environment, which is a prerequisite for greater international competitiveness of the Bosnian economy. The Association of Employers of Bosnia and Herzegovina created a document on the necessary changes to the regulatory environment, which refers to changes in the laws that regulate: value-added tax, excise duties, customs policy, court fees, public procurement, issues in the field of labour relations, etc. The issue of tax reform remains open, as well as the potential impact of this reform on the budget. The creators of economic policy in BiH, assuming that there is a political will for it, face numerous challenges and open courses of action in order to stimulate economic growth in the country and, consequently, increase the well-being of citizens.

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