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Monetary Policy Issues in Post Conflict Economies

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I. INTRODUCTION

Post conflict environments differ considerably depending on the factors that started and brought conflict to an end, the extent of damage to infrastructure and institutions, and the nature of post conflict governance. Many post conflict countries suffer from ethnic and/or religious divisions and animosities deepened by civil war (Bosnia and Herzegovina, Kosovo, Afghanistan, Iraq). Since the collapse of the Soviet Union, all post conflict territories that have received assistance with their reconstruction from international financial institutions have sought to establish or reestablish market based economies to varying degrees. Most had relatively highly centralized economies prior to the conflict. Thus reestablishment of essential monetary and financial functions generally involved a mix of reconstruction and reform/modernization. The conditions in which reconstruction and reform must be undertaken are rarely idea. They are often very far from ideal. These initial conditions and the society's desires for reform condition a country's reconstruction and development strategy.

Monetary arrangements and policies potentially contribute to nation building in several important ways. The provision of currency and overseeing the banking system and the means of payment are traditional state functions. The successful provision of a stable currency and the promotion of efficient means of payment lend credibility to the state. A single, national currency can provide a unifying national symbol, which can contribute to a sense of national identity. Policies that establish a stable and predictable value for the currency facilitate economic recovery and development and the efficient allocation of resources. A stable currency and efficient payment systems[2] contribute to the ability to engage in commerce throughout a country, which contributes to nation building. Stable currency is also a reflection of the rule of law and contributes to confidence in the state. The failure to achieve these objectives undermines recovery and economic development but because of their highly visible and fundamental nature as basic functions of states such failure can undermine efforts to establish or reestablish a credible state more directly.

The core monetary and financial functions that are needed for the restoration of economic activity and growth are the provision of a stable unit of account, the means of payment by government, firms and households, and financial intermediation (borrowing and lending). The economy can not function well without money, its own or some one else's. If it issues its own currency, it must have policies and capacities for controlling its value. To some extent at least, the economy must have the facilities to receive, payout, and safe keep

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[2] Payment systems are the means by which the ownership of monetary value is ("money") is transferred from one person to another. These include the clearing and settlement of checks, payment orders, money orders, credit or debt transactions such as with VISA or American Express, ATM transactions, direct deposits of payrolls and pensions, etc.).

money. These services are generally provided by banks, which also provide non cash payment, and financial intermediation services.

One of the first needs of every post conflict government is to pay its employees and pensioners and eventually to meet its other financial obligations domestically and abroad. The success with which the economy's longer run development or reform goals in the money and financial area are met in terms of speed and cost will depend on how well the emergency measures it must take to fulfill the above core function fit with longer run goals.

Drawing on the experiences of Afghanistan, Bosnia and Herzegovina, and Kosovo, and to a lesser extent on East Timor (now Timor Leste), Serbia, and West Bank and Gaze Strip, this report sets out the key issues that need to be addressed when restoring and reforming monetary and financial functions in post conflict economies and the lessons learned from the experience of the last decade. The report is organized as follows: Section II summarizes the monetary and financial issues that must be dealt with in post conflict economies. Sections III – V present more detailed case studies for Bosnia and Herzegovina, Kosovo, and Afghanistan. Section VI concludes with broad lessons of these experiences for future assistance in rebuilding the monetary and financial systems of post conflict economies.

II. Monetary and Financial Issues in Post-Conflict Reconstruction

Initial post conflict efforts must of necessity focus on the most urgent needs. Emergency measures may be needed to provide the public with food and water and/or the financial means to acquire them. Measures may also be needed to restore electricity or other sources of heating and lighting, sewage and other waste disposal, and telecommunications. In Iraq, for example, it was initially very difficult for aid workers to schedule meetings because Iraqi phones were not working. In the monetary and financial areas the core urgent needs are to have a currency and the means to use it. If the state, whether a continuing one or a new one, cannot meet its payment obligations to its employees and the public, the public and the economy will suffer as will the credibility of the government. The decisions taken with regard to how best to fulfill the emergency need to make payments will heavily influence the options available for subsequent reform and development of the monetary and financial systems. This is elaborated below with regard to the choice of currency and the development of the banking system.

A. Currency Choice

Existing currencies

In the medium term, nation building will be best served with respect to currency choice by the adoption of a currency whose value can most easily and reliably be stabilized and maintained. This might be a foreign currency with a historically stable value or a national currency issued and controlled by a central bank in accordance with well defined and predictable rules. However, in the initial months following the end of hostilities the authorities have no choice but to use whatever currencies are already available and being used. With the exception of Timor Leste, the currencies and payment arrangements in place at the end of war in the countries reviewed here were functional for some time and thus required no emergency measures.

In **Kosovo**, where the vaults of the regional branch of the National Bank of Yugoslavia had been seriously damaged and where not accessible, the authorities and public had to rely on German marks, which were very widely used anyway. The lack of coins was initially a problem, which rectified itself over a number of months as the result of merchants and visitors carrying in large amounts of German mark coins. The strong political desire of the Albanian majority to replace the Yugoslav dinar with a currency of their own could not be permitted by the UN administration, because Kosovo formally remains a province of Serbia. Similar considerations keep the Palestine Monetary Authority from issuing its own currency.

In **Bosnia and Herzegovina**, the German mark was also widely used, but the Croat majority region also used the Croatian kuna and the Serbian majority area also used the Yugoslav dinar. Neither of these areas issued a currency of their own, whereas in the Bosniac majority region a central bank had issued a currency fixed to the German mark. These Bosnian dinars were in poor condition and deteriorating but most transactions were made in German marks. Small changes in shops often took the form of candy or gum. Continuing with the arrangements in place for several years did not prejudice the later introduction of a new national currency under currency board arrangements.

Afghanistan had several currencies in use: older and newer notes issued by the central bank in Kabul and by the central bank in exit in the North, as well as unauthorized notes issued by a northern war lord that circulated as legitimate in the north. It also had an extensive network of money changers who also provided payment services in a variety of currencies (U.S. dollar, Pakistani rupee, Iranian rial and the Afghani). Counterfeiting was a concern. Use of the U.S. dollar immediately would have been very convenient and had much to recommend it; however, it might have made its subsequent replacement with a new national currency more difficult. The government had to sell dollars to buy existing Afghanis for its budget expenditures.

Serbia used its own Yugoslav dinar, which had been introduced a few years earlier following a hyperinflation, but it was not freely convertible. German marks were widely held as a store of value.

With the exception of Serbia and Kosovo (which technically remains part of Serbia) and Timor Leste, all of these countries issued new currencies within six months to two years. Serbia had no reason to replace its existing currency. Kosovo was not allowed to issue a currency of any kind and Timor Leste dollarized.

The currencies already in use generally bridged the gap until new currencies could be designed, printed and issued. The more challenging problem has generally been how to make payments in these currencies. This is taken up further below.

New currency

A new currency may be needed or useful in some circumstances. The motivation for a new currency is more often the result of political rather than economic considerations. In Afghanistan and Bosnia and Herzegovina new currencies were desired to establish a clear national symbol and identity. However, in these countries a new currency was also desirable to clarify and unify the currency situation and thus to improve monetary control and economic integration.

If a new currency is desirable, the choice of a foreign currency (dollarization) rather than a new national currency is also a choice of a monetary policy regime. It imports the track record of stability of the currency chosen, which can establish currency stability immediately and without the need for domestic monetary policy capabilities. The credibility of the monetary regime is established almost immediately with a very high degree of public confidence.

Adopting a foreign currency also has the considerable advantage of speed. The foreign currency can be introduced within days or weeks, though the logistics of importing it can be formidable. If there is an existing currency that would need to be redeemed for the foreign currency, only modest time would be needed to develop the redemption and exchange rules and arrangements. The existing and foreign currencies could coexist as legal tender for some time if their rate of exchange were fixed. In Iraq, for example, dollars were used for several months until new Iraqi notes were printed. A similar approach had earlier been suggested (and rejected) for Afghanistan.

The choice of a foreign currency carries with it the choice of the monetary regime of the country that issued the currency chosen. The use of the dollar or Euro would ensure a stable value for the currency without concern for any lack of domestic data and/or capacity in the central bank. It is an automatic, market driven system, which is one its great attractions, especially for post conflict economies. Dollarization also removes any possibility for financing government expenditures by printing money. This is almost universally considered an advantage (except sometimes by Finance Ministries or parliamentarian) because the possibility of central bank lending to the government has historically often proven an irresistible temptation with well know inflationary consequences. Preceding the introduction of the Euro in Europe, all central banks joining the common currency area were required to become independent and to prohibit lending to the government.

There may be occasions, however, when external and/or supply shocks could be mitigated if the monetary authorities had the capacity to adjust the money supply rather than forcing a general adjustment in the price level. Variations in agricultural production in response to weather and of international oil prices are common sources of such shocks. But post conflict countries may be particularly prone to supply disruptions arising from damaged infrastructure and continuing insurgency as in Afghanistan and Iraq. A dollarized economy does not have this option, although the central bank of a country with its own currency may not have the information, instruments and/or skills to effectively use its control over the money supply.

Dollarization is also expensive in two ways. Its initial introduction must be paid for with "real" money, i.e. it cannot just be printed by the country that wants to use it. In addition, the country looses the seniorage income from printing its own currency.[3] In addition, dollarization, once established is not easy to reverse, though the move to a currency board is a relatively easy step from dollarization. A currency board has virtually the same inflation/discipline advantages as dollarization but allows the country to capture the seniorage profits from issuing its own currency.

Though Argentina seriously discussed the possibility of dollarization a few years before its fiscal default and consequent collapse of its currency board arrangement, no countries have take such a step in recent years with the notable exceptions of Ecuador, El Salvador and Timor Leste. Kosovo and the West Bank and Gaze Strip remained dollarized because they were not sovereign states legally able to issue their own currencies.

Introducing a currency issued by the domestic central bank has the advantages of providing a national symbol, which can contribute to the establishment of a national identity, and of generating profits (seniorage) from the monopoly issue of bank notes (or more broadly, "base money"). Aside from currency board arrangements, which are a close cousin of dollarization, the use of a national currency also provides the monetary authority with the possibility of manipulating its supply to domestic circumstances to achieve price stability or other objectives (monetary policy). This can be an advantage if the central bank is free (independent) to pursue appropriate objectives and has the capacity to effectively formulate and implement monetary policy. This is often not the case for post conflict countries.

The choice of a national currency (other than in a currency board arrangement) places greater importance on the capacity of the central bank to control its balance sheet and to evaluate economic and financial conditions in order to maintain a stable value of the currency. These issues and options are discussed below under Monetary Policy Objectives and Regimes.

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[3] Abstracting from printing and maintenance costs, the value of the monopoly on printing currency derives from the interest earned on the asset counterparts to the interest free currency issued.

New currency design, issue, and exchange

When time permits, the process of agreeing on the design of a new currency can be an important state building undertaking. The key decisions with regard to design are note size, security features (paper, ink, printing technologies, micro threads, water marks, etc.), themes (national heroes, buildings, art, etc), text, colors, durability.[4] In Afghanistan speed was of the essence and existing design work was extensively relied on with almost no discussion. However, in Bosnia and Herzegovina agreement on a “common” design for the new currency was a required and essential part of state building. Such agreement took nine month to achieve after adoption of the new central bank law, which itself took over a year and a half to adopt after the signing of the Dayton Peace Agreement. Even then the international community forced the final choice of the design but only after Bosnia’s three ethnic groups were prepared to accept an external decision. The new currency has been an important integrating and state building factor.

Other important issues include the number and amount of note denominations (1, 5, 10, 20, 50, 100 or 2, 5, 25, 100, 500, etc.), the aggregate and relative numbers of each to print initially, and the initial value of one unit in relation to typical domestic household purchases. Related decisions are whether to issue coins and the breaking point between the highest-value coin and the lowest-value bank note.[5] The value of the new unit should be simple in relation to the old currency it replaces (a round number) and have convenient purchasing power. In Bosnia and Herzegovina one unit of the new currency was exchanged for 100 of the old one and in Afghanistan one unit of the new currency was exchange for 1,000 units of the old one. A critical political decision was taken to allow the redemption of counterfeit Afghani’s introduced by northern war lords with a 50 percent discount. This was the approximate market value of these notes in Kabul.

Security features consist of those that help the general public identify the authenticity of the notes, those designed for people more specialized in detecting counterfeits (bank tellers and sorting machines) and those known only to and used by the central bank itself. An appropriately designed and targeted education program in these features must be developed and implemented. The general public needs good information not only on how to recognize the new currency, but also on how the central bank will control its supply and value. The approach taken in Afghanistan was unusual by announcing plans for the new currency and the arrangements for redeeming the old one only one month before its introduction. The short period for public education was chosen to minimize the risks of counterfeiting (especial old notes that could be redeemed for new ones). However, the program was so rushed that the

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[4] These and other aspects of note design are reviewed in more detail in the IMF Working Paper: “The Design and Printing of Bank Notes: Considerations When Introducing a New Currency” Prepared by Richard K Abrams, March 1995.
[5] *Ibid,* page 10.

planned two month exchange period had to be extended one month to ensure that all legitimate exchanges could be completed. This increased the risk of counterfeiting.

Normally the design, printing and delivery of new bank notes take one to two years. In Afghanistan and Iraq this time period was dramatically shortened by the combination of clever choices, hard work and luck. In Afghanistan the new authorities discovered that the Taliban regime had already contracted a German printer to develop new notes and that considerable work in designing them had already been done. In Iraq, the already existing pre Saddam dinars (the so called "Swiss dinars") were used with modest modifications. Printing plates for the Swiss dinar still existed and were used.

Introducing the new currency may be done in a variety of ways but generally involves some exchange of the existing currency(s) for the new one. The easiest way to introduce a new currency is for the government to start using it for all of its salary and pension payments (which are usually in cash) and for banks to pay out deposit withdrawals in the new currency after exchanging the old for the new in their vaults. Thus merchants would withdraw new currency from their banks with which to make change and would deposit old currency with their banks at the end of the day. To the extent that the exchange takes place in this gradual way, the cash distribution, storage, handling, and accounting systems in place can and should be utilized. The work can be done by domestic central bank and bank staffs with technical advice from outside.

In every instance, however, including for the exchange of national European currencies for the new Euro, designated exchange points and rules for direct exchanges have also been required. This aspect of the introduction of a new currency has required more technical assistance and some times direct involvement from outside advisors. Exchange points must be established and provided with adequate security. These might be limited to banks and/or post offices, or might also include temporary store front locations or mobile teller facilities. Clear rules for the exchange must be developed and communicated effectively to the public. These would include the hours of operation, any limits on the amounts that may be exchange cash for cash or cash for deposits, and identification documents required by the person making the exchange if any. Exchange staff must be trained, and vault, procedural and accounting safeguards and security must be reviewed and or established. It goes without saying that existing banking facilities, staff and procedures should be relied upon to the extent possible. [6] In the absence of a functioning banking system, Afghanistan used the services of money changers.

Procedures are also needed for securing and ultimately destroying redeemed old notes to ensure that they are not redeemed a second or third time. In many instances destroying the old notes effectively proved somewhat challenging. In Iraq the central bank initially accepted

[6] For a more detailed discussion see the IMF note on: "Introduction of a New National Currency: Policy, Institutional, and Technical Issues" Prepared by Richard K Abrams and Hernán Cortés-Douglas, June 1993

old notes from banks and credited their clearing account at the central bank (or paid off credit from the central bank) on the basis of a sample count. Early on it switched to full counting before the notes were burned, which took a full year to complete. During this period monetary data and banks' positions with the central bank were clouded by the fact that banks showed the return of more old notes (when sent to the central bank) than the central bank acknowledged receiving (only when counted). The destruction of old notes proved an unexpectedly difficult task in Afghanistan as well.

In some cases, such as in Afghanistan and Iraq, the security situation has posed serious challenges to every aspect of the exchange from the transportation of the bank notes from the printer to the central bank's headquarters, to the second leg distribution of cash from the central bank's headquarters vaults to its branches and from its branches to exchange centers. The security of the cash at every point including at the final exchange points was difficult and required considerable military assistance. In many instances branches of banks were not functioning, and/or because of war damage were not suitable. None the less preference should be given to rehabilitating such facilities rather than establishing new ones.

In Bosnia and Herzegovina, the introduction and exchange of the new currency occurred without difficultly because it was handled by the existing, fully functioning payment bureaus of the previous regime (see section II. C. subsections on Payment Systems Modernization for a discussion of the Yugoslav payment bureau system).

B. Monetary Policy Objectives and Regimes

With regard to monetary policy, countries face two key questions: a) What should the objective of monetary policy be and b) How can that objective best be achieved in the post conflict environment of the country. Historically many central banks were seen as a convenience source of government revenue. In the developed world of an earlier day they were often assigned the task of maintaining full employment. Thus historically central banks were often the engines of inflation and occasionally of hyperinflation.

In the last decade, a clear international consensus has immerged that the central and over-riding goal of monetary policy should be price stability and that the central bank should be left free to determine how best to achieve it. Smoothing macro economic shocks, fostering financial sector development, are important but secondary objectives that should influence the manner and pace of pursuing price stability but should not over ride that long run objective. This consensus reflects several relatively recent understandings: a) the theoretical argument that in the long run monetary policy cannot affect GDP and economic growth (beyond providing a stable price environment) and considerable empirical evidence to support it; b) the very short run nature of the once famous Philips curve trade off between unemployment, which is now understood to apply only to unanticipated inflation; c) the political propensity to emphasize short-term goals, and the historical experience of harmful inflations at the hands of politically dominated central banks; and d) the technical difficulty of successfully fine toning monetary policy even when it might be theoretically justified.

A separate question is how to define price stability operationally. Developed market economies have tended to define price stability as an inflation rate in the 1 to 2 percent range because of suspected upward biases in most consumer price indexes. Developing or emerging market economies more often define price stability as an inflation rate in the range of 2 to 4 or 5 percent because, in addition to the above factor, of the large structural and relative price changes in such economies, which can more easily be absorbed at the somewhat higher inflation rate.

Central banks also often supervise banks or a broader part of the financial sector and have the responsibility for payment system oversight. Thus to overcome the inflation bias that derives from the short run preference of governments to print money to finance their expenditures and/or stimulate employment over what they know is in the long run benefit of their countries, almost all modern central bank laws forbid the central bank to lend directly to the government, mandate it to seek price stability, and make it independent from government interference in finding the best ways of doing so (while holding it accountable in various ways for achieving this objective).

Several special considerations often come into play in the post conflict situation. The need for reconstruction expenditures are high and the capacity of the government to raise revenue (other than by printing money) is very limited. While a policy of deliberate inflation (above say 4 or 5 percent) cannot be justified on the grounds of economic growth and development per se, it might be justified on the grounds that it is the only way to increase the revenue of the government needed for valuable expenditures. There may be validity to this argument, but it is a tool that can be difficult to control. The capacity of the central bank to resist government pressure for financing may be low; and its capacity to implement an effective monetary policy may be very limited. Given the importance of price stability for economic development and for the credibility of the new government, the international community has generally been prepared to provide much of the financing for reconstruction and supported, if not insisted on, central bank independence and a mandate of price stability.[7]

Two regimes are particularly attractive for many post conflict countries because of their strong commitment to price stability and low technical requirements from the central bank. The use of a foreign currency—dollarization—carries no requirements of the central bank and is highly immune to government interference. A currency board (which firmly fixes the exchange rate, fully backs its currency with foreign currency, and passively supplies the amount of currency demanded by the market) has the same advantages plus allows the central bank to capture the seniorage profits and to gain the political advantage of a symbol

[7] Donor funds can finance unlimited amounts of imported goods and services. There are limits, however, on the amount of external funds an economy can absorb domestically without inflationary consequences. Beyond some modest point, increased government expenditures domestically need to come from the diversion of domestic resources from other uses. Generally taxation is preferable to inflation for such purposes.

of national identity form issuing a national currency. Kosovo and Timor Leste have dollarized and Bosnia and Herzegovina has adopted currency board rules.

If a country has its own currency, it faces a range of policy options from hard exchange rate pegs to free floating rates with some other policy anchor. The hardest peg with the highest credibility and least demands on data and analysis by the central bank is a currency board. Its main prerequisites are firm acceptance by the government that there will be no central bank financing and sufficient domestic price flexibility to adjust to any trade shocks. Bosnia and Herzegovina has a currency board that has been highly successful. It was easily agreed to by the Bosniac, Croat, and Serb representatives at the Dayton Peace negotiations because they were already familiar with the system and because it provides for no discretion over monetary policy and was thus easier to accept politically where trust was almost nonexistent. Even then the Dayton Peace Agreement provided for a foreign Governor

Table 1: Real GDP growth and Inflation
(in percent per annum)

	1998	1999	2000	2001	2002	2003	2004	2005
BOSNIA AND HERZEGOVINA								
GDP (1)	15.6	9.6	5.5	4.4	5.5	4.0	5.0	5.0
Inflation (2)		3.7	4.8	3.1	0.4	0.6	0.4	
AFGHANISTAN								
GDP (3)					28.6	16.0	8.0	
Inflation (4)				-43	52	10	10	
KOSOVO								
GDP (5)					1.2	3.1	3.2	
Inflation (6)				11.7	3.6	1.0	1.5	

Sources (1) EBRD Transition Report 2005 (2005 is the average forecast)
(2) CBBH Selected Economic Indicators
(3) IMF: Selected Issues and Statistical Appendix.
Fiscal years run from March 21 to March 20. Thus 2002 refers to 3/21/02 to 3/20/03
(4) IMF: Selected Issues and Statistical Appendix.
(5) BPK Monthy Statistical Bulletin--Selected Macroeconomic Indicators
(6) BPK Monthy Statistical Bulletin--Selected Macroeconomic Indicators

chosen by the IMF for the first six years. The Central Bank of Bosnia and Herzegovina is generally thought to be the most successful state institution in the country and has made a major contribution to state building.[8]

Soft or managed pegs potentially anchor the system in the same way as a currency board without any legal commitment to maintain the exchange rate if external conditions change. It introduces some scope for domestic liquidity management by the central bank (i.e. some sterilization of the monetary effects of foreign exchange transaction).[9] This can be useful in some circumstances but has often been misused resulting in domestic conditions inconsistent with the exchange rate and thus leading to its collapse and sometimes an exchange rate crisis. The Central Bank of Iraq (CBI) has such a policy. The exchange rate of the Iraqi dinar is determined in the market, which the CBI influences by daily foreign exchange auctions of dollars. The CBI's monetary policy is clearly anchored by its exchange rate target, which determines the amounts sold in the auctions. As with a currency board, an exchange rate target is clearly seen and understood by the market and in small open economies like Iraq a stable exchange rate contributes to stable prices. None the less, because of the lack of security and supply problems inflation in Iraq has been moderately volatile averaging 32 percent in 2004.

Free floating or only lightly managed exchange rates require an alternative anchor for monetary policy. In some well developed economies inflation is directly targeted in so call "inflation targeting" regimes (e.g., England, Canada, New Zealand, Poland, Czech Republic). But such a sophisticated approach is well beyond the grasp of any likely post conflict country.[10] Thus some variant of an intermediate monetary aggregate target is the most

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[8] At a conference in Sarajevo celebrating the first five years of the CBBH, its New Zealand Governor, Peter Nicholl, stated that: "The currency board approach to the monetary policy has achieved the objective it was asked to achieve: financial stability in BiH. This has brought considerable economic and social benefits to the economy and the citizens of Bosnia and Herzegovina." P 35. Dragan Kovacevic, Editor, ***Modern-Day European Currency Boards, Practice and Prospects***, CBBH (Sarajevo) 2004

[9] Central banks control the money supply and monetary conditions primarily by controlling the amount of their liabilities held by the public including banks. When a central bank buys or sells foreign exchange in the market, usually to influence the exchange rate, it has the opposite effect on domestic liquidity, i.e. the public's holdings of domestic currency and deposits with the central bank. If these liquidity or monetary effects are undesired by the central bank, it can undertake offsetting "sterilization" transactions in domestic assets.

[10] Targeting inflation directly (rather than indirectly via the exchange rate or money growth rate) requires adequately developed financial markets through which the central bank's policies are transmitted to economic activity and inflation, reliable data on key economic and financial magnitudes, and the capacity of the central bank's staff and management to understand (model) the relationship between its policy instruments and inflation.

common anchor to monetary policy (and the public's inflation expectations) when the exchange rate is market determined. As with any successful monetary policy regime, monetary targeting (or inflation targeting) requires sufficient central bank autonomy (e.g. zero or very limited lending to government) for the central bank to control its own balance sheet. It also requires timely information on factors that effect its balance sheet, an understanding of how to deal with them, and the instruments with which to do so.

Afghanistan has a target for the growth in currency in circulation as part of its IMF Staff Monitored Program. It implements this target by determining the amount of dollars it will sell in weekly foreign exchange auctions after taking account of the increase in currency resulting from the government's sales of foreign exchange to the central bank and the government's use of the Afghanis there by purchased to make its salary and other domestic payments.

The central bank of Afghanistan has been successful in controlling the growth in currency in circulation, but it has proved much more difficult to determine the public's demand for currency with stable prices. This is the essential link between the growth in currency and prices (inflation). On several occasions the IMF has agreed with the Afghan authorities to a change in the target for currency on the bases of judgments that its demand was greater than forecast. Such judgments are difficult to make in real time even when data is reliable and timely, which it is not in Afghanistan. A monetary target presents many more challenges to the central bank's capacities but affords it much greater flexibility to react to events (to the extent the central bank correctly understands these events).

Afghanistan had many characteristics that pointed toward a fixed exchange rate regime of one sort or another (small open economy, poor data, very limited institutional capacity at the central bank, etc). There were also factors favoring a more flexible exchange rate (significant structural changes that would require significant and difficult to determine changes in the real exchange rate, and vulnerability to external shocks). At the end of the day, Afghanistan's market traditions and the strong preferences of the authorities favored a market determined exchange rate. In many respects, the coherence of the policies and actions to implement monetary policy are more important than the regime itself.

C. Banking and Payment Systems

In the immediate post conflict period, banks are rarely functioning. However, they are the facility most able to safe keep and disburse cash and will need to be used and restored as rapidly as possible. The fuller restoration and or development of banks' credit and non-cash payment functions, which will be critical for economic recovery and development, will take much longer and should be undertaken carefully and deliberately.

Banking offices and staff are very likely to be needed from the outset to facilitate government and enterprise payments for wages and pensions as discussed in the preceding section. Their vaults, cash handling procedures, security, and teller window staff will be essential for the quick restoration of these payments.

Supervision

In the triage environment of early post conflict economies, banks and certainly non-cash payment systems take second place. For some months banks can be left to carry on whatever limited activities they might be performing without much official intervention. However, as soon as feasible a governmental decision should be taken with regard to banks. Who will supervise them? Are the supervisor and the underlying legal provisions for banking and its supervision in place or do they need to be developed? Should existing banks be allowed to resume full operations or should they be required to be recertified (relicensed)? What should be done with the state banks?

All of the post conflict economies under review in this paper adopted new banking laws and undertook multi year training programs to develop modern banking supervision capabilities. In Afghanistan, Kosovo, and Timor Leste new licensing requirements were established and all existing banks were required to reapply.

In **Afghanistan** three of the six state banks have been provisionally licensed and by mid 2005 four foreign owned banks and four branches of foreign banks had been licensed. In **Kosovo** none of the existing banks qualified to be relicenced. However, within two years enough banks were in operation in all major cities to allow the BPK to terminate its temporary banking services for the public. In 2005 there were seven foreign and domestically owned banks licensed in Kosovo.

In **Bosnia and Herzegovina** banks in the Federation and in the Republika Srpska were separately licensed and supervised by Banking Agencies established in each "Entity." Initially banks licencied in one Entity operated only within that Entity. In 2000 there were 55 licensed banks country wide with assets about 32 percent of GDP. By the end of 2004 33 licenced bank were in operation—24 in the Federation (of which 5 were under provisional administration), and 9 in the Republika Srpska—with assets about 60 percent of GDP. Branching across Entities had become common.

Ownership

All cases in this study had state owned banks as well as some privately owned banks. In all cases the state owned banks initially dominated the banking sector and were either insolvent or poorly and inefficiently run. All such banks were large employers.

The IMF and World Bank strongly advised down sizing and privatizing state banks. They were notoriously inefficient, non-commercial in orientation, and almost always corrupt (over hiring of friends and non-commercial lending to state owned enterprises and friends). This advice was strongly embraced throughout Central and Eastern Europe, where essentially all public banks were liquidated or privatized, and where the banking sectors are now almost entirely privately and foreign owned. Cleaning up the state banks is important for increasing the efficiency of the banking system, and for facilitation the development of more efficient private banks. Efficient and competitive banks make important contributions to economic recovery and development. Privatizing (or closing) state banks can also be an important component of reducing corruption (both private and political) which is generally essential for public confidence and support of the state.

However, cleaning up the state banks has short run political costs. Reduced corruption opportunities limit the means for paying for political support from key political players (as opposed to the population at large). Such support is sometimes an essential part of reconciliation or of gaining acceptance of the new state. Sometimes, however, the ability of the ruling party to use the resources of state banks to strengthen their hold on power can have the opposite effect. For example, the maneuvers by the government of the Serbian Entity (Republika Srpska) to perpetuate a state bank monopoly over payments, was deeply resented by private banks.

Cleaning up the state banks invariable means reducing employment by these banks, which can produce a loss of political support among a broader segment of the public. For all these practical reasons, addressing the state bank problem is not the first priority. It needs to be carefully planned and executed and will almost always be implemented late in the reform process and take a long time to complete. In the interim, it will be important to prevent the state banks from expanding and especially from extending new loans to related parties (friends) or for unpromising state projects. Often liquidating or “cleaning up” state owned banks cost the public treasury very large amounts of money. If banks are privatized, it is also important that the sales be to proper owners at fair prices, both for reasons of efficiency but also for reasons of public acceptance of the process as fair. However, undue delay, which is more often the case, carries high costs as well. Banks play a very important role in allocating scarce resources to the best uses, and thus the funds expended on economic development are more likely to be well and productively spent if banking sector inefficiencies are dealt with first. The task is complete in Bosnia and Herzegovina, and Kosovo, but has not really begun in Afghanistan or Iraq.

Under the new banking laws adopted in these economies, foreign ownership was permitted and over time some foreign banks were established and some domestic banks were purchased by foreign entities (generally banks). The entry of foreign banks into the domestic market has very strong benefits. Badly needed banking services are provided more quickly and efficiently. More importantly, international standards and expertise are brought into the local market and more rapidly disseminated. The entry of foreign banks is often opposed by the existing banking interests, who are often closely allied with political interests.

Payment systems modernization

Payment systems include interbank settlements and retail business and household non-cash payments using checks, payment orders, debt cards, credit cards, etc. Payment instructions require procedures and technologies for clearing and settling deposit transfers between accounts and ultimately between banks. Systems that existed before conflict invariably must be used for some time following the end of conflict.

In all cases in this study, the major payment systems development following the end of conflict concerned reform and modernization. Modernization invariably focused first on establishing the capacity for efficient electronic interbank payments—so called large value transfers—which are important for the development of interbank lending and trading markets and the transmission of monetary policy. Donors have often rushed to finance expensive Real Time Gross Settlement (RTGS) systems before they could be cost justified and before the stakeholders in the market had a clear understanding of what was needed. RTGS systems permit quick and low cost (per message) electronic payments between banks and are the backbone of modern payment systems. They were often established along side electronic payment order clearinghouses (ACH and GIRO systems). They are attractive to donors because they are discrete, well focused, attention getting, and important (even if often premature) and much of the cost is spent on foreign venders.

The most unique and challenging payment system reforms were in Bosnia and Herzegovina and other former Yugoslav Republics because of the unique system of domestic payments that was in operation there. The Social Accounting Service, SDK, (or SPP, ZAP, and ZPP in the three ethnic regions of Bosnia and Herzegovina) had a technical and legal monopoly on non-cash domestic payments.[11] While transferable deposits were technically with banks (the liabilities of banks), deposits and withdrawals and transfer (payment) orders were made at offices of the SDK, which transferred funds and maintained accounting records on behalf of all banks. The SDK was actually much more than a payment system, encompassing statistical and financial police functions as well for the MOF. It had an extensive branch network, employed more people that the commercial banking sector, and was politically very powerful. Replacement of these organizations in the three regions of Bosnia and Herzegovina by modern, bank based payment systems and tax collection required over two years of concentrated and coordinated effort by the IMF, USAID, World Bank, US Treasury and other donors. The strategy was developed painstakingly and jointly by the donors (lead by the IMF) and the authorities with clearly assigned responsibilities for different aspects of the work.

The new clearing house and RTGS systems in Bosnia and Herzegovina are own by the CBBH and came into operation in 2002. They fully reintegrated the domestic non-cash systems of the three regions of Bosnia and Herzegovina that had separated during the wars based on the central bank's new currency, the Convertible Markka (KM). In the last quarter of 2004 these two systems completed a total of 5.61 million transactions, with a value of KM

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[11] Služba Društvenog Knjigovodstva, or SKD, translates loosely as the Service for Social Accounting. The Bosniac name for its branch/version of this institution was Zavod za Platni Promet, abbreviated as the ZPP. The Croat area version had the same name but abbreviated it as ZAP as in Croatia. The Serbian area institution was called the Služba za Platni Promet—SPP before being made (temporarily) a department of a newly formed state bank, the Srpska State Bank (SSB).

7.85 billion. RTGS transactions made up 2.5 percent of these transactions and 69 percent of the value. The old SKD organizations ceased to exist in their earlier forms and functions.

D. Banking Services for Government

While modern central banks are almost universally forbidden to lend directly to the government and to the nonbank public, virtually all central banks accept government deposits and most perform some payment services for the government. It is in these areas that the government and the central bank are most interdependent, especially in the early post conflict days when banks and payment systems may not be functioning well.

A proper division of labor and accountability between the MOF and the central bank assigns government expenditure, cash, and debt management to the MOF and monetary policy, foreign exchange reserves management, and often banking supervision to the central bank. The first domestic financial requirement of government following the end of conflict is the resumption of its payments of government wages and pensions. These payments are most often in cash and require the services of a large number of people to verify the rolls of payees and the amounts due them, to distribute and safe keep the cash needed for payments, to administer the actual disbursements and to verified the identity of the recipients and otherwise minimize fraudulent payments.[12]

These activities always involve the resumption of a previous activity and thus the starting point must be an assessment of the previous systems of payment and monitoring and of their capacity to restart. In many instances the new post conflict government, especially if it is provided by foreign powers, is not well informed about existing systems or in good contact with existing government personnel. But there is no faster or surer way to resume payments than to take up previously existing staff and systems. In some instances new programs, such as the National Solidarity Program and National Emergency Employment Program in Afghanistan, will build their own lists of payments and payees, but will still need to rely on the banking/payment systems in place for actual disbursements.

Bosnia and Herzegovina functioned very smoothly in this regard. The successors of the Yugoslav SDK, one each for the Bosniac (ZPP), Croat (ZAP) and Serb (SPP) dominated areas, continued to function without much change for several years following the war and ensured continuity and a degree of efficiency in carrying on basic government payment functions.

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[12] Foreign payments for debt service are often suspended for a period following the end of conflict. Payments for new imports are often made by donors for a period. None the less, the technical capacity to make payments abroad and to manage foreign currency assets abroad (authorized operators of SWIFT—"Society for Worldwide Interbank Financial Telecommunications" the standard international payment messaging system.) will need to be address fairly early on.

Kosovo posed much more difficult challenges. Its predecessor institutions were not as useful or relevant. Yugoslav dinar payments were replaced with German mark payments and these were almost totally in cash. Thus the Kosovo offices of the Yugoslav SDK became German mark cash storage and distribution centers and efforts were made to install new accounting systems and procedures from the start. Staff training in and acceptance of the new systems were inadequate.[13] As a result, the also newly established Treasury/Finance Ministry opened its own accounts abroad and continually complained of inadequate records and service from what became the Banking and Payment Authority of Kosovo (BPK).

The experience in Kosovo drove home the lesson that changes should be minimized and that any new procedures need to be implemented with considerable training. Kosovo has no currency of its own and thus did not go through an exchange. However, even the relatively simple step of replacing the multi window procedure for depositing or withdrawing funds from the central bank (the old payment bureau) with a single universal teller window and the associated changes needed to insure adequate internal control and security proved very difficult because of inadequate training and buy in by local staff (see case study for Kosovo). For almost a year, the Banking and Payment Authority of Kosovo (BPK) was not able to produce accurate records on the cash in its vaults.

Afghanistan was able to draw on the extensive branch net work of the central bank. Because of the central bank's heavy involvement in commercial/payment activities, it had more offices in Afghanistan than any commercial bank (74 throughout the country). Even in 2005 the government relies heavily on these central bank offices for making government payments. More importantly, it used the existing century old and highly development network and payment services of money changers and the hawala system (an unregulated system of money remitters.)

III. Bosnia and Herzegovina

A. Background and Initial Conditions

Bosnia and Herzegovina was one of the six republics making up the Socialist Federal Republic of Yugoslavia (SFRY). Following Slovenia and Croatia, which declared independence in the summer of 1991 (and later Macedonia), the Republic of Bosnia and Herzegovina (BH) declared its independence from the SFRY in March 1992. The UN and most of its members quickly recognized it, but its independence was promptly challenged by the Yugoslav National Army and local Serb militia, who launched a war in April 1992 that

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[13] Staff understood the safeguards build into the existing, familiar tell window system. They were not comfortable with a universal (one stop) teller window because they did not fully understand its security/audit features.

continued until the last of many cease-fires on October 10, 1995. In the midst of these hostilities, which saw some of the most brutal fighting ever seen in Europe, armed conflict also erupted between forces in the Croat-majority area of BH and the Republic (Muslim-majority area) army, which lasted from early 1993 until February 25, 1994. The death toll of these combined conflicts in BH is estimated at about 250,000 and about three million of the country's 4.4 million inhabitants were displaced from their homes (about one million became refugees abroad).

Bosnia and Herzegovina has existed since the Middle Ages under a variety of foreign (Ottoman, Austro-Hungarian) rulers. Over most of its history it was a multiethnic region. Sarajevo, where Catholic and Orthodox churches, Jewish synagogues, and Muslim masques have peacefully coexisted for centuries, has particularly thrived in such an environment. The three principal ethnic groups—Croats (Catholic), Bosniacs (Muslims), and Serbs (Orthodox)—lived in close proximity throughout the country. By the end of 1995, Bosnia's three ethnic majority regions had become ethnically more homogeneous as a result of the ethnic cleansing that had taken place during the recent wars, and each region had its own government, army, and currency arrangements.

During the Balkan wars, the common currency of Yugoslavia (the Yugoslav dinar) gave way in each republic to the newly independent republics' own currencies (e.g., the kuna in Croatia, and the Bosnian dinar in Bosnia and Herzegovina). The war time currency situation in Bosnia-Herzegovina was complicated. Upon its declaration of independence and the onset of civil war, the National Bank of Bosnia and Herzegovina (NBBH) designed a new currency (the Bosnia-Herzegovina dinar—BHD) to replace the Yugoslav dinar. Because of intensified fighting, Sarajevo soon came under siege for 1100 days, the designs had to be faxed to the printer in Celje in Slovenia. Once printed they could not be delivered to Sarajevo and were thus sent to a NBBH branch in Zenica, 80 kilometres away from Sarajevo, on August 7, 1992. They were introduced on August 17 at the exchange rate of 350 BHD per German mark. The payment bureaus (discussed below) changed bank accounts to the new unit and handled the exchange of notes for Yugoslav dinars. To deal with the inability to transport the new notes into Sarajevo, the NBBH issued coupons printed in Sarajevo and Yugoslav dinars in its vault to which it had affixed special stamps. These currencies fed the hyperinflation also building in Serbia for Yugoslav dinar. Black market exchange rates were many times the official rate, which itself had reach 120,000 BHD per DM by January 1, 1994. The new government elected in the Bosniac area in October 1993 launch a new program to stabilize the currency. A new BHD, printed in Zenica, was issued in early 1994. Four zeros were dropped from the old BHD and a large number of measures were adopted to control its value. These eventually included currency board like rules and the market exchange rates converged to the office rate of 100 BHD per DM by early 1995.

During the Bosnian wars, the Bosniac majority area continued to use the BHD, the Serbian majority area of the Republika Srpska (RS) used the YUD and the Croat majority area began to use the Croatian dinar. Each of the three regions also gave some quasi-official status to the German mark. Thus the DM was widely used in all three regions for making domestic payments during and following the Balkan wars. Payments across regional boundaries could thus be made in German marks through a correspondent bank in German or elsewhere. Such foreign currency payments, which were performed for their customers by banks directly, were expensive and thus limited to relatively large amounts.

The main governmental structures of the country broke into three as well. This was true for the Armies, of course, but also for the Finance and other Ministries, the central bank and Yugoslavia's unique system of payments, the Yugoslav Service for Social Bookkeeping (SDK). The banking system broke up as well with branches of the same bank being separated from their parents across ethnic/regional boundaries.

In many respects, in the monetary area the SDK (the so called payment bureau) was a more critical institution than the central bank. SDK was a system designed to maximize state control over economic activities in a centrally planned economy. All domestic non-cash payments (deposit transfers) were made through the SDK. It had a legal monopoly on such payments. All enterprises were required by law to make all of their domestic payments through the SDK, except for wage payments, which they made in cash withdrawn from the SDK by debt to their accounts with their bank. Cash was generally deposited and withdrawn from SDK offices, which outnumbered the offices of banks. Payment instructions (payment orders) were given at the offices of the SDK and statements of account balances were picked up there. Each enterprise had a particular SDK office with which it did business. Banks were not directly involved.

In fact, however, the payments made through the SDK were really transfers of balances that enterprises and others kept with their respective banks. The payment bureau was really an accounting and payment instruction processing entity. The monopoly SDK system was integrated technically and legally throughout Yugoslavia. One of the first steps by each republic upon its independence was to separate its SDK operation technically and legally from the broader Yugoslav system. Similarly one of the first steps within Bosnia and Herzegovina after the onset of its internal war was the separation of its payment bureaus into three separate systems that no longer interacted with each other. The Bosniac region of the SDK, headquartered in Sarajevo, became the ZPP, the Croat region, headquartered in Mostar, became the ZAP after its Croatian brothers' payment bureau with which is was not technically or legally related, and the Serbian region (the RS) payment bureau, headquartered in Banja Luka, became the Serbian Payment Bureau (SPP). The ZPP processed payments in Bosnian dinars. The ZAP processed payments in Croatian kuna. And the SPP processed payments in Yugoslav dinars. During the internal war, as a war time measure, all three payment bureaus accepted actual deposits of German mark cash (which was kept in their vaults) and allowed domestic payment through their clearing systems in German marks. Unlike the ZPP and ZAP, the SPP remained technically liked with what was left of the Yugoslav system. As a result, payments cleared through the SPP were ultimately settled on the books of the National Bank of Yugoslavia in Belgrade.

The NBBH became, as a practical though not legal matter, the central bank only of the Bosniac area. Before the independence of Bosnia and Herzegovina, the Republika Srpska had had its own branch of the National Bank of Yugoslavia, which became the National

Bank of Republika Srpska (NBRS). The Croat majority area did without a central bank and relied on its regional payment bureau, the ZAP, to perform quasi central bank functions. Of these only the NBBH issued its own currency, which it did in accordance with informal currency board rules. The exchange rate of the BHD was fixed to the German mark at 100 to one and all notes issued were fully back by German marks.

After three and a half years of bloody war, on September 8, 1995, the foreign Ministers of BH, Croatia and the Federal Republic of Yugoslavia (FRY--consisting of the remaining two republics--Serbia and Montenegro) signed "Agreed Basic Principles" for a peaceful settlement of the war. This was followed on September 26 by "Further Agreed Basic Principles" and on October 10 by the final cease-fire. "Proximity Talks" among the Presidents of BH, Croatia, and the FRY on a peace agreement and a new constitution reintegrating the regions of Bosnia and Herzegovina began on November 1, 1995 in Dayton, Ohio under the sponsorship of the United States. These talks resulted in the initialing on November 21 of a General Framework Agreement for Peace in Bosnia and Herzegovina, which included a Constitution for the continued existence of the country, and were followed by an international peace conference in Paris at which the final agreements were signed on December 14, 1995.

Peace between the Croats and Bosniacs following their war in 1993 was formalized by the Washington Agreements of August 1994, which resulted in the creation of the Federation of Bosnia and Herzegovina. In reality, the Croat and Bosniac majority areas remained substantially separate. When international technical assistance began in 1996, each continued to operate separate payment systems and use different currencies (kuna and BHD). Though Bosnia and Herzegovina now formally consists of two so-called "Entities:" the Federation and the Republika Srpska, in reality it continues to function as three distinct areas.

At that time each of Bosnia and Herzegovina's three ethnic regions had currencies and functioning payment systems. Each had established Finance Ministries and other administrative bodies of government. For a time government revenues would come largely from donor financial support. There were no immediate and pressing technical difficulties with making required payments in any region of the country.

B. Monetary Policy

Leading up to the Dayton Peace negotiations, the IMF's First Deputy Managing Director, Stanley Fischer, met with the IMF's Executive Directors from the G7 member countries on October 17, 1995, to discuss issues related to Bosnia and Herzegovina and their possible future membership in the Fund. On behalf of the G7 (the U.S., Germany, Japan, U.K., France, Italy and Canada), the Directors requested the IMF to prepare a brief note for the upcoming Dayton peace talks outlining the requirements of viable fiscal and monetary structures in confederacies.

The goal in this area was to find an arrangement for satisfying the monetary and payment needs of Bosnia and Herzegovina that would facilitate the economic recovery of the country and that would be acceptable to the warring factions. The monetary arrangements should also contribute to the economic reintegration of the divided country, and should be capable of becoming operational very quickly. The Dayton Peace Agreement would need to be acceptable to three warring groups who really wanted to remain as separate from each other as possible.

The IMF advised that the above objectives would be best served (at a minimum) by a unified monetary system. In its simplest and purest form, a unified monetary system is one in which every one uses the same currency. But the world has produced many examples of variations on this theme. The essential requirement for a viable unified monetary system is that the money supply for the area as a whole is under proper control (an uncontrolled supply of money would result in uncontrolled inflation). This requires, first and foremost, that there be no more than one monetary policy. If there is more than one monetary authority, there must be very clear and binding rules that link their activities together to ensure that the quantity of money is well determined and controlled.

These considerations suggested that the most promising options were for the county to choose a foreign currency as its legal tender, to adopt a national currency board, or to adopt two (or three) regional currency boards with the same currency peg and exchange rate. The first option, a foreign currency, had the advantage that no central bank had to be put in place to issue a currency and control its quantity. It was an option that was, de facto, to some extent already in place.

While each of the three ethnic majority areas used its own currency (Bosnian dinar) or the currency of the neighboring country defining its ethnicity (Croatian kuna and Yugoslav dinar), all three also used the German mark. While retiring the Bosnian dinar (the only currency in BiH issued by a central bank operating in the country) would need to be organized, the kuna and Yugoslav dinars could be exchanged in the market for German marks as they could be used in Croatia and Yugoslavia respectively. Dollarization, i.e., using the German mark, came with several costs. The seigniorage from issuing money would be earned by the Bundesbank rather than by the BiH central bank. Furthermore, the use of a foreign currency might not contribute to reintegration and nation building in the same way that the symbol of a national currency might.

The case for a currency board, the second and third options, seemed quite obvious. The conditions normally required for the successful establishment of a currency board (a healthy banking sector and sound public finances) did not exist in BiH. Bosnia's banking sector was in shambles (as many of its borrowers had been bombed out of existence, and the rest suffered from the general collapse of the economy). Government revenues at the state (countrywide) level where not yet well established and were heavily dependent on donor grants. However, the only remaining domestically issued currency, the Bosnia and Herzegovina dinar (BHD), was fully convertible into German marks at a fixed rate. The BHD was issued by the NBBH basically following currency board rules already. Thus the sort of discipline and stability provided by a currency board was already well understood and accepted. Furthermore, a currency board is easier to set up and to operate than a full-fledged central bank and could thus be put in place more quickly. Perhaps more importantly, the high level of distrust between the three major ethnic groups and/or the three previously warring regions of the country would have made it very difficult to gain their cooperation with a discretionary central bank. As a currency board has little or no discretion, surrendering authority to a national currency board should be far more acceptable to the three regions than to any other form of monetary authority.

The second two options, one national or several regional currency boards, would both fulfill equally well the criteria of stable, non-discretionary monetary policy, and administrative simplicity. The option of a national currency board was the marginally more efficient of the two (establishing one institution rather than several) and would contribute more to nation building, if the three regions were prepared to embark in that direction.

The IMF recommended a single currency issued a single central bank in accordance with strict currency board rules. Such provisions were adopted in the Dayton Peace Agreement in Article VII of the new constitution, with the further requirement that the governor must be a foreigner selected by the IMF for the first six years. At the end of the six year period, the state government (joint Presidency) approved the continuation of the currency board rules and extended the term of the foreign governor (Peter Nicholl from New Zealand) on extra year. The term expired December 31, 2004 and a Bosniac, Kemal Kozarić, became governor. In one of his first public interviews (reported on the CBBH website) the new governor stated that: “The change at the top is not bringing about changes in the status and operations of the CBBH.”

C. New Central Bank Law

The members of the CBBH Board were appointed to their positions by the Joint Presidency of Bosnia and Herzegovina before the new central bank formally existed and were the direct counterparts to IMF advisors in developing the text of the central bank law. 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.

The struggle between the three ethnic groups over these issues reflected purely and simply the individual power concerns of each group. The Serbs wanted as much separation and autonomy as possible while the Bosniacs wanted the opposite. The choice of a strict currency board was already included in the Dayton Peace agreement, and was not controversial.

Voting strength of Directors

The Constitution adopted in Dayton provided that the four person Board would consist of one Director each from the Bosniac, Croatian, and Serbian majority areas and the Governor from a foreign (non adjacent) country. It further provided for Bosniac and Croat

Directors to share one (Federation) vote and for the Governor to break ties. The central bank law finally adopted clarified that the Governor was a regular voting member of the Board so that his vote could help create a tie, that he could then break as Governor.

The branches

The role of CBBH branches was also a hotly debated issue. Having relaxed somewhat their 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 law as finally adopted has detailed language about “Main Units” and the functions they perform. 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.

Currency name and design

The new currency name and design was not agreed until the political leadership of the previously warring groups was ready politically to move forward with the implementation of the new central bank. The name of the new currency, “Convertible Marka” (KM) and the general principles guiding the design of the new notes were agreed so that the new central bank law could be adopted and the new institution established. Gentle but persistent international pressure played a key role.

The Bosnian Serbs wanted their own version of the new currency, 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. The compromise 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.”

The details of the new design were put off until a bit later. Each ethnic group put forward its proposed design, which was knocked down by one of the other groups. In a few cases “national’ heroes of one ethnic group or the other where proposes, which was clearly objectionable to the other two. Generally, however, designs were rejected because there was not yet political support for moving forward with the new currency. No design would have been acceptable and any excuse might be offered. This exercise was repeated a number of times. As a practical matter the growing delay was only a problem for the Bosniac area because of the old and worn condition of the Bosnian dinars, which would be replaced by the new notes.

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 and made is own proposal to his Board. When his Board could not agree to act, he submitted the resulting designs to the UN Office of the High Representative (OHR). 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. It would not have been possible to force any of the political leaders to take actions they strongly opposed. 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 Serb and Federation versions of the new bank notes were initially issued in their respective areas. The Governor decided that no effort would be made to sort circulating or returned notes into their two versions in order to return them to the "proper" Entity. The differences between the two versions of the currency were more noticeable than were the twelve versions for each U.S. currency note (one for each of the twelve Federal Reserve Banks) but only modestly so and after a few years the two versions were thoroughly mixed without public notice.

D. Payment System

Because of the use of foreign currencies and the continued functioning of the three regional payment bureaus, payments within each region could be and were being made without difficulty. Even interregional payments could be made via foreign correspondent accounts, but these were expensive though the number of interregional payments were limited.

The most immediate need was to establish interregional settlements. For the first few years following the end of the war, such payments were made by sending fax payment orders on one of the telephone lines that had been established for the Office of the High Representative. The flow of payments between regions were netted and settled every week, or whenever the net amount exceeded an agreed limit. Settlement took the form of driving German mark cash in the trunk of a car from the payment bureau of one region to the boarder with the region of the receiving payment bureau.

The most difficult challenge technically and to some extent politically, was the transformation and phasing out of the three payment bureaus and in the case of the Bosniac and Serb regions the liquidation of their central banks. Each of the three majority ethnic regions, with its own payment bureau, had unique and challenging problems to over come.

The common problem was that the payment bureaus of each region were large and politically powerful organizations. They employed a very large number of people who did not want to lose their jobs or power. They were well connected with the ruling political parties.

The transitional problems with the payment bureaus in each region were closely liked to the inherited central bank in its region (or in the case of the Croat majority area, the central bank functions performed by the ZAP), which are discussed below. On January 5, 2001, the old SDK based systems taken over in each region from the Yugoslav system closed down. In their place the CBBH operated a Real Time Gross Settlement System (RTGS) and a small value, giro, net settlement clearinghouse system. Both originated payment instructions directly from banks and were settled on the banks' clearing accounts with the CBBH. However, getting to that revolutionary place took almost three years of intensive work by the IMF, World Bank, US Treasury, USAID, and other international donors. The work was highly technical and very political. The interregional payment clearing and settlement aspects brought payment bureau staff from the three regions together for the first time since the being of the wars and made its small contribution to national healing. This work was lead by the CBBH and the IMF advisor assigned to it for this purpose, Kim Rhee.

Sarajevo

The payment bureau of the Bosniac region (ZPP) had been formally merged with the payment bureau of the Croat region in Mostar (ZAP). The Federation wide bureau existed on paper only, however. The management of the ZPP accepted in principle that they would need to change and adopt the bank based payment systems found in market economics, but they hoped to evolve into the service providers through which payment instructions were cleared, if not settled. In this way they hoped to preserve much of their existing monopoly. The first major victory with the ZPP was its reluctant acquiescence to shifting the end of day net settlement between banks to the new central bank. They rightly suspected that this was the tip of the iceberg that would eventually sink them.

The insolvency of the National Bank of Bosnia and Herzegovina and its continued use by government entities almost sank the currency board arrangements of the new central bank (CBBH) and thus almost destroyed its credibility. IMF advisors assumed that the NBBH would cease banking operations when the CBBH was opened. This did not happen. After closing (transferring to banks) all non-government deposits with the NBBH, government entities in the Federation (municipalities mainly) continued to maintain their accounts with the NBBH and to make and receive payments using these accounts. The NBBH did not have a (German mark backed) reserve account with the new central bank. If more deposits flowed from the NBBH into other banks, the reserve accounts of these other banks at the CBBH went up without the balances of the NBBH with the CBBH going down. As a result the monetary liabilities of the CBBH went up without any increase in its German mark assets, thus violating the currency board rules.

The hole in the NBBH's balance sheet (the source of its insolvency or at least of its lack of German mark cover) resulted from a war time loan to the Bosniac government (presumably to finance the war). This loan had not been repaid and there was no way that the Croatian municipalities were going to contribute to repaying it now that they were part of the Federation of the Croat and Bosniac majority regions.

The first steps toward resolution of this problem were for the NBBH to open a reserve account with the CBBH (by transferring additional German marks to the CBBH) for use in settling net payments with other banks and for the ZPP to agree not to process payment orders draw on the NBBH for which there were not sufficient funds in the new reserve account at the CBBH. These arrangements were not in place until May 1998, over six months after the first violation of the currency board rules.

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 Bosniac majority Cantons for covering some losses that resulted from a war time loan to the Bosniac government. A freezing of municipality deposits with the NBBH and related steps to protect the CBBH were not successfully implemented until December 1998. The NBBH was not fully liquidated until late in 1999. The process of resolution was slow and involved patience with political sensitivities, and constant and increasing pressure from international donors (especially the IMF).

Mostar

The Croat majority region had no central bank but its payment bureau (ZAP) had taken on limited central bank functions by accepted in it's own name banks' clearing accounts (a liability) against which it held the equivalent value of German marks and kuna as cash in its vaults. It also required banks to deposit with it kuna equivalent to 45 percent of their deposit liabilities, which were all in kuna. There was some risk that the termination of kuna deposits and payments through the ZAP could result in the public's exchange of kuna for KM more rapidly than banks could liquidate and convert their kuna assets.

The first and easiest step for the payment bureaus in all three regions was to terminate the German mark payments. All German mark deposits with the payment bureaus were fully backed with cash. These deposits and related payment activities were terminated on October 1, 1999 with no difficulties. In the case of the ZAP, the potentially more difficult step of terminating the similar payments and cash backed deposits in kuna were terminated on the same date without difficulty as well.

The actual implementation of these steps on October 1, 1999 was delayed from the end 1998 date in the Federation Internal Payment Law adopted in the summer of 1998. The IMF had some concerns whether the German mark and kuna deposits with the ZAP were fully back with cash. After all, a backing shortfall was behind the serious problems encountered with the NBBH and the ZPP. It also had concerns that banks could have difficulties converting kuna to KM, which had to be done outside the CBBH in the market, if the public's desire to make such conversions was too rapid. At the end of the day no problems were encountered, though delayed implementation might have helped.

The delays encountered in the Croat majority area were most likely the result of the political leaderships concerns over the integrity of the new central banks currency board arrangements in light of the insolvency of the NBBH discussed above.

Banja Luka – Pale

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, KMs were the official means of payments in the territory of the RS. Starting with the 1998 budgets, KMs were 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 Yugoslav authorities in Belgrade closed the access of the RS payment bureau to the NBY and to banks in the FRY.14 As a result, it became impossible to continue the

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[14] 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.

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 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 authorities in the RS were generally more proactive than their counterparts in the Federation. Anticipating the need to liquidate the NBRS and to dismantle its payment bureau (SPP), the RS merged the SPP and the NBRS into the Serb State Bank (SSB). The other banks in the RS were furious over the unfair competition from the new state bank that also continued to have a domestic payment monopoly.[15] The IMF made the separation of the new institution into a state bank and the dismantling of the payment bureau operations a condition for further lending. The RS gradually come into line with the new countrywide currency, the CBBH, and the new bank based countrywide RTGS and Giro clearing house.

E. Banking Agencies

The IMF's original proposals to the peace negotiations in Dayton where for a single banking supervisor within the new central bank. This was rejected, and the Dayton agreement provided for two Banking Agencies to supervise banks, one for the RS and one for the Federation. Thus initially there were two banking systems. However, the international advisors succeeded in convincing the RS and the Federation governments to adopt virtually identical banking laws. These laws also established rules for "cross border" branching and licensing that integrated the two banking systems as much as possible. Furthermore, foreign advisors helped the two Banking Agencies draft virtually identical licensing and prudential regulations. Within a year or two of adopting these laws banks in each Entity began operating branches in the other and a national banking system began to take root.

The CBBH's role in coordinating supervision between the two Entities has been used to broaden its role in the supervision area and it is expected that the two Banking Agencies will eventually be merged into the CBBH.

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[15] The new state bank advertised that depositors might as well open their deposit accounts with the SSB because they would have to go there to make a payment anyway.

IV. KOSOVO

A. Background and Initial Conditions

Kosovo, a largely Muslim, Albanian province of Serbia has been the emotional central of Serbian nationalism since the defeat of Serbian Prince Lazar by the Turks on June 28, 1389 in the Battle of Kosovo at Polje outside of Pristina, the capital of Kosovo. Following centuries of Ottoman rule between 1389 and 1913, Kosovo became a part of Serbia during the Balkan War in 1912. It was briefly part of Albania during World War II, but has been part of Serbia since 1945. It enjoyed an autonomous provincial status from 1968 until 1989.

On the 600th anniversary of the Battle of Kosovo, Slobodan Milosevic, then President of the Republic of Serbia, gave a rousing speech in support of a Greater Serbia to over one million Serbs at the exact spot of the Turkish victory in 1389. He followed this performance by rescinding Kosovo's autonomy and imposing marshal law on the province. Albanian Kosovars in management positions through out the area were replace by Serbs, their schools were closed and a decade long period of an underground Albanian Kosovar government began. Since its loss of autonomy in 1989, Kosovo has been an integral part of the Republic of Serbia. The latter is one of the two republics (the other is Montenegro) that make up what is left of the Federal Republic of Yugoslavia (FRY) established in 1992.

During this period, the underground League for a Democratic Kosovo (LDK) had offices in several European cities. In May 1992, writer Ibrahim Rugova was elected president of the self-proclaimed and unrecognized Republic of Kosovo. Throughout this period this government in exile collected voluntary taxes from Albanian Kosovars, operated unofficial schools for Albanian children, and provided other basic governmental services outside the Serb run official administration.

By 1993, 400,000 Albanians had left Kosovo in response to deteriorating socio-economic conditions. Serb and Albanian residence became more isolated from each other. Politically more militant supporters of independence formed the Kosovo Liberation Army (KLA) and undertook a terrorist campaign that eventually led to full scale war in early 1999 following many stumbling diplomatic efforts throughout 1997 and 98 to establish a mutually acceptable peace. The west, in the form of NATO, finally intervened militarily with aerial bombing starting March 24, 1999. During the 73 days of NATO bombing that followed almost a million Kosovars were driven out of Kosovo.

On June 9 the FRY accepted the terms of peace with NATO and on June 10 the UN Security Council approved UNSC resolution 1244 which endorsed the peace agreement. Key provisions include the right of refugees to return home, substantial autonomy for Kosovo WITHIN YUGOSAVIA as part of the commitment of all member states to the sovereignty and territorial integrity of Yugoslavia.

NATO has estimated that:

- "By the end of May 1999, over 230,000 refugees had arrived in the former Yugoslav Republic of Macedonia , over 430,000 in Albania and some 64,000 in Montenegro. Approximately 21,500 had reached Bosnia and over 61,000 had been evacuated to other countries. Within Kosovo itself, an estimated 580,000 people had been rendered homeless.
- It is estimated that by the end of May, 1.5 million people, i.e. 90% of the population of Kosovo, had been expelled from their homes. Some 225,000 Kosovar men were believed to be missing. At least 5,000 Kosvars had been executed.
- NATO forces have flown in many thousands of tons of food and equipment into the area. By the end of May 1999, over 4666 tons of food and water, 4325 tons of other goods, 2624 tons of tents and nearly 1600 tons of medical supplies had been transported to the area."[16]

Post conflict administration of Kosovo was assigned by UNSC resolution 1244 to the United Nations Interim Administration Mission in Kosovo (UNMIK). Politically, the Albanian Kosovars recognized either the government in exile of Ibrahim Rugova and the League for a Democratic Kosovo (LDK), or the "Provisional Government of Kosova" of the now "disarmed" Kosovo Liberation Army (KLA) of Hashim Thaci (Ushtria Clirimtare E Kosoves –UCK), which evolved into the Democratic Party of Kosova. Each initially claimed to have a President, Finance Minister, etc. The Serb Kosovars withdraw almost exclusively to enclaves in the North. Thus UNMIK had no clear, domestic counterpart to whom to devolve authority.

At the end of conflict, legal tender in Kosovo was the dinar of the FRY. None the less, German marks (DM) had been in wide spread use in Kosovo, despite legal restrictions against their use, for many years. Even before the war, Kosovars used DM to a large extent as a store of value and for payment transactions. After the war this preference became almost absolute. Cash in the street was generally limited to DM with dinars only used for small change.

Kosovo also had the same Yugoslav financial institutions as have been described above for Bosnia and Herzegovina. Until the breakup of the former Yugoslavia in the early 1990s, the National Bank system was decentralized into a network of Republican and autonomous regional National Banks, one of which was the National Bank of Kosovo (NBK). The National Bank system was accompanied by a parallel, countrywide network of Republican and autonomous regional Payment Bureaus, one of which was the Payment Bureau of Kosovo (the SDKK[17]). Both the National Bank of Kosovo and the SDKK ceased

[16] "NATO's role in relation to the conflict in Kosovo,"http://www.nato.int/kosovo/history.htm

[17]The branch of the Yugoslav payment bureau system in Kosovo—Sherbimi I Kontabilitetit Shoqeror I Kosoves—or the Public Accounting Service of Kosovo.

to exist in this form under a more centralized system that emerged in the early nineties. The Payment Bureau system of the former Yugoslavia was replaced by the NBY Department of Settlements and Payments (DSP), the latter being defined as a specialized organization within the NBY.

The headquarters of the National Bank of Kosovo in Pristina were severely damaged in NATO bombings on April 6–7, 1999 and could not be used. Its modern vaults in the building's basement also could not be used and the supply of Yugoslav dinars in its other vaults was very limited and declining. NBK's remaining staff of banking supervisors had ceased any activity.

In June 1999 the offices of the SDKK were operational, though hampered somewhat by broken telecommunications linkages among its branches. The PC's left in the branches were obsolete models, but were adequate for preparing the diskettes for transport to the data center in Pristina. The on-line connection to Belgrade was still used each day but only for conveying outgoing payment orders - again for customers to make use of their dinar balances. These offices were performing payment transactions in YUD at about 5 percent of the amount before March 1999, which required only part-time staff.[18] Cash withdrawals were rationed at five percent of requests to stretch out available inventories of dinar notes to avoid complete shut-down of the office.

Following the end of the war in June 1999, only a few of the five banks and 49 branches of outside banks that were licensed (by the NBY in Belgrade) to operate in Kosovo were still operating and only on a very limited basis. Given the role of the payment bureaus system in Yugoslavia, banks had never been involved in providing non-cash payment services anyway.

[18] The number of staff reporting for work at the Pristina at that time was estimated at about 55-60 (about 10 percent of previous levels). Although the operating hours of the Office remained the same, staff was idle throughout most of the day. This was also true in all of the other offices of the SDKK.

B. Money and Payment System Issues

As Kosovo remained part of Serbia, it could not issue a currency of its own. However, UNMIK quickly decided that the use of DM should be made legal and facilitated. Thus there were no issues of monetary policy to resolve. There were issues, however, with regard to what formal support would be provided for both cash and non-cash payments in DM and how to address an acute shortage of DM coins.

There was an urgent need to initiate payments for UNMIK and enterprises and to provide safekeeping and other payment services in DM. There was a strong desire on the part of the International Community to replace the SDK throughout the former Yugoslavia and this was proving difficult everywhere it had existed. It was decided by all stakeholders to dissolve the SDKK immediately. Thus until a new authority could be legally established, UNMIK provided for the urgently needed monetary services (e.g. safekeeping of border taxes and making pension payments) by hiring the staff and management and leasing the facilities and equipment needed for the entire operation from the SDKK. Clear instructions and supervision were given to the “new” management and staff by UNMIK, but the existing SDKK procedures were used wherever applicable and adjusted as needed. The SDKK proper continued to process the few Yugoslav dinar payment orders it received and had the dinars to pay out.

The provisional civil administration under UNMIK had the authority to administer the assets of the Yugoslav payment bureau offices in Kosovo in accordance with existing (or new) laws. But the ownership of assets was complicated and often unclear. This posed significant challenges to UNMIK’s operations. The IT systems of the SDKK, for example, were owned by the NBY in Belgrade.

The use of DM was made legal (along side the Yugoslav dinar) on September 2, 1999. A regulation formally giving UNMIK control of the SDKK was adopted on October 15. Following a big debate in Washington about whether to create separate banking supervision and payment institutions, the IMF, World Bank, and USAID quickly prepared legislation to establish one new institution, the Banking and Payment Authority of Kosovo (BPK) to take over the SDKK’s payment functions and to license and regulate banks. The BPK was to be an autonomous authority with most of the powers of a central bank, including bank licensing, supervision, and regulation (except to issue its own currency and to extend credit).

Temporarily the new institution would be allowed to accept deposits from the public and provide payment services with those deposits, inventory DM banknotes and coins, and provide local DM settlements for banks. As a practical matter this more or less continued the existing practice of the SDKK. This was a controversial measure, which ran the risk of building up (or prolonging) a commercial function that it should shed as quickly as private banks could be established to take them over. In fact, the first IMF funded Managing Director of the BPK was replaced because of his over enthusiasm for building up these commercial functions.

Foreign advisors prepared the "Regulation" of the BPK (UNMIK's laws were called Regulations). The first draft of the law was prepared in the summer of 1999 in Washington by the IMF in consultation with the World Bank, the U.S. Treasury, and USAID advisers. This draft was reviewed and modestly amended by the UN's New York lawyers. The resulting draft was presented by the UN High Representative to an Economic Policy Review Committee of local leaders. An IMF team then traveled to Pristina and spent many hours answering questions about the draft. On the basis of that meeting and written comments from Kosovars, the draft was revised and issued by UNMIK on November 15, 1999. This procedure was below the minimum amount of local consultation the IMF considered desirable but it seemed acceptable in that environment. A similar procedure was followed with the Regulation on Bank Licensing, Supervision and Regulation. These regulations reflected the UNMIK policy decision that banks operating in Kosovo would be licensed and supervised in Kosovo rather than Belgrade.

One of the early initiatives to improve BPK operations and controls concerned the introduction of universal (one stop service) teller windows. The inherited operation usually required customers to stand in several lines before completing their transactions. Non-cash transactions (usually check transactions) were carried out at designated non-cash windows. Cash transactions were carried out in a two step process at designated Cash Teller windows. The clerk at the first window performed the initial interaction with the customer, receiving the paperwork, etc. Behind the clerk at the cash window there was a Cash Teller, who had control of the cash box. One Cash Teller served two cash windows. The cash window clerk handed the paperwork to the Cash Teller, who verified the paperwork, and either counted and handed over cash for the withdrawal or verified the deposited cash from the deposit transaction. The Cash Teller signed the deposit or withdrawal slip for cash and provided them to another clerk at a second window where the costumer would pick them up. The deposit/withdrawal slip signed by the customer, the clerk and the cash teller was then delivered to another team of employees (on another floor) who entered the transaction into the computer system.

The Universal Teller replaced all of these operations with one person. The purpose of the Universal Teller concept was to facilitate a one-stop service for customers of the Bank (the ability to get all your business sorted out at a single teller window), and to rationalize the internal operating procedures.

The change into a Universal Teller concept involved the following:
1) Re-modeling the Teller windows / workstations to contain equipment for full services;
2) Equipping each Cash Teller (who interacted directly with the customers) with Banknote counting / verification facilities, cash storage boxes with coin trays adapted to EUROs / DMs, computer and printing facilities (one printer shared by each two cashiers);
3) Installation of a bank teller transaction system for online registration of transfers, deposits and withdrawals. The online registration system worked directly with the customer accounts system and was linked to the general ledger structure of the bank; and

4) Reworking the operating procedures and providing training to enable proper operating procedures and supervision, as well as reconciliation procedures.

The same process changes were implemented at the 6 BPK branches. Due to a lack of communication infrastructure and inherent operational issues related to instability in electricity supply, there was a need for special solutions at those sites. The procedures were essentially the same, but the bank transaction operations were conducted on stand-alone applications that where implemented specifically for off-line operations. There were daily exchanges of account status and transactions between the BPK branches and head office (initially by physically transporting diskettes and later electronically, as the telecommunications facilities improved).

Additionally, the new universal teller window operations removed the SDKK from the process, which was revolutionary. In the old system, all transactions that the customer wanted to do with "his" bank had to be performed at the SDKK. Therefore, all non-cash transactions in the country went through the SDKK and the individual bank's standing was reconciled each day in a centralized clearing process.

Though training in the new equipment and procedures was provided, staff expressed unwillingness or unease at adopting the new system. The foreign advisors concluded that this reflected to some extent at least the deliberate desire of local managers to slow down or resist the changes imposed by the transformation of the payment system. In addition, some local managers had an interest in maintaining a certain degree of chaos as a smoke screen for activities that the foreign advisors were not supposed to see.[19]

However, to some extent foreign advisors underestimated the difficulty of the task of installing these new systems. The Kosovo branches of the SDK had been managed by ethnic Serbs. The original managers had been removed from their posts when Kosovo lost its autonomous status 1989. Most of them had moved abroad to Albania or Macedonia. When the Serbian Army withdrew on June 11, 1999, Serbian management and trained staff fled as well leaving neither operating manuals, nor vault keys nor currency needed for recovery. The remaining ethnically Albanian staff was jubilant but lost. When the old ethnically Albanian management and staff returned soon thereafter, they were 8-9 years removed from current operations. They returned to “empty, looted building shells and blank-faced indigenous employees expecting immediate return to their old jobs paying former salaries, and benefits. This feeling of entitlement was exacerbated by the harsh deportation measures taken by Serbian authorities (police eviction, confiscation of passports and other legal documents, loss of all personal property, etc.). Outbreaks of open hostility and physical violence between ethnic groups continued for many months.

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[19] Local examinations conducted long after the new system was put in place, encountered literal “shoebox” cash deposits that were not on record. These were presented as “safe-keeping” storage, and were clearly unauthorized by the “official” management.

"After fruitless appeals to the National Bank of Serbia for support, the SDK in Kosovo was forced to start up payment operations from scratch – an exercise in the "blind leading the blind", literally and figuratively as there were frequent power, heating, and water service outages. Its only source of income was from customs receipts trickling in from the border entry points. Lacking a formal processing system and accounting controls, the cash was stored in a small vault under single accountability in the IMF office at UNMIK headquarters. This condition continued for several months with the IMF Resident Representative riding shotgun on military convoys having cash aboard.[20] Meantime, Kosovar staff returned to their old posts, signing duty rosters at 8 am, chatting, snacking and smoking until signing out in the early afternoon. Public commerce largely reverted to barter and cash using D-Marks or US Dollars; the noncash payment system collapsed.

"At the beginning of the transition, the Kosovo payment system lacked:

- legally licensed banks (a few rump offices had opened),
- credible noncash payment regime; few payment orders issued used the old SDK account numbers; all paper handling was manual with over-the-counter presentment to banks,
- efficient teller lines; every transaction was tied to teams of controllers and liquidators assigned to specific accounts (3 clerks per 1 transaction was the template for the socialist business world),
- operable computers with central bank application and database software,
- data communications between departments within the Pristina Office, and between it and the 6 branches and 22 sub-branches,
- universal account numbering scheme to identify customers across all banks and branches,
- reliable utilities - telephone, electricity, and water, occasionally available,[21]
- adequate physical security for cash deposits; Fiscal Authority money piled up in the Pristina vault with each business day; unverified deposits kept intact according to each CFA agency, and
- trained managers, supervisors and employees.

"Over the span of 24-36 months, foreign experts paired with local counter parties implemented the following solutions in the BPK:

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[20] This IMF employee, Scott Brown, was later seriously injured in Baghdad, when the UN headquarters in the "Canal Hotel" were destroyed by a terrorist bomb.

[21] During the winter of 1999/2000, the electricity supply were often out at least 12 hours a day, spread across 24 hours in intervals of two hours. The in-house power generation systems were dimensioned for handling short power intermissions, not continuous operation for hours.

- Procurement and installation of a modern local-area network (LAN), PC workstations and two application and backup servers for a new PC-based bank system, uninterrupted Power Supplies (UPSs) and network printers.(funded by USAID),
- PC-based banking software and training support acquired via a grant from the Norwegian government,
- formal western-style universal account numbering system devised and mandated by BPK; installed by commercial banks,
- universal teller stations enabled one-stop banking services at each BPK window; number of windows was shrunk about 30-50%; corresponding drop in staff requirements, revision of all documents involved in payment/cash transactions and integrated with the revised operating procedures,
- rudimentary clearinghouse established after third bank was licensed; with volume growth clearinghouse was automated and later connected on line to banks for electronic file deposits,
- Vault cash put under a dual control regime - upon formal transfer from the IMF in January 2000; commingled cash deposits adopted (generic vault); computerized vault inventory management system devised and configured within the above mentioned banking system,
- Euro replaced D-mark,
- complete personnel management regime installed, including job descriptions, salary schedules, benefit programs, and formal employee relations policies,
- Emergency power backup generators acquired, and,
- Local staff trained for most positions."[22]

C. Assessment

The key policy decisions were:

- Make DM a second legal tender

- One institution or two (banking supervision--payments)

- Prolong the SDKK or establish a new institution right off
  1) SDK hard to kill and still needed (our quick route vs. Locals long route)
  2) Use SDKK IT systems? Needed OK of Belgrade

- Scope of payment activity in the future –to build an institution or not

[22] Personal correspondence from Len Fernelius, IMF payment systems consultant in Kosovo from 1999 – 2002.

1) Accept deposits from government and related services?
2) Accept settlement account deposits from banks?
3) Administer YUD payments via SDK/NBY system?
4) Maintain DM cash and coin stock

The strategy adopted resulted in the immediate demise of the SDKK as intended. However, the establishment of the new BPK proved more difficult than anticipated despite considerable international support (from the IMF, USAID, World Bank, and Norway). Following the end of conflict, all Serbian management of all state or quasi state organizations left Kosovo, which meant that all management with any experience over the past decade left. Generally the remaining Kosovar staff appointed to these vacant positions were those who had occupied them ten years earlier before Kosovo lost its autonomy. Thus capacity of local staff was very low.

The basic strategy of establishing a new organization (the BPK) rather than restructuring the existing ones (the NBK and SDKK) was sound, but its requirements were underestimated in several respects. First of all the existing staff of the NBK and SDKK needed to be dealt with and they did not initially accept the idea of applying for positions in the new organization, which would occupy what they considered their worker owned property. The existing SDKK accounting software had to be used initially, with adaptations to add the DM and the installation of a new package was plagued with problems. The existing software was owned by the NBY, whose permission was required for upgrades and proper maintenance. The boundaries of the law were stretched in several areas. The NBY hardware was plagued by component failure; in October 1999, only 1 of 4 processors in the System Mainframe was still in operation, and the peripherals and utility systems were in a condition of disrepair. Spare parts were not readily available. The system was operating in a language and with a character set not very transparent for external consultants. Also, approaching the eve of the Y2K issue (the millennium bug), it was at best unclear how the system would tolerate the transition.

Political considerations led to some departures from purely economic judgments. The initial size of BPK staff was set higher than justified by its needs in order to soften the employment impact on existing NBK/SDKK staff. The “Governor” of the NBK, who had been “appointed” by both shadow governments (Arje Begu) was made Chairman of Board in order to gain his agreement not to be appointed Managing Director (which went to foreigners for some years).

Advisors recommended that from the start of operations of the DM Transition Payment Services, the multiple teller window organization of services used by the SDKK for transactions in Yugoslav dinars (YUD) should be replaced by a single stop universal teller window. Because of inadequate training and local staff resistance to changes, this proved much more difficult than expected.

The senior most management positions at the BPK and at the new Ministry of Finance (MOF) were occupied by foreign advisors from USAID contractors, the IMF, and other bilateral donors. Cooperation among these groups proved to be a major challenge even among USAID contractors. As but one example, the World Bank and USAID had prepared a draft banking law for a separate banking supervision institution. The IMF had prepared draft banking and payment laws that envisaged a single institution performing both sets of functions. These differences were fortunately resolved in Washington in a cooperative way.

The failure of the BPK to provide reliable account information on MOF balances on a timely basis created tensions between the BPK and MOF (both headed by foreign advisors), which opened its own accounts abroad for a while. Communications and information sharing among these groups was inadequate. Efforts were also hampered by a lack of continuity in the senior management of the BPK. To some extent, management and adequate operational control were also hampered by micromanagement and at times differing opinions among advisors (e.g. between the BPK Managing Director—an IMF consultant—and the Deputy MD—a BearingPoint/USAID consultant).

The development of the BPK's banking supervision functions, on the other hand, which was fully under the supervision of a USAID contractor (BearingPoint), was an unqualified success. Banks were licensed, regulations adopted and supervisors trained on schedule. Within two years two or more banks operated in all of the major cities allowing the BPK to terminate its private sector deposit taking activities in those cities and eventually close its branches there.

It took about two years longer than planned for the BPK to close all branches and reduce staff to about 100 and to operate with an acceptable degree of efficiency. However, once the task was directly undertaken in 2002, it was accomplished effectively and without complaint from displaced staff. The success of this task reflected careful planning and communication with staff at every step of the way. Severance packages and serious help with relocation to new jobs were given to those who lost their jobs with the BPK.

It should also be mentioned that BPK undertook an unprecedented replacement of all DM cash with EURO, moving approximately 1 Billion DM in cash out of Kosovo and replacing it with the equivalent value in EUROs. The replacement of these banknotes had to be financed upfront unlike most Central Bank domestic operations. Considering the geographical aspects of the operation and the fact that the BPK had to provide a "starter kit" for an entirely new cash situation including 75 metric tons of coins, it is safe to say that this operation was singular in the world of cash management.

This undertaking involved a large portion of the BPK operations capacity. The requirement to provide adequate cash exchange services for the commercial banks as well as for expediting the cash exchange process by providing public exchange operations through the BPK branches led to keeping the BPK branches open through the EURO changeover period. This was absolutely necessary both from a capacity point of view as well as for security reasons.

V. Afghanistan

A. Background and Initial Conditions

Civil strife raged on and off for decades, largely between Afghanistan's different ethnic groups and their regional leaders. The interests of the largest minority Pashtuns in the south, the Tajiks, Turkmen, and Uzbeks in the North and the Hazaras in the West were continually fanned by neighboring countries with their own interests in mind. The forty year reign of King Zahir Shah ended in 1973 when Prince Daud, a former Prime Minister, proclaimed himself the first President of the Republic of Afghanistan. President Daud and his entire family were assassinated on April 28, 1978 in a military coup headed by communist party leaders with close ties to the Soviet Union. Feuding between communist factions lasted until Russian solders moved into Afghanistan Christmas Eve 1979 and took control of the Presidential Palace.

Civil war intensified during Soviet occupation (with CIA and foreign assistance to several resistance groups) until the Soviet Army began withdrawing in 1988 with President Najibullah (a Soviet puppet and former Head of the Secret Policy) in control. During this period the cities were dependent on the Soviet army for security and on Soviet aid for food and other necessities. Much of the countryside depended on U.S. and Arab aid.

When Burhanuddin Rabbani was elected president of the Republic in 1993, full scale civil war irrupted as regional war lords Dostom, Masoud and Hekmatyar began to fight for control of Kabul. In 1995 the Taliban began a campaign against one war lord after the other until by 1997 they controlled what was left of Kabul and 95 percent of the country. Thus political division and civil war raged for over 20 years and multiple power centers and regional rulers (war lords) provided what stability and security there was. It is estimated that 4–7 million Afghanis fled the country during this quarter century, mostly to Pakistan and Iran.

Even before the Soviet invasion of Afghanistan in 1979, Afghanistan's once private banks had been "socialize" during 1974-76. Under Soviet control during most of the 1980, the banking system was further transformed into the Soviet model of specialized monobanks. Da Afghanistan Bank (DAB), the central bank that had been established in 1939, also performed many commercial banking functions through its large branch network.

Banking was dormant during the Taliban rule. Interest on existing loans was canceled and was not allowed on new loans. Deposit mobilization dropped to very low levels and banks stopped lending. Their loan portfolios deteriorated as large numbers of borrowers defaulted. No currency was printed and the government had very little recourse to central bank financing. Payment services were increasing provided by moneychangers and the unregulated hawala system rather than banks.

When U.S. military forces toppled the Taliban regime in November 2001 following the Al Qaeda terrors attacks on the U.S. on September 11, 2001 the Afghanistan financial system consisted of DAB, three state-owned special purpose development banks and three state-owned commercial banks.[23] There were about 400 registered money changers operating in Kabul with and a much larger but unknown number operating in the rest of the country.

"None of these financial institutions had been operating in a normal fashion for years. Among the banks, financial intermediation had in effect come to a halt. Having experienced exceptionally difficult conditions over many years with episodes of hyperinflation and exchange rate collapse, it was hardly surprising that the banks were suffering. In an analysis, in early 2003, of the Agricultural Development Bank's balance sheet, the value of the average loan in the banks portfolio amounted to $0.65 per borrower. In another example, the leading bank, Banke Millie Afghan, had already ceased financial intermediation in 1992, but during 2002 had managed to extend a total of six commercial loans."[24]

"At the end of 2001, Afghanistan's financial system had largely ceased to exist. The country had become almost entirely cash-based. Banks had essentially stopped functioning during the Taliban years and whatever financial infrastructure had survived the many years of conflict was in very poor condition. What remained was the informal Hawala system that people could use to change and transfer money. Confidence in the national currency, the Afghani, was low, as it had lost much of its value following years of high inflation. [25]

The economy was heavily dollarized. The U.S. dollar, Pakistani rupee, Iranian Rial, and the currencies of other neighboring countries were used widely The central bank was not even in control of "its own" currency. In addition to older issues still in circulation but no longer printed,[26] the Rabbani Afghani, issued since 1992, was the official currency issued by DAB. The Rabbani Afghani had no human faces and were thus acceptable to the Taliban regime, which continued to issue them from existing stocks. The internationally recognized government in exile in the northern areas of Afghanistan, which also claimed to control and operate DAB, but from northern offices, ordered additional printings of the Rabbani notes from the Russian printer Mezhdunarodnaya Kniga. When this came to light the Taliban regime outlawed those notes, which had higher serial numbers than the earlier issues held by DAB in Kabul. The government in exile then ordered additional printings using duplicates of

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[23] Two institutions that were licensed by the Taliban regime to perform banking service based on Islamic principles never started operations.

[24] Åke Lönnberg, *Building a Financial System in Afghanistan,* May 29, 2003 pages 6-7.

[25] *Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth* IMF Country Report No. 03/299, September 2003, page 97

[26] These were the so called Shah Afghani versions I and II, issued before 1974; the Daud Afghani, issued from 1974 through 1978, and the Najibullah Afghani, dating from the 1980s through 1991.

older existing serial numbers and circulated them in the north. These were, obviously, indistinguishable from the originals. It is suspected that more than one duplicate printings were made and there are many rumors about where many of these notes wound up. The Afghani note situation was further complicated by high quality counterfeits printed abroad and issued by two war lords in the north to pay their troops. General Dostum issued notes printed from plates prepared by Thomas de la Rue at the instruction of a previous government official, who had the authority to place the order at the time.

B. Currency and Payment Issues

The Interim Authority installed by the UN on December 22, 2001 faced the usual critical problems of meeting its financial obligations (payment salaries and pensions and suppliers), providing a currency with which to do so and establishing the means for preserving its value.[27]

By the end of 2001 when the Interim Authority took over, the remaining stock of "official" Rabbani Afghanis in the vaults of the central bank in Kabul was very low. In addition, "President" Rabbani of the Northern Alliance received additional shipments of notes his government had ordered, some of which were issued. General Dostum's notes where in general used in the Uzbek regions he controlled where they traded at or above par (relative to "official" notes), but traded in Kabul with an approximately 50 percent discount. The U.S. dollar and other currencies were widely used.

In these circumstances, the Interim Authority needed to decide on an existing currency for government wage and pension payments, and to determine what its currency and monetary policy regime would be in the medium term. These choices had important consequences for establishing the credibility of the new government. The IMF outlined three options: a) immediate full dollarization; b) partial dollarization by government and continued use of the official Afghani by the public; and c) issuing a new currency as quickly as possible.

"An alternative option, recommended by IMF staff based on pragmatic economic and technical grounds, was to use a foreign currency to conduct government transactions until the new currency could be introduced. Meanwhile, the public would have been free to use any

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[27] The Taliban government had never been recognized by the UN. Thus it was the government of Burhanuddin Rabbani, of the Northern Alliance, that transferred power to the UN appointed Interim Authority headed by Hamid Karzai. The Interim Authority transferred power to the Transitional Authority established by the Emergency Loya Jirga, Afghanistan's traditional tribal council, on June 13, 2002. A Constitutional Loya Jirga prepared a new constitution, which it ratified on January 4, 2004. On October 9, 2004 Karzai was elected President under the new Constitution and Parliamentary elections are scheduled for mid September 2005.

mutually agreed currency for any transaction and to hold any currency. Existing Afghanis would have continued to circulate until redemption by the new currency, within a floating exchange rate regime, but the central bank would not issue more Afghanis. The government would have announced its commitment to redeem existing Afghanis for the new currency at a later to be determined rate."[28]

I personally doubted the viability of the IMF's preferred option as the value of the existing currency during the interim period before it could be redeemed was uncertain.[29] The IMF wanted it to float, because they wanted the new currency when it was issued to float. The old currency's value was to be protected by restrictions on issuing any additional amounts and by the promise to redeem it for the new currency when the time came at its prevailing market value at the time. Market sensitivity to this issue is illustrated by a press conference in Kabul on January 29, 2002 at which I responded to a reporter's question about the dollarization option by describing its pros and cons without mentioning what would happen to the existing Afghanis. Following the press conference the Afghani depreciated about 25 percent against the dollar until action Governor Abdul Qadeer Fitrat explained that they would, of course, be redeemed for dollars at a fixed and fair value. Its exchange rate recovered within a day or two.

The authorities chose to issue a new currency quickly. They saw the issue of a new currency as an important contribution to the credibility of the new government and thus to state building. However, the period until a new currency could be designed, printed, delivered and issued, posed some very difficult choices. This period was kept to nine months by a clear focus on this objective by President Karzai, good advice, hard work and good luck.

During this nine month period, DAB in Kabul received delivery of new Russian printed notes with duplicate serial numbers that had been ordered earlier by the Rabbani government. Acting Governor Fitrat refused to issue these notes on principle and because of the difficulties with control posed by the duplicate serial numbers. Instead, the government was forced to sell aid provided dollars to the market in order to acquire existing Afghani's (hopefully legitimate ones) to use for government expenditures until the new currency was available.

Taking advantage of an existing contract and preliminary work on the design of new currency notes undertaken between the Taliban regime and Gieseck&Devrient, a reputable German note printer, new notes were designed and printed in an extraordinarily short time. For a period there was discussion of issuing some of the new ("German") notes before the

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[28] International Monetary Fund, "Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth," IMF Country Report No. 03/299, September 2003. Page 98.

[29] I favored full dollarization for at least two years or longer.

official conversion period started. But the authorities were concerned that without adequate public information about the new notes, which was not feasible in such a short period of time, public confusion could undermine the reputation of the new currency.

The greater challenge was developing and implementing sound plans for the distribution and safekeeping of the 500 tons of new notes, and of the even larger amounts of redeemed old notes (and their safe destruction), the rules and locations of exchange and the education of the public with respect to them, and the internal procedures of the exchange needed to minimize theft and corruption and training of 2,500 DAB staff to carry them out. The usual infrastructure of bank and central bank branches, with vaults and staff trained in cash handling, was very largely absent. In addition to airplanes and armored cars, satellite phones, counting machines and accounting equipment, to name but a few items, were procured. The new currency had to be safely transported to 47 secondary exchange points throughout the mountainous country (almost the size of Texas) and from there to other facilities at which Afghanistan's 26 million people could make the exchange. About half of the total currency had to be flown to exchange points. The destruction of old notes, which proved a challenging task, was decentralized thus reducing the amount of transporting needed, but increasing the need for proper field security and monitoring.

The very tight time table did not allow for fully adequate preparation but with only a modest delay the new currency was introduced on October 7, 2002. From then until January 2, 2003 the old Afghanis (both those issued from Kabul and those that had been issued earlier with duplicate serial numbers in the north) were exchanged at the rate of 1,000 old for one new Afghani. Two types of "unofficial" Afghani notes where exchanged for political reasons at a 50 percent discount to the rate used for official notes "(close to the actual discount at which these counterfeits traded in the Kabul money market)."[30] Approximately 19 trillion old Afghanis were exchanged for new ones, compared with an estimated 13 trillion outstanding at the start of the exchange program. The difference is attributed to the exchange of counterfeit notes and some amount of doubt exchanges (reexchanging old notes more than once). It is also possible that the number of duplicate serial numbered Afghanis was somewhat under reported from the outset. The lack of adequate preparations resulted in a relatively high loss rate from corruption of one sort or another, but the achievement of a quick and successful exchange quickly improved DAB's control over its currency, provided the government with a reliable currency for its budgetary operations, and provided an important symbol of the existence and capacity of the new government. The logistical challenges of putting together and managing such a large one off undertaking should not be underestimated. Overcoming the political challenges of obtaining regional (war lords) and public cooperation and support, which by no means could be taken for granted, was a very major and critical accomplishment as well.

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[30] *Ibid*, Box V.1 page 100

The introduction of the new currency in record time also owns much to the determination and focus of the Karzai government, its delegation of the authority to take key decisions to Ashraf Ghani, the Finance Minister, the ability of Governor Anwar ul-Haq Ahady and DAF to organize the logistics of the exchange, and the help of the IMF, USAID, and international donor community.[31] In addition to the speed with which new notes were designed and printed, the decision to allow the public to exchange existing notes without limit simplified the exchange process.

More importantly, the decision to utilize the services of money changers (hawala dealers) was critical. The hawala dealers had an established network for dealing in cash throughout Afghanistan (and the Middle East) that the barely functioning banks did not. The public requires payment services for good and bad purposes. Like the U.S. dollar itself, hawala dealers facilitate the use (laundering) of opium money and the financing of terrorism as well as the remittances of money earned by Afghanis abroad to family members at home and other normal payments. Initially the U.S. government opposed the use of hawala dealers, who by the nature of their operations could not be closely monitored or controlled. This opposition was overcome by the lack of viable alternatives. The hawala dealers were formally brought into the exchange process and their role was essential to its success.

C. Monetary Policy

The decision to issue its own currency meant that Afghanistan would also need to adopt a policy regime to ensure the stability of the value of its currency. Traditionally the afghani has traded freely at market determined exchange rates and the government, with IMF support, wished to continue this policy. Thus the policy regime would need to aim to control the growth in the supply of afghani to match the growth in its demand at stable prices. This requires data, analysis, and policy instruments that will enable DAB to determine and achieve an appropriate growth rate for money. These capacities take some years to develop.

In the interim, the government adopted a policy of no deficit financing in order to remove the usual source of money creation and inflation. The central bank law subsequently adopted on September 18, 2003, but not Gazetted until February 2004 (the first draft prepared by the IMF was available in the spring of 2002) restricted DAB from lending to the government. This is now a common feature of independent central bank laws. For all practical purposes, there was no banking sector to lend to either. The source of monetary growth came from the sales of donor provided foreign exchange to DAB for the afghanis spent through the budget. DAB in turn auctioned dollars to the market as a means to withdraw any excess liquidity created by the first operation and to stabilize (but not fix) the exchange rate. As part of a Staff Monitored Program with the IMF, DAB targeted the growth

[31] A separate case study for Afghanistan in this volume, coauthered by Mr. Ghani, provided and more detailed discussion of the currency issue.

of currency in circulation using its foreign currency auctions as the primary instrument of control.

These weekly auctions of dollars to the market were initially conducted only with money changers. In 2005 they were broadened to allow banks to participate and in the future it is expected that money changers will need to participate through banks. The government quickly agreed to make DAB independent but was very slow in adopting the new central bank law. USAID financed a large scale project with BearingPoint to modernize the structure, systems, and staffing of the central bank. One aspect that was very effective, but not without its problems was recruiting young, well educated Afghanis as BearingPoint employees in the central bank on whom its training efforts were focused (they were often resented by regular DAB employees). In mid 2005 most of these BearingPoint local employees became regular DAB employees while some were hired away by private banks.

D. Banking and Payment Systems

As with most other post conflict economies, banking sector rehabilitation and/or reform was a second order priority. Technical assistance in drafting a new banking law, which provided for the establishment of branches of foreign banks and for foreign ownership of Afghan banks, was provided in mid 2002 and the new law was adopted in early 2003. Under the new law all existing banks were required to seek new licenses.

Three of the state banks were relicenced (Bank Millie Afghan, Pashtany Tejaraty Bank, and Export Promotion Bank), four foreign owned banks (Afghanistan International Bank, First Micro Finance Bank, Kabul Bank, and Arian Bank) and four branches of foreign banks (Standard Chartered Bank, National Bank of Pakistan, Habib Bank, and Punjab National Bank of India) have been licensed. As of August 31, 2004, the total assets of these banks amounted to about Af 14 billion (of which 70 percent was with the state banks). This compares with about Af 35 billion currency in circulation at that time.

By mid 2005 nothing had really been done to wind up the three state banks that had not been relicensed nor to restructure the three that had been. Resolving state banks, which almost always involve large numbers of employees and issues of favoritisms and other forms of corruption, is invariably a delicate political issue. There is little political appetite to address the work ahead for these banks until at least after the parliamentary elections in September 2005. As these banks have been largely dormant for a long time, neglect for a period is not unreasonable (as long as they are not making new loans). In this environment the new foreign banks and branches are growing rapidly and the money changes and hawala systems continues to provide the back bone of the payment system. Though DAB has been gradually shedding its commercial bank functions, it will not be feasible to end all of them (payment services for the government) until the state banks have been fully resolved.

VI. Lessons and Conclusions

Technical assistance to Afghanistan, Bosnia and Herzegovina, and Kosovo (as well as to Serbia, Timor Leste, and West Bank and Gaze Strip) in the monetary area has had mixed success. Advance planning and preparation helps foreign assistance to be available when most needed. Advice already at the stage of peace negotiations can be particularly helpful in providing a sound foundation for subsequent development of sound monetary arrangements as illustrated by the Dayton Peace Agreement for Bosnia and Herzegovina. Early planning can also help minimize and deal with turf battles and donor coordination issues. These and other lessons are summarized below.

A. Planning and Donor Coordination Is Required

The donor resources available for post conflict reconstruction are limited and need to be used effectively. In addition, policy advice and reform strategies are less likely to be adopted and implemented if the donor community does not speak with more or less one voice. To a large extent, financial policy leadership is provided by the International Financial Institutions in accordance with well established competences. Such broad agreement on the assignment of leadership responsibilities has generally made it possible to settle rather quickly and easily the marginal turf battles that inevitably exist at the beginning of each new post conflict reconstruction experience. Mechanisms of coordination, such as Donor Consultative Groups, are very important. These mechanisms are generally well understand, but need to be rebuild with each new post conflict case.

A highly successful example of coordination of work somewhat outside of the ordinary is provided by the reform of the payment bureaus in Bosnia and Herzegovina. Two and a half years following the Dayton Peace Agreement donors applied considerable pressure on the Entity governments to dismantling of the payment bureau successors of the Yugoslav SDK and gave the reform of the payment system to high priority. Though technically relatively efficient, the payment bureaus of the three regions had been powerful instruments of state and political control of the economy and were thought to be slowing the economic reform and integration that was expected to contribute to the development of the new political arrangements. The payment bureaus also undercut the development of banks, which in other countries provided many of the payment services provided by these bureaus.

Many donors were very eager to contribute to this effort. Sharp differences of view immerged among them over how to proceed. The main difference, which was more among individuals than donor organizations, was with regard to the extent of donor or local control of the process. One group pushed for a Donor Steering Group to control the process to ensure that the reform "was done right" and expeditiously. Another supported a donor advisory group with implementation control with the locals, arguing that a smooth transition to a modern payment system was not likely without local ownership and support. The IMF took the leadership in preparing a draft strategy document, which set out the proposed elements of the future payment systems and the means for developing them while dismantling the existing payment bureaus (SPP, ZAP, and ZPP). The document was first discussed among the donors (World Bank, EU, USAID, US Treasury, and others) and revised accordingly. With an agreed donor position, the revised document was discussed in a series of meetings of the Bosnia and Herzegovina Payment System Council (which had representative from all three ethnic regions).

Once agree, the document became the blue print of reform with individual donors assigned specific responsibilities for assistance. Control of the project was with the locals (the CBBH, SPP, ZAP, ZPP and respective Entity finance ministries). Rather than a Donor Steering Group, the donors established an International Advisory Group on Payment Bureau and Payment System Reform. Payment system reform was assigned to the CBBH (and IMF). Other donors were assigned to payment bureau reform with respect to its other functions and organizational structure. Two years later, on January 5, 2001, the CBBH launched a Real Time Gross Settlement system and Giro clearinghouse and such activities through the payment bureaus ceased. These systems have been a spectacular success. The transformation of the Payment Bureaus as institutions was less successfully in handling the employment impacts.

B. Short Term Needs and Long Run Development

The solutions to the immediate needs for a new government to have a currency and to make payments need to be considered in the light of the best approach to the long run development of the monetary and banking system of the economy. Existing facilities and staff should generally be used initially but this may contribute to the perpetuation of approaches that are not appropriate in the long run. Advance planning by experienced experts and a clear but evolving strategy for development are the antidote.

The most important short term decisions with respect to long run options are:
a) the choice of currency and monetary policy regime;
b) the extent to which existing institutions, facilities and laws are used initially; and
c) the extent of modernization of state banks destined to be privatized or liquidated.

In **Bosnia and Herzegovina** the advance agreement on the monetary regime in the Dayton Peace Agreement was an enormous advantage that allowed reconstruction and reform to focus on the institutional establishment of a new central bank and the liquidation of existing ones and on the very challenging task of reforming the highly centralized payment bureau system of domestic payments. Reliance on the existing payment bureaus in the beginning assured immediate continuity of domestic payments, but it may have prolong the period of transition to a new modern, bank based payment systems. None the less the modernization of the core payment systems and development of the banking system proceeded steadily in an orderly fashion without disruptions. Bosnia was the first former Yugoslav republic to completely replace the old SDK type centralized domestic payment monopoly, despite starting later.

In **Kosovo** the United Nations Interim Administration Mission in Kosovo (UNMIK) quickly agreed to establish the German mark as a legal tender (along with the existing

Yugoslav dinar) and to use it exclusively for domestic payments (temporarily) through the existing payment bureaus. This indorsed what was already in place and facilitated focusing on developing the limited purpose Banking and Payment Authority of Kosovo (BPK) and developing the banking system with modern bank based payment systems. However, the immediate replacement of the SDK payment bureau system imposed a hardship on the Serbian population, which continued to use the Yugoslav dinar extensively and needed payment services in dinar.

Afghanistan faced bigger challenges because of a more complicated, multiple currency situation. A number of factors favored dollarization, including the speed with which a foreign currency could have been introduced and the ease of managing it. However, for historical and statebuilding purposes the authorities choice to issue their own currency. This proved to be quite costly in terms of delay, direct costs, and corruption. However, they were able to take advantage of earlier partially completed work to issue a new currency in just eight months. A new central bank law protects the value of the new currency from the inflationary effects of central bank lending to government, but the choice of a market determined exchange rate monetary policy regime has placed heavy demands on the central bank's capacity to manage monetary policy, which it is not yet fully able to fulfill. The government also continues to rely on the central bank's branch network and commercial operations as well as the hawala (money changers and remitters) to facilitate government payments. The government had a difficult choice of whether to quickly expend the activities of the state banks or to continue to use the services of the central bank. Its choice to use the central bank and hawala system for payments should result in a more carefully considered strategy for the state banks going forward but such a plan has not yet been developed.

Iraq, on the other hand, faced very difficult currency choices and decided to issue a new currency (technically a new note series of the same currency) in order to increase the depleted note supply with notes without Saddam Hussein's picture without dollarizing. Though economically advantageous, the Coalition Provisional Authority (CPA) decided that dollarization would not be acceptable politically. As an emergency interim measure, U.S dollars where imported and used in government salary and stipend disbursements and additional Saddam dinars were printed until the new notes could be produced and issued. Though the stability of the new notes would depend on the monetary regime adopted, no clear decisions on a monetary regime were taken by the time the new notes were exchange for the old ones. The currency exchange itself was very successful, but the propensity of the CPA to focus on fire fighting, has resulted in quite limited capacity building at the Central Bank of Iraq. Two years after the toppling of Saddam's Ba'athist regime, the U.S. Embassy and military remain heavily involved and focused on cash distribution around Iraq. The lack of security continues to overshadow every thing else.

C. There Are No Blank Slates

The world has no blank slates. Every society has existing institutions, customs, and attitudes, which are ignored at the new government's (or its advisors') peril. The Central Bank of Bosnia and Herzegovina was legally a new institution but it took over the buildings, systems, and some of the staff of predecessor central banks. The Banking and Payment Authority of Kosovo was a radically new institution, but it took over the buildings, systems and some of the staff of the National Bank of Kosovo and of the Kosovo branch of the Yugoslav payment bureau. New systems and ways of operating needed to be built from those existing bases. They are not constructed on a blank slate and dealing with existing staff posed many serious challenges.

Though the **Palestine Monetary Authority** had no predecessor nor any existing buildings, staff or systems, there were existing arrangements in place for banking and payments, which provided the experience and frame of reference from which new approaches and systems needed to be built. In some instances a new institution may be easier to develop than reforming an existing one, but not always. In any event, the management of the new (or old) institution will be working with the human capital and experience available and change and new knowledge take time to develop properly.

Progress in developing the **Banking and Payment Authority of Kosovo** was slower than it needed to be because when establishing new systems and procedures, the difficulties of overcoming earlier training were underestimated. Not enough effort was made to obtain local buy in to the need for the new systems and training in the new systems was inadequate.

In all cases, political sensitivities and conflicts need to be understood and dealt with. The time and resources required are easily underestimated.

D. Policies Must Reflect Capabilities

Some policies are more demanding than others. What is possible will depend on what is in place and what resources can be drawn on.

Dollarization can be implemented quickly and easily, but with its own limitations and political draw backs. **Bosnia and Herzegovina** relied extensively on existing institutions for several years and the Current Board arrangements minimized the demands on the new central bank while it focused on its establishment and on reintegrating the monetary and payment systems. This was as much a political as a technical challenge and gave the time needed for the gradual reestablishment of interregional trust. Dollarization in **Timor Leste** provides a similar example.

The adoption of a new accounting system at the **Banking and Payment Authority of Kosovo** also proved a very major challenge to the staff. The difficulties in modernizing information systems even in the United State (take the recent example of the $100 million dollars spent by the FBI on a new case management system that failed and was abandoned)[32], illustrates the difficulties even in favorable environments.

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[32] "FBI Pushed Ahead With Troubled Software", By Dan Eggen, *The Washington Post*, June 6, 2005, p 1.

The monetary regimes adopted in **Afghanistan and Iraq** are much more demanding, with much less by way of usable existing systems to draw on. Serious errors in implementing monetary policy have been avoided by the protection established in the new central bank laws against central bank lending to government and by the current adequacy of donor provided international reserves with which to stabilize the exchange rate. The results have not been as good, though it is still early. The security situation, especially in Iraq, has prevented much of the development and capacity building at the central bank that might otherwise have been possible.

The design and introduction of a new currency is a once off undertaking for which relevant local experience is not likely to be found. Foreign assistance will invariably be needed and was effectively used in Bosnia and Herzegovina, Timor Leste, Afghanistan and Iraq.

E. Political Support for Reforms Is Needed

Other than for purely technical matters, reforms in the financial sector are difficult to implement without local understanding and support and are less likely to take root and survive.

Even in the presence of NATO troops, the local political leadership in **Bosnia and Herzegovina** would not agree on and accept a new country wide currency for over two years after the December 1995 Paris signing of the Dayton Peace Agreement. The three Joint Presidents did not agree on a new central bank law creating the Central Bank of Bosnia and Herzegovina until May 1997. The CBBH opened its doors on August 11, 1997. The new bank notes were not issued until June 22, 1998. However, the very slow pace of these steps built sufficient local support that the new central bank and its currency became an enormous success in a bitterly torn country with few successes.

Though heavy handed compared with Bosnia and Herzegovina, the process by which the central bank and banking laws were adopted in Kosovo by the **United Nations Interim Administration Mission in Kosovo (UNMIK)**—one of the few other instances, along with East Timor, of post conflict reconstruction lacking a sovereign counterpart—included serious discussion with and among Kosovars.

The goal of government and enterprise efficiency, which was important for economic development and thus ultimate success in statebuilding, often conflicted with short term needs to maintain household income and security, which was also important for public support of the state. For this reason the steps to shed redundant workers and thus make institutions more efficient were often implemented slowly and with a delay. The slow pace of the downsizing of the BPK in Kosovo is an example. However, such delays also ran the risk that padded staffs and poor work ethics could be ingrained or perpetuated for a long time. This also illustrates the tension between short term and long term considerations. The difficulties in implementing the Universal Teller Window systems and new accounting systems in Kosovo also illustrate the impossibility of reform without local support.

A number of the reforms adopted in Iraq by the Coalition Provisional Authority with minimal local consultation and buy in were simply ignored once sovereignty had been returned to Iraqis. Thus the merger of three of the state banks into a fourth and the resolution of the central banks claims on the government adopted by the CPA where never implemented.