

Peter Nicholl: Is the capital in Bosnia and Herzegovina expensive?

Speech by Mr Peter Nicholl, Governor of the Central Bank of Bosnia and Herzegovina, at the Conference "Is the capital in Bosnia and Herzegovina expensive?", Sarajevo, 13 October 2004.

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Is the price of capital in BiH high? Based on a simple comparison with Western Europe and a number of the countries in Eastern Europe that are further down the reform path than BiH, the answer is clearly yes. Given the risks and uncertainties that still exist in the political, economic and legal systems in BiH the answer is no. What we need to focus on today is what are these risks and uncertainties and how can we work together to reduce them.

This meeting today is focusing on the banking sector. There are a lot of improvements that still need to be made in the BiH banking sector. But we also need to remember that reform in the banking sector has gone further and faster than reform in any other sector of the economy. As a consequence of that, both the availability and the cost of capital has come down substantially in BiH over the last few years.

The first area to focus on therefore is the reform of the rest of the economy. The banking sector is extremely liquid at present - even though their lending is growing at a rate that worries the IMF. They are holding KM 790 million more on their reserve deposits at the CBBH than required by our 10% reserve ratio. They are also holding substantial short-term funds abroad.

One of the reasons for this is that there is still a shortage of credit-worthy borrowers. It is easy for a bank to lend money. The challenge for a successful bank is to make sure the borrowers will be able to pay it back. While this simple rule seems blindingly obvious, the BiH banking system in the past was burdened by bad debts because this simple banking rule was ignored.

What needs to be done to increase the number of credit-worthy borrowers in BiH?

- a) Company registration process (and the process for closing a company): a simplified system is under preparation but I am very surprised by how slow the process has been. The banks and the Central Bank together reformed the internal payments system in BiH over nine months. The issue of simplifying the company registration process has been talked about for about four years. It is time some of these reforms were completed rather than just talked about.
- b) Tax system: the current tax system is very fragmented and costly for businesses, especially small businesses. The introduction of the VAT system should go a long way to improving this. I know the Government is now trying to get this system introduced as soon as possible. Some of the delays are now being caused by the international community. I urge everybody involved, including the international community, to work to get this system in place as soon as possible.
- c) Regulatory system: in this area there has been little progress despite it being identified as a problem area by a World Bank study several years ago and despite the gains that have been made by the bulldozer exercise. In fact, I think the situation may have got worse as many new regulations have been introduced but the old ones don't seem to be removed. The extensive regulations allow a bureaucrat to decide how a business should operate - often in great detail - rather than the investor who is risking his money to set up the business.
- d) Public utilities: the costs of the products supplied to businesses by public utilities in BiH, such as electricity and telephones, are very expensive. They are, in effect, another tax on business.

Legal system and courts: like most things in BiH, the court system is very complex and it tends to move very slowly. For a commercial sector, including the banking sector, to be able to take business decisions and invest with confidence, it must have recourse to a legal and court system that resolves contract disputes quickly and fairly. A recent World Bank study covering 126 countries concluded that a poorly-functioning court system may add as much as 2-2.5% to all interest rates in the country. It is therefore very significant. If there is one single area that can have a large impact on getting the cost of capital in BiH down it is improving the legal and court system. The introduction of specialist commercial courts is aimed at improving this situation. I would be interested to hear from the bankers at this meeting whether they have yet noticed any improvement.

I have made these comments about the regulatory and legal systems first as I think the biggest impact on getting the cost of capital down in BiH will come from improvements in these areas. But that does not mean there is nothing we can do in the financial sector itself that will continue and hopefully accelerate the reduction in the cost of capital that has already occurred.

Country risk: there is a country-risk element in interest rates in BiH. Most of us who live and work here believe it is higher than justified because external perceptions of BiH are still more negative than the reality of BiH. We all have to work on changing these perceptions and on improving the reality of BiH even further. What can we do:

- show more political cohesion and decisiveness. I see many signs that the three governments in BiH are working together in BiH much more than before. This has to be continued by the BiH politicians, encouraged by the international community and explained to the rest of the world by both;
- one of the main reasons we got a formal sovereign credit rating earlier this year was to improve the external perception of BiH. The initial rating of B3 with a positive outlook was quite good and has helped improve BiH's international image. Once the laws on the internal debt issue are passed in both entities, I intend to go back to Moody's Rating Agency and request that they consider an upgrade for BiH;
- information: road-shows, article etc. The Government, banks and business can all play a role. We all need to be 'salesmen' for BiH.

Capital markets: BiH has a strong Central Bank and a banking system that is now playing a major economic role. We need to focus now on accelerating the development of the capital markets in BiH as they are still extremely small. This will have two major impacts on the cost of capital in BiH:

- it will provide the banks with instruments in which they can invest their substantial liquid funds and earn a better return than they do at present. Banks at present have quite a large proportion of their asset portfolio on which they earn very little: 1-2%. They therefore have to earn more on their loan portfolio in order to improve their overall rate of return on assets;
- it will give enterprises a larger range of sources of capital. This should allow the types of capital available to better meet their needs and could also reduce the cost of capital by increasing competition.

What are we doing to develop the capital markets:

- Stock exchanges: two stock exchanges have been established in BiH but both are still very small. But there are two very positive trends already underway:
 - a) turnover on both exchanges is steadily increasing;
 - b) most of the stock exchanges in the region have agreed to develop a common database. They have announced that this is the first step towards common trading. This is very good news for the capital markets in the region.
- Government securities market: a draft law that will give a legal basis for this market is ready and hopefully will be introduced to Parliament very soon. A lot of work has already been done on the infrastructure for this market. Most of the elements already exist - registries, clearing and settlement systems - and the CBBH is getting financial and technical assistance from the US to establish a new issue facility. At a technical level I think we could be ready to issue the first short-term security as early as the first quarter of 2004 - provided the law is passed. This meeting should support the speedy introduction and passage of this Law.
- A leasing law has been drafted and will also hopefully be introduced to Parliament soon.
- One company has issued a company debenture (I am not sure if this is the name you use in BiH) on the RS Stock Exchange. It is very small but it is the first example of a new capital raising instrument for enterprises in BiH.

Reserve requirements: the final issue I want to comment on is the reserve requirements imposed by the CBBH. I am sure the banks here today will say this is one element in the high cost of capital in BiH. Before they do so, they should think about the following two facts:

- The reserve requirement we impose, which is currently 7.5% and will rise to 10% from 1 December, is much lower than in neighboring countries. I understand that the ratio is 19% in Croatia and 22% in Serbia for example.
- The remuneration we pay banks on the reserve deposits at the CBBH, which is around 2% on required reserves and 1% on excess reserves, is quite generous compared with most other central banks in Eastern Europe. We are one of the few central banks to remunerate total reserve deposits.
- The banks can say that these reserve requirements do impose a cost on them. My point is that the cost the CBBH imposes on you is less than the central banks in the neighboring countries impose on their banks so it is not an explanation for the cost of capital being higher in BiH.

Conclusion: the banking system has improved significantly in BiH and this has brought down the cost of capital. But there are further improvements that can be made. In particular, it is very important to accelerate the development of the capital markets in BiH. The CBBH promises to continue to be actively involved in this process. BUT, the things that will do most to bring down the cost of capital in BiH are outside the financial system - they are improving the court system, easing the tax and regulatory burden on business and working together to improve the external perception of BiH in order to lower the country risk premium in our interest rates.