

## **THE CURRENCY BOARD TRAP: THE CASE OF BOSNIA AND HERZEGOVINA**

SILAJDZIC, Sabina\*

---

### **Abstract**

This paper provides a comprehensive analysis of the attractions and disadvantages of fixed exchange rates and currency board arrangements (CBA) principally drawing on the experience of Bosnia and Herzegovina (BiH). It assesses merits and costs related to this arrangement, primarily looking at the rigidities and constraints the regime imposes on macroeconomic policies, and the subsequent impact on growth and development. Finally, the paper elaborates if and under which conditions, the weaknesses associated with the regime are off set with its repeatedly assigned advantages of i.e. macroeconomic stability, low inflation, increased confidence and established credibility as well as reduced “costs” to business transactions and investments. The paper concludes that Bosnian currency board was viable temporary solution and that serious consideration shall be given to exiting the regime.

*JEL classification:* F31

*Key words:* *Currency Board Arrangement, Policy misalignments, Transition*

---

### **1. Introduction**

In the last decade there has been considerable discussion on what exchange rate policies shall be pursued by developing countries as well as countries in transition as mean of successful transformation and effective mechanism to economic restructuring, private sector growth and promoted stability. The central to this, rather broad and growing debate, has been the role of fixed exchange rates, and the currency board arrangements (CBA) in particular. Currency board arrangements have recently undergone a revival, resulting in an increasing concern of economists and policy makers about the benefits and costs of currency boards. Eventually, they have been introduced in this decade in Argentina, Estonia, Lithuania, Bulgaria,

---

\* Sabina Silajdzic (Basic), Faculty of Economics, University of Sarajevo, Trg Oslobođenja 1, Sarajevo, Bosnia and Herzegovina, e-mail: sabina.basic@efsa.unsa.ba

inclusive of Bosnia and Herzegovina and have been proposed for number of other countries. The Currency Board in BH operates since 1997 and has, just as in many other countries, played a significant role in the country's overall stabilization. Notwithstanding these benefits the critical issue is not retrospective in nature, i.e. was the currency board a right option and what benefits has it brought? On the contrary, the critical issue is the current sustainability of the regime. Is it a right policy that would lead Bosnia to a sustainable development path and integration into the EU? If not what is the alternative policy, and could it possibly be pursued in the time to come? This paper provides a comprehensive analysis of the attractions and disadvantages of such arrangements principally drawing on the experience of Bosnia and Herzegovina (BiH). The first part of the paper assesses general merits and costs related to this arrangement, primarily looking at the rigidities and constraints the regime imposes on macroeconomic policies. In regard, the first part provides dispersed concluding remarks in regard to when and under which conditions, the weaknesses associated with the regime are offset with its repeatedly assigned advantages of i.e. macroeconomic stability, low inflation, increased confidence and established credibility as well as reduced "costs" to business transactions and investments. The second part of the paper however, studies currency board regime in Bosnia, its historical evolution and accomplishments. Brief assessment of the reasons for adopting and nature of currency board operating is provided as basis for succeeding detailed analysis of the regime. The third part of the paper, however, provides comprehensive analysis related to currency board sustainability, issues and controversies. Thus risks and costs related to continued adherence of currency board option are thoughtfully elaborated considering economies internal and external imbalances and future macroeconomic prospects. The concluding remarks follow. The conclusion lay down that the country has entered currency board trap and that domestic and international policy makers shall no longer hesitate to abandon the regime.

## **2. The currency board regime: merits and costs.**

*2.1 What is the currency board and how it operates?* The currency board arrangement is an extraordinary rule-based monetary system,

which operates strictly in accordance to the rules rather than discretion. In its simplest form it may be defined as monetary regime based on explicit legislative commitment to exchange the domestic currency at a given parity. This concept implies that monetary authorities are legally obliged to ensure that the currency can be issued only against foreign exchange and that it remains fully backed by foreign assets. The rigidity of the regime is thus seen in authority's commitment to restricted or even eliminated use of key monetary policy instruments aimed to influence both financial and money market dynamics. Thus, traditional functions of central bank such as monetary regulation i.e. interest rate and inflation policy targeting, and the most essential function of Lender of Last Resort (LOLR) aren't permitted under this monetary structure. However, the central bank can still give credit to governments and commercial banks or even undertake other monetary operations provided that it holds foreign reserves in excess to what is needed to fully cover monetary base. In the Annex A1 other features of this system are analyzed.

*2.2 Why opt for currency board arrangement?* In line with above elaborated currency board characteristics and its operating features, its seem obvious even though controversial, that the currency board essential merits stem directly form rigidities it imposes on monetary and fiscal authorities. In other words, the rules that eliminate or at best severely limit the scope of discretion in monetary and exchange rate policies enhance confidence in the respective authorities as well as financial- and banking sector in particular. The currency board arrangements are thus accredited with better macroeconomic performance reflected in better inflation as well as growth performances, even if compared to countries operating fixed exchange rate regimes (A.Ghosh, A.Gulde and H. Wolf, 1998). Nonetheless it is primarily the strict legal provisions and barriers which prevent any political abuse and easing of the policy rules at the expense of monetary and macroeconomic stability, which makes a considerable distinction between the currency board and any other form of fixed parity regime. This in return, raises confidence of both local and international investors in exchange rate parity, macroeconomic stability and banking sector stability, but also may substantially promote both financial and trade integration with the

reserve country/region, in particular. Further, the empirical evidence suggest that the currency boards have made an essential contribution to the stabilization programs in number of countries i.e. in Argentina immediately after the introduction in 1991 the inflation rate has stabilized thus coming down from about 10 000% in 1990 to below 5% in 1994 and continued to decrease in the following years, also in Estonia and Lithuania despite the preserved two-digits inflation rate throughout the transition period, the inflation rate was substantially brought down i.e. in Estonia from the levels of about 1000 % in 1992 down to below 40% already a year after the introduction of currency board.<sup>1</sup> In addition to monetary and fiscal soundness, which induce stabilization, most countries experience strong economic recoveries after the stabilization period often due to remarkable growth in private sector investments and huge foreign capital inflows. In return, surge in private capital inflows associated with most of the currency board countries with the exception of Bosnia, in particular, result in increased broad money but also in an increased and risky reliance on foreign capital assets. In accordance to the theoretical premises assigned to the fixed exchange rate regimes, currency board tends to induce interest rate stabilization and convergence in most countries. In spite of usually prevailing differences in interest rate parities between the domestic and the anchor country and thus, quite high disparities persisting over a quite long period such as in Argentina throughout the whole currency board period, interest rates do tend to stabilize if compared to the period prior to the adoption (Tomas J.T. Balino and Charles Enoch 1997). A complementary analysis of this question is included in Annex A2. This article explores outstanding issues and controversies related to the regime in general and the specificities of the Bosnian experience. Final argumentation in the Bosnian case assessment goes in favor of currency board exiting from the position of relative strength as opposed to reasonable problems and credibility discretion in due course.

*2.3 What are the weaknesses and costs of the currency board regime?* Controversially the weaknesses of the regime can be derived

---

<sup>1</sup> Balino and Enoch. (1997), pp 8-9

from its main strengths, depending on the nature of arguments as much as on specific conditions of domestic economy. First, it is exactly the nominal exchange rate rigidity, which may pose too much risk to regimes sustainability in case of high and continuous real exchange rate misalignments. The problems associated with real exchange rate fluctuations are not marginal, and can become a burden and even source of discredit. In effect, the commitment to attain nominal exchange rate parity is often difficult to attain due to persistent differences in price fluctuations, and thus may come at high costs. Therefore the decision as to what is the proper exchange rate parity and what shall be the reserve currency or set of currencies is of essential importance. However, having a reasonable perception about the appropriateness regarding the mentioned decisions is not a clear cut. On the contrary the mistakes in this respect would come at high cost, and high real exchange rate fluctuations may incur costs of loss of credibility already at the early stages. Also, following wrong macroeconomic policies of the anchor country may be counter-productive and come at odds with domestic economy performance objectives. In other words, wrong choice on anchor currency or set of currencies may have a negative effect on trade account, thus further inducing policy misalignments. Notwithstanding these theoretical premises, the empirical evidence shows that most of the exchange-rate stabilization programs have experienced booming economic performance and real exchange rate appreciation. More details on this question are presented in Annex A3.

The experience of CBA (Currency Board Arrangement) countries suggest that capital flows and interest rate arbitrage may be ineffective and cannot serve as substitute for central bank liquidity management, causing constant liquidity mismatches and penalizing financial transactions. Particularly, specific credit and country risk as well as doubts on the regimes sustainability may be reflected in different risk proxies such as differences in passive interest rates for domestic and anchor currency, massive reserve currency denominated credits, short-term loans maturity, as well as explicit country risk rate added to the real interest rates. For instance, due to persistent short-term liquidity imbalances CBA countries strive to build up excess international reserves as to engage actively in open market operations i.e. Argentina, Hong-Kong, Estonia. This implies,

however, that the countries incapable of excess reserve asset accumulation would face serious problems mitigating the negative effects of imposed restrictions. Unfortunately, the Bosnia is the pure example of the elaborated problems and associated costs on growth performance and high unemployment rate.

### **3. The evolution and nature of currency board in BiH.**

*3.1 The BiH Controversial Political Context* Four years of war in Bosnia and Herzegovina (BiH) was brought to an end by Dayton Peace Agreement in December 1995. This established BH as a single sovereign country divided into two Entities: the Serb controlled Republika Srpska (RS) and the Bosniac/Croat controlled Federation of Bosnia and Herzegovina (FBH). The Dayton Accord has produced highly decentralized state structure, with central state institutions having very limited power, its role being limited to the bare minimum necessary for BH to be considered a single sovereign country (foreign policy, international trade and debt, monetary policy, immigration, international law enforcement, and air traffic control), plus relations between the Entities (inter-entity transport, communications and law enforcement). The Entities have responsibility across a much broader range of issues, including many which are more commonly (or even exclusively) held by national governments. These include: internal affairs, policing and justice; taxation and custom administration; agriculture, energy, industry and other economic policies; health and social policies; environmental policies, refugees and displaced persons and reconstruction programs. Embarking on a course of post-war reconstruction, political reconciliation and a transition from state controlled to market economy, was not, and still isn't, an easy task, particularly considering the need for coordinated and consensus based reform decisions among the Entities. Therefore the political will and commitment to reforms and state institutions strengthening remain the key pillars to overall success and better future for BH citizens regardless of their ethnic roots and religious background. Eventually, despite the evident economic and political progress in the eight years aftermath of Dayton Accord, self-sustainability still presents a key challenge for BiH. Eight years after the war and \$5 billion spent on post-war reconstruction and economic rehabilitation, achieving a

sustainable development path revealed in emancipation from poverty, raising living standards and increasing equality represent the essential issue the future BiH economic policies need to adequately address. BiH authorities strive to turn a currently aid-dependent economy into a one driven by free and stable market forces. In the course of this the current currency board arrangement presents one of the essential policy issues primarily because the regime on the whole determines the overall macroeconomic performance and the dynamics of growth, in particular. Yet, the key issue becomes if the CBA and the resulting policy misalignments has been the source of growth contraction and worrying macroeconomic performance in the last years? Further, an implicit question is the one of currency board sustainability considering the reverse trend and outstanding external vulnerability indicators in specific.

### *3.2 The Central Bank as Currency Board*

*3.2.1 The legal and institutional framework of CBA.* As noted earlier, macroeconomic policy for the whole of BiH is largely dictated by the requirement of the Dayton Agreement that the Central Bank should operate as a currency board for the first six years period of post-war reconstruction. The Central Bank of Bosnia and Herzegovina (CBBH) was established in accordance with the Constitutional provision and respective Law on 20 June 1997. In December 2002 the monetary regime of the currency board has been prolonged for another medium-term period, decision valid until December 2006. The CBBH is an independent and sole authority in charge of establishing and supervision of monetary policy and monetary policy instruments, all according to the powers given to the Board by the Law. The CBA in BiH presents one of the most extreme and rigid rules based system, the one which may be referred to as “pure” CBA in function. The BiH rules strictly imply that local currency can be issued only against the Central Bank’s holdings of foreign currency. Therefore, CBBH maintains monetary stability by issuing domestic currency only against the 100% coverage of base money, with at least 50% of backing in Euros. . Currency board also means that the currency is convertible (i.e. there are no restrictions on buying or selling foreign currency), and that the exchange rate is fixed (at 1

KM to 0.51 €) with no possibility of adjusting it up or down.<sup>2</sup> Moreover, the CBA framework prevents authorities from running a budget deficit, unless it is financed by foreign loans or grants, posing fiscal policy constraints. Minimum reserve requirement is 10%, indeed effective in lowering systematic risks but posing relatively tight liquidity conditions for the banking sector, and higher operational costs.

### *3.2.2. The essential merits of CBA during reconstruction period*

Throughout the period the currency board has, just as in many other countries, played a significant role in the country's overall stabilization. Considering both, overall political economic context of a post-conflict BiH, no doubt that the Currency Board has been the right or most probably the only viable policy choice. Indeed, it has been a prudent policy for the Bosnian economy as it has brought macroeconomic stability and increased overall credibility to monetary authorities and banking sector in particular. Thus, CB has served as successful tool for currency transition, from three currencies to single currency in use. Eventually, both citizens and private sector regained confidence in single state currency. Also, the regime has played a most prominent role in political reconciliation and has contributed to strengthening of, and growing confidence in the state institutions. Notwithstanding these benefits the critical issue is not retrospective in nature, i.e. was the currency board a right option and what benefits has it brought? On the contrary, the critical issue is the current sustainability of the regime.. Is it a right policy that would lead Bosnia to a sustainable development path and integration into the EU? If not what is the alternative policy, and could it possibly be pursued in the time to come? Yet, in an attempt to assess the appropriateness of Bosnian Currency Board there are several issues that need to be carefully addressed: The issues reflecting internal and external balance i.e. REER, Unemployment and Growth, Fiscal Policy and Fiscal Accounts, Current Account and Public debt.

---

<sup>2</sup> No adjustment of Exchange rate is allowed under this arrangement, and the exchange rate is fixed by law, Regulation Decree.

#### **4. Assessment of appropriateness and sustainability fo BiH CBA.**

*4.1 Real Effective Exchange Rate Movements and Repercussions on Currency Board.* As under the currency board arrangement, the exchange rate cannot be adjusted through nominal exchange rate movements, instead the real exchange rates adjust themselves through price changes. Thus, rather than an appreciation of the nominal exchange rate during the reconstruction phase, real exchange rate adjustment have taken place through price inflation. (See inflation rate Chart)<sup>3</sup> The International Monetary Fond estimates that for the first three years of reconstruction phase 1998-2001, consequently, as the large-scale aid inflows increased the supply of foreign exchange a real exchange rate appreciation has occurred and REER appreciated by about 17% (IMF staff estimates). This is not, in it self, a very serious problem. It was necessary as excess demand pushed up prices for non-tradable goods due to the surge in aid flows during the first reconstruction phase (until about 2000). The real appreciation, reflected in price inflation, was, in effect, of marginal concern. This is because BiH economy has not reached its full capacity utilization, which in turn, had it been occurred would have imposed much higher inflation rates, as evident for other transition and currency board economies i.e. Lithuania and Estonia. However, as the reconstruction progresses, and the aid is winding down the effect is reversed. This, however, imposes much grater problems, since in order to achieve real depreciation, inflation would need to be lower than in the Euro zone (the currency is fixed against the Euro). Figures A1 and A2 in the Annex present, respectively, the evolution of inflation by one hand and the evolution of NEER and REER in BiH.

This is exactly the trouble the BiH is facing today: a need to achieve real depreciation and correct for exchange rate misalignments. Eventually, the trend in the last two years has been reversed, and REER depreciated (See REER Chart) This in turn means that the domestic policies have been so deflationary, severely depressing output, increasing unemployment and reducing real incomes. However, the REER depreciation does not seem temporary as BiH

---

<sup>3</sup> Source: CBBH

economy has not reached its external balance and thus, has extremely low level of private capital inflows. This situation and respective future prospects are indicative of continuing deflationary policy and, in fact, further employment of fiscal restriction measures, with inevitably reverse effect on the economic growth potential. Thus, these policies reveal an extremely high social costs, rising unemployment and inequality, particularly in case of low level domestic and foreign investments, as it is the case today in BiH.<sup>4</sup> Another questions related with this section are analyzed in Annex A5.

*4.2 BIH Economic internal equilibrium assessment.* Exactly, as the theory presupposes, the BH recent deflationary policies have resulted in relatively maintained macroeconomic stability and low inflation, but also in flattering growth rates and increased unemployment, reflecting extremely high social costs of maintaining the regime. Thus the constraint the regime imposes on public finances seriously impedes effective policy and program off setting of those social costs. The positive stabilization and political merits of the regime turned into serious negative repercussions. These imbalances and economic structural deficiencies prevents embarking form the performance contraction, thus threatening the regime's sustainability. The BiH main internal economic indicators suggest outstanding disequilibria and minimum capacity utilization which pose certain worries on both regime sustainability and regime's justifiability in the medium and long term.

*4.2.1. Growth performance.* The remarkably growing economy reflected in high growth rates right in the aftermath of Dayton Accord, was a byproduct of the low base economic performance because of the war, as well as fuelled post-war reconstruction aid. The real GDP growth rates were 24, 13 and 10 per cent for the years 1997,1998 and 1999 respectively.<sup>5</sup> Notwithstanding the growth performance, BiH has not moved significantly closer to sustainable development path. The spurt of growth in the second half of the 1990s is now faltering, with the average real GDP growth rate of

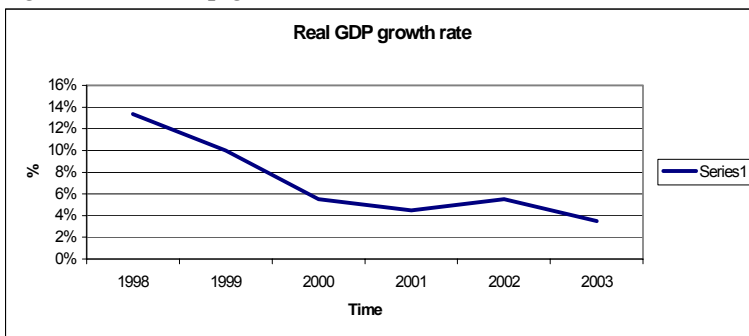
---

<sup>4</sup> Source: CBBH (estimated Foreign Investment for 2002 was KM 300 mill.)

<sup>5</sup> CBBH: see also table 1, p. 12 of this report

below 5 % for the last three years.<sup>6</sup> Only in the last years, growth rate declined from 5.5% in 2000 to 4.5% in 2001 and at 3.5% for 2003. Initial growth projections for the last three years turned out to be over-optimistic, and, unfortunately, currently available indicators suggest a steady fall in annual GDP growth (*See table 1 and chart 1a, 1b below*). The GDP in 2003 amounted to about € 6.2 billion, while GDP per capita, measured on the basis of purchasing power parity, remains among the lowest in the region at around € 1,900. 2004 estimated GDP is still below half its pre-war level, and it is expected that the pre-war GDP level may be reached only by 2010, thus stipulated by the best case scenario.<sup>7</sup>

Figure 1. Real Gdp growth rate in BiH



Despite, the clear evidence of vigorous economic activity outside the legal system<sup>8</sup>, the growth performance is indeed worrying. Poverty Reduction Strategy Paper projects that BH macroeconomic and financial sustainability is dependent upon its ability to grow at the minimum average rate of 5%, attract foreign investments in the

---

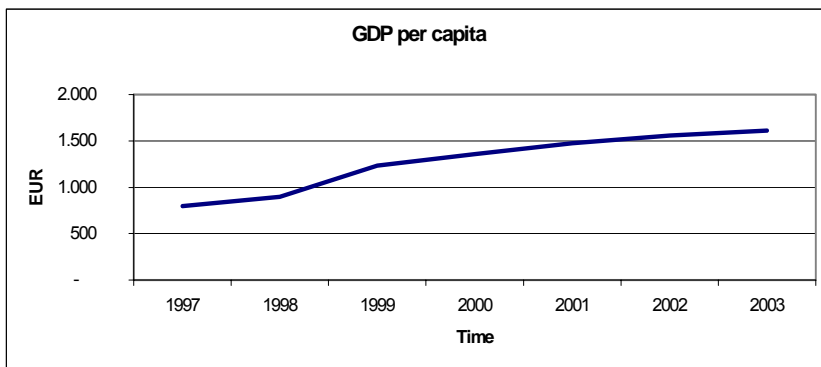
<sup>6</sup> CBBH

<sup>7</sup> Poverty Reduction Strategy (PRSP) BIH, Chapter on Macroeconomic framework and analysis, (the document has no page indication)

<sup>8</sup> It is estimated that if informal sources of value creation and income are taken into account (non-registered transfers by BH citizens from abroad, undeclared company revenues, non-recorded micro-firms and employee income, smuggling, tax evasion etc) the level of GDP could rise by 20% (the estimated size of the informal economy).

minimum value of 9% to GDP (from today's 3%), increase its savings by seven times, and reduce trade deficit by achieving an average export growth rate of 15% and a decline in imports by averaging 5 % over the medium term period (2004-2007).<sup>9</sup> Unfortunately, this scenario seems overoptimistic if compared to 2004 performance estimates of for instance GDP nominal growth rate of below 3 percent (CBBH).

Figure 2. Real Gdp per capita in BiH



Source -Charts 1&2 : Central Bank Of Bosnia and Hercegovina (CBBH)

Form the above illustration of economic performance it seems obvious that the currency board regime has induced severe output contraction. Continued adherence to this policy would further result in recessionary fluctuations. The costs of keeping the regime had already become too high and unjustifiably, bearing high risk of loss of confidence in the regime. Thus even worrying indicators which clearly reveal the true problems are those of rising unemployment and poverty. However, the REER depreciation does not seem temporary as BiH economy has not reached its external balance and thus, has extremely low level of private capital inflows. This situation and respective future prospects are indicative of continuing deflationary policy and, in fact, further employment of fiscal restriction measures, with inevitably reverse effect on the economic

---

<sup>9</sup> BH PRSP; Macroeconomic and Fiscal framework (MFF)

growth potential. Thus, these policies reveal an extremely high social costs, rising unemployment and inequality, particularly in case of low level domestic and foreign investments, as it is the case today in BiH.<sup>10</sup>

*4.2.2 Unemployment and Poverty.* Eventually as noted earlier, poor growth performance of BH coincides with even more worrying socio-economic indicators i.e. unemployment and poverty. The level of unemployed is outstandingly high. The number of people living in poverty is the highest in the region and according to the Living Standard Measurement Survey (LSMS), the poverty incidence is estimated at 20,5%, with estimated poverty levels of 25 % in RS and 16% in FBH. A more detailed analysis of these questions is presented in Annex A6.

*4.2.3. Fiscal Account imbalances: Public Finances and Public Debt*  
*Public Finance.* The financial position of the government authorities represents a critical constraint on economic policy; and this constraint is rigidly enforced by the currency board principle, as noted earlier. The BiH authorities, taken as a whole, are only able to spend what they receive either from taxation or from donors. Eventually, improving economic performance (achieving greater growth rates) and improved fiscal management i.e. tax collection, represent the only viable source of increased government revenues. In other words, strengthening public sector finances is complicated by two major tax reductions (or constraints) being posed by international community for the reasons of economic efficiency: on import tariffs (and, in particular, import tariffs and duties exemption due to free trade agreements); and on wage-related taxes and social security contributions.<sup>11</sup>

*Public Debt.* Due to outstanding financial aid-dependency and high external vulnerability, the external debt had been progressively accumulating during the reconstruction period. In the year 2002 the public debt has reached its peak at the level of over 66% to GDP. Since then, the external financial assistance has decreased sharply in order to reverse the trend and curb threatened debt and fiscal

---

<sup>10</sup> Source: CBBH (estimated level of Foreign Investment for the year 2002 was KM 300 million)

<sup>11</sup> PEIR Study, World Bank, 2002, WB, BH

sustainability of the country. Following the year 2002 some of the outstanding debt was restructured and even dropped. Subsequently the total level of outstanding external debt in the 2004 is estimated at 36% of GDP. In addition, today the external debt is rather sustainable representing about 110% of exports with relatively low debt servicing to export ratio of 8%, due to favorable rather concessionary composition of external debt. In the Annex A7 a complementary analysis of this section is presented.

*4.2.4 Banking Sector.* Banking sector in BiH is rather stable posing no direct, or say minim risk to potential systematic liquidity crises. This is primarily due to the sector's successful transformation, rather the respective allowance of foreign banks predominance as well as strict regulation of the banking sector. The foremost international character of the banking sector contributes to sectors relatively easy access to foreign money markets via their mother companies, which in return, compensates for tight money market liquidity owed to monetary operation restrictions the regime imposes on the central bank. Further, the strict regulation of the sector reflected in relatively high rate of minimum reserve requirements of 10%, as well as introduction of tight liquidity trigger points of 100% and 95% backing of short-term liabilities, for 90 day and 180 days deposits respectively. Thus, the minimum risk capital adequacy ratio (net capital/risk weighted asset) is 12%. Since short terms deposits constitute 90% of all bank deposits, this however, implies that banks need to assure backing of almost all their liabilities with liquid assets. Indeed, the strict regulation imposes tight liquidity conditions within the market. Eventually the interest rate remains high with average interest rate of 11% for the last year. Thus the average country risk rate is approximated at 3%. Thus, the structure of credit portfolio clearly indicated that the banking sector is not instrument to spur private sector growth but rather consumption. Above 60% of credit portfolio is consumer related crediting.<sup>12</sup>

*4.3 External account Balance.*

*4.3.1 Current Account and Trade deficit.* The enormous surge in imports immediately after the introduction of the regime remains persistently high through the whole period. In fact, high volumes of

---

<sup>12</sup> Data Source: CBBH. CBBH Statistical Bulletin 2003.

imports reaching the incredible level of 75% of GDP in the year 2000, remain relatively unchanged averaging to above 70% since the currency board introduction. (Source:CBBH). On the other side the level of exports remains marginal, with only slight increase of 4% since the 2001. Subsequently, the trade deficit average is over 60% to GDP in the same period. (Source:CBBH). Current account deficit remains at 29% to GDP in the 2003. These, impressive figures, indeed, are beyond any conventional wisdom regarding external capital flows. On the contrary, they reasonably pose question on currency board sustainability over the medium term. Thus, the relative growth in money supply is due persistently high aid flows and external financing of twin deficits. In regard, if we look at the moneys supply chart below, it is evident that meaninglessly the money supply has been increasing, with a sudden enormous increase during the 2000/2001 period. However, it is worth noting that this increase is not due to positive BoP balances in the period, but rather due to the change in anchor currency form DM to EURO, and the respective conversion of non-registered DM by domestic population. The, change in anchor currency was necessary due to the establishment of the European Currency and Monetary Union. However, according to the CBBH estimates the estimated international reserve and money supply level for the year 2004 indicate slight decrease of about 3%. . However, this is an indication that the trend has already been changing with risk of further decrease over the medium, as financial aid assistance is solely but surely wiping out. Yet, this is exactly the major threat to the regime sustainability. Nonetheless, these remarkably high deficits reached by BH economy are well beyond any figure of other comparable country, i.e. Estonia, Bulgaria, and Lithuania, with for instance, Estonia reaching the highest current account deficit of 9% to GDP in the 2001.<sup>13</sup> In accordance to the intertemporal approach of the current account deficits, chronic CA deficits shall not immediately impose an alarming signal to country competitiveness and external balance. Economic transformation implies necessary rebuilding of capital stock accumulation, and is reasonably associated with higher

---

<sup>13</sup> Grunter (2002)

current account deficits. These assumptions are indeed reasonable, provided that capital inflows are used to finance capital accumulation rather than consumption. In reasonable time-frame, thus, the changing pattern of trade and respective current account shall become evident.

Table 1.

Balance of Payments	1999	2000	2001	2002	2003
Gross Official Reserves					
Millions of US Dollars	472	482	1234	1187	1604
In Months of Imports of goods and services	1,3	1,4	3,4	3,0	3,4
Current Account Balance					
Millions of US Dollars	-1099	-883	-1216	-1753	-2095
As a percentage of GDP	-22,4	-18,6	-24,3	-30,9	-29,6
Trade Balance <sup>4)</sup>					
Millions of US Dollars	-3300	-2627	-2958	-3341	-3926
As a percentage of GDP	-67,3	-55,4	-59,0	-59,2	-58,7

Unfortunately, the persistence of extraordinary high deficits through out the 8 years period in Bosnia is not accompanied by the respective changes in economic fundamentals. This reasonably may be reflected in missing substantial increase of private capital inflows, and FDI flows into productive sector in particular. On the contrary, capital inflows were rather official in nature and by and large invested by (public) sector, and financial inflows were used to finance consumption rather than private and industrial sector restructuring, indicative by import structure (Imports of consumables is above 75%). The substantial capital stock accumulation has not occurred neither if looking at trivial growth in productivity and industrial capital accumulation, or capital share in import structure, which is below 5%.

The two critical issues are the trade deficit and money supply. The trade deficit could no longer be offset by import tariffs and/or export subsidization due to bilateral free trade arrangements and fiscal constraints.; Second, the incoming pressure on monetary reserves

might only be improved via special support facility i.e. in the form of a fund financed by donors to provide balance of payments and fiscal support in the case of crisis. It is clear the external imbalances would hardly be sustainable over the medium term, even, provided that the negative trend in foreign private capital inflows suddenly changes.

The change and reverse capital inflows trend would need to be radical with FDI flows increase for about four times<sup>14</sup> the current level as to compensate for decreasing official financial assistance over the medium term. In conclusion, persistent external imbalances would soon no longer be attainable, seriously threatening the sustainability of the regime. Figures A3 and A4 are included in the Annex A9.

## **5. Concluding remarks on the currency board trap**

Indeed, the Currency Board has been the right policy for the period of Bosnian post-conflict rebuilding, period of political reconciliation and major reconstruction. It has brought stabilization and confidence and perhaps insulated the country from political and economic risks associated with monetary discretion within highly decentralized state structures. However, it seems clear that the positive trends related to essential merits of the regime have turned into high socio-economic costs, thus posing serious risk to the regime sustainability over the medium term period. Indeed, the essential problem lies in economic fundamentals, economies structure and non-diversified industrial structure, in particular. Thus the privatization is at slow pace, initially due to disastrous massive privatization model, but concurrently also due to high insolvency incidence and diverse public companies deficiencies such as labor issues, thus making those companies unattractive to foreign investors. Passive trade liberalization with no industrial or private sector restructuring policies envisaged prior to opening up of markets resulted in non-significant capital stock accumulation and industrial sector restructuring. This is evident from marginal private sector contribution to GDP of 36%.<sup>15</sup> The economic slowdown and risk of recession pose a reasonable threat to currency board sustainability.

---

<sup>14</sup> PRSP Macroeconomic Framework, Projections: [www.prsp.info](http://www.prsp.info)

<sup>15</sup> BH Statistical Office

Thus, envisaged further reduction in public spending as to sustain fiscal policy imbalances, are only beginning to have pro-recessionary effect on the economy. In case of GDP contraction, the debt/GDP would inevitably increase to sustain the external imbalances, thus raising the risk premium because of incurred fiscal account imbalances. These effects would accumulate expectations and contribute to casting doubts on the sustainability of the currency board. The persistent slowdown in growth performance can not be regarded as temporary shock but rather structural problems the BiH economy faces.

In conclusion, due to continual and incoming negative economic shocks associated with the currency board regime and its trap, it seems of essential importance that Bosnian policy makers, meaning International Financial Institutions and local authorities, do not hesitate to abandon the currency board before it is too late. People of this country have suffered a lot, and thus experiencing Argentinean fate would truly be unnecessary and unfair.

### **References:**

- Atish R.G., Annie-Marie G. and Holger C.W., (1998), "Currency Boards: The ultimate Fix?", IMF Working Paper WP98/8
- Balino, T.J.T., and Enoch, Ch. (1997), "Currency Board Arrangements Issues and Experiences", IMF Occasional Paper 151. IMF, Washington DC.
- Grunter, F. J. (2002), "Currency Board and Debt Trap: Evidence from Argentina and evidence for Estonia", Herriot-Watt University, UK
- Halpern L., C. Wyplosz, (1997) "Equilibrium Exchange Rates in transition economies", IMF Staff Papers, Vol 44, 430-461
- Ho C., "A survey of the institutional and operational aspects of modern – day currency boards", BIS, Paper, No 110, March 2002
- Roubini, Nouriel (2001b) "Should Argentina Dollarize or Float? The Pros and Cons of Alternative Exchange Rate Regimes and their Implications for Domestic and Foreign Debt Restructuring/Reduction", New York University.
- Silajdzic (Basic), S.(2003), "The BH external debt sustainability: issues and controversies", Faculty of Economics Sarajevo, BiH.
- Websites: [www.cbbh.gov.ba](http://www.cbbh.gov.ba) [www.prsp.info](http://www.prsp.info)

On line Annex at the journal website

Journal published by the EAAEDS: <http://www.usc.es/economet/ea.htm>

## Annex

### *A1.What is the currency board and how it operates?: Further questions*

Such limited margin for central bank policy discretion suggests that market forces solely determine the money supply mostly via endogenously induced changes in the international monetary reserves. This, in effect, means that the level of capital provided is by and large dependent upon the countries ability to attract long-term foreign capital inflows, as well as on its ability to retain it. The pure adherence to the regime's prescribed rules, in return, shall serve as direct source of confidence in both exchange rate and banking sector stability, which is based on trust in monetary authorities. Even though, restrictions on currency and other central bank liabilities issuance, and the reserve-backing rule appear quite intrinsic to CB, in practice, most of the countries operating under the currency board, have introduced slight modifications to reflect local conditions or rather ease inherent monetary policy inflexibility. For instance, the Argentinean baking rule used to differ substantially form other currency board arrangements or better "pure" currency board, in that it allowed that up to 1/3 of backing could be met with the US dollar denominated government debt.<sup>16</sup> This in turn implied that no more than 66% of base money needed to be backed with foreign assets. Similarly, the structure of foreign assets used as baking requirement differ form country to country, thus in effect implying grater or less restrictions regarding the definition and percentage of liquid asset share. As opposed to Argentinean or Brunei's relatively flexible baking rule, the Lithuanian central bank backs 100% money base (M0) plus liquid central bank liabilities i.e. commercial banks and government deposits, securities and promissory notes issued by the bank. Notwithstanding the concurrent remarkable differences in operating regulations, Bosnian central bank, on the other extreme, is entitled to 100% backing of all central bank liabilities. Moreover, under the currency board regime just as under other forms of fixed regimes, interest rate and inflation convergence is crucial to avoid exchange rate and other policy misalignments. Thus, interest rates

---

<sup>16</sup> Balino and Enoch. (1997), 1-2

play an essential role in facilitating this adjustment. As CB shall imply no exchange rate risk, the interest rate convergence with the anchor country becomes reasonable in due course. However the theory does not always reveal its self in real world. Since country risk constitutes the essential part of interest rate formulation, and since interest rate is rather determined by local factors and market adjustments, the convergence isn't likely in countries with either grater country risk assigned or unfavorable local conditions such as i.e limited capital mobility, unfavorable capital flows, structural deficiencies etc. or number of these factors combined that build a risk premium into a domestic interest rates. Thus, it is also worth noting that country risk assessment as well as currency board sustainability assessment is subject to attitudes just as much to the institutional and legal arrangement of the currency board. This is why most of the countries operating under the currency board are experiencing difficulties in achieving better results in interest rate convergence. Similarly, extensive real exchange rate misalignments are common phenomenon due to huge inflation rate disparities between the pegged and the anchor country. Also essential factors influencing convergences implicit in this structure are capital account mobility and terms of trade. Both, by and large influence the level of discrepancies and as well as dynamics of convergence. Importantly liberal capital and trade accounts shall theoretically induce convergence and minimize policy misalignments. However, this is not always the case because of persistent monetary disequilibria and unfavorable local markets conditions in domestic economies. Thus, the liberalization may be counterproductive in case of outstanding dynamics of capital flows i.e. persistent huge capital inflows or outflows. In conclusion, the legal commitment and the stringency of currency issuance to maintain the parity and diverse monetary regulation restrictions, implicit in the laws and acts establishing the arrangement, represent the essential features that distinguishes a currency board arrangement form other forms of fixed exchange rate arrangements. Such outstanding rigidity imposed by the regime is exactly the basis of the regimes credibility and subsequently the source of diverse advantages derived from this distinctive rule-based feature, such as the essential merits of increased or regained confidence in monetary authorities. Other succeeding advantages are

often assigned to i.e. established macroeconomic stability, low inflation, increased investments and foreign capital inflows, high growth performance. More importantly, the core merit of the currency board system is reflected in certain guarantees of the way it operates and maintaining exchange rate parity in particular. Thus, any deviation from rigid legal framework establishing the currency board may be seen as counter-effective to the merits assigned. For illustration, the currency board credibility may be discredited by a legal framework, which allows scope for i.e. either issuance of unbacked monetary liabilities or changing the currency peg either by currency revaluation or devaluation such as it is or has been the case in most currency board countries with the exceptions of Bosnia and Bulgaria. . In other words, if legal framework allows for such policy options envisaging disobedience of the legal barrier to changing the exchange rate, and attendant legal restrictions on the use other policy tools would seriously harm currency board credibility, this increasing the risk of regime's sustainability. In addition, to strong commitment to maintain exchange rate parity and the resulting monetary policy restrictions, the currency boards impose stringent discipline on fiscal authorities, as it eliminates monetary financing of fiscal deficits, in effect restraining government's form running budget deficit. However, in spite of intrinsic rules rather than discretion of currency board regime, in reality the regime's regulative picture is not always unambiguous. Often, central banks face trade-offs between discretion and credibility as sometimes, stringent rules may raise high policy risks such as financial sector fragility or external vulnerability, which would be discussed later in the document. Notwithstanding the rigidities imposed by the currency board regime, it is worth noting that certain policy restrictions implicit in currency board arrangements are not unlike those of conventional central banks, and those who opted for pegged exchange rate regimes, in particular.

#### *A2. Why opt for currency board arrangement?* Further questions

The interest rate adjustment that occurs irrelevant of its degree of convergence, is primarily due to the increased credibility and confidence in the countries macroeconomic stability, and most importantly intrinsic and continued efforts to enhance banking sector stability. Sound banking sector, and presence of international banks

with their access to liquidity sources in an international arena, is considered essential under the currency board regime due to the restricted policy options of credit and LOLR provisions, particularly important for preventing systematic liquidity crisis. Increased investors confidence should rather result in increased financial intermediation and broad money. Yet, generally speaking currency boards are often perceived as less vulnerable to destabilizing capital outflows thanks to rigidity of backing and other attendant rules imposed. The reasons for opting a currency board as opposed to other forms of fixed exchange rate arrangements are numerous and disputable, thus varying on a case to case basis. Notwithstanding these contingency factors, countries opt for currency board as opposed to other fixed parity regime mainly due to one or more of the following reasons: a) in case of persistent high(per)-inflation and disastrous inflationary-spiral effects often combined with series of failed stabilization programs implemented (such as the case of Argentina), but also in case of investors' loss of confidence and reduced monetary capacities such the case of Hong Kong with its aim to regain investors confidence in financial and money market after the 1982 currency crisis)-in both cases currency board serve as arrangements for countries willing to regain confidence in monetary policy; b) in case of difficult transition period (Estonia, Lithuania, Bulgaria)and/or inherent lack of institutional capacity and experience with complex monetary policy frameworks; c) often as permanent solutions, in case of countries willingness to preserve the benefits of belonging to common currency area under the optimal currency area considerations and/or formally joining that area (i.e. Estonia, Bulgaria); d) may serve as useful transitional arrangements for countries with no/limited central bank tradition and capacities due to the regime's operational simplicity, as well as in case of poorly developed financial market (i.e. Caribbean countries); e) or alternatively may be best suited in case in which political constituency or processes do not allow for central bank independence despite the strong commitment to fiscal discipline, as monetary policy may be perceived as an effective tool of political rivalry, thus having severe consequences on economic stability, i.e. some post-conflict countries-the argument is valid also in case of Bosnia. The adoption of currency board regime is by no means a clear-cut

decision as often argued. On the contrary, the success or failure of currency board option is rigorously determined by the specificities of broader economic, structural and institutional set of characteristics and arrangements but is also dependent upon attitudes of both local and international players.

*A3. What are the weaknesses and costs of the currency board regime? Further questions.*

The real appreciation is primarily due to high capital inflows as well as domestic economy structural adjustments resulting in inflation rates persistently higher than in anchor country. This was the case of almost all currency board countries i.e. Argentina, Estonia, Lithuania, Bulgaria with notable exception of Bosnia. Price fluctuations are exactly the reason why liberalization of markets and labor market, in particular, becomes an essential mechanism for smooth and endogenous market and price adjustments, and tool to curb high real exchange rate fluctuations. Despite, the experience shows that real exchange rate misalignments incur, because Real Effective Exchange Rate (REER) is determined by real and fundamental variables of macroeconomic internal and external balance. In this regard, the real costs of the regime may incur at the time of real exchange rate corrections, and in those countries aiming to achieve real depreciation, in particular. The correction of real appreciation would imply a prolonged period of tight liquidity and high unemployment rates. Even more so in case of asymmetric macroeconomic policies opted by the anchor country for the respective period e.g. restrictive and inflation targeting policies, as well as in case of constrained capacity of domestic country tradable sector. In other words, countries with predominant no-tradable sector are particularly vulnerable as vast majority of domestic goods and service cannot be traded and therefore isn't source of significant external capital inflows. In conclusion, the real exchange appreciation is less problematic if it is caused by initial undervaluation of the currency or increased productivity in the tradable sector (Balassa-Samuelson Effect) since it shall be a temporary in both cases. On the other side, if real appreciation is due to huge capital inflows in non-productive sector of the economy and subsequent increasing consumption, that in return do not have

positive long terms effects on the economy and its increased productive capacities, but would only crate a temporary consumption bubble, thus leaving structural and liquidity deficiencies at the time of the reverse trend. Such reverse trend and succeeding output contraction may cast doubt about the regime sustainability. It seems that the Bosnia is unfortunately the *éclat ant* example of the latter, meaning missed opportunities of capital stock accumulation and increased capacities at the time of huge capital inflows. However, the causes and the degree of misalignment of REER fluctuations are both difficult to determine as well as quantify. As a consequence, reasonable assumption in regard to local factors that induce exchange rate adjustments via price changes, need careful consideration. Secondly, the previously elaborated merit of promoted fiscal discipline, reflected primarily in purged monetary financing of budget deficit, can indeed be considered as major weakness depending on initial country circumstances and soundness of respective fiscal policy objectives. Eventually, the constraints the regime imposes on fiscal accounts may come at odds with growth and development objectives at the time of fiscal consolidation, in particular. Thus, this argument is more relevant for countries with limited capacity of economy's real sector and/or poor revenue collection. The risk associated with fiscal policy constraints may be seen in government alternative choice to use external debt as source of budget deficit financing. Subsequently, problems associated with poor and bad external debt management, may result in public debt accumulation and payment arrears due to non-accommodated fluctuations in treasury management. Eventual casting of doubts on external debt management and its financing my incur loss of credibility in the regime and its sustainability. This scenario implies risk of self-fulfilling crisis and exchange rate attacks. The solution to this problem looks as if easy and clear cut from a theoretical perspective- pursue sound fiscal policies and create surplus to accumulate international reserves, reducing country's dependence on foreign savings. However, in real world fiscal restrictions seem peculiar with most developmental policy objectives of transforming economies, paradoxically of those that come as the potential candidates for currency board adoption, with the exception of Hong Kong. Final but not least regime's main weakness of restricted

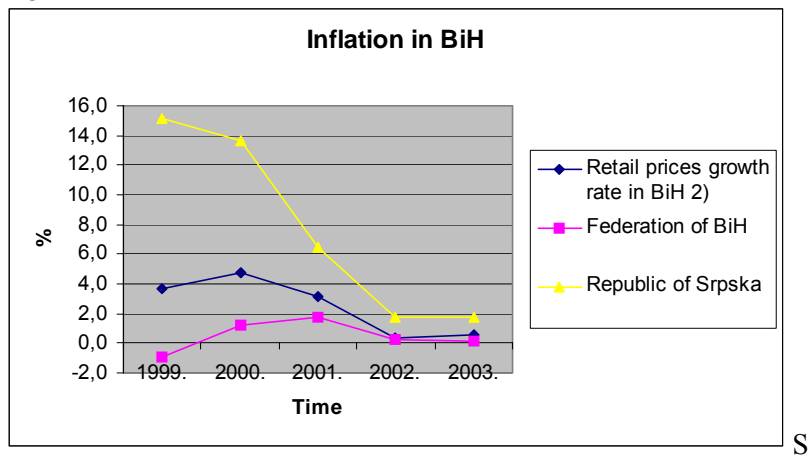
LOLR function has, absurdly been conceived as one of the essential merits. The major argument in favor of merits induced via restricted LOLR function stems from the perception that the posed lending constraints on monetary authorities shall induce sound behavior of monetary authorities and banking sector authorities, thus, in effect, promoting stability within the markets. However, this is only partially true since credibility is determined by institutional and legal arrangements as much as by local attitudes and individual perceptions, local capacities and institutional knowledge, which may induce sound credit and finance related practices. Thus, ironically, the fact that the central bank is deprived from its main rescue policy option may induce loss of credibility at the banking sector at the times temporary instabilities or persistent policy misalignments, leading to disastrous effects. Furthermore, considering empirics of self-fulfilling financial crisis it seems obvious that the individual behavior has much less to do with circumstantial objective reasoning, but much more with pure psychological reactions inducing panic and risk-averse behavior- the contingency effect. Therefore, the historical record of both fiscal and monetary authorities' behavior as well as individual experience and perception of crisis becomes essential determinant of dimension of such counterproductive behavior, in cases of even minor individual bank liquidity crisis. This becomes an important consideration. However, more important weakness associated to restricted LOLR function is not that much of unsound banking sector behavior and the subsequent risk of systematic banking crises<sup>17</sup>, as it is its intrinsic weakness of inability to influence capital market conditions and its dynamics. This is particularly important for CBA that are totally restrained from performing monetary operations. Thus if economic performance is largely dictated by capital flows and interest rate arbitrage it in fact may be subject to unnecessary (downward) fluctuations or even longer output contractions.

---

<sup>17</sup> Proper behavior may effectively be induced by comprehensive legal and institutional regulation of the banking sector, i.e. comprehensive regulation of bank risk exposure via liquidity ration, minimum required reserve ratio, capital asset ration, minimum capital adequacy ratio

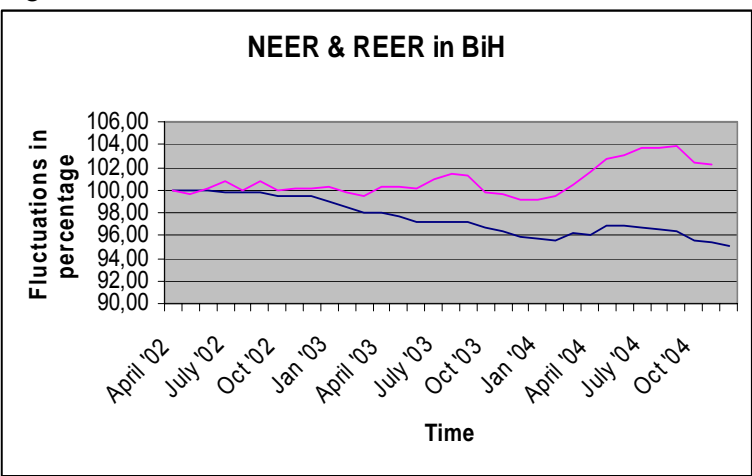
A4. Evolution of inflation, NEER and REER

Figure 1. Evolution of inflation in BiH



Source: Central Bank BiH (CBBH)

Figure A2. Evolution of NEER and REER in BiH



*A5. Is this depreciation threatening the sustainability of Currency Board?* The answer to this question is not a clear cut. If, the REER depreciation of about 4% points is solely perceived as the actual correctness of exchange rate misalignment incurred during the immediate reconstruction phase, than the answer is no. On the other side the prompt answer lies in an assessment of economy's movement toward its internal and external equilibrium or away from it? In other words, if economy continues to experience negative economic movements, reflected in flattering growth rates, rising unemployment, and current account deficits than this trend, however, may pose serious threat to currency board sustainability. In addition, the relevant question than becomes the one on relevance of socio-economic costs incurring because of the continued adherence to currency board option, and not exclusively the one of threatened sustainability.

*The real appreciation option?* A probably more attractive option of pursuing REER appreciation, highly depends on the BiH external debt position and its ability to borrow internationally and/or attract substantial inflows of foreign private capital. In general, the overvaluation option is at the best temporary solution, and, thus, is only viable to the extent the country is able to borrow internationally to finance its balance of payments deficits, or at best as long as current account deficits are financed through FDIs indicating an economies move to its external equilibrium. Since, in Bosnia current account deficit is financed through aid flows, with marginal private capital inflows and, in fact, trivial level of FDIs attractions; (FDI volume remains below 3% of GDP.<sup>18</sup>), and the only relevant issue becomes its ability to further borrowing. This option, however, does not seem viable considering that external/international financing are declining and already problematic level of public debt, reflected in the following indicators (see Basic(2003): *debt to GDP ratio equals 55%, and debt to export ratio being 125% (EDT/GDP and EDT/XGS)*), as well as BH's assigned Sovereign Country rating of

---

<sup>18</sup> CBBH

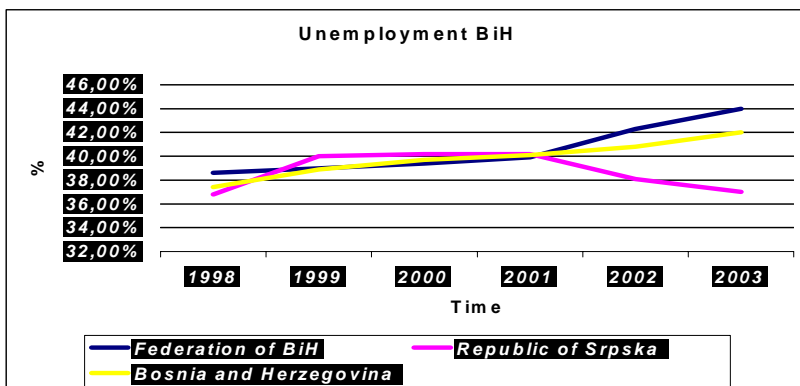
“B3”<sup>19</sup>. Moreover, creditors’ reluctance to further lending will be and are greatly increasing if creditors see the country’s debt servicing capacity as being compromised by the institutional arrangements of an exchange rate. Considering the current circumstances restrictive policies seems the only feasible option under the currency board. Otherwise the exchange rate would become increasingly overvalued; which in Bosnian case could hardly be sustainable due to its persistent imbalances. Thus, it would make exports and import-substituting domestic industries even less competitive. In other words, the second option of allowing further overvaluation of currency seems hardly a viable alternative.

*A6. Unemployment and Poverty.* Eventually as noted earlier, poor growth performance of BH coincides with even more worrying socio-economic indicators i.e. unemployment and poverty. The level of unemployed is outstandingly high. The average level of unemployment in BiH is estimated at about 42%, and has remained at about that level throughout the whole of post war period with some slight increase. These figures suggest that the private sector growth is rather at a slow pace, incapable of absorbing the increasing army of the unemployed. In Federation, the privatization process and the accompanied downsizing is greater in absolute numbers than the private sector growth and new job creation. In RS the opposite is truth, due to much slower dynamic of the privatization processes. In short, the recent trends of the transition process in BH indicate greater value destruction than value creation. Eventually, most Bosnians are getting poorer, particularly in Republika Srpska. There is clearly indication of high level of income inequality as well as poverty. Most people in both Entities are living far below the “substance” level (minimum level necessary to satisfy and meet basic human/living needs i.e. food, shelter, health protection, education etc). The average monthly wage in Federation amounted to EUR 260 in 2003. But the basket of typical consumables needed to

---

<sup>19</sup> Sovereign rating is an assessment of borrower’s likelihood to default on its obligations, Rating B3 assigned to BH by the Moody’s company for internationally ratings (Feb,2004) is the lowest sovereign rating, indicating high risk obligations.

keep a family of four costs EUR 240. The corresponding average growth rates of the two variables indicate no raise in real average living standard from 2001 onwards. The number of people living in poverty is the highest in the region and according to the Living Standard Measurement Survey (LSMS), the poverty incidence is estimated at 20,5%, with estimated poverty levels of 25 % in RS and 16% in FBH. In addition, more than 30 % of population falls under the highly vulnerable category and are living just above the poverty line.<sup>20</sup> According to the LSMS survey the poverty line is estimated at the level of annual income below 1850 KM, whereas according to the same source, the highly vulnerable category is considered to receive an annual income of just above the defined poverty threshold (up to an annual income of 2050 KM)<sup>21</sup>



Source:CBBH

The shortfall is even more striking in RS, where the average monthly wage was EUR 200 in 2003, but the basket of essential items cost EUR240. As noted above, the fact is that the picture is even bleaker than those averages indicate, given that 46 per cent of Federation's

<sup>20</sup> BiH Medium Term Development Strategy - PRSP (2004-2007), p. 21-22. Again, it would be worth adding what the poverty line is in this para.

<sup>21</sup> Living Standard Measurement Survey, Zavod za Statistiku BH, 2001, BH

population and 75 per cent of those in the RS cannot afford this notional basket of goods and foodstuffs.<sup>22</sup>

*A7. Fiscal Account imbalances: Public Finances and Public Debt. Further questions.*

*Public Finance.* The financial position of the government authorities represents a critical constraint on economic policy; and this constraint is rigidly enforced by the currency board principle, as noted earlier. The BiH authorities, taken as a whole, are only able to spend what they receive either from taxation or from donors. Eventually, improving economic performance (achieving greater growth rates) and improved fiscal management i.e. tax collection, represent the only viable source of increased government revenues. In other words, strengthening public sector finances is complicated by two major tax reductions (or constraints) being posed by international community for the reasons of economic efficiency: on import tariffs (and, in particular, import tariffs and duties exemption due to free trade agreements); and on wage-related taxes and social security contributions.<sup>23</sup> Because of the currency board arrangement, any reduction in revenues from these sources would lead directly into lower government expenditures or into higher rates of taxes if not off set by higher growth rates; surge in investments and private sector growth. Since, BiH has little or no scope for any further increases in tax rates or base<sup>24</sup>, the main burden of current and future fiscal adjustments falls on the public expenditure side. This would imply cuts in distributive policy spending; benefit transfers i.e. social security, unemployment etc.; health services and education in particular. The prevailing situation in terms of public management and spending in particular in Bosnia and Herzegovina is not sustainable. The weight of the public sector as a whole, throughout all the institutions – state, entities, cantons, districts and municipalities – is extremely high by any standards. According to the

---

<sup>22</sup> “Early warning system in Bosnia and Herzegovina”, *UNDP Quarterly Report*, October-December 2003

<sup>23</sup> PEIR Study, World Bank, 2002, WB, BH

<sup>24</sup> Reasonable assumption since direct tax rates are already relatively high and hardly sustainable averaging 20% in both entities, source: CBBH

World Bank data for the year 2002 in BiH, general government expenditures accounts for 60.7% of GDP compared to 49.2% in the EU (average) and 41.4% in transition CEE countries (average). In countries of former Yugoslavia like Croatia, Macedonia, and Slovenia, general government spending in 2000 was 51.3%, 36.6%, and 43.6% of GDP, respectively.<sup>25</sup> National economic output is insufficient to cover growing public expenses. The international financial assistance is still remarkable in volume terms although declining. According to the WB PEIR, the consolidated general government deficit in 2000, including capital spending, arrears, off-budget defense spending, was equal to 11.2% of BiH's GDP.<sup>26</sup> However, budget deficit has been substantially reduced during the last two years to the estimated level of below 3% of GDP in 2004 (CBBIH). Further reducing of fiscal imbalances would have negative repercussions on economy, society as a whole even income distribution in particular. This is obviously going to affect the more vulnerable groups of the population and those who rely more on social spending. Over-tight fiscal constraints represent an important obstacle to effective policy-making, effective administration and high quality public services. Thus it seriously impedes growth potentials. Because of the currency board arrangement, any reduction in revenues from these sources would lead directly into lower government expenditures or into higher rates of taxes if not off set by higher growth rates; surge in investments and private sector growth. Since, BiH has little or no scope for any further increases in tax rates or base<sup>27</sup>, the main burden of current and future fiscal adjustments falls on the public expenditure side. This would imply cuts in distributive policy spending; benefit transfers i.e. social security, unemployment etc.; health services and education in particular. The prevailing situation in terms of public management and spending in particular in Bosnia and Herzegovina is not sustainable.

---

<sup>25</sup> European Commission, 2003, Basic functional and financial audit of BH institutions-Draft, EC Commissioned Report, p. 4

<sup>26</sup> World Bank, 2002, PIER Study, WB, BH

<sup>27</sup> Reasonable assumption since direct tax rates are already relatively high and hardly sustainable averaging 20% in both entities, source: CBBH

*Public Debt.* Yet the public debt does not pose serious threat to currency board sustainability, but clearly external financing could for not too long be used as source of BoP deficit and fiscal account deficits financing, in particular. Posing sustainability on these accounts over the medium term would, and in fact, already has resulted in output depression. However, despite the relative stabilization of foreign debt accumulation the country remains donor-dependent. The persistent donor dependency is revealed in a continuous foreign debt financing of both internal/fiscal and external/Balance of Payment (BoP) sustainability amounting to average of 12% of GDP for the last 4 years. In addition, the economies' chronic inability to assure balanced financial/capital flows, reflected in chronic BoP deficits in spite of massive external donor funding, clearly assigns constrained economic capacity, and limited ability to increase export performance in particular. These suggest serious problems on the country's external account balance.

A8. The weight of the public sector as a whole, throughout all the institutions – state, entities, cantons, districts and municipalities – is extremely high by any standards. According to the World Bank data for the year 2002 in BiH, general government expenditures accounts for 60.7% of GDP compared to 49.2% in the EU (average) and 41.4% in transition CEE countries (average). In countries of former Yugoslavia like Croatia, Macedonia, and Slovenia, general government spending in 2000 was 51.3%, 36.6%, and 43.6% of GDP, respectively.<sup>28</sup> National economic output is insufficient to cover growing public expenses. The international financial assistance is still remarkable in volume terms although declining. According to the WB PEIR, the consolidated general government deficit in 2000, including capital spending, arrears, off-budget defense spending, was equal to 11.2% of BiH's GDP.<sup>29</sup> However, budget deficit has been substantially reduced during the last two years to the estimated level of below 3% of GDP in 2004 (CBBIH). Further reducing of fiscal imbalances would have negative repercussions on economy, society

---

<sup>28</sup> European Commission, 2003, Basic functional and financial audit of BH institutions-Draft, EC Commissioned Report, p. 4

<sup>29</sup> World Bank, 2002, PIER Study, WB, BH

as a whole even income distribution in particular. This is obviously going to affect the more vulnerable groups of the population and those who rely more on social spending. Over-tight fiscal constraints represent an important obstacle to effective policy-making, effective administration and high quality public services. Thus it seriously impedes growth potentials.

A9.

