Speech by Principal Deputy HR Larry Butler at a Conference on the BiH Financial Sector: “BiH Needs Government Securities Market, Strong Banking Supervision”

Ladies and Gentlemen,

One of the lessons made plain by the experience of the Central and East European transition countries in the last decade is that you cannot fix an economy piecemeal.

You have to do the job holistically.

Privatisation doesn’t work if you don’t upgrade the business environment as a whole; business environment improvements aren’t effective if they are not accompanied by legal reform; legal reform only succeeds if there are funds to cover adequate salaries for judges and prosecutors, and funds for example, to computerize caseloads.

And so it goes on.

Transition is multifaceted. You can’t make satisfactory progress on just a handful of elements – you have to keep moving forward on a broad front.

This is nowhere more true than with regard to the financial sector.

BiH’s overall economic development prospects are dependent on a healthy financial sector.

A healthy BiH financial sector is dependent on BiH's broad economic development.

A clear and very pertinent example of this interdependency can be found in the current effort to establish a functioning market in treasury bonds.

The development of a government securities market will help lower interest rates and will help all participants in the credit market price their securities.

The knock-on effect of this on business is likely to be substantially positive. As we all know, the banking sector's inability to make cheap capital available in the years immediately after the war represented a major restraint on the development of a vibrant SME sector. And that in turn represented a drag on business expansion and job creation.

A functioning government bond market would also attract money from outside BiH. The possession of a financial sector that offers diverse and credible instruments for investment sends a clear signal to the international financial community as a whole – that a given economy boasts the kind of financial infrastructure that should make investors sit up and take notice.

It is a positive marker in regard to the kind of investment that BiH desperately needs in order to create jobs.

The Law providing the authority to establish a government securities market in BH was finally passed on 29 June this year. Unfortunately it was only enacted after a very long delay, which meant that the development of the capital markets in BiH fell behind all of the other countries of former Yugoslavia . Slovenia , Croatia and Serbia have already established government securities markets and Macedonia 's market will be launched later this year.

As far as *I* know, there were no sound technical or substantial

objections to the passage of this law. Its slow progress seems to have been the familiar result of a familiar failing – politicians did not understand the importance of this particular piece of economic legislation. They didn't see the benefits it could bring to the people of BiH.

That's the kindest interpretation. Perhaps they understood but didn't care. Let that be a matter for voters to judge.

What is crucial now is that the technical work that is needed to establish this market is done as quickly as possible. Some of this work has already been done, under the guidance of the U.S. Treasury and the Central Bank. The US is funding a programme that will integrate disparate market elements – the existing Central Bank payment and settlement system, the Entity registries, the stock exchanges and the satisfactorily functioning banking system – and link them with a new issue facility and a Central Bank bond registry. To track and facilitate changes in the ownership of bonds, providing a secure secondary market for trading these bonds.

All that is needed now is the political will to move forward.

Despite a conspicuous *absence* of political will in regard to some key elements of the economic transition effort, BiH has notched up impressive successes – including the complete and effective rehabilitation of the banking system.

Immediately after the war, most bank assets were state owned, and more than 90 percent of loans were non-performing. Confidence among depositors was low, and there was almost *no* confidence among prospective investors. The banks themselves were neither capable of, nor very much disposed toward, fulfilling their key role of financing business development.

The passage of effective modern banking legislation and the elimination of the Payment Bureaus turned that around. In 1988 there were 72 banks operating in BiH; at the end of last year the number had been reduced to 33, of which five are under

provisional administration.

Following a major shakeout and a series of mergers and closures, the economy has been left with a banking system in much better condition. The deadwood has been cut away and those banks that remain open for business do so on the basis of European standard financial and operating criteria.

A deposit insurance scheme has been successfully established, and as of the end of last year 21 banks were members of the scheme.

Recent trends indicate that public confidence in the banking system is rising – a direct reflection of increased banking efficiency as the result of improved competition.

And the practical accompaniment to all of this? Interest rates have fallen steadily; and lending to businesses and to individuals has increased.

This has been done against a backdrop of growing confidence in the KM, administered by the Central Bank's Currency Board.

KM bank deposits have increased at a much faster pace than foreign currency deposits. I need hardly tell this audience that having one of the most stable currencies in the region is a not inconsiderable resource for economic planners to build upon.

Yet we sometimes get the impression that the politicians have *still* not understood what is going on here.

A lynchpin of the effort to overhaul the banking sector and make it perform better has been the setting in place of a viable supervisory structure.

Let no one underestimate the importance of this. The Banking Agencies have been in the forefront of a battle to secure the BiH banking industry from endemic corruption and wholesale theft. The agencies have performed well, and their work has

been invaluable – as the unfolding stories of corporate graft and abuse of deposit holders at Hercegovacka banka and Privredna banka Istocno Sarajevo starkly reveal.

Practical assistance from USAID and the IMF has helped to improve the capacity of regulators and the quality of regulation over the last two years – but this has not been matched by the same level of support from some political authorities.

Currently there appears to be an attempt to undermine the independence and effectiveness of banking supervision. The RS Government passed a Conclusion on 31 July 2005 that the transfer of bank supervision to the BiH Central Bank and the abolition of the RS Banking Agency are not constitutional. Yet the whole point of transferring bank supervision to the Central Bank is to strengthen the regulatory function.

The RS Banking Agency has done its job with courage and determination – and members of staff have as a result been subjected to verbal and physical intimidation. That's because the criminals whose various scams were being jeopardized by the Agency's intervention responded as they always do, in the most primitive way.

But why are politicians attempting to prevent the strengthening of the supervisory role? Are they on the side of the supervisors or on the side of the criminals?

Bringing the two banking agencies under the Central Bank will strengthen their independence.

It should be done and it should be done quickly.

As I said at the beginning – these are not matters of specialist interest. They are matters that affect the wellbeing of the entire country – because a viable financial sector is a pre-requisite for a viable economy.

Those directly involved in day to day business in the BiH financial sector have demonstrated that they have the enterprise and vision to move forward – we must make sure that politicians with rather less enterprise and rather narrower vision are not allowed to hold the back.

Thank you