Peter Nicholl: Perspectives on monetary policy in Bosnia and Herzegovina

Lecture by Mr Peter Nicholl, Governor of the Central Bank of Bosnia and Herzegovina, to the 1/1 Student Initiative, Sarajevo University, Sarajevo, May 2001.

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Introduction

I am very pleased to have this opportunity to talk to the top students of Sarajevo University about monetary policy in Bosnia and Herzegovina (BH). As we have only an hour and a half in all, and I want to leave plenty of time for your questions, I do not have time for a comprehensive discussion of all possible monetary policy issues for BH. So I have decided to talk on the following four inter-related issues:

- the Currency Board option;
- macro-economic sustainability in BH;
- the role of the banking sector in BH ;
- institutional design of economic institutions.

The currency board option

As I am sure you all know, the CBBH operates monetary policy in BH by a Currency Board arrangement. The three essential features of the Currency Board, all of which are specified in the CBBH law, are:

- The BH currency, the Convertible Mark (KM) is tied to the Deutschmark (DEM) at a fixed exchange rate of 1KM= 1DEM. It is now also tied to the Euro at the same rate as the DEM (1 KM = 0.511 Euro);
- The KM liabilities of the CBBH have to be fully backed with convertible foreign assets;
- The CBBH has to be prepared to convert KM for DEM at any time for any amount (i.e. It is a fully convertible currency)

It is interesting to remember back to the sort of payment and banking sector that operated in BH before the CBBH was established in 1997:

- there were four currencies in use in BH and the only one that was used over the whole country was the DEM;
- there were three payments bureaus that had a monopoly on domestic non-cash payments but could not settle electronically with each other;
- there were around 70 organisations that called themselves banks but most were very small and none of them operated over the whole country.

Linking the KM to the DEM through a Currency Board was an easy choice for BH because the DM was already extensively used in the country and was the currency people trusted.

It has been a successful choice too:

- the KM has been a stable currency against the DEM and the Euro since it was introduced;
- inflation in BH is relatively low and stable;
- KM use has risen rapidly within BH and it is now the dominant transactions currency in all parts of the country. Our KM liabilities have risen from KM 132 million when we started in August 1997 to KM 1,023 million at the end of February 2001;
- they can even be traded in a number of other countries in Europe;

- the KM has remained fully convertible. Since the KM currency was introduced we have issued around KM 3.44 billion and we have converted back to DEM around KM 2.66 billion.

I do not think there is any other type of monetary policy, except the adoption of the DEM as the currency of BH, that could have given a country like BH a stable and trusted currency this quickly.

Why has the currency board worked in BIH?

I think there are four main reasons:

- first, people have faced many financial traumas. They therefore value a stable currency. The Currency Board consequently has a high level of public and political support within BH;
- second, people had complete trust in the anchor currency, the DM a strict Currency Board has allowed the CBBH, a new institution with no track record, to gain some of the credibility of the DEM and the Bundesbank;
- third, some people say it is because the CBBH has a foreign Governor. I think that is only a small part of the reason.
- in my view, the major reason it has worked is the very good legal and institutional framework the CBBH has.
  - the goal of the CBBH is simple, clear and specified in the law;
  - the law limits our activities where there would be any potential conflict with the Currency Board requirements;
  - within these statutory goals and limitations, the CBBH is independent of political direction;
  - we have sensible and sound internal decision-making processes;
  - we are easily and firmly held accountable. A breach of the Currency Board requirements would be quickly obvious to all. Within the current economic jargon, it is a very transparent form of policy implementation.

Some economists and others argue that a Currency Board has disadvantages because of the limitations it places on the economic roles of the CBBH for example:

- the CBBH can not play a role in providing liquidity to the banking sector (i.e., it can not act as lender of last resort);
- the CBBH can not finance the Government;
- the CBBH can not play any direct role in financing economic development;
- the exchange rate can not be used as a tool to adjust to economic shocks or poor economic performance.

These areas of policy discretion, if used wisely and in moderation, could be of advantage to economic development in BH. There are lots of projects in BH for which a ‘little bit’ of CBBH finance may be helpful. But the problem would be in keeping the CBBH credit to a ‘little bit.’ The experience of the region is that excess central bank credit has usually been created and the result is inflation. That does not help business, employment or confidence in BH. So in my view, the strict Currency Board is the best approach for BH.

Will the currency board be continued in BIH?

I believe it will for the following reasons:

- there is widespread support for it because it has provided one of the few elements of stability the people of BH have had for some time;
- it would be risky to change it. confidence in the KM would drop as people waited to see how any alternative monetary policy would work;

- Currency Boards have worked well in other eastern European countries such as Latvia and Bulgaria. Currency Boards are becoming acceptable, even fashionable;
- the long-term goal of BH policy is to take the economy closer to Europe. The KM is already tied to the Euro. It would therefore seem sensible to maintain this link.

Macro-economic sustainability in BIH

While I believe strongly that BH should maintain its Currency Board, there will need to be changes made in other areas if BH is to have macro-economic sustainability over the medium term. The Currency Board requirement means that the CBBH can not issue KM currency in any quantity it chooses or the economy needs. The amount that can be issued is tied to the net position of Bosnia and Herzegovina's external accounts. This is the Currency Board arithmetic.

What does this Currency Board arithmetic mean for a central bank and a country? If the net position on a country's external accounts is positive, the central bank's foreign reserves will increase as the foreign inflows are changed into the domestic currency. There is nothing to stop a Currency Board having more than 100% backing for its domestic currency liabilities.

(Indeed, at present the CBBH has foreign reserves equal to 106% of our KM liabilities.) So if the overall foreign accounts are in good shape, there will be no pressure on the Currency Board and medium term economic sustainability will be easy.

But, if the country's overall foreign accounts are negative, the situation is very different. If people wish to buy foreign exchange with their KM currency, the CBBH has to do so without limit. That is what full convertibility means. The level of the CBBH's foreign reserves will fall as will the volume of the domestic money supply. The Currency Board rules will still be met, but the balance sheet of the CBBH will decline and could continue to decline until there were no more foreign reserves. At that stage, BH could only meet foreign expenditures as they earned or gained foreign exchange.

The current position of the balance of payments of BH are a cause for concern. The trade deficit is very high. The amount of foreign private capital coming into the country is still very low. The flows that have made the situation work are the large amounts of official capital and repatriations by Bosnians living abroad.

Looking ahead:

- we know the level of official capital flows will slow, the only uncertainty being exactly when this will occur:
- it will be difficult to rapidly increase export receipts, though more could be done than has so far occurred;
- the country is very heavily dependent on imports. A slowdown in reconstruction will slow imports to some extent. But a rapid slowdown in imports would also hurt consumption and living standards;
- it is difficult to predict or rely on repatriations;
- the item that has the most potential to change rapidly is foreign private investment. But for BH to attract more foreign private investment the environment for private investment will have to change substantially.

If BH does not attract large quantities of private foreign investment, pressure will come on the level of foreign reserves as the official capital flows slow down. This in turn will decrease the domestic money supply and put upward pressure on interest rates. Monetary policy as implemented through a Currency Board arrangement is pro-cyclical when the economy has a foreign exchange problem i.e. It will increase the contractionary pressure on the economy.

The situation facing the BH economy is critical and urgent. Most of the policy-makers have some understanding of the foreign exchange problems. But they still seem to think they have policy choices and a sense of urgency is lacking. In my view the only choice is to make BH an attractive place for private investment and to do everything necessary to attract foreign private capital. If that does not happen, the BH economy will have major foreign exchange problems and the currency board will be unable to protect the country from those shocks. Indeed, it could become one of the victims of those shocks as politicians look for scapegoats to explain the country's economic problems to the people.

Foreign investment is increasing. In 1999 for example, direct foreign investment was 50% higher than in 1998 and though we do not yet have figures for 2000, I am sure it has risen strongly again. But while this growth rate sounds spectacular, it is from a very low base. Direct foreign investment into BH in 1999 is estimated to have been KM 170 million. The current account deficit for that year was KM 1.4 billion. So private foreign investment financed just 12% of the current account deficit in that year. BH needs to be increasing private foreign investment by around 200% a year over the next two years rather than 50% a year if the current economic growth rates are to be sustainable when the official aid flows slow down.

This target is possible. The arrival here of foreign banks from Austria and Croatia shows that there is increased interest from foreign investors. But the climate for private investment in BH is still far from supportive. This applies to local investment as well as foreign investment. There are still problems in the legal system, which is incomplete, the licensing and regulatory systems, which are far too bureaucratic, intrusive and multi-level, and in the financial system, which is still relatively weak.

Improving the environment for private investment, both local and foreign, is the key economic issue facing this country. It is this that will determine whether BH has a sustainable economy – and whether it is a country in which good students like yourselves should stay to be a part of its future.

The banking sector

As I said in the last section, a weak financial sector is one of the factors that hampers private investment in BH. The good news is that this gloomy picture finally began to change in 2000. I will mention just a few of the highlights.

- First, the payments system underwent fundamental reform. The old state-owned centralised system that had a monopoly was closed. It has been replaced with a modern European-type system with two clearing houses, a RTGS one and a Giro one, owned and operated by the Central Bank and payments are being conducted by the commercial banks. The suppliers we used had put similar systems into place in nine other European countries. But it was done more quickly in BH than anywhere else showing that it is possible to implement large, technical projects in BH successfully. It has been operating since 5 January 2001 and is going very smoothly.
- Second, minimum capital requirements for banks were increased and it became possible for a bank registered in one entity to operate branches in the other entity. Five banks are already doing so and more will follow.
- Third, more foreign banks commenced operations in BIH in 2000, either by applying for licenses directly or by purchasing an existing BH bank. Increased foreign competition will be very good for the BH economy. It will give depositors more choice and will force the local banks to improve the range and quality of the services they provide if they want to survive. One can already see these effects occuring after only a few months.
- Fourth, a limited deposit insurance scheme has started which should help return citizens confidence to the banks that qualify. So far, only four banks have been admitted to the scheme and it is only operating in the Federation.
- Fifth, most of the state-owned banks (there are around twenty state-owned banks in BH) finally had their opening balance sheets approved and they moved into the privatisation phase. But progress in bank privatisation continued to be very slow in 2000. While this is disappointing, in my view it is no longer critical for the process of bank reform in BH as the reform process is being largely driven by privately-owned banks, including the recently arrived foreign banks. The citizens actually show a higher degree of trust in privately-owned banks as compared to state-owned banks. While at first sight, this may seem to be paradoxical it is completly understandable once one knows a bit of the financial history of the region.

There is still a long way to go before BH has a banking sector that can play the major role that the banking sector plays in most other countries in Europe, including most other transition economies in Eastern europe. But 2000 will be seen as the year in which the BH banking sector finally began to move in the right direction and it is certain that the speed of change will accelerate even more in 2001.

The system will be fundamentally different and stronger in a year's time compared with today. The CBBH will do all it can to ensure that happens. Similar progress needs to be made in the other areas so that private investors, both Bosnians and foreignors, see this as a good country to invest in.

Institutional design of economic institutions

I want to conclude my lecture with some comments on the institutional design of economic institutions. Many internationals, and quite a lot of Bosnians, are critical of the performance of many of the state institutions in BH. I do not want to comment on the structure of state political institutions. But I know it is possible to build successful state economic institution in BH. The CBBH is a state economic institution. It works successfully. In my view, the major reason it works successfully is the way it is structured. I set out some of the features earlier in the paper but they are so important that I will repeat them:

- the CBBH has clear and unambiguous goals;
- it has a sound and clear legal framework;
- it has good internal decision-making and monitoring processes;
- it has a sensible degree of independence.

In other words, the legal and operational structure of the CBBH is much the same as that of Central Banks in other countries – and it works, even in BH.

But most other state institutions, and particularly the economic ministries, are constructed in a completely different way. They have unclear goals, rotating heads, consensus decision-making, frequent changes of staff etc. They are built on political criteria rather than on effective operational criteria, even though there job should be to implement decisions taken by politicians, not to act as politicians. We should not therefore be surprised by the relatively poor performance of many of these organisations.

I believe the design of state economic institutions is an issue the BH authorities and the international community need to pay more attention to. Setting up an institution isn't enough. The way it is structured will have a big impact on how effectively and efficiently it operates -no matter who its staff are. Also, making the ministeries political undermines the responsibility and effectiveness of the institutions in BH that should deal with political issues – the Presidency, the Council of Ministers, the State Parliament, and the Entity Governments and Parliaments.