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Bank of Albania and LSE Conference

MONETARY POLICY, ECONOMIC INTEGRATION AND „THE NEW NORMAL“

Closing panel with the Governor's Roundtable: What does all this mean for integrating small economies?

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1. Introduction

Mr. Chairman, fellow Governors, Ladies and Gentlemen,

It is my great pleasure and privilege to participate in today's Bank of Albania and London School of Economics and Political Science co-organized conference entitled: *Monetary Policy, Economic Integration and "the New Normal"*. There is no doubt that the topic is relevant. We are talking about the Southern-Eastern Europe (SEE) joining the EU. What can be more relevant for the future of our countries? After the fall of the Berlin wall, three decades ago, joining EU for our region seemed like a done deal, something that might happen quite soon. After the initial adjustment to the basics of the market economy, convergence was (relatively and depending on a country) fast. But, as always in history, processes are neither simple, nor linear. Global Financial Crisis (GFC) has changed the world we live in, especially for us, central bankers. Indeed, as our organizers pointed out in the Conference agenda, it is time for some serious reconsideration of previous experience, but even more so of some future challenges.

Having in mind the Organizer's guidance, for the rest of my speech, I will focus on the following questions:

- What are the consequences of monetary policy changes in developed countries after the global financial crisis (GFC) on the Central Bank of Bosnia and Herzegovina (CBBH) and Bosnia and Herzegovina itself (BH)?
- What do we expect from "normalization" of the policy and when do we expect it to happen?
- Role of foreign banks and the capital market,
- About FINTECH and Artificial Intelligence and
- What can the CBBH do on BH's road to EU?

So, let me start.

2. What are the consequences of monetary policy changes in developed countries after the GFC on the Central Bank of Bosnia and Herzegovina (CBBH) and on Bosnia and Herzegovina (BH)?

BH is a small open economy trying to be part of the European Union (EU), and therefore the euro area. That is our strategic goal. We have applied for the EU membership two and a half years ago, but we are still a potential candidate country. Awaiting *avis*, we hope to become a candidate country soon. Joining the EU will most probably be a long process, as nobody expects SEE countries to become the EU members before 2025. Since 1997, the CBBH has been operating the Currency Board arrangement, under very strict criteria. Our currency, the convertible mark (BAM) was pegged to the Deutsche Mark and then, to euro, after its introduction. In addition, supervision of banks is not in the CBBH mandate, but nested in two separate Banking Agencies. There are certain stands that operating under Currency Board arrangement means we have no independent monetary policy or exchange rate policy. At a surface it might seem true. But, we are far more

than a „big exchange office”, as some call us. In other words, operating under Currency Board regime does not mean that the CBBH does not play an important role in this process of joining the EU and euro area and in monetary policy itself. And this has not changed with the GFC, i.e. we still have limited powers to stabilize the economy. So, we might be one of rare institutions that have not changed way we operate due to the GFC. Let me remind you that we have some important instruments at our disposal and we do our best to use them efficiently on BH's way to the EU, including **firstly reserve requirement**; The CBBH is in charge of regulating reserve requirement imposed on commercial banks. We used it actively in the past, especially after the GFC, boosting the liquidity in the system. Furthermore, we amended the Decision on required reserves also in order to harmonize with the ECB policies. When ECB increased its „penalty” on banks overnight deposits in March 2016, as part of non-conventional monetary policy measures, we almost immediately introduced negative interest rates on excess liquidity that commercial banks hold with us. Currently, we charge -0.2%, i.e. 50% of the ECB overnight deposit rate. We will continue to follow trends in the euro area and in our economy and use our decision on reserve requirement and excess reserves in the future, as well.

Secondly, the CBBH is in charge of the overall **payment system in BH**. We constantly improve it, adhering to the SEPA (Single European Payment Area) and the PSD2 (Payment System Directive 2). As you know, changes in payment systems are dynamic and we are ready to continue building a robust and resilient payment system in the future that will serve our economy in the best possible way. Fintech, innovations and in general disruptive technologies in this area are something that will keep us busy for a long time to come.

Thirdly, we are learning to use „the latest” monetary policy instrument i.e. **communication policies**, as well.

Fourthly, the CBBH research function, including Financial Stability Report and our Annual Report is a significant contribution to better understanding of economic trends in BH and contribution to the financial system's

development in BH. **In addition, coordination of the Banking Supervision Agencies in BH and chairing of the SCFS** (Standing Committee for Financial Stability) are part of the CBBH mandate. During the „collateral damage“, done to BH in the aftermath of the GFC, we used very actively those coordinating mechanisms and reserve requirement. We intend to intensify coordination to be ready for the future crisis. Nobody knows when or how the next crisis will hit us, but there is no doubt there will be one before we join the EU and we want to be ready for it.

Finally, if the exchange rate is nominally linked to the euro, i.e. we cannot use nominal exchange rate as a policy tool, this does not mean that we cannot influence competitiveness of the BH economy. I am referring to the real exchange rate. First by maintaining price stability (by adhering to the Currency Board arrangement) and second, we try to use our public appearances and publications to advocate quicker and deeper structural reforms. For the region, monetary history is important and one must not forget ours, the hyperinflation and misuse of permanent devaluation in the former state. That is why we want a different step forward. Having in mind constant political pressures for the Currency Board to be "weakened" or to be abandoned, it is very important for the CBBH to maintain the existing policy independence and thus, maintain and strengthen the credibility of the Currency Board. So we do not think about the proper moment to exit the Currency Board and have „independent policy“, because we consider that we should enter the EU with the Currency Board and then the euro area, too, in the same or similar way as Baltic states successfully did, not long time ago.

3. What do we expect from „normalization" of the policy and when do we expect it to happen?

First, will interest rates increase? For our Central Bank, it is the ECB policy, but also the global situation in the world, that are of primary importance. For example, low or negative interest rates on our assets (bonds, deposits) have

led to a fall of our revenues. When the ECB changed its overnight deposit interest rates of banks (March 2016) we introduced a negative interest rate on excess reserves in bank accounts in the CBBH. In the future, we will continue along similar lines. We have noticed that some major central banks started to raise the rates, especially the FED. The ECB keeps its „gunpowder dry“ on interest rates, at least for the time being. Their forward guidance indicates that there might not be increase in their rates until mid-next year. In October, the ECB decided that “net purchases under the asset purchase programme (APP) at the new monthly pace of €15 billion (will continue) until the end of December 2018“. This may affect commercial banks interest rates in the euro area thus influencing indirectly ours. So, it seems reasonable to expect that interest rates will start increasing in the euro area, but we believe very gradually. True, it is difficult to predict, especially the future. Second, to answer the question when normalization will be achieved, we would need to define what „normalization“ is. Is it simply the average value of the past rates? If yes for how many years? Five years before the GFC? Difficult to say. But I think most of us in this room would agree that levels of interest rates, we see now, are „not normal“ but „exceptional“. But will „the new normal“ be around 5% nominal rates or closer to 2%, is not clear at this point. If the rates go up, we will look for the „silver lining“, i.e. we expect this will have a positive impact on our revenues. As far as commercial banks interest rates are concerned, in our view, the ECB policies and external world do influence local rates, but the main causes of relatively higher lending rates in BH are primarily within Bosnia and Herzegovina like: the sovereign risk, inadequate foreclosure procedures or more generally lack of enforcement of contracts – rule of law, etc. Thus, we in Bosnia and Herzegovina should worry less when the ECB will start raising rates and focus more on our own domestic problems, instead. And we have no influence on the ECB anyhow. As the saying reads: Why worry about things we cannot change?

4. Role of foreign banks and the capital market.

In BH, the capital market remains underdeveloped. The fact is that on the very small market, both Entities created their own stock market infrastructure with separate stock exchanges. One in Sarajevo (SASE), and another in Banja Luka (BLSE). Operations on them started more than 15 years ago. But, due to the usual factors in such cases i.e. small size of the markets, lack of privatization, and public mistrust in previous privatization programs, these resulted in very shallow market. Unfortunately, as a result of the GFC, foreign investments are not growing. Most probably, the political instability contributed to the fact that foreign investors shy away from BH. Thus, commercial banks are the main financial intermediaries. Most banks are foreign owned. Our systemic stability is influenced by behavior of systemically important banks in BH. As most of them are foreign owned, we strongly support the Vienna Initiative, including Vienna 2.0 and maybe Vienna 3.0 in not so distant future. All the countries in our environment are small and for all of them foreign banks play a dominant role. NPL remain high in BH, compared to other countries covered by Vienna 2.0. That is why we strive for even stronger cooperation among our countries. Maybe this Conference can communicate *urbi et orbi* the support for this?

5. About FINTECH and Artificial Intelligence:

Financial sector is heading toward significant changes, as digitalization is changing the landscape of the financial industry very rapidly. There is an abundance of literature on this topic, without a consensus view of the outcome for central banks. Some play with the idea to issue their own digital currencies, the Central Bank Digital Currency (CBDC), like Riksbank, the Reserve Bank of India, the People's Bank of China, etc. But harsh reality is that distributed ledger technologies (DLT) i.e. blockchain and numerous and various cryptocurrencies make not only main headlines of mass media, but

are increasing their share in the financial world. One cannot say what shall prevail in the future. Our approach is that we want to be careful with our own regulation on those issues. We believe that the conservative approach to cryptocurrencies is optimal for us and we will continue closely to monitor the development and attitudes of central banks in the world, especially the ones of Financial Stability Board (FSB), the BIS and the IMF and, of course, the main central bank for our Currency Board, the ECB. Because, it is better to be safe than sorry. We have been building our credibility for two decades now, and we are well aware that we can lose it in a moment. Yes, we know from Argentina's Currency Board history, in particular, that confidence in the Currency Board can quickly be lost. And *vice versa*, especially from the Baltic States, it is possible to enter the EU and the euro area with the Currency Board regime. An example of Latvia, although extreme, says that when in economic policy we have a clear goal (entering the euro area) and all policies should be subordinated to it, then success is guaranteed. As the old saying goes: „An obstacle is something that you see when you take your eyes off your goal“. This is why we want to continue our conservative policy, of course, by following developments in the environment. Let me make a comment on Argentina, a case sometimes used as an argument that Currency Boards are not sustainable. Recent negotiations with the IMF on the new program clearly show that it is not the Currency Board, per se, that is „crisis prone“. It is not following the necessary preconditions for its stability that will „kill it“. As we all know, it is the economic fundamentals and credibility that are the main „ingredients“ for a sustainable Currency Board. More specifically, we think that a sound banking system and fiscal discipline, as well as focus on structural reforms and convergence toward the EU are among the most important preconditions for a sustainable Currency Board and prosperous Bosnia and Herzegovina.

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