

Benoît Cœuré: The use of local currencies in EU candidate and potential candidate countries

Speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the International Conference on the occasion of the 20th anniversary of the Central Bank of Bosnia and Herzegovina, Sarajevo, 22 September 2017

Dear Governor,

Dear Member of the Presidency of Bosnia and Herzegovina,

Dear Chairman of the Council of Ministers of Bosnia and Herzegovina,

Dear Ambassador,

Dear colleagues from the central banks,

Ladies and gentlemen,

I am delighted to be here in Sarajevo today to celebrate the 20th anniversary of the Central Bank of Bosnia and Herzegovina (CBBH). I would like to thank Governor Softić for the invitation to speak to you on this occasion.

When the CBBH was founded in 1997, people in western Europe were still paying with their national currencies. The ECB did not yet exist and there had not even been a decision on which countries would eventually participate in monetary union from its launch. For a European central banker, this almost feels like ancient history. The past 20 years have been too hectic, too exciting and too eventful to fully appreciate the passage of time.

So significant birthdays are always a welcome opportunity to take a step back and consider what has worked and what has not. And for the CBBH, like for many other central banks, there can only be one yardstick to measure success: the achievement of monetary stability, the primary objective of the CBBH. And looking back over the past 20 years, you clearly have delivered on your mandate. By effectively implementing the currency board arrangement, you created trust and confidence in the currency and you were able to secure this confidence over time. I would like to congratulate the past and present management and all staff of the CBBH for this success over the past 20 years.

Your achievements are particularly remarkable when seen in the light of the challenges you have faced in implementing the monetary framework. A small, open economy like Bosnia and Herzegovina, where total merchandise trade

accounts for more than two-thirds of nominal GDP, is constantly exposed to foreign shocks that are often hard to anticipate. This is a demanding environment for central banks, in particular when several shocks hit the economy at the same time, as has been the case in recent years. In fact, it is probably fair to say that the global economy was in almost constant flux following the outbreak of the financial crisis ten years ago. Here in Europe, of course, and in the euro area in particular, we faced significant challenges that required unprecedented action by central banks and governments.

So the current resilience and broad-based strengthening of the global economy represents a welcome change for policymakers, here and in many other parts of the world. An increasing number of economies, across both advanced and emerging markets, are benefiting from the recovery. Unemployment has fallen to pre-crisis levels in many countries. And the broad stabilisation of oil prices has reduced the strong disinflationary pressures that were putting additional downside pressure on headline inflation at a time of economic hardship in many regions around the globe.

The euro area too is now contributing to global growth, rather than subtracting from it, in large part thanks to the range of monetary policy measures taken by the ECB in recent years. This is certainly good news for Bosnia and Herzegovina, where exports to the euro area account for more than half of total exports.

Making the cyclical recovery sustainable

At the same time, the current global cyclical recovery also harbours risks – risks of complacency and inaction. Despite the encouraging upturn in growth and the shift in consumer and investor sentiment, some of the more fundamental obstacles to sustainable growth have not disappeared. In the euro area, for example, there is still considerable scope in all Member States to improve the range of economic, social and legal frameworks that shape the conditions in which households and businesses operate. We should not allow ourselves to succumb to the false impression that the current cyclical recovery will heal all wounds.

Deep-seated structural reforms are needed to boost potential growth, raise productivity, increase resilience to shocks and, ultimately, foster sustainable real convergence among Member States. In a speech in Brussels a few months ago, I highlighted the clear empirical relationship in Europe between the quality of institutions and GDP per capita.^[1] This means that sustainable growth requires unflinching policy efforts to ensure that our institutions are fit for purpose.

In a globalised world, where we are more likely than not to be directly affected by the actions of others, this is probably true for all countries, whether inside or outside the euro area or the EU. What the EU offers, however, is a framework to overcome common global challenges together, as long as all Member States play by the rules. For candidate and potential candidate countries this means that adopting suitable economic and legal

structures and putting in place the appropriate institutions in good time will allow many of the benefits of EU membership to be frontloaded.

This also applies to central banking. The ECB, and in fact the entire European System of Central Banks (ESCB), supports central banks in the region on their path towards joining the EU. While the ECB plays no formal role in the EU accession process, it contributes in its areas of competence. As you know, we maintain close relations with central banks in candidate and potential candidate countries, which will eventually become part of the ESCB and later the Eurosystem.

Through technical cooperation, we also support central banks in building and enhancing institutional capacity. This may take the form of EU-funded programmes, twinings with ESCB national central banks or regional workshops and seminars hosted by the ECB. The CBBH was one of the first beneficiaries of such technical cooperation in the region through EU-funded and ECB-coordinated programmes in 2007 and 2010-11. These programmes also involved many EU national central banks and are remembered as being very successful.

In addition, the ECB contributes to the assessment of the Economic Reform Programmes of candidate and potential candidate countries as part of the EU's economic and financial dialogue with applicants. Here the ECB naturally focuses on monetary and exchange rate policies and financial stability. Our views then feed into the joint conclusions of the economic and financial dialogue between the EU and the Western Balkans and Turkey.

This year the ECB recommended that countries take five main actions: (i) adopt and implement comprehensive non-performing loan (NPL) resolution strategies; (ii) strengthen the use of local currencies; (iii) expand the analytical and policy toolkits of central banks; (iv) reinforce the medium-term orientation of fiscal policies; and, finally, (v) improve the overall business and institutional environment, with a view to reducing external vulnerabilities, among other things.

Many of these recommendations also apply to current EU Member States, as I alluded to before. In particular, low productivity, together with large stocks of NPLs and sovereign debt, remain a drag on growth in large parts of the euro area. Also with respect to the third recommendation, on expanding the policy toolkit of central banks, the ECB is no exception. The environment of low interest rates and low inflation forces us to constantly review and upgrade our analytical toolkit to ensure we take the best possible decisions in our pursuit of price stability.^[2]

Unofficial euroisation as a policy challenge

Let me therefore spend a few minutes on the one recommendation that is specific to candidate and potential candidate countries, albeit not uniformly to all, namely that the use of local currencies be strengthened.

As you know, the high degree of unofficial euroisation is a striking feature of the banking systems in the Western Balkans. In the region as a whole, on average 56% of total loans and 52% of total deposits are denominated in, or

indexed to, foreign currencies, in most cases the euro.^[3] This phenomenon, also known as currency substitution, is driven by many factors, such as low confidence in the domestic currency, which is often the result of not-so-distant memories of monetary instability.

Another factor relates to the fact that the risk premium on loans in the domestic currency is higher, thereby providing an incentive to take out foreign currency loans. Lower funding costs, in turn, are often supported through strong integration with the euro area via trade and financial channels, but also via migration and remittances, which contribute to the holding of bank deposits in euro. All this is conducive to widespread unofficial "euroisation".

But a high degree of foreign currency use also has serious drawbacks. For example, unofficial euroisation, while being a sign of trust in the euro as a stable store of value, constitutes a financial stability risk in the event of sudden and substantial exchange rate fluctuations. Households and firms may suddenly no longer be able to service their foreign currency-denominated debt, creating credit risk for banks. The same holds true for dollarisation in other parts of the world, as the Asian financial crisis vividly demonstrated.

Unofficial euroisation also impedes monetary policy transmission and may limit the overall room for manoeuvre of monetary policy. In Albania and Serbia, for instance, where central banks have adopted inflation-targeting frameworks, exchange rate flexibility remains relatively limited as policymakers are mindful of adverse balance sheet effects resulting from sudden and substantial exchange rate fluctuations. In countries that have opted to stabilise the exchange rate in the first place, such as Bosnia and Herzegovina, maintaining the credibility of the framework remains central to keeping financial stability risks contained.

Prospective EU countries that have their own legal tender and monetary policy have recognised these risks and constraints, and are thus making efforts to promote the use of the local currency, in line with the ECB's recommendations. This is certainly not an easy task. Success crucially hinges upon the track record of the domestic monetary authority in maintaining monetary stability. To this end, central banks in the region have made laudable progress in recent years. Efforts need to be channelled towards extending this track record.

History teaches us that central banks' success in sustainably maintaining confidence in the currency critically hinges on two elements: political independence and a clear mandate. The ECB was successfully built on these principles. Independence and a clear stability-oriented mandate ensure that central banks are not overburdened with pursuing other, potentially conflicting objectives, and that monetary policy makes the best possible contribution to growth and employment. They are therefore also a necessary condition for strengthening the use of local currencies.

Experience in other regions of the world – in Latin America, for example – suggests that targeted prudential measures as well as deeper local capital

markets in domestic currency can reinforce the use of local currencies.^[4] Such advances should ideally be embedded in a carefully designed comprehensive strategy involving all relevant stakeholders. Serbia adopted such strategies in 2012, and Albania has done so more recently, while other countries have started to put in place measures of this nature or are considering designing similar strategies.

So progress is clearly visible, in particular on the lending side, but more remains to be done. There are certainly no quick fixes, as currency substitution tends to be a sticky phenomenon. But the drawbacks of unofficial euroisation deserve policymakers' attention. The expectation that countries will at some point join the EU, and eventually also the euro area, should not divert attention from such policy efforts.

Conclusion

Remaining challenges, however, should not distract from past achievements. So let me conclude by congratulating you once more on the impressive track record that the CBBH has built up over the past 20 years.

The ECB will continue to offer technical cooperation and advice whenever possible, and we will accompany you and other central banks in the Western Balkans on your journey towards the EU. We look forward to our future work with colleagues from the region, including you, Governor Softić, and the Central Bank of Bosnia and Herzegovina. I wish you and your colleagues all the best for the next 20 years and beyond.

Thank you for your attention.