South East European Studies
at Oxford

workshop report

The impact of the Euro crisis and investment opportunities in Bosnia and Herzegovina

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St Antony's College
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This report draws on discussions at the high level seminar entitled 'The Impact of the Euro Crisis and Investment Opportunities in Bosnia and Herzegovina', which was held in Oxford on 11th May, 2012 and was co-sponsored by SEESOX and the Central Bank of Bosnia and Herzegovina. The participants were academics, Central Bank Governors and Deputy Governors, other officials, and market participants from the region of South East Europe and elsewhere. The report represents SEESOX's interpretation of discussions at the workshop and does not purport to reflect the views of any of the participants. We would like to thank Governor Kozarić for supporting this event and his team for contributing to the organization of the seminar.

Overview

The workshop took place in a context of considerable market uncertainty about the outlook for growth and financial stability in the euro area. Participants discussed in turn the economic situation and EU accession status of Bosnia and Herzegovina; the impact of the euro crisis on financial stability in the region; the experience with regional co-operation among monetary authorities; and the potential for a new development agenda.

Three broad themes cut across the workshop discussions, and these were relevant both to the Bosnian economy and to its neighbours in South East Europe.

The first theme was the role of the EU anchor. Despite some steps forward, there had been a weakening of faith in the EU and euro area anchors – and also some serious questioning whether the accession process itself was truly effective in the areas of state-building and the rule of law. There was thus a dilemma how to catalyze progress on reform, and also on regional integration – although the blossoming of some new networks of co-operation within the region could perhaps be seen as a silver lining.

The second theme was the impact of the crisis on growth and financial stability. This impact had been mitigated by earlier measures to strengthen bank balance sheets, so that a meltdown had been avoided. But liquidity and access to finance had now emerged as a constraint, and risks remained of further shocks from the euro area. The fine track record of central bank cooperation in the region should be extended to issues such as consultation with banks' home authorities; regulatory arbitrage and liquidity shifting; strategies to promote local currency financing; the refinement of central banks' objective functions in light of financial stability priorities; and the future pattern of financial integration, as well as other research issues.

The third theme concerned the need for a new growth agenda. This rested on five pillars: a reconsideration of the – so far rather 'asymmetrical' – role of the state in facilitating growth; a concern to improve core elements of the business environment; a more specific targeting of export integration with poles of growth in the EU; an assessment of the macroeconomic policy conditions for sustained growth, including rebuilding adequate fiscal space; and more effective regional co-operation – including in promoting infrastructure linkages.

Bosnia and Herzegovina – Political challenges and accession perspectives

It was argued that during the past few years the political situation in BiH has been worsening, and particularly so since the proposed new constitution was not agreed in 2006. Previously, the country had been more successful in terms of both rebuilding the economy and strengthening institutions in the period of post-conflict stabilization. Today, the state built on the 1995 agreements is seen as inefficient and too complicated in its administrative structure, with its governance criticized by the EU. Nonetheless, the country has made some strides – with the military now in a token role and many ethnically cleansed areas restored. However, the country still relies on continuing international engagement, and cannot make required progress for the EU accession process. There is insufficient debate, some thought, on the optimal standards by which BiH and other states should be judged.

This raises the issue how beneficial the state-building approach in BiH has been. It was suggested that the process has been highly prescriptive and external. The fact that the ends of EU state-building are non-negotiable inhibits political involvement and reduces space for democratic discussion and choice. The accession process then becomes central, and more a stick than a carrot. The continued presence of the OHR arguably has an inhibiting effect on the development of indigenous state-building efforts. More limited and clearly defined efforts could have a higher chance of success. Such questions need to be debated in an open way.

A key dimension of state-building is the rule of law. A speaker argued that, in this regard, the EU's "Accession-Assessment-Assistance" triangle poses difficulties for all acceding countries. Accession is multi-faceted, while assessment standards have varied over the years and across countries. Rule of law promotion is too means-based and institution-focused. There is a need to address existing power structures and their political dynamics, which are the networks with an interest in the status quo. In other words, the EU needs to move to an ends-based and citizens-based approach to the rule of law. Citizens should be free from the arbitrary use of power; benefit from legal certainty; be treated equally before the law; have access to effective justice; and be able to claim their rights, including law and order. A network of monitors is required, with an assessment system that maps the measures to be taken when there is a breach; the creation of new indicators; and the identification of nodes of support. Sequencing; timing; and assessing the beneficiaries are of utmost importance to ensure that BiH passes the sustainability of rule of law test. This requires an EU role that is both more ambitious and more humble.

The impact of the euro crisis on financial stability in Bosnia and Herzegovina

The Law on the Central Bank eliminates the scope for discretionary monetary policy, except for the policy on required reserves. The CBBH has initiated the creation of a financial stability committee, which encompasses several other institutions (the Ministries of Finance, Bank Supervisory Agencies, Deposit Insurance Agency). Although the economic management of the state is not always coordinated well, during the crisis all actors agreed that the Governor of the CBBH would be the voice on matters related to financial stability, and this proved very effective. During the crisis, communication was an important policy instrument. The lowering of reserve requirements was very timely and provided necessary liquidity for the banks in the period of financial stress. The CBBH does not have a lender of last resort function, and therefore such preemptive actions were very important for maintaining financial stability.

Like other countries in the region, BiH has a bank-centric system – commanding 84 percent of total financial assets. In 1997, BiH had 76 commercial banks registered, but none of them served the whole country; consolidation has reduced this number to 29, which are largely foreign-owned. In the pre-crisis period the BiH banking sector was well-capitalized, liquid, without exposures to US junk bonds or troubled sovereign debt. Bank credit was growing strongly, and though there was an increase in property lending, there was no bubble. Banking supervision was both detailed and relatively firm. The capital adequacy ratio is currently some 17.5%. After serious losses in 2009 and 2010, the banks made profits in 2011. Liquidity is being maintained, but NPLs have increased to 12%. Credit growth in 2011 was recovering and amounted to 6%, but this still was not sufficient to support a satisfactory pace of economic growth.

Due to the external shocks caused by the global financial crisis, the BiH authorities signed a Stand-by-Agreement (SBA) with the IMF in July 2009, which expired at end-June 2012. The crisis in the euro-zone has been causing a decrease in the country's liquidity and foreign exchange reserves, with deleveraging severely impacting liquidity and credit. Thus, new negotiations with the IMF are soon to start. The IMF has conditioned the new SBA on reforms in public administration and restructuring public expenditure. Governments in BiH have implemented a range of austerity measures, which have been very difficult – particularly because the cutting of salaries has been resisted, and viewed by some as counter-productive.

The euro area crisis, and the volatility created by it, may persist for a long time. Negative shocks continue to emanate from the region. The transmission mechanisms are the foreign trade channel, funding channel (particularly for banks) and confidence channel (risk perceptions). Some participants in the workshop also noted that there are risks surrounding the euro as an anchor currency, which deserve urgent and continuous attention. Financial safety nets and lender of last resort functions are also important issues and need to be thoroughly considered.

In light of the ongoing financial crisis in the euro area, and its spillover effects, central bank objectives need to be re-evaluated. Previously, the key goal for central banks was price stability. Today, whether or not reflected explicitly in central bank statutes, financial stability must also be included. This is more complicated to specify in terms of goals and accountability. Beyond this, the biggest concern in the medium term lies in the prospects for growth, which are related to many other economic aspects, and maintaining debt sustainability. As discussed below, BiH and the region appear in need of a new growth model. In the last 10 years, countries faced the problem of excessive credit growth. In the coming decade, the problem is likely to be the opposite.

Regional cooperation between monetary authorities

Monetary and exchange regimes in the region differ – ranging from free floating in Albania and Serbia, on one side, to the currency boards in BiH and Bulgaria and the use of the euro in Montenegro and Kosovo on the opposite side. Across the region, however, the scope for a discretionary monetary policy is very limited. Financial systems are heavily reliant on financing through commercial banks, although insurance companies, leasing companies, and investment companies are an integral part of the financial system. The supply of additional liquidity to the real sector is almost dependent on lending activity of commercial banks. Since the banks in the region are majority-owned by the banks from the EU, financial cycles in the banking sector of Western Europe have a direct impact on lending activity. Countries are exposed to more-or-less the same banking groups from Austria, Italy, France, Slovenia, and Greece.

Collaboration among the central banks of the region has been strong in recent years, and it rose to a new level in response to the crisis. Nonetheless, scope remains to further deepen this collaboration, and make it more operational. A first and important point arising from recent experience is that it is desirable for countries in the region to have a common voice in conducting a dialogue on regulatory changes in banks' home countries. This type of collective stance would make the Western Balkans stronger in discussions with European regulators. In this connection, the Vienna initiative was also discussed – including the question what governors would like to see emerge from Vienna 2.0. In the view of some, Vienna 1.0 was successful in preventing the crisis, and the question was what to expect in the second phase. In more general terms, if there is no coordination between home-host supervisors, it is very difficult for the central banks and commercial banks to operate. If, on the other hand, coordination is there, then market mechanisms will adjust.

A second area for deeper co-operation is the field of regulatory arbitrage, as countries have similar business and banking groups operating in the region. Among other factors, banks may shift NPLs from one subsidiary to another, causing a capital and liquidity drain. Similarly, if collateral is evaluated differently across countries, then regulators may experience challenges. A third issue is the need to monitor banks shifting savings from one jurisdiction or country to another. Fourth, there is a need to improve data exchange about trade flows in order to improve forecasting models. Fifth, some issues exist in supervision, and the countries could seek greater harmonization.

Central banks in the region could also cooperate more in coordinating their research capacities. Certain clusters have started to develop in the region: conferences, a journal introduced by Central Bank of Montenegro, a seminar series at the National Bank of Serbia are promising initiatives, where the quality of research and invited economists are notably high. Another initiative is the training for specific software used in economic analysis from Macedonia. One could extend these activities and develop these clusters further in the region.

As banking sectors in the region are highly dependent on mother-banks from Western Europe there is a high probability of currency-induced financial risk. One of the ideas launched three year ago by EBRD is to support domestic financial markets in the region, by introducing new financial instruments in local currencies – which is highly important for financial stability in any country in the region. The economies in the region are highly euroized by tradition and legacy (from the former Yugoslavia): the problem derives from the liability side of bank balance sheets, as households are used to save in foreign currency. It is important to note that the foreign sources of funding are also denominated in foreign currencies.

Foreign exchange risk is therefore transmitted to the unhedged borrower. The central bank and supervisors may then be faced with wide-spread problems and defaults resulting from foreign-exchange risk. The use of local currency in

Serbia has recently been promoted with the first medium-term bond issued by a subsidiary of a major international bank. In this context, the role of IFIs could be very supportive. They could either directly issue local currency bonds or act as the guarantor for bank bonds. A final topic in this session was the use of reserve requirements as a main instrument of monetary policy in the region. It was noted that some central banks had addressed excessive growth of bank credit through this mechanism.

Bosnia and Herzegovina and regional cooperation: Towards a new development agenda?

Given the current economic crisis in the euro area, and dangers of a new global recession, one of the key questions is how to improve economic outcomes in BiH and its region. When it comes to BiH, a key question is: how will it cope with the unfinished domestic reform agenda? The CBBH-SEESOX workshop was very timely since liquidity pressures in the system had started to grow again and the SBA with the IMF was due to expire in June 2012.

Before the crisis, BiH experienced a similar growth model to that in other countries in the region (and many other transition economies). Growth was led by domestic demand, which was fuelled by credit expansion by banks from Western Europe. This credit expansion to households and enterprises had widened the trade deficit. When the global crisis hit, the need for rebalancing became obvious. The first goal was to safeguard the currency board, and maintain adequate liquidity and external financing for the system. The worst was averted thanks to the very swift action of the CBBH, including in lowering reserve requirements. Fiscal restraint was put in place and deficits started to decline. The government deficit dropped from 6% in 2009 to less than 2% in 2011. There was a strong determination to close the gaps in the entity budgets. Economic recovery which had begun in 2010 was very weak, and the risk of relapse is still present. The IMF is not very optimistic regarding growth prospects for BiH and the SEE region. Due to political and institutional instability caused by late establishment of the Council of Ministers (which took 16 months after the elections) the credit rating of BiH was downgraded by Moody's.

With negative trade and funding spillovers from the euro area, what should be the agenda in a country that is small, open, operating in an unfavorable setting, and still having unfinished reforms? There is certainly a need to closely monitor the financial sector's health to maintain macroeconomic stability, and also to rebalance the growth model. A range of ideas were put forward on this topic, and these can be resumed under five main headings.

1. Shifting to a different role of the state. The problem in BiH and the region is not 'too little state' or 'too much state', but the 'asymmetric' role of the state: a role that has been insufficiently effective in fostering vibrant and sustainable private sector activity, especially in the traded goods sector. One example is the need to develop infrastructure linkages, which calls for a more active state. There is also too little capacity in local governments; and opportunities for inter-municipal cooperation are not exploited. The use of funds from the EU's IPA instrument demonstrates the internal governance problem: in Croatia, programmes are consistent with the agreed frameworks, while in BiH programmes are aligned with broad documents but not sufficiently with more specific sectoral policies. This coherence problem must be addressed.

2. Reviving the structural reform agenda. The public sector has to be restructured and reduced in size; and the business environment needs to be improved to achieve a favorable setting for investment. For many participants in the workshop, the weaknesses in some areas were striking, as was the overall poor ranking of BiH.

3. Adopting an approach to government initiatives that targets a different pattern of integration. Some workshop participants cautioned about the effectiveness of an unfocused approach to all of the structural reform issues identified in IFI surveys. For them it was not even clear that structural reforms *per se* lay at the heart of the problem. Their emphasis was on the more effective pattern of economic integration that has been achieved not only in some of the BRICs but also in Central Europe. The key was to foster dynamic linkages in the traded goods sector, which lead to more export-driven growth. 'Good institutions' by themselves are not enough to deliver this. Central Europe had a synergistic pattern of integration, which fitted with the industrial restructuring underway in Germany and other core EU economies. South East Europe is left out of that picture, despite a relatively favourable geographic location and its latecomer advantages in terms of cost competitiveness.

Models of "industrial upgrading" can take many forms. Examples could be FDI-led models, or the emergence of SEE tycoons, or a strong development bank as in Brazil. There is no precise model of structural reform that is valid in all regions: the common aspect is that market-enhancing structural reform fosters effective integration and growth in a targeted manner. "Growth enhancing governance capabilities" can be part of structural reforms. Once growth gets the initial push, this agenda can be enlarged. World Bank Chief Economist Justin Y. Lin, it was reported, has suggested that SEE should identify fast growing industries in other regions that are at risk of losing competitiveness, as opportunities for integration and industrial upgrading. Leading local firms in this process can generate knowledge spillovers in the economy. There may be scope for identify potential leading firms at home and abroad, and in the meantime supporting the process through improvements in hard and soft infrastructure.

Trans-national companies were indeed behind the growth models in Central Europe, but perhaps there are new agents who will arise in the case of a new SEE growth model.

4. A more balanced macroeconomic model, with sustainable financing. It was noted that discussion of competitiveness and sustainable growth tends to focus on microeconomics. However, the growth pattern of SEE has been problematic also at the macroeconomic level. It involved excessive external borrowing to finance vulnerable domestic imbalances (originating in the nontraded goods sector), and insufficient fiscal space to cushion shocks. The pattern of bank-centred financial integration, in a poor business environment, served to expand consumption and residential construction. The prospect for EMU membership encouraged good things (such as FDI), but some bad things as well, such as consumers bearing currency risk. Moreover, labor market integration saw a pattern of transient migration that enabled real wages in SEE to rise ahead of the convergence of their home economies. With (to differing degrees) rigid exchange rates, it has proved hard to reverse the resulting loss of external competitiveness. Turning around Asian economies after the crisis of the late 1990s required massive devaluation and export-led growth, which was easier at a time when external demand was buoyant. This required currency flexibility. It is thus necessary to consider all aspects of the emerging market convergence model, in which the capital accumulation process is central. It is crucial to manage well the process of trade, financial and labour market integration.

5. Action at the regional level. Turning to the regional level, the economic crisis has revealed more than one common trend across the region, and there has been some improvement in networks of co-operation. Each of the countries is characterized by large external imbalances, and low savings. Countries have a broadly similar economic structure, based on the production of low value added goods, while the regional free-trade agreement (CEFTA) has only partially stimulated regional trade. The prospects and gains of regional cooperation are constrained by many structural bottlenecks in the system such as infrastructure and roads. There are issues of political will, but also of capacity: institutional strength, human resources, and funding all constrain regional cooperation. There is now a degree of recognition in political leaderships that regional cooperation is a key aspect of dealing with the crisis: cross-border infrastructure projects are important, such as the 2010 project to create a joint railway company between Slovenia, Croatia and Serbia. The importance of cooperation in hard infrastructure projects is obvious, since these are small countries. Cooperation in 'soft infrastructure' is also important, but more difficult to pursue in the region due to war legacies.

Regional investment policies in the Europe 2020 agenda call for collective regional action on the structural reform agenda. This is a very promising initiative. More widely, the EU accession process has introduced a new climate of change. But this points to key questions for the future South East Europe: how strong will the EU and euro area anchors prove; and is there sufficient political will and capacity to turn this into an opportunity for the region?*

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- To promote the multi-disciplinary study of the region within the University of Oxford (e.g. politics, international relations, anthropology, sociology, economics) working in collaboration with other Centres and Programmes within the University, including student societies;
- To spearhead intellectual exchanges and debate on these issues among networks of individuals and institutions beyond Oxford;
- To foster cooperation between the academic and the policy making communities.

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