

KOSOVO EXPERIENCE WITH EUROIZATION OF ITS ECONOMY

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Ladies and Gentlemen,

I am very grateful to our hosts, Bank of Albania, for their kind invitation to this Fifth International Conference. I am honored to represent on this forum, Banking and Payments Authority of Kosovo, one of the youngest financial supervision and “central banking” institutions in the Balkans.

Banking and Payments Authority of Kosovo (BPK) was established by UNMIK in 1999 to oversee the implementation of the monetary and financial framework, to foster an efficient and safe payment system, and back the development of a sound financial sector in the territory of Kosovo. Initially, in November 1999, BPK’s immediate objectives were bank supervision and provision of payments services, which included supplying an adequate quantity of banknotes and coins.

Later on, the BPK’s role was enhanced and expanded to include licensing, supervision, and regulation of all financial institutions (including insurance and pension funds), in line with a trend initiated by the UK, and the creation of the Financial Services Authority.

1 CHANGEOVER CHALLENGES

A) Adaptation of DEM

One of the many challenges that Kosovo faced after the conflict was to choose a monetary framework. Given the massive rush towards foreign exchange cash holdings and the vanishing of the Yugoslav dinar as a medium of transactions, it was not surprising that, in September 1999, by one of its first Regulation “On the currency permitted to be used in Kosovo”, UNMIK legitimized the use of the Deutsche mark and other foreign currencies in Kosovo.

In fact, it was Kosovo’s population that adopted Deutsche mark as its common currency. UNMIK Regulation merely identified the Deutsche mark as the currency in which the budgets, financial records and accounts of public bodies, agencies and institutions, and UNMIK itself, were to be formulated. At the same time, Regulation offered freedom to the parties to any contract, or any other voluntary transaction, to denominate such transaction in any widely accepted currency agreed upon by them. Furthermore, Regulation removed all foreign exchange controls and restriction, on the possession, use, or disposition of any currency, whether in cash or in a bank account, whether situated inside or outside the territory of Kosovo.

The Deutsche mark was adopted unilaterally, as the de facto legal tender currency of Kosovo, and this did not involve any negotiations with the Deutsche Bundesbank or European Central Bank at that time. The adoption of the Deutsche mark, and subsequently Euro, was not accidental. It followed two decades of extreme monetary instability, accompanied by a high degree of unofficial use of the Deutsche mark as a store of value and medium of exchange. In the pre-conflict period, Deutsche mark was the most widely used foreign currency; there were significant amounts of physical cash already in circulation. Population was familiar with the currency. The Kosovar Diaspora remittances, estimated at over 500 million euro in 2002, had been generating a regular and significant flow of money into Kosovo for years. These inflows were almost entirely made in form of physical cash. After the end of the conflict, in absence of banking facilities in Kosovo, most of direct foreign assistance also necessitated physical cash inflows.

At the time when UN assumed administration of Kosovo, the adoption of a monetary framework anchored by the use of the Deutsche mark presented itself as a natural choice. The use of a stable currency was pivotal in maintaining macroeconomic stability and played a critical role in rebuilding people's trust in the financial sector. It was also designed to provide a critical support for an outward-oriented development strategy, which was a necessity more than a choice, given the size of the domestic market.

B) Conversion from DEM to Euro

When the replacement of legacy currencies by the Euro in the Euro zone countries was carried out in early 2002, it also became necessary to replace Deutsche marks in Kosovo. The BPK was entrusted to take the lead on this project, with the aim to ensure a smooth and safe changeover to the Euro, at the lowest cost as possible. Unreserved support for the project from UNMIK and EU provided the necessary and strong help in changing and approving the essential legislation.

In contrast to the "adoption" of the Deutsche mark as the principal currency in Kosovo in 1999, or to better describe it – legalizing its already wide usage - the transition to Euro had to be carried out in cooperation with European Central Bank, as well as some national central banks in the Euro zone. Indeed, introducing Euro notes and coins had to be performed with the help and assistance of countries of the Euro zone.

The particular circumstances faced by the authorities in Kosovo presented various challenges in preparing for the withdrawal of the Deutsche mark and the injection of the Euro. The high degree of cash orientation in the economy meant that there was no direct way to estimate the volume of Deutsche marks in circulation and consequently its distribution by denominations. Based on the decisions taken by the ECB, allowing the non-Euro zone Central Banks frontloading of Euro banknotes and coins from the beginning of December 2001, the BPK decided that about 100 million euro was to be frontloaded before the 1st of January 2002.

2 BENEFITS OF EUROISATION

A) Support For The Development Of The Financial Sector

Euroisation supported the development of Kosovo's financial sector, which had to be created from scratch after the conflict. At the beginning, there were no banks in Kosovo and virtually all transactions were settled in cash. For nearly two years in fact, there was no financial sector in Kosovo, and the only financial entity, Micro Enterprise Bank (MEB), specialized in micro credit. The next two years, however, witnessed a rapid development of the financial intermediation in Kosovo, especially of the banking sector. Between March and November 2001, six banks were established, bringing so much needed competition into the sector.

In 2002 and 2003, Kosovo's seven commercial banks expanded significantly. Given the small size of Kosovo's economy and population, and the bad experiences with banks in the recent past, Kosovo's financial system is characterized by a strong participation of foreign entities. European commercial banks, together with Development Agencies and other financial institutions, have become the majority shareholders of Kosovo's two largest banks. American Bank of Kosovo was created by capital participation from the USAID in November 2001, and was sold in early 2003 to Raiffeisen Bank, from Austria. MEB was rebranded as ProCredit Bank in August 2003. The other five banks have local entrepreneurs as their majority shareholders.

At the end of December 2004, Kosovo's financial system was composed by 7 banks, operating through 247 offices, 14 micro finance institutions, 3 other non bank institutions, 7 insurance companies and 1 Pension Saving Trust. Kosovo's banking system covers a wide geographical area. There is one branch for approximately every 9 000 inhabitants, far to developing countries, where there is one branch for every 1 500 inhabitants. The total assets of banking institutions amounted to 700 million Euro as of December 2004, equivalent to 40% of GDP. The banking system's capital was 45 million euro at the end of 2003. All Kosovo banks comply with, and most already exceed, the minimum required amount of capital, which BPK

increased to 4 million euro in December 2003, bringing it more in line with the EU directive of 5 million euro.

B) Reduction of Cash in Circulation

Reduction of cash in circulation was one of the main objectives of the BPK. The changeover itself provided a unique opportunity to reach this objective and simultaneously assist in strengthening of the banking system. The BPK planned on exchanging household amounts of up to 1,000 Deutsche marks per individual free of charge, and levy a fee of 2% on amounts between 1,000 and 10,000 Deutsche marks, that was also the maximum amount of cash exchange allowed. Amounts exceeding 10,000 DM had to be placed as Euro bank deposits. At the same time, every effort was made to facilitate the role of retail establishments in withdrawing the Deutsche marks from circulation through a natural process.

By announcing upper limits on the amounts of exchange, as well as clearly setting final date of dual currency circulation period, cash holders were strongly encouraged to deposit their money at the banks, instead of taking a risk of not being able to exchange it in time. This strategy was accompanied by incentives from banks, offering now improved and diversified services, to attract new customers to open accounts. Although this scenario looks simple, its implementation presented some problems. The main, of course, was an on-going lack of confidence in the banking system. This was further aggravated by a still limited access to the banking facilities. At this time, Kosovo's commercial banks had at their disposal only 24 offices, whereas the BPK operated through a network of 23 offices, of which more than a half were small, local agencies opened only during limited hours, and 7 mobile-bank teams. Nevertheless, the three months period prior to the cash changeover saw an increase of nearly 300 million Euro in bank deposits. Today, total bank deposits stand at approximately 600 million euro. However, Kosovo's "currency in circulation"-to-deposit ratio, of somewhere in the region of 75 to 85 percent, is still one of the highest in the world.

The euro cash changeover was successfully completed on 28 February 2002. So, from that moment, Kosovo's economy has been

effectively fully “euroised” as well. Euroisation is often defined as the adoption of the Euro as legal tender and official currency by the Authorities of a country outside the Euro zone. This definition also implies that the Authorities decided to relinquish their monetary policy instruments and abandon their national currency. I need to stress again that Kosovo’s post-conflict circumstances were, and still are, rather specific, both politically and economically. Taking into consideration the widespread unofficial use of the Deutsche mark and its role, already well exceeding what could simply be called as parallel currency, UNMIK accepted this choice as a “fait accompli”.

C) Monetary Stability

At the time when Kosovo opted for Euroisation, annual inflation stood at over 40%. Its official currency (the dinar) was totally discredited and its use was almost non-existent. UNMIK was not merely replacing a discredited national currency, it was putting in Kosovo a sound monetary foundation necessary for the economic, social and political reconstruction in the years to come.

Inflation in Kosovo did not disappear immediately following introduction of the Deutsche mark, and subsequently the Euro. In 2000-2001, Kosovo recorded double-digit inflation, fuelled by massive foreign aid and private inflows. Subsequently, inflation decelerated sharply and is now below the average Euro zone inflation. Of course, there are other contributing factors than Euroisation, such as high unemployment and low economic activity.

Adopting Euro as a national currency brought also monetary stability to Kosovo. The risk of devaluation of the national currency was removed. The BPK, who acts as a fiscal agent to the local administration, does not run exchange risk, while managing the official reserves. These reserves are invested primarily within the Euro zone countries, at Central banks, and at highly rated financial institutions. Economy of Kosovo does not face a significant exchange risks. By the same vein, Euroisation has prevented Kosovo for double currency exchange rate, the legal one and informal one. This should eventually lead to lowering cost of borrowing and increasing investment, stimulating economic growth and welfare.

Unlike inflation differentials between Kosovo and the Euro zone, interest rate disparity continues to be significant. While the bank deposit rates quickly came down to the Euro zone levels, loan interest rates continue to be higher. Loan interest rates hover at around 9-14 percent and are higher than in most western countries, while deposit rates are now down to around 2½-4 percent. The contributing factors here are the level of the risks faced by lenders, among which a continue lack of reliable accounts, a weak legal framework, as well as the uncertainty of the status of Kosovo.

D) Reduction of Transaction Cost

Introduction of Euro simplified and significantly reduced transaction costs, especially when we consider the importance of trade within the Kosovo economy. The neighboring countries, predominantly the former Yugoslav republics, remain Kosovo's main trading partners. However, the Euro, like the Deutsche mark before 2002, is also widely used in the region. Significant trade balance deficits, running at around 85% of GDP in 2003, continue to be worrisome in Kosovo. At the moment, these deficits are being covered by remittances and donors assistance, but with an increasing risk of both of these sources reducing gradually in the coming years, the issue has to be urgently addressed.

E) Macroeconomic Stability

Euroisation in Kosovo had also some long term political objectives. It is considered by many as "irreversible". Euroisation is expected to foster macroeconomic stability, solve the credibility problem, but mainly enhance fiscal discipline by eliminating the possibility of printing money to cover fiscal deficits. Over a longer period of time, when other conditions are also met, it should lead to increased foreign direct investments.

Generally, Euroisation is expected to foster economic integration of the Euro adopting country with the economy of the issuing country, in this case the whole Euro area. More often than not, the adopting country already has strong economic or political ties with the issuing country. Euroisation in Kosovo did not follow this pattern, as it was

a direct result of political and economic disintegration of the former Yugoslavia, and of the United Nations intervention. But looking into the future, it should eventually lead to speed the full integration of Kosovo into the Euro zone.

F) Cost of Euroisation

Euroisation, while having positive effect on the economy as a whole, also brought some costs. Even if we exclude the cost of the initial euro cash changeover, the loss of income from “seigniorage”, and the opportunity cost of holding cash reserves for the Central bank, adds to a sizeable amount. Nevertheless, the costs could be considered affordable, compared with the advantages provide by Euroisation.

In the past few months, the BPK has initiated a dialog with the ECB, which has brought to the signing of a MOU between the two Institutions. This MOU alleviates the BPK with part of the financial burden related to the transportation of Euro banknotes and coins in circulation in Kosovo. As a direct result of the previously mentioned level of remittances and their cash nature, Kosovo has been a net exporter of euro banknotes since mid-2002. I can also add that even with our strict cross border cash flow controls, we tend to process more banknotes, and even coins, that could be reasonably expected in a small economy like Kosovo’s. I would welcome some further discussions with our neighbours on this subject, as it may help us all to solve this problem over a longer term.

The final remark that I would like to make on costs of Euroisation, relates to what all central bankers worry about, that is the possibility of one of the banks under our supervision developing liquidity problems. Following the unilateral adoption of the Euro, a Central bank is facing more constraints to perform its lender functions. Nevertheless, in the context of a unilateral adaptation of the Euro, it is thinkable for a Central bank to provide liquidity to commercial banks, but not to a large extend, due to the challenge for such a Central bank to lend more than its own funds.

We all understand that a failure of one institution, in a fragile environment that we work in, could quickly spread out and threaten

the solvency of the whole, otherwise sound, banking system. Our approach to this problem is twofold. We maintain readily available cash reserves that might be used in exceptional circumstances, but primarily we concentrate our efforts on safeguarding the system against such an eventuality. We do it through a very rigorous, thorough and meticulous supervision.

In conclusion, if Euroisation has not solved all the financial problems in Kosovo, and if Euroisation has brought constraints to conduct an independent monetary policy, its advantages are definitely positive, mainly because the use of Euro has participated to the stability of the financial sector.

Thank you very much for your attention.

