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# The Early History of the Central Bank of Bosnia and Herzegovina

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**by Warren Coats[1]**
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## Introduction

The CBBH opened its doors for business on August 11, 1997 with monetary liabilities of DM 132,584,030.72 million and an equal amount of foreign currency assets. Over ten months later, by the end of June 1998, the CBBH's monetary liabilities were DM 123 million, a modest decline. By the end of 1998, however, the size of the central bank had jumped to DM 254 million, almost double its opening size. It has grown very rapidly ever since and by the end of 2002, the CBBH's foreign currency assets stood at DM 2.5 billion—a truly astounding growth.

The worrisome shrinkage of the CBBH over its first ten months suggests that its subsequent success was not assured. Indeed over its first year, the CBBH confronted and overcame a number of very challenging problems. Its ultimate success was the result of the good will and eventual cooperation of the three ethnic representatives on the Board of the CBBH and of its dedicated staff and management. That it survived its difficult first year at all, however, had a lot to do with the wise choice of a currency board arrangement, the sound implementation of that arrangement in the CBBH law, and the very hard work of a relatively few people. Three people in particular must be mentioned, the first two governors of the CBBH, Serge Robert and Peter Nicholl, and IMF consultant Kim Rhee. In addition to the other members of the CBBH board, Manojlo Ćorić, Kasim Omićević, and Jure Pelivan, I should also mention the hard work and dedication of the CBBH's initial Vice Governor's: Enver Backović, Dragan Kovačević, and Ljubiša

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Vladušić. If I venture beyond this very short list I will get increasingly into trouble by omitting worthy names, but I must also mention Anka Musa and Maruf Burnazović.

In order to more fully appreciate the impressive success of the CBBH today, I want to review a few of the issues that threatened it during its formation and first year of operation. These issues largely reflected the innate difficulties of institutional change and the natural suspicions that each ethnic group had of each other immediately following the end of one of the bloodiest wars the world has ever known. The appropriateness and soundness of a currency board arrangement was never an issue. The issues that threatened the CBBH were initially ones of control and public identification and subsequently concerns over the ability of the CBBH to adhere to currency board rules because of the role of the payment bureaus and of the predecessor central banks.

## The CBBH Law

The esteemed members of the CBBH Board were appointed to their positions before the new central bank formally existed and were our direct counterparts in developing the text of the central bank law. Their first meeting together was here in Sarajevo on November 11, 1996 to discuss with us the draft central bank law. It was the first time they had seen each other after four years of war. Trust was low, and tensions were high. The contrast between those earlier days with the constructive and cooperative relationship that exists between these men today could not be greater.

The IMF had prepared a draft of the central bank law in Washington and had circulated it to the authorities earlier that year. The draft provided for a strict currency board arrangement with a single currency and a few limited measures for dealing with potential liquidity shocks. The draft contained rather standard governance measures. Over the week of November 11 -15, during which each paragraph of the draft was discussed, the members of the future board had almost nothing to say about the currency board arrangements, but they had a great deal to say about the governance and bank note aspects. What had taken us the most time and discussion in Washington when first preparing the draft law, took up almost no time at all here in Sarajevo and Pale during that cold week in November. What had been boiler plate for us in Washington was sharply and almost bitterly debated here in Sarajevo. That was natural, actually. Bosnia had experience with currency board arrangements and strongly embraced them. There was ***much*** less acceptance in Bosnia of ideas of one country, one central bank, and one currency as required by the Dayton agreement.

The issues that dominated the discussions over the details of the central bank law in November 1996 were the provisions on the voting powers of the Board, the role and powers of the branches of the central bank, and the name and design of the currency notes. No one even thinks about these issues today, but it may interest you to quickly review them.

## The Board

The Constitution adopted in Dayton had several unusual provisions that became the sources of considerable discussion when drafting the law. The first of these was the sharing of one (Federation) vote by the Bosniac and Croat members of the Board. Did the one shared vote mean that if these two members disagreed no Federation vote would be cast or that opposing half votes would be cast? In fact, there is no circumstance under which it would matter which interpretation was accepted. However, considerable discussion arose over the difference of treatment of the RS member and the Federation members. The Dayton agreement specified the ethnicity of the two Federation members of the Board, but did not do so for the RS member. Could, for example, a Bosniac (Moslem) from Banja Luka hold the RS seat? The central bank law that was finally adopted ignored this asymmetry, with the agreement of the Office of the High Representative (OHR), and provided for a Croat and a Bosniac from the Federation, and a Serb from the RS.

The Dayton agreement also states that the Governor may break tie votes of the Board. This gave rise to a controversy over whether the Governor was a regular member of the Board or only broke ties. If he was a regular member of the Board, he could create a tie and then break it. As a member of the Board, the Governor would be entitled to vote. Thus, if the Federation members disagreed (and either split their vote or cast no vote) and the Governor and the RS member disagreed, the Board would be tied and the Governor could then cast another vote to break the tie and the Governor's views would prevail. If the Governor was not a regular member of the Board, he would only vote when there was a tie and the same configuration of votes as in the preceding example would result in the Serb's views prevailing. The interpretation that won out in the Central Bank Law, which was the interpretation that we at the IMF gave to the Dayton agreement, was that the Governor was a regular voting member of the Board, which gave him a very strong position.

## The Branches

The role of CBBH branches was also a hotly debated issue. Having relaxed somewhat the initial position that there should be separate central banks in the two Entities, the Bosnian Serbs sought to preserve as much autonomy as possible for the Entities by assigning important powers to the branches of the central bank that would be established in each Entity. There was even a discussion of whether the foreign exchange backing required by the currency board arrangement would be owned by and invested separately by each branch.

The Bosnian Serb position was a mix of symbolism and substance. Indeed, the issues on which all three representatives took strong positions were often a mix of symbolism and substance. The Bosnian Serbs had long insisted that the branches be named "Central Banks," even if they were subordinate to the Headquarters of the Central Bank in Sarajevo. Their position followed the existing practice in Yugoslavia. Of greater

substance, they fought for the law to explicitly delegate significant authority to the branches.

The law as finally adopted has detailed language about "Main Units" and the functions they perform. Such provisions cannot be found in any other central bank law I know of. Nonetheless, the law clearly establishes one nationwide central bank and the Main Units are clearly fully subordinated and integrated branches of that single central bank.

As a result of last minute changes to the draft, the Law as adopted states that:

"The main unit in the Republika Srpska shall be called:
Main Bank of the Republika Srpska
Of the Central Bank of BiH (Article 74.I.)"

When I first read the above name of the branch in RS, I assumed that it was a typographical error or mistranslation. I feared that the name of the CBBH would remain unknown in the RS. In fact, however, when the ***Main Bank of the Republika Srpska*** opened in Pale (it has since been moved to Banja Luka), "Central Bank of Bosnia and Herzegovina" was spelled out in full on the front of the building housing the branch office.

## Glasses

Obviously, the national currency to be issued by the new central bank would need a name and a design for its currency notes and we knew that an agreement on these issues would be difficult. However, agreement on these issues could be saved until the end, as they had no implications for the central bank law itself. In the discussions of the draft law with our counterparts we used the name "glasses" (my imagination was running thin at that time) for the unnamed new currency to facilitate our discussions of the law.

Intense discussions ensued over the meaning of a single currency and of legal tender. The Bosnian Serbs wanted their own version of glasses, which would be issued by their branch of the central bank but would be legal tender throughout the country and fully interchangeable with the Federation version. This, in their view, was consistent with the essence of a single monetary area and system. Manojlo Ćorić, the Serb member of the Board (and here with us today), presented us with a number of lessons in the great diversity of currency arrangements in the world, in order to fortify his argument that a single currency could have two versions.

There is indeed more diversity in the world's monetary arrangements than I had realized. During these negotiations, we were getting to know one another and what different words and concepts meant to each of us through the intermediation of interpreters. It was not easy to clearly and definitively understand each other, especially when I suspect not every one wished to be clearly understood all the time. To test whether a single currency with two designs was really a single currency in the minds of the Board members, I pointed out that non-cash glasses (deposit balances) had no design at all, only amounts

that could not be distinguished in terms of which branch had issued them. To my relief, this was understood and accepted by all.

The compromise we reached was that each entity would have its own version of the currency, which would circulate freely throughout the country with equal legal tender status. The two versions would look like the same currency, generally having "common design elements," as well as "distinct design elements for the Federation of Bosnia and Herzegovina and the Republika Srpska."

Just before the draft central bank law was agreed and submitted to the Joint Presidency, the name of the new currency was chosen. Between November 1996 and May 1997, each member of the Board had made interesting and worthy suggestions for the name of the new currency. Before there was a political will and commitment to move forward, however, no name would be acceptable to all three groups. When that time was reached in May, all of the good names had already been rejected. At that point David Lipton of the U.S. Treasury suggested the pedestrian, but descriptive name Convertible Marka (KM), which was immediately accepted.

## A Troubled first year

The central bank law was adopted June 20, 1997 and went into force June 27. The CBBH formally came into being on August 11 within the 45 days stipulated in the law. On that day settlement of payments through the banking system moved to the new central bank. Opening the CBBH on time was a major accomplishment, if not a near miracle. The first 44 employees of the new bank, all drawn from the staff of the National Bank of Bosnia and Herzegovina, were not appointed until the Friday before the Monday opening. Only ten staff of the NBBH had been assigned to work with Kim Rhee and Serge Robert in advance of the opening.

As a practical matter, when the CBBH opened, it was only operating in the Bosniac majority area—the area that had been served by the NBBH following the wars. To become the country wide central bank it was meant to be, the CBBH would have to open its branches in Mostar, Pale, and Banja Luka and to issue its own currency. The opening in Sarajevo was amazingly smooth, but problems emerged almost immediately that threatened the completion of the above tasks. These problems all had to do with the challenges and difficulties associated with unwinding the activities of the predecessor "central banks": the NBBH, the National Bank of the Republika Srpska, and the Mostar ZAP, which was functioning as a quasi central bank in the Croat majority area, and with the role of the payment bureaus in the system. Looking back, the difficulties were gigantic. That these problems were eventually over come convinces me that there was political good will on all sides, i.e., that there was a genuine desire to implement the Dayton agreement.

## The NBBH Problem

The first sign of trouble came within the first few days when one of the municipalities asked how it could withdraw cash from its account now that the CBBH was the central bank. But of course its account was still with the NBBH, not the new CBBH, which had taken over only the deposits banks had with the NBBH. The question perplexed us, however, and was the first alarm bell of "the NBBH problem".

Within a day or two of opening, the monetary liabilities of the CBBH increased above its foreign currency assets, something that was not supposed to happen. This was a second alarm bell. It took us a while to figure out what was happening. Depositors with the NBBH where making payments (on net) to depositors with other banks. When these were settled at the CBBH, there was a credit to the reserve accounts of the recipient banks but no offsetting debit to the NBBH. This was because the NBBH had no reserve account with the CBBH. It was not part of what was supposed to be a closed system. As a result of these continued operations of the NBBH and the net outflow of its deposits, the first year end balance sheet of the CBBH showed a very embarrassing shortfall in the required foreign currency cover of its monetary liabilities.

The *NBBH problem* was the result of the fact that the NBBH continued to operate as a bank and had deposits not fully covered by foreign currency assets. Thus whenever there was a net outflow of deposits to other banks, the NBBH was not able to transfer a comparable value of German marks. When these payments, which were cleared through the payment bureau, were settled at the CBBH, the new central bank found itself inadvertently extending credit to the recipient banks and thus violating the currency board arrangement. Jure Pelivan, who sits here with me today, went ballistic. As a result of this problem, the opening of the Mostar Main Unit of the CBBH, which was to have followed soon after the opening of the headquarters and Main Unit in Sarajevo, was delayed until April 6, 1998. Though the Main Unit in the Republika Srpska opened on time in Pale on September 15, 1997, it had no operational role at that time as there were initially no KM deposits and payments to be settled in the RS.

The ultimate success of the CBBH depended critically on overcoming the NBBH problem. The existence of the problem meant that the public could not have full confidence that the CBBH would adhere to currency board rules. In addition, there was a serious risk that the public would confuse the financial difficulties and potential default of the NBBH with the condition and integrity of the CBBH.

The NBBH problem had several interrelated components. While the NBBH had surrendered its monetary operations to the CBBH, it continued its banking operations. We had not foreseen its continued operation as a bank. By itself its normal banking operations would not have been a problem. But it was not treated like other banks at the CBBH because it had no reserve account that could be used for the daily settlement of payments among banks. In addition, after transferring most of its foreign exchange to the CBBH when it transferred its deposits from other banks, it did not have enough foreign exchange left to cover even small outflows of deposits of its other non-bank customers.

Initially the CBBH and NBBH used the device of a trust account with the CBBH from which the NBBH could cover net outflows of its deposits. The purpose of the trust account was very different, however. It had been provided for in the law to deal with the uncertainty over the actual amount of currency liabilities of the NBBH, which had been transferred to the CBBH when it opened. Kasim Omićević, who also sits here with us and who was then both the Governor of the NBBH and the Bosniac member of the CBBH Board, argued correctly that not all of the notes issued would be redeemed when the new currency was issued. Thus the NBBH should get back any German marks initially transferred to the CBBH that were in excess of what was subsequently actually redeemed. After the fact, the CBBH returned DM 4,569,903 to the NBBH representing the short fall in redemptions relative to the Bosnian dinar that had been issued. If I remember correctly, Kasim had guessed that the amount would be of that magnitude.

The trust account approach to the problem had several critical flaws. First, the NBBH ran out of foreign currency and could not keep enough in the trust account. Second, the mechanism did not provide a suitable means for blocking payments from NBBH accounts when the NBBH didn't have sufficient reserves. On several occasions I obtained the agreement of Serge Robert, then the governor of the CBBH and also sitting here with us, and Kasim for the NBBH to open a regular reserve account with the CBBH and to operate it like any other bank. Unfortunately, these agreements were not implemented until April 1998.

The NBBH's reserve account was finally put into full operation on April 21, 1998 and the NBBH issued instructions to transfer an addition DM 20 million to the new account with the CBBH. Aside from the fact that most of the additional foreign exchange never arrived at the CBBH, the new arrangement worked properly and the funds in the NBBH's reserve account at the CBBH proved sufficient to settle all net payments by its depositors until May 5 when another modest overdraft occurred. On that occasion, both the ZPP failed to adhere to the settlement instructions requiring it to unwind the excess payments and the CBBH failed to hold up the settlement of payments for the day. On the following day the overdraft was reversed on its own. As a result of these combined failures, which again caused the currency board rules to be violated, the IMF postponed the meeting of its Executive Board to consider approval of the financial package that had been negotiated with the authorities by the IMF staff.

Full resolution of this problem required the closing of all deposits with the NBBH and its liquidation and the reform of the payment system and the old payment bureaus. Liquidation of the NBBH required an agreement among the Cantons for covering some losses that resulted from a war time loan to the Bosniac government. A deposit freeze and related steps to protect the CBBH, were not successfully implemented until December 1998. The NBBH was not fully liquidated until late in 1999. Once again, the fact that such an agreement was reached and the liquidation successfully carried out eventually demonstrates the underlying good will and commitment of all parties to fulfill the requirements of the Dayton agreement.

## The Mostar ZAP Problem

During the wars, the Croat majority area became isolated monetarily. German marks and Croatian dinars and later Croatian kuna were in widespread use. Both were the liabilities of foreign central banks. After severing its ties with the NBBH during the war, the Mostar ZAP took on limited central bank functions as the settlement bank for DM and kuna. It held a one hundred percent cash reserve against DM deposited with it and required (informally) banks in its area to deposit a 45 percent cash reserve with the ZAP against their kuna deposit liabilities.

In order to encourage the use of KM, these DM and kuna payments through the ZAP were ended on October 1, 1999. My friends here today will remember, however, that we press for this step to be taken much earlier. With our prodding, amendments to the Federation Internal Payment Law adopted in the summer of 1998 required the termination of domestic payments through the ZAP and the ZPP in DM and kuna by the end of 1998.

Ending DM payments through the payment bureaus proved to be easy, as we had expected. DM could very easily be exchange for KM or kuna and once the old system was ended, almost all of the DM withdrawn from the payment bureaus was transferred to the CBBH for KM. The same was required of the ZPP in Sarajevo with the same result.

The situation with regard to the kuna deposits with banks was somewhat more complicated because they were not fully back by cash and because they could not be directly exchanged for KM at the CBBH. If the public continued to hold the same level of kuna deposits with their banks (HRK equivalent to KM 89.5 million at the end of 1998), the kuna then held by banks with the ZAP (about KM 25 million) could easily be transferred to Croatian banks and/or to the vaults of the banks involved.

At the time, we hoped that the public would convert some of their kuna deposits and cash into KM. We anticipated that a problem could arise if the public wished to convert its kuna deposits with banks into KM at too rapid a rate. Forty five percent of the deposits could be converted immediately by withdrawing the kuna banknotes from the ZAP. However, the ability of banks to convert a larger amount would be limited by the maturity and hence timing of the repayment of their existing kuna credits and other assets, their ability to sell “non-liquid” kuna assets for cash (banknotes or deposits), and the extent to which the kuna deposits withdrawn by the public were replaced with KM deposits.

We recommended that the transfer of kuna and DM deposits for domestic payments via the ZAP should be ended by June 1998 and that the use of the ZAP as a depository for kuna and DM banknotes should be phased out by June 1999. In fact both steps were taken at the same time but not until October 1, 1999 in both the Federation and in the RS. It is interesting to note that while foreign currencies held by banks, the payment bureaus, and the CBBH rose roughly DM 150 million between September 30 and December 31 1999, DM assets of the CBBH rose almost DM 450 million and those of the banks rose

less the DM 200 million. The DM 324 million in foreign currencies withdrawn from the payment bureaus between these dates were used predominantly to buy KM and thus wound up with the CBBH.

## The NBRS Problem

When the CBBH was launched, the dominant currency in the RS was the Yugoslav dinar (YUD). This reflected the historical, economic, and political ties of the RS to the Federal Republic of Yugoslavia (FRY). The situation in the RS was also different than in Sarajevo because the Yugoslav dinars in wide use there were issued by a foreign central bank, rather than by the NBRS, which had been a branch of that foreign central bank. This meant that the YUD in circulation in the RS were not really the liabilities of the NBRS, nor did the NBRS have the German mark assets to cover them. Furthermore, unlike the situation in Mostar, the Yugoslav dinar was not freely useable as they were over valued and subject to exchange controls. Taken together these facts meant that it was not possible to replace YUD with KM as had been done with the Bosnian dinar in the Federation. Instead, the public and depositors in the RS gradually increased their use of KM as they chose to exchange DM for the new currency. The insolvency and other problems of the NBRS were thus more isolated from the operations of the CBBH than had been the case for the NBBH.

The greater soundness of the KM (more stable value and freely convertible) had become a strong incentive to hold and use it in the region. During this early period, the RS government pressed ahead with steps to encourage the use of KM. It issued an instruction that, effective from July 1, 1998, KM was the official means of payments in the territory of the RS. Starting with the 1998 budgets, KM was used in the presentation for all governmental budgets. The portion of the RS government staff's salary paid in KM was 50 percent in December 1998, 70 percent in January 1999, and became 100 percent soon there after. The amount was limited by the Government's holdings (and receipts) of KM (or of DM with which to purchase KM).

On November 6, 1998, the RS Government abandoned the FRY official exchange rate of 6.0 YUD = 1 DM, and moved instead to 7.5 YUD = 1 DM, a rate broadly in line with the prevailing market rate in the RS and FRY at the time. In response to this change in policy, the authorities in the FRY closed the access of the RS payment bureau to the NBY and to banks in the FRY.[2] As a result, it became impossible to continue the practice of making payments between the RS and the FRY by submitting payment orders to the RS or FRY branches of the Serbian payment bureaus (SPP and SDK), and efforts to shift to cash payments were frustrated by an increasing shortage of YUD banknotes in the RS. The efforts of the public to convert their YUD deposits into cash in order to make payments in the FRY confronted the inability of banks to pay out banknotes both because

[2] Until that moment, a payment from an RS enterprise or bank to a FRY enterprise or bank could be made by debiting the payor's account with the SPP and crediting the payee's account with the SDK. The reserve accounts of the payor's and payee's banks with the NBY were debited and credited respectively.

of the limited supply of YUD banknotes in the RS and because of banks' own lack of liquid assets with which to buy banknotes.

These developments forced the insolvency of the NBRS and of many RS banks into the open and their resolution could no longer be avoided or postponed. While these problems created serious challenges for the RS government, they never posed serious risks for the CBBH.

## The New Banknotes and Coins

Naming the currency proved easy compared to agreeing on the actual note designs so that they could be printed and issued. Without currency the CBBH was half a central bank at best. The currency notes and coins would be the most tangible and visible symbol of the integrated country. In the beginning, the three ethnic groups dragged out the process.

Work on the note designs preceded the opening of the CBBH and continued after its opening in parallel with the other activities already discussed. Serge Robert, the first governor of the CBBH, had arranged for Banque de France to print the notes at no cost, and the French printer provided technical advise on the design. As required by the law, there were to be two versions of each note. However, each set must look like the same currency with only modest variations. It was agreed that one side would have the face of a famous person and the other of a famous or beautiful building or structure or work of art. The person and object chosen by each Entity for its notes could not be offensive to the other Entity. Both sides of each denomination would be identical except for the difference in the face and the object and the fact that the name of the central bank in Latin letters and Cyrillic would be in different order. in the Federation version the Latin letter name would be at the top, and in the RS version the Cyrillic version at the top. My hope was that you would need to look carefully to see that there was any difference.

Over the course of 1997, each ethnic group submitted several designs, which were each rejected by the other. The international community's patience was wearing out. On November 18, 1997, Robert S. Gelbard, then U.S. Envoy to BiH, sent the following letter to Bosniac President Izetbegovic:

*Dear President Izetbegovic:*

*In recent days, President Krajisnik conveyed to your office a revised set of designs for the Republika Srpska (RS) version of the temporary currency coupon. In his written proposal, he also accepted in full the Croat version of the Federation Designs.*

*We believe that the new proposal is reasonable and fully consistent with the central bank law and the Dayton Agreement. The valid objections of your side have been taken into account, leading to removal of six personal images and the shield with the "4 S'S" from the previous RS designs. The RS flag and Coat of Arms remain. Unlike the shield, these are official RS insignia, which we find to be beyond reasonable objection. The Central*

*Bank Law contemplated distinctive features on the respective sets of designs. Names of the entities were prohibited, but official insignia were not. The required common elements, including the promissory sentence of the Central Bank of Bosnia and Herzegovina, were clearly stipulated and the current RS Designs adequately reflect them.*

*I understand that President Zubak has informally accepted the new proposal, and I would urge you to do the same. As you know, agreement on a temporary currency is one of the necessary preconditions for an IMF program for Bosnia and Herzegovina. The temporary currency design has already consumed too much time and energy on all sides. It is imperative that we resolve this matter promptly. I would strongly urge you to undertake to resolve this issue with your co-Presidents before the December 3 Peace Implementation Council Steering Board meeting in Paris so that it does not become an issue at the Bonn Ministerial.*

*Let me underscore that we are talking here about temporary coupons. Permanent currency will follow in due course, but it is not practicable now.*

*If these negotiations fail – and the responsibility now lies with you – the international community may decide to impose temporary currency designs. If that happens, I will ensure that any imposed designs are consistent with the Central Bank law and based on the reasonable proposals already on the table, including the latest submissions from the RS. It is only fair that no party will be rewarded for obstructing the negotiation process.*

*I look forward to seeing you soon in Sarajevo.*

*Sincerely,*
*Robert S. Gelbard*

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You are forgiven if you have forgotten that the initial notes were to be temporary coupons. The central bank law had some very unusual and specific provisions governing the new currency notes:

*Article 42 . Currency features and interim notes (Coupons)*

*1. The Governing Board of the Central Bank shall determine the face value and size of banknotes and coins in accordance with Article 7, paragraph e, of this Law. The design of the banknotes and coins shall be decided by the Governing Board with the approval of the Presidency of Bosnia and Herzegovina.*

*2. As an interim measure until a permanent solution for the design of the notes has been agreed upon, and as legal tender for cash payments, the Central Bank will put in circulation "Coupons." The Central Bank shall not issue coins as long as the Coupons are in circulation.*

*3. The Coupons will have common design elements as well as distinct design elements for the Federation of Bosnia and Herzegovina and the Republika Srpska. The two versions of the Coupons will be of the same size for a given denomination, and will have also the following common elements:*

*a. the word "Coupon" will be on the note; and*

*b. the sentence: "To the bearer of this Coupon, the Central Bank of Bosnia and Herzegovina will pay upon demand [--] Convertible Marka" will be on the note in readable terms;*

*c. the denomination of the coupon will appear in highly identifiable numbers on both sides of the note;*

*d. as a technical security feature, the Coupon will bear serial numbers.*

*Both versions of the coupon will have equal status as legal tender throughout the territory of Bosnia and Herzegovina.*

*4. The Federation of Bosnia and Herzegovina and the Republika Srpska will each have its own design features on the Coupons. The design of the notes shall be fully consistent with the Dayton Treaty and will not include elements offensive to the other Entity. The text on the Coupon may be written in different alphabets at the choice of the Entities, one being in the Cyrillic alphabet and the other in the Latin alphabet. The names of the Federation of Bosnia and Herzegovina and the Republika Srpska will not appear on the Coupons.*

*5. The Governing Board of the Central Bank will undertake all the necessary endeavors to ensure that the Coupons will be available for circulation in both the Federation of Bosnia and Herzegovina and the Republika Srpska within three months from the adoption of this Law.*

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This provision was not in the draft we had originally proposed. It was one of those last minute additions in the final round of discussions with the U.S. Treasury that I was not part of. I disliked the idea of coupons for a variety of reasons. Its purpose, I assume, was to make it easier for the three groups to agree on a design, knowing that it could be replaced down the line. In short, it was a potentially useful psychological tool, like the interim agreement on the assets and liabilities to be transferred from the NBBH to the CBBH that was accepted in August 1997. After agreeing to an interim design, it would be easier later to agree on a permanent design (there is no such thing anyway)—perhaps by simply agreeing that the interim design would be made permanent.

Mr. Gelbard's December deadline for agreement on the note designs was not met. In February 1998, the new CBBH governor, Peter Nicholl, took the latest set of objections

from each side to the current round of proposals and unilaterally decided which he felt were justified and which were not. After his Board could not agree to act, he submitted the resulting designs to the Office of the High Representative. The High Representative approved the design and presented it to the Joint Presidency. Before the notes were printed, the OHR ruled that they were banknotes rather than "coupons" and the word "coupon" was removed from the design. This permitted the CBBH to introduce coins, which was forbidden by the Law "as long as the Coupons are in circulation."

This proved to be a very well timed intervention. No one really objected. We knew very well that it would be impossible to force any of our counterparts to take actions or participate in actions they strongly opposed. Consider how long it had taken to open the Mostar Main Unit. There were times when it was politically difficult for the three groups to explicitly agree to something they might otherwise find acceptable. At these times, an externally imposed decision might be acceptable (and probably welcomed). This was one of those times.

The delay in introducing banknotes was potentially dangerous. Until the currency notes were introduced, the balance sheet of the CBBH barely changed. In fact, if you exclude the capital that the BiH government paid in to the CBBH from the proceeds of its first loan from the IMF, the foreign assets of the central bank (and its monetary liabilities) where a bit lower in June 1998 than when it opened ten months earlier. This was a source of considerable nervousness within the CBBH. Tensions between the regions, even within the CBBH, remained high. The Comptroller General of the CBBH and others in senior management were increasingly expressing concern about some banks that were consistent net buyers of DM from the Central Bank. The Comptroller General seemed to be hinting that restrictions should be placed on such withdrawals, which gave me considerable concern.

The new banknotes were first issued on June 15, 1998 and the Bosnia and Herzegovina Dinars were demonetized June 30, two weeks later. The introduction of the new notes and the redemption of the old BH dinars went relatively smoothly and the CBBH was finally, fully established and operating in all areas of the country. The concerns of that first year melted away quickly. Thus almost four years later, when a new 200 KM note was introduced, it had only one version for both the Federation and the RS. The single design was approved by the CBBH board without controversy. I congratulate them for that. I am also amazed and pleased to learn during this visit that many people here are no longer aware that there are two versions of all notes (except for the new 200 KM notes).

## The Payment Bureau Problem

The other potential deal breaker was the payment bureau system, and the three payment bureaus that had formed during the war by splitting from the country wide bureau. These remnants of the old Yugoslav SDK were unique and powerful institutions. The payment bureaus had monopolies in their respective areas on making "domestic" currency payments for bank customers. This deprived banks of one of their central functions and

gave the government, through the bureaus, incredible information on and control over economic activity (via the related payments).

As already noted in connection with the NBBH problem, the Sarajevo payment bureau, the ZPP, had played an essential role in forcing the CBBH to violate currency board rules. While the ZPP actually had no deposit liabilities of its own, it had control over the flow of funds between bank accounts. It had a system of shadow, or giro, accounts that looked like real deposits but weren't. The public actually thought they kept deposits with the ZPP when they were really with their banks. The ZPP ran a bookkeeping system and had no real deposits. The war time German mark deposits with the bureaus were a temporary exception.

None-the-less, the payment bureaus were wealthy and powerful and employed a lot of people. It is understandable that they were not eager to give all that up. But the payment bureau system was an anomaly not found in market economies and the payment bureau management knew that. They knew that the old system would have to be replace, but they fought to preserve as much of a payment role as possible. We foresaw the payment bureaus becoming privately owned clearing houses for small value payments.

In addition to permitting banks to provide payment services directly to their customers, it was essential for the CBBH to have full control over banks' settlement accounts. We had two important reforms in mind. The first was to consolidate the required reserve and settlement accounts (accounts 201 and 620) into a single reserve account. This would be combined with a revision of the reserve requirement that would allow it to be satisfied on an average rather than a continuous basis.

The ZPP had no problem "transferring" the 201 account fully to the CBBH, but they were not willing to consolidate the two, which would mean also "transferring" the 620 balances to the CBBH. Preceding its opening and during the first year of the CBBH, we fought long and hard with Maruf Burnazović and his team over this issue. The second reform, which was more revolutionary and dangerous for the ZPP, was to permit banks to send the payment instructions for the use of their reserve accounts at the central bank directly to the CBBH (rather than through the ZPP or the other payment bureaus). This would lay the groundwork for the subsequent full take over of control of interbank, or so called large value, payments by the central bank. It clearly foreshadowed the dramatic reform, if not the demise, of the payment bureaus.

At the end of the day, however, the old professionalism of the ZPP staff and management won out. The payment bureaus had been efficient in their way and they had pride in their ability to deliver. Without Maruf's cooperation and his staff's hard work, the CBBH would not have opened successfully on Monday, August 11, 1997. The staff of the ZPP had made the accounting changes necessary to close out the 201 and 620 accounts and to establish opening balances for the new account at the CBBH. His team worked hard over that weekend to produce the numbers and technical changes needed and the CBBH open on time and settled the system's net payments without serious difficulty.

Rather than attempting to transform the ZPP, Mostar ZAP, and the SPP into modern clearing houses, the CBBH decided to build its own large and small value systems to replace the existing structures all together. The challenging job of developing and implementing the new CBBH operated interbank system was overseen by Kim Rhee, an IMF financed expert of enormous skill, energy, charm and effectiveness. Kim, also with us here today, had worked with me in Bulgaria, Moldova, West Bank and Gaza Strip, and Croatia and subsequently in Kosovo, where she is now the Managing Director of the Banking and Payments Authority of Kosovo (BPK). The primary technical assistance behind the interim and ultimate clearing and settlement rules and operations where provided by Len Fernelius, the retired Senior Vice President of the Federal Reserve Bank of Minneapolis. Len, also an IMF financed expert, had work with me in Croatia and subsequently worked with me in Kosovo and still later in Serbia.

The CBBH has implemented two systems, a real time gross settlement system (RTGS) for time critical payments and a net settlement automated clearinghouse (small value) system. The new CBBH operated systems went live January 5, 2001 and have operated smoothly there after. They completely replaced the old ZPP, ZAP, and SPP systems and returned the role of providing payment services to banks.

## Conclusion

The CBBH has continued to develop its capacities. The public's acceptance and confidence in its currency has grown significantly. One of the most dramatic demonstrations of that confidence, to my mind, was the fact that when German mark bank notes held by the public in Bosnia and Herzegovina were converted at the beginning of last year, about one third of the total of DM 4.3 billion was deposited in local banks, one third was exchanged for KM bank notes and only one third was kept as foreign currency (Euro).

The success of the CBBH that we celebrate today can only be fully appreciated by remembering the difficulties that it had to overcome in its beginning and early years. The CBBH has developed into a solid foundation for the economic rebuilding of Bosnia and Herzegovina. It has also contributed impressively to the rebuilding of trust and cooperation between Bosnia's ethnic groups, a job far from finished. It has helped demonstrate that with a level playing field, cooperation, and fair economic competition can serve mutual self-interests. It is a great honor for me to be here to celebrate this great accomplishment with you.