1. EXECUTIVE SUMMARY

The currency board arrangement in B&H ensures that the currency of B&H, 'Konvertibilna Marka-KM', is at any moment exchangable for the EURO at a predetermined and fixed ratio of 1.9558 KM to 1 Euro. The currency board arrangement as such ensures the stability of the local currency. However, the arrangement has been and is still the topic of a much debate. While one group of arguments stresses that giving the tool of monetary policy to B&H politicians would be dangerous, which is truly the case when financing growth through inflation has been proven to bring a dangerous inflation-devaluation spiral in many developing countries, including the ex-Yugoslavia in the past. For the proponents of this opinion B&H is also too small to have its own currency and benefits the most from having a strong adopted currency, and therefore the currency board provides a much desired exchange rate stability. On the opposite side is the group which argues that due to the fact that the currency board arrangement takes out of the Government's hands the monetary policy it costs the B&H real economy underperformance in terms of underemployment and economic growth. Presenting the currency board arrangement as an obstacle to the achievement of economic growth and higher employment is an oversimplification of the way that various economic variables interact and the way that economic balance (equilibrium) is achieved, both in the internal goods and labor markets and the external account of B&H.

In this paper we adopt a model which allows us to take account of the way that internal and external balance is reached and in this context analyze alternative policy options available to the government in solving current macroeconomic disbalances.

We also show using the framework of small open economy macroeconomic model that despite of the position that you might take with respect to the appropriateness of the current nominal exchange rate regime, the currency board arrangement is endangered if corrective actions are not immediately taken. Guarantees that the CBBH provides in promising to exchange KM to EURO at a fixed rate do not present a problem when the foreign currency reserves are sufficient. Exports earn foreign currency while imports deplete the foreign currency reserves in the country, foreign currency also enters the country through transfers, grants, remittances, or foreign capital flows into the country, but with the current trend of decrease in the later and the large current account deficit which stands at a 60% of GDP at the moment, the pressure on the currency board arrangement will increase, endangering its very existence. In this study we look at the problem that B&H is facing given the Currency Board (CB) arrangement in the context of the desired achievement of macroeconomic stability (as a necessary condition for EU accession) and economic growth. We evaluate the alternative policy actions that are available to the government and evaluate which policy option achieves these objectives in the best way using the standard small open economy framework which is built on a well-known Dornbusch's (1983) open economy model.

We evaluate two extreme options: (a) abandoning the currency board and (b) retaining the status quo. Both of these options, as we show by the outcomes of our econometric analysis using the adopted framework, fail to achieve desired objectives of currency stability coupled with macroeconomic stability, which is required by the criteria of an accession into the EU. We show that a third option, and an optimal policy option in the context of the adopted framework and the criteria of achieving both currency and macroeconimc stability, is the way of retaining the currency board arrangement coupled with structural changes in the labor market (making labor market more flexible and increasing the mobility of labor) and at the same time working on improving the investment climate, which will ensure that B&H becomes competitive enough to attract increased investment and in turn bring macroeconomic stability. We also show that these structural changes are necessary for achieving desired macroeconomic objectives even if the country chooses any other policy option if it is ever to achieve the long run internal and external balance and argue that short term fixes are therefore not available for B&H as may be true for any other economy. As such strong evidence is presented for the optimal policy option we urge for the relevant reforms to be done speedily in order to avoid much worse economic crisis if B&H does not perform the required actions in time. As situations in a number of countries that have experienced serious financial and currency crisis in recent history show, outcomes of such crises, if they occur, are devastating in terms of real economic losses. As we will show, under the present circumstances B&H has only one effective way in order to achieve the desired objective of macroeconomic and currency stability and avoid the crisis[1] from happening.

[1] The crisis here refers to the currency and financial crisis which can result in large real economic losses of lost employment and purchasing power that are likely result of speculative attack on the currency.