



THE ROLE OF FINANCIAL REFORMS AND ISLAMIC
BANKING TOWARDS THE ECONOMIC RECOVERY
OF BOSNIA AND HERZEGOVINA

BY

AMEL KOVACEVIC

INTERNATIONAL ISLAMIC UNIVERSITY
MALAYSIA

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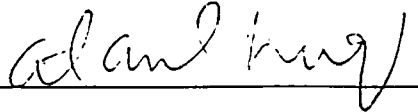
ABSTRACT

Bosnia and Herzegovina is a new independent State in Southeast Europe. During the 1992 –1995 war, unprecedented destruction of its economy took place. A banking system plays a crucial role in facilitating economic recovery. However, the banking system in Bosnia and Herzegovina is fragmented and undercapitalized. It can improve only if foreign capital is objected. This paper discusses possible contributions that foreign Islamic banks can make in alleviation of economic problems encountered in the process of privatization, the revival of industry, agriculture, the development of real estate and infrastructure, as well as the improvement of standard of living. We further explore needed reforms of the banking system and the compatibility of Bosnian banking laws with Islamic Shariah. We find that foreign Islamic banks can address the economic problems effectively through the use of the modes of finance at their command. Further, we find that introduction of foreign Islamic banks in Bosnia and Herzegovina would help in process of consolidating of the banking sector and building up public confidence in the banking system. However, foreign Islamic banks may not enter Bosnia and Herzegovina unless the banking environment is made attractive for them.

APPROVAL PAGE


I certify that I have supervised and read this study and in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Economics.

DR. ATAUL HUQ PRAMANIK
PROFESSOR, DEPT OF ECONOMICS
INTERNATIONAL ISLAMIC UNIVERSITY
GOMBAK CAMPUS, 53100 GOMBAK,
SELANGOR, MALAYSIA.


Name
Supervisor


This research paper was submitted to the Department of Economics and is accepted as partial fulfillment of the requirements for the degree of Master of Economics.

DR. SELAMAH ABDULLAH YUSOF
Assistant Professor
Head Department of Economics
Kulliyah of Economics and Management Sciences
International Islamic University, Malaysia


Name
Head, Department of Economics

This research paper was submitted to the Kulliyah of Economics and Management Sciences and is accepted as a partial fulfillment of the requirements for the degree of master of economics.

DR. MOHD AZMI OMAR
DEAN
KULLIYAH OF ECONOMICS & MANAGEMENT SCIENCES
INTERNATIONAL ISLAMIC UNIVERSITY, MALAYSIA


Name Assoc. Prof. DR. MOHD AZMI OMAR
Dean, Kulliyah of Economics and Management
Sciences

DECLARATION

I hereby declare that this research is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and bibliography is appended.

Name:..... AMEL KOVACEVIC

Signature:.....



Date:..... 28.04.2000

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To my parents Abdul-Kerim and Nimeta,

*'My Lord! Bestow on them thy Mercy even as they
cherished me in childhood'*

(Al Qur'an, 17:24)

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LIST OF ABBREVIATIONS

AAOIFI	-The Accounting and Auditing Organization for Islamic Banks
BBA	-Bai Bithaman Ajil
BBI	-Bosna Bank International
BiH	-Bosnia and Herzegovina
CBBH	-The Central Bank of Bosnia and Herzegovina
Din	-Dinar
DM	-Deutsche Mark
EBRD	-The European Bank for Reconstruction and Development
FBA	-The Banking Agency of FBIH
FBIH	-The Federation of BIH
GDP	-Gross Domestic Product
IDB	-Islamic Development Bank
IMF	-International Monetary Fund
IT	-Information Technology
KM	-Konvertibilna Marka
OBS	-Orient Bank Sarajevo
OECD	-Organization of Economic Cooperation and Development
OHR	-Office of High Representative
OIC	-Organization of Islamic Conference
PLS	-Profit and Loss Sharing
SFRY	-The Socialist Federative Republic of Yugoslavia
TIB	-Tadamoon Islamic Bank
USAID	-The United States Agency for International Development
US\$	-United States Dollar
ZPP	-Zavod za Platni Promet

1. INTRODUCTION

1.1 Statement of the Problem

Bosnia and Herzegovina (BiH)¹, in the pre-war period², was one of the six republics of the Socialist Federative Republic of Yugoslavia (SFRY) and shared its destiny of long and painful road to communism. The Bosnian economy represented the basis for Yugoslav development because majority of huge industrial complexes and the abundant natural resources are located there. Bosnian economy was well diversified with a highly skilled labor force and a capable entrepreneurial class. It has hydro energy production, intensive exploitation of various metals followed by heavy industry, wood processing, chemical and electrical engineering to electronics, car industry and information technology development. About half of the output and employment was generated by large-scale industry. Furthermore, almost 500 engineering and construction companies from BiH operated in the international market, generating roughly 7 percent of GDP (World Bank, 1997,5).

The socialist method of production in Yugoslavia was distinctive from other socialist countries because of market socialism and self-management (OECD, 1990:35)³. In 1989, BiH embarked on a process to transform itself into a democratic European state

¹ See Appendix 1

² before 1992

³ Enterprises were socially owned, endowed with assets owned by society at large and formally run by workers' councils. In principle, workers made key enterprise decisions. In practice, however, decision-making was in the hands of management, which was formally selected by workers' councils and tacitly confirmed by the political system (Damijanovic, 1985:163). The system was decentralized, allowing some competition in the product market, but generally restricting and mobility in the labor and competition financial markets.

and to make a transition to a market economy based on private property ownership. In 1992, the Serbian paramilitaries and Yugoslav Army started war against BiH brutally halting the process of reforms. The war lasted for 42 months. It has destroyed the economy and devastated human and physical resources. In addition, the dissolution⁴ of SFRY has split many companies that previously had branches throughout former Yugoslavia. It also disrupted or destroyed previous trade and supply channels, denying firms of access to product markets and inputs. BiH, at the end of the war, had a net population of about 3.4 million or 22.3 percent less than 4.377 million in 1991 (World Bank, 1997)⁵. BiH reached a total GDP of US\$10.2 billion in 1990 while due to the war GDP shrank to about US\$2.1 billion in 1994. Similarly, per capita GDP fell from US\$2,300 to US\$ 500 in the same period. Industrial production dropped by more than 90 percent that led to a huge loss in employment (World Bank, 1997,2). In mid 1999, the number of employees in the Federation of BiH was 407,194 while 328,887 persons were seeking jobs while per capita GDP was reaching US\$1,000. Overall war damages were more than US\$ 80 billion (Bosnian Government, 1996). Productive capacity ranging from US\$20 to US\$ 25 billion⁶ was destroyed while indirect damages were uncountable. The Serbs stripped the assets of a large number of Bosnian companies and some financial institutions with the assistance of Serbian management in the companies.

⁴ SFRY consisted of six republics namely Slovenia, Croatia, Bosnia and Herzegovina, Serbia, Monte Negro and Macedonia. Four out of six republics proclaimed independence in 1991-1992 period.

⁵ In 1991, BiH had a population of 4,377,033 citizens.

⁶ Bosnian government estimated that assuming a Bosnian pre-war GDP of US\$ 10,2 billion and capital output ratio of 4 to 5 times, the total pre-war capital stock was approximately US\$ 40 to US\$ 50 billion. Since nearly half of the capital stock is estimated to have been destroyed, the damage should be in the range of US\$20 to US\$ 25 billion.

Table 1. Funding needs of BiH for reconstruction and rehabilitation
in US\$ million

No.	Sector	Funds needed	Funds available	Shortage
1	Water supply and flood protection	668	154	514
2	Electricity	1,125	40	1,085
3	Transportation	8,766	308	8,458
4	Telecommunication	1,895	52	1,843
5	Agriculture	2,950	105	2,845
6	Industry	8,500	442	8,058
7	Education	915	125	790
8	Health	549	163	386
9	Housing	4,250	423	3,827
10	Mine destruction	200	57	143
11	Humanitarian aid	1,408	65	1,343
12	Subsistence minimum and other welfare services	1,183	129	1,054
13	Payment on principle of foreign debt for period 1992 - 1995	436	55	381
14	Other (refugees, peace implementation, BoP, culture, foreign dept, health insurance, pensions etc)	14,595	658	13,937
	TOTAL	47,940	3,114	44,826

Source: Government of BiH, October 1995 and Ministry of Foreign affairs of BiH 1998

The war ended in 1995 with the Dayton Peace Accord⁷ but the reconstruction and reintegration of BiH has yet to gain momentum. Total recovery and reconstruction needs of BiH are estimated to US\$ 47.9 billion, its structure is given in Table 1.⁸

⁷After 42 months of war, through international pressure, three ethnic groups namely Bosniaks, Bosnian Croats and Bosnian Serbs signed comprehensive peace settlement known as Dayton Peace Accord. It is a compromise that has legitimised ethnic cleansing and divided BiH into two entities namely Federation of BiH and Republika Srpska.

⁸ Preliminary Plan of the needs of BiH the Process of reconstruction and rehabilitation, Government, Sarajevo, October 1995

In the post war period, BiH was entitled to receive support from International Community in the amount US\$ 3,516 million for reconstruction out of which US\$ 3,114 million is realised⁹. The full amount of the support is not yet executed while its allocation has emphasised water supply, energy, transportation, telecommunication, agriculture, education, health, housing and mine destruction¹⁰. The support structure comprises of grants 78%, concessional credits 17%, commercial credits 4% and mixed grants and credits 1%. As it is seen from the above table less than 10% of needed funds are provided implying a dire need for BiH to attract foreign capital.

There exists scope for capital inflows to rebuild the war-devastated economy, but unfortunately the necessary socio-economic infrastructure for reconstruction of BiH is not there. Furthermore, BiH is in vicinity of European Union where average wage rate is higher compared to the average wage rate of KM¹¹ 372¹² in BiH. Law of comparative advantage suggests that the capital will flow from European union into BiH due to cheaper labour. Furthermore, large-scale Bosnian enterprises¹³ have comparative advantages in quality of products and cost of production as well as international reputation in their field of work but, unfortunately, BiH lacks suitable banking facilities to support their activities. The banking sector is faced with various problems. One acute problem faced by the banking sector is the shortage of capital knowing that on average capital of the Bosnian banks is KM19.5 million only. Due to unavailability of local resources because of the war, banking sector in BiH can

⁹ According to results of First, Second and Third Donor Conference, Brussels, December 1995 and April 1996 and July 1997 and additional funds pledged outside the donor conferences

¹⁰ few million of land mines are dispersed in BiH during the war.

¹¹ Konvertibilna Marka (Convertible Mark)

¹² Average net monthly wage per employee in February 1999 was KM 372 (CBBH,1999)

improve only if foreign capital is injected. Foreign capital can be classified into two broad categories namely conventional funds driven by interest and Islamic funds based on interest-free principles. Given the fact that this new sovereign nation was born as the dream of, among others, the Muslim majority, the introduction of financial institutions based on Islamic principles is worth exploring. Devout Muslims would prefer to deal with Islamic banks because practice of interest is prohibited in Islam¹⁴. BiH, a multi-religious society, should welcome all such possibilities that can contribute to revival of the economy and, thereby, promise prosperity to the people. As such, Islamic banking capital inflow shall be encouraged to contribute towards the development of the economy. With the introduction of Islamic banking, Bosnian officials¹⁵ expect heightened economic cooperation from other Muslim countries in the process of reconstruction and development of BiH.

Bosnian government is interested in inflow of Islamic funds, and is ready to allow financing on the basis of the Islamic modes of finance¹⁶. Laws or regulations for

¹³ such as Energoinvest, RMK Zenica, UNIS, Hidrogradnja, FAMOS, Agrocomerce, Šipad, Krivaja etc
¹⁴ Islam, like other monotheistic religions, prohibits the receiving and giving of interest, called riba, regardless of the purpose of the credit and level of the interest rates. The prohibition of riba has been mentioned in four different revelations of the Holy Qur'an (Hosein, 1996). The first revelation says that riba estranges men from God's Mercy (III: 39). The second one damned riba, putting it at the same level as illegal expropriation of the property that belongs to others (IV: 161). The third revelation instructs Muslims to stay clean from riba so as to strengthen their prosperity (III: 130). The fourth revelation establishes the clear distinction between riba and trade and advises Muslims to trade and not to indulge in riba transactions. In lending, Muslims should expect only the principal while even being ready to give it up if the borrower is not able to pay it back. It has also been mentioned that those who ignore this prohibition are at war with God and His Messenger (II: 174-180). Prophet Muhammad, peace and blessings of God be upon him, cursed not only those who take riba but also those who give it as well as those who witness and record such transactions.

¹⁵ Bosnian Prime Minister Dr. Silajddic, June 1998, IDB Conference held in Sarajevo

¹⁶ Islamic funds are allowed entering the Federation of BiH and are invested in the BH Steel Company, Orient Bank Sarajevo, Koksara Lukavac etc.

Islamic banking operations are not present in BiH. Without proper legislative support, Islamic banking will never be able to contribute significantly for development of BiH.

1.2 Objectives of the Study

We have identified the financial needs of BiH for reconstruction of the economy. Banks play a vital roll in development of economy. But banking in BiH is fragmented. Therefore, we need to meet the financial needs by allowing foreign Islamic banks to enter BiH. Banking environment is not favourable for the Islamic banks. Therefore, first objective of the study is to describe the fragmented state of the Bosnian banking sector. Secondly, we will explore potential of Islamic banking for revival of Bosnian economy while outlining some Islamic banking instruments. Then, we will identify reforms to improve banking sector, overcome resource bottlenecks and make Bosnian financial environment to attract foreign capital through banking system.

1.3 Methodology and Significance of the Study

Nothing in Bosnian literature has yet been published on Islamic banking. Thus introduction of Islamic banking in BiH would be a pioneering attempt. Likewise, there is very little literature available on the postwar Bosnian banking system except some reports published by the international institutions such as the World Bank, the United States Agency for International Development (USAID) and the Office of the High

Representative (OHR)¹⁷. In addition, the study relies on the data that have been published by the Central Bank of BiH, the Federal Banking Agency, and the Statistical Bureau of BiH. With regard to the analysis of the prospects of Islamic banking in BiH, personal interviews were conducted on banking authorities, bankers and businessmen. The interviews were tailored to each category of interviewees in order to investigate whether Islamic banking can gain a foothold in BiH.

Writings on the Bosnian banking sector could be found only in the specialized bimonthly magazine 'Banke' that publishes articles on the banking sector and practically nothing is found in English language. Dr Obrad Piljak vice-governor of the Central Bank in his article "*Bankarski Sistem u BiH*"(The Banking System in BiH) published in 'Banke' No.4 Sarajevo 1999, provides some analysis of the banking sector. BiH has complicated financial system due to the legacy of the Dayton Agreement. Some banks are state-owned and others are privately owned banks. Large state-owned banks have problems such as 'old foreign currency savings', non-performing loans and debts owed to international creditors that could not be promptly paid due to the aggression etc. Piljak advocates privatization of state-owned banks so that the huge potentials of the banks could be realized. Private banks are too small to make worthwhile contribution toward reconstruction and development of Bosnian economy. In addition, the Bosnian banking system must go through structural reforms

¹⁷ The mandate of the High Representative is to oversee the civilian implementation of the Bosnian Peace Agreement, initialled in Dayton. The mandate derives from the London Peace Implementation Conference of December 1995 and the Security Council Resolution 1031. The High Representative is the final authority regarding interpretation of the Agreement on civilian implementation. For further information please refer to www.ohr.int

in order to restore confidence of the public as well as foreign investors' in the Bosnian banking sector.

In next section, description of Bosnian banking sector before and after independence in 1992 and role of the Central Bank, the Federal Banking Agency and the Payment Operation Bureau will be presented.

2. BANKING SYSTEM IN BOSNIA AND HERZEGOVINA

2.1 Introduction

BiH consists of two entities: 1) the Federation of BiH, Bosniak and Croat controlled areas that are not yet integrated, and 2) Republika Srpska, territory ethnically cleansed by Serbs. The banking sector reflects a similar pattern of fragmentation since there are three distinctive banking sector fragments. This section describes Bosnian banking sector including role of the Central Bank, the Federal Banking Agency and the Payment Operation Bureau.

Apart from the territorial classification, the banking sector could be classified in accordance with the nature of ownership of state-owned and privately owned banks. The problems and issues faced by these bank groups will also be discussed. Furthermore, Bosnian banks' consolidated balance sheet together with the interest rates in areas controlled by Bosniaks, Croats and Serbs will be briefly analysed. We will focus on the Bosniak controlled area of the Federation of BiH because it is, for the time being, the only area relevant for the introduction of Islamic banking where 74% of population is Muslim. The need for consolidation and reform of the banking sector in Bosniak controlled area is highlighted.

2.2 Banking System Before Independence

At the beginning of the 1960s, the Socialist Federative Republic of Yugoslavia (SFRY) introduced a two-tier¹⁸ banking system. Wholesale and retail banks were exposed to Western banking practices through establishment of their international branch networks while enjoying a great deal of autonomy in the market place. SFRY introduced the Bank International Standards of Basle in the late 1980s. However, legal and institutional environment was not allowing banks to grow strong and efficient (Stiblar, 1997). Commercial banks were the only source of institutional capital, and bank credit was the only form of financing for enterprises. The banks were controlled by large enterprises, both as owners and debtors. They used banks to obtain financing on favourable terms. The socialist ideology saw interest rate as harmful¹⁹. Consequently, banks in former Yugoslavia were not allowed to work for profits and profits were redistributed by the state. Bosniaks, being Muslims and ruled by socialist government for fifty years, possess the collective memory of the harmful impact of interest rates thus offering the opportunity for Islamic banks to be well received.

The conflict of interests appeared due to the fact that state-owned enterprises owned the banks and at the same time, the enterprises were major borrowers of these banks. Political pressure was used to influence banking decision to lend without adequate assessment of credit risk of the borrowers and viability of the projects (Cehajic, 1999).

¹⁸ It is the system where two different bank groups exist. One group is specialised for wholesale banking rendering services to another group namely commercial or retail banks.

Furthermore, state-owned banks were bailed out whenever they confronted with problems such as liquidity shortages or bad debts. Such practices created a relaxed atmosphere for the socialist management class that weakened the banking sector.

In 1990, 30% of the total assets of Bosnian banks were considered bad debts. The Central Bank of Yugoslavia²⁰ had taken over all foreign exchange reserves from Bosnian commercial banks (Cehajic, 1999). Deposit guarantee schemes and enhanced bank supervision were not introduced in SFRY. There was a lack of competition and banks had high operating costs. It was impossible for foreign banks to get a licence in SFRY (Stiblar, 1997).

2.3 Banking in Independent Bosnia and Herzegovina

Apart from communist era legacies, Bosnian banks suffered tremendous losses during the war that led to an undercapitalised and fragmented banking sector. In post war period, financial institutions such as the Central Bank or the Federal Banking Agency were introduced in order to help and supervise the banking sector while some institutions, such as Payment Operation Bureau, hinder development of efficient and modern banking services in BiH.

¹⁹ Majority of communist writers argue that usury is exploitative product of capitalism. See Elster J. (1986) 'Karl Marx: a Reader' Cambridge University Press pp. 328-332 for further inquiries.

²⁰ Narodna Banka Jugoslavije

The war in BiH paralysed the economic system leaving the banking sector in serious crisis. The pre-war household foreign currency saving deposits of Bosnian commercial banks, which were kept in Yugoslav Central Bank in Belgrade, amounted to DM 2.257 billion (US\$1 = DM1.8695) in 1992. At the same time, loans issued to respective enterprises across the Bosnian territory were not performing for two possible reasons. Firstly, those projects that happen to be situated on territory ethnically cleansed by Serbs do not belong any more to the jurisdiction of the banking law of the Federation of BiH. Secondly, Serbs militants devastated projects that were based on the territory controlled by the Bosnian Army. The losses in the banking sector in the Bosniak controlled area amounted to DM 1,969,837 (World Bank, 1997). The war-ridden disturbance of the market forced limited operation of some projects while others were shut down. The devaluation of the local currency accompanied by hyperinflation during the first few years of the war also affected banking performance (Piljak, 1999). There are three monetary and financial institutions that influence banking operations, namely the Central Bank of BiH, the Federal Banking Agency and the Payment Operation Bureau.

2.4 Banking Environment in Bosnia and Herzegovina

In order to comprehend the financial environment we need to discuss the main institutions that significantly affect banking operations in the Federation of BiH and particularly in the area controlled by Bosniaks. The Bosniak controlled area is currently the only qualified territory for introduction of Islamic banking, having in mind anti-Muslim sentiments in the Croat and Serb controlled areas. There is only one

institution of State level importance namely, the Central Bank of BiH. At the Entity level, the Federation of BiH has the Federal Banking Agency that acts as a supervisory agency closely observing the development of the banking system. The Payment Operation Bureau (ZPP)²¹ is government-owned clearing and settlement agency that also perform tax collection and auditing functions.

2.4.1 The Central Bank of Bosnia and Herzegovina (CBBH)

In August 1997, the Central Bank of BiH (CBBH) was established so that monetary responsibilities were transferred from similar institutions²² in both entities to the state level. The CBBH functions as a currency board. It is responsible for monitoring and maintaining exchange rate policy. It serves as banker for the country but is prohibited from providing credit to the entities or any part of the economy. The CBBH maintains responsibility for the coordination of supervision. It also gives advice on the overall design of legislation and regulations (Omicevic, 1998).

The new currency note was issued in June 1998 and is overwhelmingly accepted by Bosniaks. The Convertible Mark (KM) is the legal tender for the whole of BiH, even though Bosnian Croats and Serbs prefer to use Croatian Kuna and Yugoslav Dinar, respectively. The KM is pegged to the Deutsche Mark (DM) at exchange rate 1:1. The pegging strategy²³ created by the Central Bank of BiH is applied to boost stability and confidence in the domestic currency (Omicevic, 1998). The advantages of pegging the KM to the DM are multiple due to the traditional determination of people in that part

²¹ Zavod za Platni Promet – Bosnian name for the Payment Operation Bureau

²² Example Narodna Banka Bosne i Hercegovine in Bosniak controlled area, Narodna Banka Republike Srpske in Serb controlled area.

of the world to use the DM as a yardstick in all their financial calculations. It could be explained by the fact that DM is most frequently used currency in Europe and that there is army of foreign workers from South East Europe in Germany. Since pegging strategy was introduced even before introduction of the new currency, the Bosnian recovery in the last few years has been accompanied by a high degree of macro economic stability consequent on monetary stability (World Bank, 1997). The implications of pegging the domestic currency to the Deutsche Mark are already seen due to the fact that the Serbian and Croatian currencies experience devaluation due to inflation.

2.4.2 Role of the Federal Banking Agency (FBA)

The Banking Agency of the Federation of BiH was established in the second half of 1996 to serve the purpose of unification of banking laws in Bosniak and Croat controlled areas as well as bank supervision in Federal territory. The FBA has an instructive and supervisory role with the aim of adjusting Bosnian banking operations to comply with the standards of the Basle Committee on Banking Regulations and Supervisory Practices. These internationally accepted standards define the required volume, structure and quality of capital as well as risk assessment. They also prescribe risk management standards for a single bank as well as for the entire banking system (Barš, 1997).

²³ This strategy proves to be successful because Monte Negro opted for similar solution in its endeavour to create public confidence in domestic currency.