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## **The Central Bank of Bosnia and Herzegovina Ten Years On**

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### **Article at a glance**

- After the Dayton Peace Agreement in 1995, Bosnia and Herzegovina faced a fractured governance system and lingering distrust among citizens.
- The creation of the Central Bank of Bosnia and Herzegovina, along with the establishment of sound monetary policy and a single currency note, helped unite the country's three regions.
- Bosnia and Herzegovina's experience presents a number of lessons for other states in post-conflict reconstruction. Among them:
  - Careful planning and coordination are needed for success.
  - New systems must not ignore the structures of the past.
  - Political support is essential for economic reform.

*For more information on the topics addressed in this article, see Warren Coats' 2007 book, One Currency for Bosnia: Creating the Central Bank of Bosnia and Herzegovina.*

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## Introduction

The Central Bank of Bosnia and Herzegovina (CBBH) first opened its doors for business over 10 years ago on August 11, 1997. It was a product of the Dayton Peace Agreement, which ended some of the bloodiest fighting Europe had ever seen. The bank is playing a very important and positive role in the gradual healing and rebuilding of the country. The success of CBBH and of the international community in helping establish it contains lessons for reconstruction efforts in Afghanistan, Iraq, Sudan, and the failed states of the future.

Bosnia and Herzegovina was one of the six republics making up the Socialist Federal Republic of Yugoslavia. Following Slovenia and Croatia, which declared independence in the summer of 1991 (and later Macedonia), the Republic of Bosnia and Herzegovina declared its independence from Yugoslavia in March 1992. The UN and most of its members quickly recognized the new state, but its independence was promptly challenged by the Yugoslav National Army and local Serb militia, who launched a war that April that continued despite many cease-fires until October 10, 1995. In the midst of these hostilities, armed conflict also erupted between forces in the Croat-majority area of Bosnia and Herzegovina and the Republic (Muslim-majority area) army, lasting from early 1993 until February 25, 1994. The death toll of these combined conflicts is estimated at about 250,000, and about three million of the country's 4.4 million inhabitants were displaced from their homes (about one million became refugees abroad).

The four-and-a-half-year civil war ended when the three ethnic groups agreed to the terms of the Dayton Peace Agreement. The agreement included provisions for a monetary regime, one of a number of important foundational elements of any state. The agreement established a single currency for the country's three regions, which was issued by a single central bank. Because of the deep mistrust and suspicions between the three regions, the Dayton agreement stipulated that for its first six years, CBBH would operate according to strict "currency board" rules, that its governor would be a foreigner chosen by the International Monetary

Fund (IMF), and that its governing board would comprise one Bosniac, one Croat, one Serb, and the governor.

Sound money is important to any healthy and productive economy, both as a unit of account in which contracts and financial calculations are made and as a store of value and means of payment. A stable unit of account facilitates accurate assessment of the potential profitability of investments and thus contributes to productive investment and more rapid economic growth. Money with a stable value lowers its cost as a store of value and solidifies its usefulness as a means of payment – thus increasing the efficiency of trade. Unanticipated inflation is really a form of confiscation. For example, the hyperinflation of the ruble following the collapse of the Soviet Union robbed pensioners of the real value of their pensions. The importance of a stable unit of account may be compared with the importance of property rights as a foundation of economic development.

A common (and stable) currency for all of Bosnia and Herzegovina was also important for reuniting the three regions of the country. A single currency throughout the country would facilitate trade among the regions as payments could be made more easily and without exchange rate risk. The single currency would thus contribute to greater economic integration. Greater economic integration facilitates cultural and political integration. A single currency then, like a national flag, is a national symbol that helps rebuild the national identity. Consequently, reaching agreement on the designs of the new currency notes and the national flag were difficult undertakings.

Governance in the early post-conflict period can be particularly weak. Fiscal discipline, management capacity, tax systems, and a financial administration take time to rebuild. In such an environment, it can be especially tempting to rely on the central bank to print money for government financing. Beyond modest amounts, such financing amounts to inflationary finance. The Dayton agreement deliberately constrained the new central bank with currency board rules.

The logical choice of a currency board was readily accepted by the warring factions. A currency board passively sells (and buys) its currency for a foreign currency at a fixed exchange rate. Thus its monetary liabilities (primarily its currency in circulation) are fully backed by foreign currency assets. CBBH's currency, the Convertible Marka (KM), has a fixed exchange rate to the Euro (initially to the German mark). The quantity of CBBH's currency in the market is thus determined by market demand and the domestic value of its currency (the price level) is determined largely by Euro prices throughout Europe (transmitted to Bosnia and Herzegovina through the fixed exchange rate and trade). The system is simple to operate (no monetary policy) and was most readily acceptable to all three ethnic groups.

Central banks adopting currency board rules in recent years have had very positive experiences. The Bulgarian National Bank and CBBH enjoyed average real GDP growth of 4.9 percent and 6.9 percent, respectively, and average inflation rates of 6.5 percent and 2.2 percent, respectively.\* The disadvantage of a currency board is that it cannot adjust the exchange rate to absorb external shocks (such as significant changes in oil prices), thus forcing the adjustment burden onto domestic inflation or deflation.

Bosnia and Herzegovina's banking sector has grown steadily and rapidly. Twenty-two of the 32 banks operating in Bosnia and Herzegovina are owned by a foreign majority of shareholders. Total deposits with banks rose from 26 percent of GDP in 2002 to 45.1 percent in 2006, and currency held by the public as a share of GDP has steadily declined from 13.5 percent in 2002 to 11.0 percent in 2006. Unemployment, however, remains very high at 31 percent of the estimated labor force.

CBBH opened for business with less than 70 million Euro reserves (132.6 million German marks) and the equivalent value of monetary liabilities. Its monetary liabilities (mainly currency in circulation) and Euro reserves are now well over 3 billion Euro. This represents a resounding public vote of confidence in an important institution that has made a significant contribution to a more promising future for Bosnia and Herzegovina.

Ethnic healing and political progress in Bosnia since the war has been slow but is moving in the right direction. Country-wide commerce and economic growth make an important contribution. The desire to make a living and a profit chips away at ethnic animosities. CBBH has made a very positive contribution to the process of healing and economic growth by providing a stable currency and an efficient payment system throughout the entire country, creating a single economic space that promotes integration. This contributes to the prospects for the long-term success of Bosnia and Herzegovina as a viable, prosperous state and a peaceful member of the world community. Progress on the political front has been much slower. Sectoral animosities ran very deep and are changing only slowly. Elected leaders in each region remain ethnically nationalistic.

## Lessons

Success for CBBH was not inevitable. Progress to date has been the result of applied technical assistance, the careful prioritization of monetary matters, and informed advance planning. The consideration of fiscal matters during the peace negotiations stage was particularly helpful in providing a solid foundation for the subsequent development of sound monetary arrangements. Early planning helped minimize turf battles and donor coordination issues.

The establishment and development of CBBH offers a number of lessons for other post-conflict recovery situations.

### Advance Planning and Donor Coordination Are Needed

Donor resources available for post-conflict reconstruction are limited and should be used as efficiently as possible. Furthermore, policy advice and reform strategies are less likely to be adopted and implemented if the donor community does not speak with a relatively unified voice. Mechanisms of donor coordination, such as consultative groups, are very important. Financial policy leadership as provided by the international financial institutions has generally made it possible to settle the minor issues that arise in post-conflict reconstruction, but it must also be

understood that each case presents a different set of challenges and opportunities.

In the case of Bosnia and Herzegovina, the IMF advised the Dayton peace negotiators of desirable monetary arrangements, starting reconstruction on a good foundation. While the U.S. played a decisive leadership role in coordinating the international assistance effort, it did not dictate a structure to other donors.

### **Short-Term Needs and Long-Term Development**

A new government's immediate need for currency and the ability to make payments must be considered in the light of the long-term development of the country's monetary and banking system. While existing facilities and staff should be used initially, in the long term, this approach might perpetuate outdated, inappropriate methods. Advanced planning by experienced experts and a clear but flexible development strategy can work to ensure the best results for the future.

The most important short-term decisions that affect long-term outcomes are:

- the choice of currency and monetary policy regime;
- the extent to which existing institutions, facilities, and laws are initially used; and
- the extent of modernization of state banks destined to be privatized or liquidated.

In Bosnia and Herzegovina, the advanced agreement on the monetary regime in the Dayton Peace Agreement was an enormous advantage that allowed reconstruction and reform to focus on the institutional establishment of a new central bank and the liquidation of existing banks, as well as the challenging task of reforming a highly centralized domestic payment system. Reliance on the existing payment bureaus at the start of reconstruction efforts ensured immediate continuity of domestic payments, but it may have prolonged the transition period to a modern, bank-based payment system. Despite a late start, Bosnia and Herzegovina was the first former Yugoslav republic to completely replace the old, centralized domestic payment monopoly. Reaching agreement between all three regions on a single currency note design was

difficult and took much longer than planned, but the new notes were immediately accepted by the public when they were finally introduced.

In Kosovo, the United Nations Interim Administration Mission in Kosovo (UNMIK) quickly agreed to establish the German mark as a legal tender (along with the existing Yugoslav dinar) and to temporarily use it exclusively for domestic payments through the existing payment bureaus. This endorsed existing practices and allowed work to focus on developing a limited-purpose Banking and Payment Authority of Kosovo (BPK) as well as a banking system with modern bank-based payment systems. The immediate replacement of the SDK payment bureau system imposed a hardship on the Serbian population, which continued to use the Yugoslav dinar extensively, thus requiring payment services in dinar.

### **There Are No Blank Slates**

Every society has existing institutions, customs, and attitudes, which, if ignored, can cause problems for the success of a new system. New laws must be compatible with existing laws and legal traditions or they will not be understood and implemented as intended. Furthermore, there should be a concerted effort to help staff adapt to new operations and systems. CBBH was legally a new institution, but it took over the buildings, systems, and some of the staff of predecessor central banks. Similarly, the Banking and Payment Authority of Kosovo was a radically new institution, but it took over the buildings, systems, and some of the staff of the National Bank of Kosovo and of the Kosovo branch of the Yugoslav payment bureau.

Though the Palestine Monetary Authority had no predecessor or any existing buildings, staff, or systems, there were existing arrangements for banking and payments that provided the experience and frame of reference from which new approaches and systems would be built. In some instances, a new institution may be easier to develop than reforming an existing one, but not always. In all cases, political sensitivities and potential conflicts need to be understood and addressed. The time and resources required for this task are easily underestimated.

## Policies Must Reflect Capabilities

Some policies are more demanding than others. Any reconstruction plan depends on what is in place and what resources can be secured. Bosnia and Herzegovina relied extensively on existing institutions for several years, while the currency board arrangements minimized the demands on the new central bank, allowing it to focus on reintegrating the monetary and payment systems of the three regions. This was as much a political as a technical challenge; the strong transitional system gave the time needed for the gradual reestablishment of inter-regional trust.

## Political Support Is Needed for Reform

Reforms in the financial sector are difficult (if not impossible) to implement without local understanding and support; without political support, the reforms may not ever take root. Genuine local “buy-in” is absolutely essential.

Even in the presence of NATO troops, the local political leadership in Bosnia and Herzegovina would not agree on and accept a new state-wide currency for over two years after the December 1995 Paris signing of the Dayton Peace Agreement: the three Joint Presidents did not agree on a law to create the new central bank until May 1997, and CBBH opened its doors on August 11, 1997. New bank notes were not issued until June 22, 1998. However, the slow pace of these steps allowed reformers to build sufficient local support so the new central bank and its currency became an enormous and unifying success in a bitterly torn country.

In Iraq, a number of the reforms adopted by the Coalition Provisional Authority (CPA) with minimal local consultation and buy-in were simply ignored once sovereignty had been returned to Iraqis. Consequently, the merger of three of the state banks into a fourth never occurred.

## Note

\* For Bulgaria these averages cover 1999 to 2006 and for Bosnia they cover 1998 to 2006.

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