

# **Consequences of financial crisis in Bosnia and Herzegovina**

## **Fiscal and Monetary Policy**

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### **Abstract**

Aim of this paper is to analyze effects did global financial crisis have on BiH's economy and society in general. After examination of effects, it will be researched what are the policies that government has implemented in order to decrease negative effects. Both, fiscal and monetary policies will be examined, with special emphasize will on the stand by arrangement with IMF because it was often debated whether this arrangement was good or wrong movement of the government. Moreover, this paper will provide information about have did these measures affect society and especially certain interest groups, such as demobilized military. Finally when all of these above mentioned are analyzed and discussed, conclusions about efficiency of implemented policies will be made and proposals of what could be done will be developed.

**Keywords:** global crisis, Monetary policy, Fiscal Policy, Central Bank

### **1. INTRODUCTION**

Government of Bosnia and Herzegovina introduced some measures aimed in cutting public administration costs and urge state-owned enterprise to devise saving plans. Bosnian government encourages public spending, new capital investments, building roads, open new projects. To conclude, BiH was doing pretty well until 2008, registering decent levels of

economic growth. As the crisis hit Europe, economic growth substantially slowed down, huge public deficit took place and the only solution to prevent absolute collapse was to get the loan from the International Monetary Fund. All of the fiscal policies had some effect, but they created social problems. On the other side, since Central Bank has only limited tools and thus, monetary policy could not do much.

## 2. EFFECTS OF FINANCIAL CRISIS ON BIH ECONOMY

Previous to the 2008 and global financial crisis, BiH was considered as the most stable economy in the Western Balkans. Of the great importance for macroeconomic stability at that time was that the currency has been pegged to the euro, which ultimately protected it from the fluctuations and created stability. Furthermore, economy was performing better and country was experiencing slow but continuous growth in GDP. Since BiH is approaching EU integration, much faster economic growth with higher GDP increase is required in order to catch up with EU member countries. However, when crisis hit BiH this ambition for catching up complicated further because GDP growth has immediately slowed down, due to the reduced exports, remittances and credit. Finally, in 2010 some signals of slow recovery have shown.

When talking about this crisis, inflation is usually perceived as one of the greatest problems.

Year	2007	2008	2009	2010
% change in CPI	1.5	7.4	-0.4	2.1

Table 1. Inflation

From the table above it can be concluded that crisis created high inflation, especially in the 2008 when retail prices increased by 7.4%. This big increase of price level was caused by extraordinary rise in energy and food prices on world markets in the first months of 2008.

Regarding financial inflows before the crisis, the highest percentage of these inflows were in the form of foreign direct investment (FDI). In 2007 FDI grew but in the following years it started decreasing and currently FDI represents approximately around 1% of GDP. It is important to emphasize that beside the financial crisis, the second highest problem why FDI has drastically decreased is complex political situation and insecurity.

Since the war ended unemployment is constantly high. Business cycle is very slow, not many jobs are being created, so the unemployment persists to be one of the leading problems. Existing economic crisis, as previously mentioned, had slowed business cycle further, production decreased and consequently unemployment rose. Regarding sectors that were first to feel the effects of global financial crisis, these are the strongest export sectors, metal industry and also building and industry of construction. Some of the most successful companies in the metal industry, such as Arcelor Mittal Zenica and ASA Prevent have already in 2008 decreased their production by 20-50%. In some Cantons there is need for approximately million KM per month to cover only the basic contribution for the new unemployed persons. So, number of unemployed is continuously increasing, while government is trying to implement austerity measures of cutting social expenditures. Increasing demand for social benefits and reduction in government spending created atmosphere of general dissatisfaction, strikes and social unrest.

The movements of public revenues and expenditures indicates that significant further worsening of the country's fiscal position occurred and that fiscal deficits increased further. It is evident that revenues were gradually decreasing and this was mainly due to the decrease in collection from taxes and lower collection came as a result of decreased consumption. On the other side austerity measures that were enforced as an effect had decrease in government expenditures

Further more, economic shocks have also caused an increase in the grey economy which represented significant problem even before the economic crisis. In the research about crisis and grey economy in the BiH, PhD Rajko Tomas showed that actual portion of grey economy in 2008 was approximately 60%. It can be argued that this percentage has increased even more in past two years because of the crisis and because of introduction of fiscal cash machine . Introduction of fiscal cash machine hurt small business the most and caused high percentage of these to exit from the market.

### **3. MONETARY AND FISCAL POLICY**

As the negative impacts of the global crisis make their way across Bosnia and Herzegovina, governments are employing different mechanism to improve their competitiveness and encourage economic activities. As a first step, improving competitiveness can come through currency depreciation, but in the case of Bosnia and Herzegovina it cannot be adopted because Bosnian currency is pegged to the euro through a Currency Board. Beyond currency depreciation, the Bosnia could employ other monetary and fiscal policy instruments to ease adjustment and encourage economic activity, including financial spending programs to encourage aggregate demand or loosening of lending controls to increase liquidity in the banking system. Central Banks in the region of Bosnia cut their policy rates, but for Bosnia and Herzegovina the only available macroeconomic policy was reduction of minimum reserve requirements and requirements for funds borrowed from abroad. Also Central Bank of Bosnia and Herzegovina exempted funds in foreign currency from reserve requirements. In 2008, it cut reserve ratio for all deposits from 18% to 14% by increasing the liquidity and free credit potential, is aimed at stimulating banks to keep the growth rate of the lending activity which was considerably slowed down. The tendency of slow-down of growth of bank lending to private sector started.

As the tendency of decrease of activities in the local credit market continued, the Governing Board of the Central Bank of Bosnia and Herzegovina in November 2008, passed a decision according to which all the new credit lines withdrawn by commercial banks from foreign countries should be excluded from the base for required reserve calculation. This measure was aimed at stimulating the inflow of capital from foreign countries in the local banking sector and providing additional incentives to the credit activity of commercial banks. In December 2008, the Governing Board also passed a decision on introducing a differentiated rate of required reserve on commercial bank deposits. The purpose of this decision is to release additional liquid funds from the required reserve for commercial banks, in order to stimulate larger credit activity in attempts to make a positive influence on the level of economic activity in the country.

Also new decision about deposit insurance limit is brought, new amount increased from 7.500 to 20.000 KM, and Deposit Insurance Agency provides insurance of deposits in commercial banks in the amount of 35.000KM per person.

The influence of the financial crisis in 2008 was indirectly felt in BH economy as well, particularly in its financial sector. Slowing of capital inflows from abroad and withdrawal of deposits from domestic commercial banks, which partly contributed to the negative balance of sales and purchases of KM, as well as a reduced pace of growth of credit activities of banks resulted in a considerably slower growth of money supply relative to previous years.

In 2009, the banking sector in BH, despite strong effects of the world economic crisis, managed to maintain stability and responds successfully to clients' demands, which served to safeguard the confidence in the banking system. In order to mitigate negative effects of the global financial crisis, around the middle of the year the banking agencies adopted the Decision on Temporary Measures for Reprogramming of Credit Liabilities of Physical Persons in Banks, which allowed banks to reprogram all obligations of a debtor's at his request.

The slow-down of capital inflows from foreign countries and the withdrawal of deposits from the local commercial banks, which partly contributed to the negative balance of KM sale and purchase, and also the decline of the growth rate of bank lending activities resulted in a significantly slower growth of money supply.

### **3.1 Fiscal Policy**

Government of Bosnia and Herzegovina introduced some measures aimed in cutting public administration costs and urge state-owned enterprise to devise saving plans. Bosnian government encourages public spending, new capital investments, building roads, open new projects.

#### **Letter of Intent**

In early May 2009, members of the Fiscal Council of BH and delegation of the International Monetary Fund (IMF) harmonized a Letter of Intent that was forwarded to the Governing and Executive Board of IMF, in which a three-year Stand by arrangement was agreed for Bosnia and Herzegovina in the amount of EUR 1.2 billion with annual installments of EUR 400 million each

In the Letter of Intent they proposed many policies in order to decrease budget deficit. One of them was end 2009, we intend to: (i) eliminate special unemployment benefits granted to demobilized soldiers by allowing the sunset clause to expire; (ii) introduce a maximum income threshold for eligibility for civilian and veterans benefits; (iii) reduce all civilian and veterans' benefits by 10 percent and eliminate indexation; and (iv) reform war veterans' pensions. These reforms will entail the revision of existing legislation, including: (i) Decree on eligibility for pension under more favorable conditions of the military insurees of the Army of FBiH; (ii) Decree on eligibility for age pension under more favorable conditions of the military insurees of the Army of FBiH; and (iii) Decree on eligibility for age pension under more favorable conditions of the members of the former Army of FBiH and civil servants and employees of the former Ministry of Defense of FBiH.

#### **IMF Stand-By Arrangement**

Faced with increasing financing pressures in early 2009, the authorities put together a comprehensive program supported by an IMF Stand-By Arrangement. The program was designed to safeguard the currency board and cushion the effects of the deteriorating external environment, while adopting policies to correct fiscal imbalances and strengthen the financial sector. The authorities' approach included: (i) gradual fiscal consolidation accompanied by

structural fiscal reforms to bring public finances on a sustainable path; (ii) steps to strengthen the resilience of the financial sector alongside commitments by foreign parent banks to maintain their external exposures to BiH and keep their subsidiaries capitalized; and (iii) substantial financing from the Fund along with funds from the World Bank and the EU.

The program helped mitigate the impact of the crisis on the economy. Private investment and spending on consumer durables collapsed, while private current consumption softened to a lesser extent, on the back of moderate growth of wages and social benefits. The drop in domestic demand appears to be leveling off, aided by stabilizing credit conditions. Private investment, however, continues to lose ground as a result of weak FDI inflows.

#### Results of Stand – By Arrangement

The program helped mitigate the impact of the crisis on the economy. Inflation has decelerated.

The Federation government approved with a delay the pension reform strategy in June 2010, and parliament adopted the public wage legislation in July 2010 (both end-March structural benchmarks). Eligibility audits of war benefit recipients started only in July and are yet to produce any tangible results (continuous benchmark from start of year). The end-March structural benchmark on the reform of privileged pensions, which was missed by the Federation, was also redesigned. In Republika of Srpska, all end-March 2010 benchmarks related to eligibility audits, the reform of privileged pensions, and the pension reform have been met.

By the end of the Stand by Arrangements, the level of Fund credit outstanding is projected to reach 8.5 percent of GDP, and Fund repurchases and charges would peak at 63 percent of total debt service in 2014. The country's excellent record of meeting Fund financial obligations, the expectation that the program would lay the foundations for the return to a sustainable medium-term growth path, and a strong political commitment to the program provide assurances that B&H should be able to meet its financial obligations at defined time.

Fiscal coordination was improved. Since its establishment in 2008, the role of the Fiscal Council in coordinating fiscal policy across the country has been limited. It is important that the authorities take steps to improve the Council's operational framework and involve it in the design of medium-term fiscal policy and fiscal targets.

The establishment of the Fiscal Council in 2008 represents an important step in advancing national fiscal policy coordination. Recently, there have been increases of excises to align tax rates with EU levels, but discretionary revenue gains were partly offset by declining customs collections owing to EU accession. Direct taxes were lowered and exemptions re-defined. Tax administration has also improved and, contrary to the experience in many countries, collection does not seem to have suffered during the recent crisis. On the expenditure side, progressive increases in wages and social benefits have occurred since 2006 in a pro-cyclical fashion, dampening the effect of the automatic stabilizers. Unemployment benefits, which generally act as a counter-cyclical force on the expenditure side, have increased during good times with the rights awarded to demobilized soldiers in the Federation.

During the period of crisis Bosnian government propose some discretionary revenue measures. In 2008 Association Agreement with EU (lowered import tariffs on EU goods) was made. In 2009 Increase in the road fee (+0.10 KM/l), excises on coffee and progressive increase in excises on tobacco.

With monetary policy assigned to maintain the currency board arrangement, fiscal policy was the only available instrument to soften the economic downturn. However, given the starting unsustainable fiscal position, a discretionary fiscal stimulus was not a policy option.

During these period in Bosnia and Herzegovina some reforms were adopted, such as Rights-based benefits reform. Much of the spending pressure affecting the fiscal accounts over the past few years stems from poorly targeted and inefficient rights-based benefits. There was agreement on the need to press ahead with the implementation of the reform of the system of rights-based benefits according to the action plan prepared in consultation with the World Bank. Faced with increasing demographic pressures, the authorities have initiated reforms of the pension systems. The Federation approved a pension reform strategy, which still needs to be fleshed out in greater detail and to incorporate an overhaul of privileged pensions. In the RS, with the pension reform strategy already approved by parliament, the authorities need to follow through with the preparation and adoption of pertinent legislation.

Reforms to rein in the wage bill was also implemented. BiH's government payroll has grown substantially in recent years and is very high compared with other countries. There is still a need for deeper reform of public administration.

#### **4. CONCLUSION AND PROPOSALS OF MEASURES**

To conclude, BiH was doing pretty well until 2008, registering decent levels of economic growth. As the crisis hit Europe, economic growth substantially slowed down, huge public deficit took place and the only solution to prevent absolute collapse was to get the loan from the International Monetary Fund. All of the fiscal policies had some effect, but they created social problems. On the other side, since Central Bank has only limited tools and thus, monetary policy could not do much.

In the case of Bosnia and Herzegovina the best way to correct consequences of crisis is to change policy of public finance, to decrease the budget deficit and decrease of public deficit. Main problem and weakness for Bosnian financial system is so high level of the benefits provided to special groups of citizens and thus it is absolutely necessary to make reforms regarding spending on these benefits.

Further more, it would be good if more flexible mechanism of the use of required reserves of the Central Bank through use of the securities would be introduced and if Central Banks would get the right to set the interest rate of the commercial banks. Of especially help would be establishment of domestic bank which would than help development and support new investments and development of the Bosnian financial sector.

Government should provide help to the domestic companies in order to keep their status on the market, to keep stable unemployment rate and increase their competitiveness. One of the measures that could be is the increase in the level of the public sector works that will create jobs.

Sector of economy that should be supported the most heavily is agricultural sector, to encourage the production of the agricultural goods that are currently being imported and increase consumption of domestically produced goods. These will lead also to the increase in GDP of the country and help export expansion.

Finally, introduction of progressive taxation could create some positive results, but detailed cost-benefit analysis should be done in order to evaluate whether this type of taxation would increase government revenues.

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