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Establishing a Banking System During Stability Operations – Roles for the Military? The Kosovo and Afghanistan Experience

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Introduction

Economic growth is an important factor in establishing peace and security in a post-conflict environment.[1] Without broad economic improvements, stability is difficult to achieve, let alone maintain.[2] Research conducted by Paul Collier (2007) empirically affirms the need for economic growth in order to achieve enduring stability. In the absence of economic growth, his research shows that forty percent of all post-conflict countries return to violent conflict within a decade.[3]

Common features of conflict-ridden economies are vulnerability to external economic shocks, "fragmented markets, limited access to credit, reduced confidence, depleted human capital, increased illicit economic activities" and debilitated economic institutions.[4] These circumstances increase both the costs and risks of commercial activities and investments, thereby increasing the risk of delay in establishing sustainable economic solutions to conflict. [5, 6 ,7]

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[1]Kreimer et al., The World Bank's Experience with Post-Conflict Reconstruction (Washington, DC: The World Bank, June 1998), http://www.wds.worldbank.org/ external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&theSitePK=523679&entityID=000178830_98111703551072&searchMenuPK=64187283&theSitePK=523679 (accessed 22 September 2010), 22.

[2]United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, *Guiding Principles for Stabilization and Reconstruction* (Washington, DC: United States Institute of Peace Press, 2009), 9-133.

[3]Paul Collier, "Post-Conflict Recovery: How Should Policies Be Distinctive?" (Centre for the Study of African Economies, Department of Economics, Oxford University, 2007), http://users.ox.ac.uk/~econpco/research/dfs/PostConflict-Recovery.pdf (accessed 8 October 2010), 2.

[4]United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries* Washington, DC: USAID, January 2009, http://pdf.usaid.gov/pdf_docs/PNADO408.pdf (accessed 9 October 2010), 4.

[5]United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-132.

[6]Staff of the Monetary and Financial Systems Department, *Background Paper for MFD Technical Assistance to Recent Post-conflict Countries* (Washington, DC: International Monetary Fund, 13 December 2004), www.imf.org/external/np/ta/2005/ eng/022805.htm (accessed 17 November 2010), 4, 8 and 12.

In order to achieve sustainable economic development, the host nation needs an effective banking system. Empirical research conducted by Ross Levine (2000) on forty-nine countries between 1976 and 1993 affirms this necessity.[8] Levine found that the development of the banking system is strongly associated with growth per capita, physical capital accumulation and growth in productivity.[9] The banking system also facilitates economic activity by providing payment services, mobilizing deposits, and easing investment financing. An effective financial system provides funds and connects lenders and investors.[10] Levine's research further indicates that in countries where the legal system emphasizes the rights of creditors and where contracts are rigorously enforced, there will be better-developed banks. His results are consistent with the results of other scholars.[11]

Because a healthy banking system is indispensable for economic development, this paper assesses the impact of the Kosovo and Afghanistan governments, the two primary international financial institutions (the World Bank[12] and the International Monetary Fund[13]) and the primary U.S. development facilitating organization (the US Agency for International Development), have in establishing post-conflict banking systems within Kosovo and Afghanistan. The analysis is conducted utilizing widely accepted macroeconomic and banking assessment and efficiency variables. Finally, because economic growth and security are interrelated and interdependent,[14] the study will further determine an appropriate role for the military (the U.S. in particular) in facilitating this effort.

The economic and banking system assessment variables (AVs) are depicted in table 1 below.

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[7]Ronald W. Johnson and Syedur Rahman, "Improved Budgeting and Financial Management as a Tool for Enhancing the Performance of Local Government in Developing Countries," *International Journal of Public Administration* 15, no. 5 (1992): 1241-1261.

[8]Ross Levine, "The Legal Environment, Banks, and Long-Run Economic Growth," *Journal of Money, Credit and Banking* 30, no. 3 (August 1998, Part 2): 597.

[9]Ibid., 596.

[10]International Finance Cooperation of The World Bank Group, *Afghanistan Country Profile 2008* (Danvers, MA: The World Bank Group, 2008). http://www. enterprisesurveys.org/documents/EnterpriseSurveys/Reports/Afghanistan-2009.pdf (accessed 24 December 2010), 11; United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries* Washington, DC: USAID, January 2009, http://pdf.usaid.gov/pdf_docs/PNADO408.pdf (accessed 9 October 2010), 73.

[11]Dimitris K. Christopoulosa and Efthymios G. Tsionas, "Financial Development and Economic Growth: Evidence from Panel Unit Root and Cointegration Tests," *Journal of Development Economics* 73 (2004): 69.

[12] The World Bank is a vital source of financial and technical assistance to developing countries around the world…to help people help themselves and their environment by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors.

[13]The International Monetary Fund (IMF) is an organization of 187 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

[14]Jonathan Haughton, "The Reconstruction of War-torn Economies" (Technical Paper, Harvard Institute for International Development, June 1998), http://citeseerx.ist. psu.edu/viewdoc/download?doi=10.1.1.116.6026&rep=rep1&type=pdf (accessed 9 October 2010), 3.

Assessment Variables

Economic Variables	**Banking System Variables**
The annual growth of GDP	Does the banking system use an international recognized system for accountability
The credit provided by banks as percentage of annual GDP	The percentage of firms that have a line of credit with financial institutions
The annual rate of inflation	The increase or decrease of deposits during the development of the banking system
The increase or decrease in foreign direct investment	The increase or decrease of investments during the development of the banking system
The annual percent increase in the total volume of money	The percentage of firms using banks to finance their investments
	The value of collateral needed for a loan
	The percentage of firms identifying access to finance as a major concern
	The confidence in the rule of law
	The protection of property rights by the government
	The effort of the government to fight corruption
	Five internationally recognized central banking system characteristics [15]

Source: Created by Authors.

The efficiency (profitability) of the banking system will be determined by using AVs based on reports of the central Bank of Afghanistan and Kosovo (see table 2).[16] Since both countries are in

[15]Five internationally recognized banking characteristics must be present in any central banking system; a central bank with oversight of the local network of banking services or banks, the pursuit of price stability, the facilitation of a stable system of payments, providing independent economic advice to the government, and ensuring commercial banks have sufficient financial funds to meet their obligations. [15] These five criteria are assessed by using the central bank policies and regulations of Kosovo and Afghanistan.

[16]Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009* (Kabul, Afghanistan: Da Afghanistan Bank, August 2009), http://www.centralbank. gov.af/pdf/DAB_QB_Annual-1387%282008-2009%29.pdf (accessed

a different phase of development, different AVs are used to determine the efficiency of each banking system.

Assessment Variables to Determine Efficiency of the Banking System

Afghanistan	**Kosovo**
Breakdown in bank ownership	Total amount of reserves
Growth in bank assets	HHI assets[17]
Growth in bank loans	HHI loans
Growth in bank deposits	HHI deposits
Return on average bank assets	Return on average assets
	Return on average equity

Source: Created by Authors.

Kosovo Case Study

Activities of the World Bank

In early 2000, the World Bank provided two Economic Assistance Grants to support the Kosovo economic reform program by providing United Nations Interim Administration Mission in Kosovo (UNMIK) with financial resources. One of these Economic Assistance Grants was to facilitate the development of the Kosovo banking system, because the commercial banking system and local payment bureau ceased to exist in 1999. [18]

The World Bank further provided technical assistance to financial institutions to facilitate economic growth and improve the financial sector in three main areas.[19] The first area consisted of direct assistance to the Central Bank of Kosovo (CBK). The World Bank assisted in the preparation of development strategies on market development trends, the development of a

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9 February 2011), 94-101; Central Bank of the Republic of Kosovo, *Annual Report 2009* (Prishtina: Central Bank of the Republic of Kosovo, 8 July 2010), http://www.bqk-kos.org/repository/docs/Annual%20Report%202009.pdf (accessed 8 February 2011), 42-43.

[17]Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers. The HHI takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.

[18]World Bank, "Implementation Completion Report on Two Grants in the Amount of US$ 5 Million each to the United Nations Interim Administration in Kosovo for the Benefit of Kosovo," 20 June 2001, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2001/08/04/000094946_01072504014322/Rendered/PDF/multi0page.pdf (accessed 8 February 2011), 2.

[19]The World Bank, "Procurement Plan," The World Bank Group, 4 November 2009, .http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/07/05/000333038_20100705013319/Rendered/PDF/554140PROP0p1010Plan0040November009.pdf (accessed 8 February 2011), 2-4.

medium term staffing plan, and the campaign to raise population awareness on financial products, returns and risks.[20] The World Bank also provided direct assistance by strengthening the framework for regulations and supervision of the CBK.[21] Specific examples include the implementation of a regulatory database, support on financial analysis, training of banking personnel in European supervisory agencies and review of licensing procedures of the CBK.[22]

The second area of assistance by the World Bank supported the Association of Microfinance Institution of Kosovo (AMIK) and others in developing a microfinance industry in Kosovo. This consisted of training in technical issues, management, planning and assessment.[23] Within the third area, the World Bank provided technical assistance to the Kosovo Bankers' Association (KBA).[24] The KBA is a non-profit, non-governmental organization, established in 2002. All commercial banks operating in Kosovo are members of KBA. The KBA's goal is to support the development of a sound banking system and to promote long-term economic development of Kosovo.[25] The World Bank provides training for KBA members in trade finance, operational risk management, credit policy, and audits.[26]

Activities of the International Monetary Fund

The IMF began assisting Kosovo in 1999 by preparing four draft laws. These drafts instituted the use of currencies, banking, payment transactions and the establishment of the BPK, one of the two predecessors of the CBK.[27] The next step involved the IMF providing technical assistance for the establishment of the BPK in November 1999. The BPK established a system for domestic payments, licensed and supervised domestic banks, and ensured liquidity, solvency and effective functioning of the local banks.[28] The importance of the BPK further increased with the introduction of the Euro in Kosovo in 2002.[29] In September 2006, the BPK, with support from the IMF, transformed into the CBAK in order to strengthen its role as Kosovo's central bank.[30]

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[20]Ibid.
[21]Ibid.
[22]Ibid.
[23]Ibid., 3.
[24]Ibid., 4.
[25]Kosovo Bankers' Association, "Short History," 22 July 2010, http://www.bankassoc-kos.com/?cid=2,41 (accessed 8 February 2011).
[26]The World Bank, "Procurement Plan," 4.
[27]International Monetary Fund, *Annual Report 2000: Making the Global Economy Work for All* (Washington, DC: International Monetary Fund, 30 April 2000), http://books.google.com/books?id=JTnjIFIvwfkC&pg=PA86&lpg=PA86&dq=IMF+MAE+kosovo&source=bl&ots=ONJMzburvH&sig=I0P_OlJZQ_vpOwmiuhw66S0EwDA&hl=en&ei=EbI3TeiWKYvSsAOOlYmOAw&sa=X&oi=book_result&ct=result&resnum=1&ved=0CBYQ6AEwAA#v=onepage&q=IMF%20MAE%20kosovo&f=false (accessed 8 February 2011), 86.
[28]Dimitri G. Demekas, Johannes Herderschee, Davina F. Jacobs, *Kosovo, Institutions and Policies for Reconstruction and Growth* (Washington, DC: International Monetary Fund, 2002), http://www.imf.org/external/pubs/ft/Kosovo/2002/eng/iprg/ iprg.pdf (accessed 8 February 2011), 3.
[29]Ibid., 11.
[30]United Nations Interim Administration Mission in Kosovo, *Kosovo*, June 2008, http://www.unmikonline.org/docs/2008/Fact_Sheet_July_2008.pdf (accessed 8 February 2011), 10.

In June 2008, Kosovo established, with technical assistance from the IMF, the current Central Bank of Kosovo (CBK).[31]

The IMF also assisted in the development of the Kosovo banking system in other ways. For example, it provided assistance in the development of a banking supervision framework, putting it in line with international standards. The IMF also helped in the development of research and statistical capabilities, as well as in an accounting and control framework. The IMF further provided advice in order to develop financial services for the people and government of Kosovo, as well as on how to manage foreign exchange reserves. Finally, the IMF provided external managing directors for the central bank.[32]

Activities of United States Agency for International Development

USAID began supporting Kosovo in 1999. However, support was mainly focused on the return and integration of refugees and the rebuilding of infrastructure. USAID also assisted Kosovo in establishing a government, rule of law, civil society and independent media. Additional support built functional institutions through technical advisors.[33] Although USAID was not deeply involved in the development of the banking system of Kosovo, USAID provided credit and initiated a project for small and medium enterprises to access credit through the creation of the Kosovo Business Finance Fund. This fund facilitates economic growth by providing credit to small and medium enterprises in Kosovo.[34] The development of the Kosovo Business Finance Fund led to the establishment of the American Bank of Kosovo, which now operates as a financial institution managed primarily by Kosovo citizens.[35]

Sustainable Economic Growth in Kosovo

Kosovo achieved an average annual GDP growth of approximately 4.4 percent from 2005 to 2009 (see table 3). Only Albania managed comparable annual growth during this same period. When comparing real GDP (GDP minus inflation), Kosovo's performance is even better, although the economic and financial crisis negatively influenced real GDP in 2007 and 2008 (see table 4). Growth in real GDP seems to indicate a positive economic trend.

[31]International Monetary Fund, "Mission Concluding Statement," 16 September 2009, http://www.imf.org/external/np/ms/2009/091609.htm (accessed 8 February 2011).
[32]Piero Ugolini, *Kosovo: Assessment of MFD's Technical Assistance Program* (Washington, DC: International Monetary Fund June 2006), http://www.imf.org/external/ np/pp/eng/2006/0630 06k.pdf (accessed 8 February 2011), 7.
[33]United States Agency for International Development, *Kosovo Strategic Plan 2010-2014* (Washington, DC: USAID, June 2006), http://pdf.usaid.gov/pdf_docs/ PDACQ298.pdf (accessed 8 February 2011), 3.
[34]United States Agency for International Development, *Transforming Banking System in Kosovo* (Washington, DC: USAID 12 May 2009), http://www.usaid.gov/ stories/kosovo/ss_kosovo_loan.html (accessed 8 February 2011).
[35]Ibid.

Annual Percentage Growth Rate of GDP at Market Prices
Based on Constant Local Currency

	2005	2006	2007	2008	2009
Kosovo	3.4	4.9	4.0	5.4	4.0
Albania	5.5	5.0	6.0	7.5	2.5
Bosnia and Herzegovina	5.0	6.2	6.8	5.4	-2.9
Montenegro	4.2	8.6	10.7	6.9	-5.7
FYROM	4.1	4.0	5.9	4.8	-0.7
Serbia	5.6	5.2	6.9	5.5	-3.0

Source: World Bank, "GDP Growth," http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/countries/1w-KV-IQ-AF?display=default (accessed 1 February 2011).

Annual Percentage Growth Rate of Real GDP at Market Prices
Based on Constant Local Currency (GDP minus inflation)

	2005	2006	2007	2008	2009
Kosovo	4.8	4.3	-0.4	-4.0	6.4
Albania	3.1	2.6	3.1	4.1	0.3
Bosnia and Herzegovina	n/a	0.1	5.3	-0.2	-2.5
Montenegro	n/a	n/a	n/a	n/a	n/a
FYROM	3.9	0.7	2.3	2.4	0.4
Serbia	-10.5	-6.5	0.5	-7.4	-10.8

Source: World Bank, "GDP Growth," http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/countries/1w-KV-IQ-AF?display=default (accessed 1 February 2011).

At the same time, Kosovo's annual rate of inflation can be characterized as volatile, which is consistent with the rest of the region (see tables 3, 4 and 5). The challenge is to control inflation; stable price levels facilitate greater real growth in GDP.[36]

[36]Howard S. Ellis, "The Importance of Price Stability," In *Economic Development, Challenge and Promise,* ed. Stephan Spiegelglas and Charles J. Welsh (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1970), 242.

Annual Percentage of Inflation

	2005	2006	2007	2008	2009
Kosovo	-1.4	0.6	4.4	9.4	-2.4
Albania	2.4	2.4	2.9	3.4	2.2
Bosnia and Herzegovina	n/a	6.1	1.5	7.4	-0.4
Montenegro	n/a	n/a	n/a	n/a	n/a
FYROM	0.2	3.3	3.6	7.2	-0.3
Serbia	16.1	11.7	6.4	12.9	7.8

Source: World Bank, "Inflation," http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG/countries/1W-AF-KV?display=default (accessed 1 February 2011).

To explain the relationship of growth in GDP and inflation in more detail, the next set of AVs are applied to determine how Kosovo liberalized trade influenced the annual increase in demand for money and the availability of credit provided by banks. Therefore, the figures of annual money supply as a percentage of GDP, annual foreign direct investments and credit provided by banks as percentage of GDP will be evaluated.

Kosovo had considerable growth in money supply from 2005 until 2008 (see table 6).[37] At the same time, Kosovo attracted a relatively low volume of foreign direct investment within the region (see table 7). Credit provided by banks, as a percentage of GDP remained also remarkably low compared to the other regional countries (see table 8).

Because money supply is considerable when compared to the rest of the region, it would seem to indicate that Kosovo did not have a well-designed monetary policy to limit money supply, resulting in inflation. At the same time, Kosovo failed to attract foreign direct investment. Although foreign direct investment is normally not locally financed, when foreign direct investment and credit provided by banks is low, it could be an indicator that local banks do not fulfill the role of financial mediatory. A failing financial system could hamper the willingness for foreign direct investments and the provision of credit for local investments.

[37]"Money and quasi money as referred to in Table 6, comprises the sum of currency outside banks, demand deposits other than those of the central government, and the time, savings, and foreign currency deposits of resident sectors other than the central government. This definition is frequently called M2".

Annual Percentage of Money Growth

	2005	2006	2007	2008	2009
Kosovo	20.3	5.5	23.4	23.6	n/a
Albania	14.1	16.0	13.7	7.7	n/a
Bosnia and Herzegovina	18.7	25.7	32.7	-0.1	-0.7
Montenegro	83.4	119.2	98.8	-10.1	-8.9
FYROM	15.9	24.8	30.7	10.9	n/a
Serbia	42.1	38.3	42.5	9.8	n/a

Source: World Bank, "Money and quasi money growth (annual %)," http://data.worldbank.org/indicator/FM.LBL.MQMY.ZG?display=default (accessed 1 February 2011).

Net Inflow of Foreign Direct Investment per Capita to Acquire a Lasting Management Interest

	2005	2006	2007	2008	2009
Kosovo	n/a	n/a	n/a	278 mil	222 mil
Albania	n/a	n/a	n/a	287 mil	316 mil
Bosnia and Herzegovina	n/a	n/a	n/a	239 mil	53 mil
Montenegro	n/a	n/a	n/a	1.45 bil	2.1 bil
FYROM	n/a	n/a	n/a	294 mil	98 mil
Serbia	n/a	n/a	n/a	408 mil	260 mil

Source: World Bank, "Foreign Direct Investment, Net Inflows in US$," http://data.worldbank.org/indicator/BX.KLT.DINV. CD.WD/countries/1W-AF-KV?display=default (accessed 1 February 2011).

Annual Credit Provided by Banking Sector as Percentage of GDP

	2005	2006	2007	2008	2009
Kosovo	11.3	7.0	3.3	10.5	n/a
Albania	48.6	54.5	61.3	66.9	n/a
Bosnia and Herzegovina	43.6	47.4	54.3	58.5	58.0
Montenegro	17.5	35.9	78.2	88.0	77.2
FYROM	20	23.5	34.4	42.7	n/a
Serbia	29.1	25.7	31.4	39.4	n/a

Source: World Bank, "Inflation," http://data.worldbank.org/indicator/FS.AST.DOMS.GD.ZS/countries/1W-AF-KV?display=graph (accessed 1 February 2011).

Effectiveness of the Banking System in Kosovo

Kosovo has instituted formal structures within the banking system and codified them by law. Currently, the CBK functions as an internationally recognized central bank, has full legal authority according to Kosovo law, and reports to the Kosovo Assembly.[38] The tasks of the CBK meet the internationally recognized banking standards and are consistent with the AVs for the banking system. The CBK also fulfills the international recognized standards for accountability in accordance with the International Financial Reporting Standards, as adopted by the International Accounting Standards Board.

However, the banking system in Kosovo fails to fulfill the role of financial intermediary. According to research by the Enterprise Analysis Unit of the World Bank, only 15 percent of the firms in Kosovo have a line of revolving credit or loans with a financial institution. A large number of firms, 85 percent, use alternative means (e.g., family, friends and employees) to finance their loans. Finally, only 25 percent of the firms use banks to finance investments in fixed assets.[39] When compared to other countries in the region, Kosovo's results are poor.

Furthermore, the amount of risk to lenders is highest in Kosovo, reflecting a lack of confidence in the financial system. To get credit in Kosovo, a lender has to provide 236 percent collateral. That is almost 50 percent more than the average of the other Balkan countries. In contrast, it is striking to note that only 13 percent of the firms in Kosovo identify access to finance as a major concern (see table 9).

[38]The Central Bank of the Republic of Kosovo, *Functions and Responsibilities* (Prishtina: Central Bank of the Republic of Kosovo, 2009), http://www.bqk-kos.org/?cid=2,2 (accessed 8 February 2011).
[39]The World Bank, *Enterprise Surveys*, 2010, https://www.enterprisesurveys.org/CustomQuery/ViewCustomReport.aspx (accessed 8 February 2011).

Financing of Firms in Kosovo in 2009 in Percentage of Total Firms

	Line of credit with financial institutions	Internal finance	Bank finance	Value of collateral	Finance a major constraint
Kosovo	15	85	25	236	13
Albania	42	77	36	154	17
Bosnia and Herzegovina	65	44	60	173	25
Montenegro	50	25	76	151	10
FYROM	61	62	47	176	28
Serbia	68	53	43	137	28

Source: World Bank, "Enterprise Surveys," https://www.enterprisesurveys.org/Custom Query/ViewCustomReport.aspx (accessed 1 February 2011).

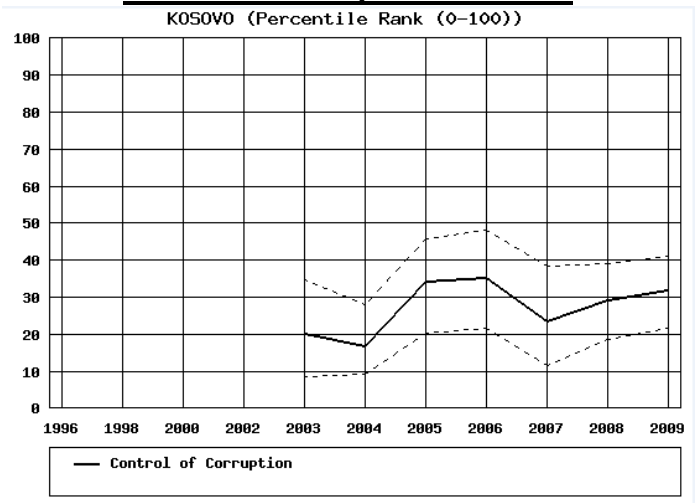
Although, foreign direct investment remains low, the amount of banking deposits has increased from 837 million Euros in 2005 to 1.7 billion Euros in 2009.[40] That is an increase of over 200 percent. This seems to contradict previous results. However, it is possible that the introduction of the Euro could have had a positive influence on trust in the currency and therefore, Kosovo banks. However, trust in the currency does not automatically mean trust in the financial system and ultimately, causality cannot be determined.

A financial system, including banks, depend on the confidence in the system among consumers and investors.[41] In Kosovo there seems to be a lack of confidence in the financial system. The rule of law, protection of property rights and the efforts of the government to fight corruption are indicators of the level of confidence. According to the Kosovo Progress Report 2010 by the European Union, Kosovo made progress in the rule of law. However, political obstruction persists, as well as a lack of efficiency and coordination between the different agencies within the judicial system.[42] In addition, property rights are not fully ensured because of the weak enforcement capacity within Kosovo. Figures 1 and 2 depict the aggregated views of enterprises, citizens and experts on the quality of governance on the control of corruption and the rule of law in Kosovo.[43] Although control of corruption and the rule of law seem to be improving, they

[40]Central Bank of the Republic of Kosovo, *Monthly Statistics Bulletin No. 111* (Prishtina: Central Bank of the Republic of Kosovo), November 2010, http://www.bqk-kos.org/repository/docs/2010/MSB%20no%20111.pdf (accessed 8 February 2011), 11.
[41]Ake Lönnberg, *Restoring and Transforming Payments and Banking Systems in Post-Conflict Economies* (Washington, DC: International Monetary Fund, May 2002), http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/lonnb.pdf (accessed 24 November 2010), 3.
[42]European Commission, *Kosovo 2010 Progress Report*, 9 November 2010, http://ec.europa.eu/enlargement/pdf/key_documents/2010/package/ks_rapport_2010_en.pdf (accessed 8 February 2011), 11.
[43]"Percentile rank indicates the percentage of countries worldwide that rate below the selected country. Higher values indicate better governance ratings. Percentile ranks have been adjusted to account for changes over time in the set of countries covered by the governance indicators. The dashed lines indicate the statistically-likely range of

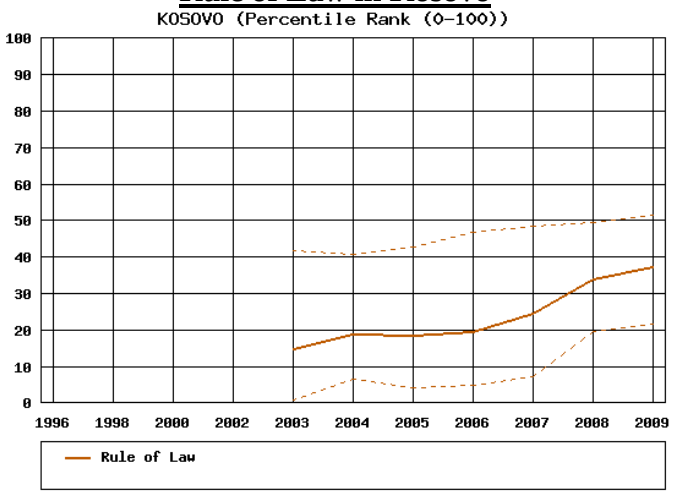
remain low when compared to other Balkan countries. Kosovo has a percentile rank of 30 of 163 countries surveyed in 2008 for the control of corruption and a percentile rank of 33 for the rule of law in 2008.[44]

Control of Corruption in Kosovo



Source: Daniel. Kaufman, Aart Kraay, and Massim. Maztruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues,* September 2010, http://info.worldbank.org/governance/ wgi/sc_chart.asp# (accessed 1 February 2011).

Rule of Law in Kosovo



the governance indicator. For instance, a percentile rank of 75% with the dashed lines at 60% to 85% has the following interpretation: an estimated 75% of the countries rate worse and an estimated 25% of the countries rate better than the country of choice. However, at the 90% confidence level, only 60% of the countries rate worse, while only 15% of the countries rate better".

[44]The World Bank, "Worldwide Governance Indicators," 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp (accessed 8 February 2011).

Source: Daniel Kaufman, Aart Kraay, and Massimo Maztruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues,* September 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp# (accessed 1 February 2011).

The evaluation of the AVs mentioned in the right column of Table 1 shows that the banking system in Kosovo must become more effective and must become the country's financial mediatory. Too many firms rely on alternative means to finance investments. Few firms have a line of credit with financial institutions, and few firms use banks to finance their investments. Borrowers have to provide exceedingly high levels of collateral to get credit. The risk in providing credit by banks is high and there appears to be enough informal ways to finance investments. The AVs indicate a lack of trust and confidence in the banking system, which appears influenced by a weak rule of law, difficulty enforcing property rights and the prevalence of corruption in Kosovo. These factors severely hamper the development of a reliable banking system and therefore limit the possibility for sustainable economic growth. These problems are well within the collective powers of the World Bank, the IMF, USAID and the Kosovo government to positively influence. What the aforementioned challenges ultimately indicate is the necessity for prolonged and robust direct involvement of these institutions, coupled with prudent governance, and sound monetary and fiscal policy by the Kosovo government.

Efficiency of the Banking System in Kosovo

According to the above analysis, the effectiveness of the banking system can be improved upon in order to facilitate sustainable economic growth. The next step is to evaluate the efficiency of the banking system. Therefore, the total amount of reserves and the amount of concentration of assets, loans, and deposits will be assessed, as well as the return of average assets and equity (see table 10). The concentration of assets, loans and deposits is expressed as HHI.

Concentration of assets, loans and deposits is still high in Kosovo. According to the 2010 Financial Sector Bulletin of the CBK, the three largest banks in Kosovo have approximately 82 percent of all banking assets. However, since 2008 there has been a decline in the concentration of assets, loans and deposits amongst few banks. This could indicate an increase in the number of smaller bank loans. Table 10 depicts differences in percentages between the HHI for assets, loans, and deposits for 2008 and 2009. The largest decline is in loans. This indicates, according to the CBK, an increase in loans provided by smaller banks because the assets, loans and deposits are spread among more banks.

HHI for Assets, Loans and Deposits (In Points)

	2008	2009	Difference in percentage
Assets	2887	2575	-11
Loans	3014	2572	-15
Deposits	3016	2647	-12

Source: Central Bank of the Republik of Kosovo, *Financial Sector Bulletin*, http://bqk-kos.org/repository/docs/Financial%20Sector%20Bulletin%20No_10.pdf (accessed 1 February 2011).

Deposits are the main source of finance in Kosovo.[45] This may explain why the global financial crisis did not have the same impact of Kosovo as it had in other Balkan countries (see table 3). The return from average assets and equity decreased between 2008 and 2009. This indicates that expenditures grew faster than income from financial activities.[46] This parallels the economic circumstances and consequences of the global financial crisis. The banking system relies heavily on domestic deposits for finance and at the same time, FDI is low. This could indicate a lack of international focus. The Achilles heel here resides in the lack of FDI entering Kosovo, which is a direct byproduct of the same problems retarding the effectiveness of the Kosovo banking system. An increasing flow of FDI into Kosovo would be a strong indicator that the banking/financial system of Kosovo is improving. Again, it is well within the powers of the World Bank, the IMF, USAID and the Kosovo government to positively influence the development of the banking system and its influencing factors.

Afghanistan Case Study

Activities of the World Bank

In 2001, the World Bank stated that after more than twenty years of conflict, Afghanistan was one of its poorest members.[47] Afghanistan lost most of its infrastructure and human capital due to internal conflict.[48] The countries' financial sector no longer operated and commercial banks were dysfunctional. The domestic and the international formal banking system were also disrupted.[49]

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[45]Central Bank of the Republic of Kosovo, *Financial Stability Report*, 40.
[46]Central Bank of the Republic of Kosovo, *Annual Report 2009* (Prishtina: Central Bank of the Republic of Kosovo, 8 July 2010), http://www.bqk-kos.org/repository/docs/Annual%20Report%202009.pdf (accessed 8 February 2011), 42-43.
[47]The World Bank, "Afghanistan World Bank Approach Paper," November 2001, http://siteresources.worldbank.org/INTAFGHANISTAN/Resources/ afgApproach.pdf, (accessed 9 February 2011), 1.
[48]Ibid.
[49]The World Bank, "International Development Association Program Document for a Proposed Credit in the Amount of SDR 54.7 million (US$ 80 million equivalent) to the Islamic Republic of Afghanistan for Programmatic Support for Institution Building," 6 July 2004, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP /IB/2004/07/12/000160016_20040712102143/Rendered/PDF/281920AF.pdf (accessed 9 February 2011), 1.

Many activities were taken over by an informal system, better known as the *Hawala* system.[50] The *Hawala* system is an informal financial transaction system executed outside of the formal financial sector. The local exchange dealers provide banking services like currency exchange, money transfers and, deposit services to the local population. All activities occur outside the official banking system.[51]

In June 2010, The World Bank had 32 active projects in Afghanistan with a commitment of over US$ 2.7 billion.[52] The World Bank continued to provide advice to the government of Afghanistan. The World Bank's development of Afghanistan is based on three pillars. The first pillar is to build the capacity and accountability of the Government of Afghanistan in order to provide affordable, accessible, and adequate services to its citizens. The second pillar is designed to promote growth of the rural economy. The third pillar supports growth of a formal, modern and competitive private sector.[53] Within the scope of these three pillars, the World Bank focused on restructuring the banking system. The World Bank provided technical assistance for the development of necessary infrastructure in the financial sector and strengthening the capacity of the central Bank of Afghanistan, *Da Afghanistan Bank* (DAB). The World Bank also provided assistance to implement changes in the financial sector.[54] The World Bank assisted in improving human resource management, accounting and auditing, and assistance for the development of a system to supervise commercial banks according to international standards.[55] An additional task was to improve credit risk assessments in order to reduce risk and increase credit based lending.[56] To facilitate credit risk assessment, the World Bank assisted in the development of a collateral registry for movable and immovable property.[57] Finally, the World Bank assisted the DAB and the Afghanistan Bank Association in the development of bankers training.[58] These programs focused on improving the efficiency and reliability of the banking system.

Activities of the International Monetary Fund

The reform of the Afghan banking system started in January 2002, when the IMF visited Afghanistan for the first time after the defeat of the Taliban.[59] The IMF provided policy advice and technical assistance in order to ensure a solid foundation for economic management and

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[50]Ibid., 2.
[51]Samuel M. Maimbo, *The Money Exchange Dealers of Kabul* (Washington, DC: The World Bank, August 2003), 2-3.
[52]The World Bank, "Afghanistan: Supporting State-Building and Development," July 2009, http://siteresources.worldbank.org/IDA/Resources/IDA-Afghanistan.pdf (accessed 9 February 2011), 3.
[53]The World Bank, *Afghanistan: Interim Strategy Note*, 5 May 2009, http://www.worldbank.org.af/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/AFGHANISTANEXTN/0,,contentMDK:22216104~menuPK:305990~pagePK:2865066~piPK:2865079~theSitePK:305985,00.html (accessed 9 February 2011).
[54]The World Bank, *Financial Sector Strengthening Project*, 17 September 2008, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/09/17/000076092_20080918160815/Rendered/PDF/Project0Inform1cept0Stage0F0SEPT017.pdf (accessed 9 February 2011), 4-7.
[55]Ibid., 4-5.
[56]Ibid., 6.
[57]Ibid.
[58]Ibid., 6-7.
[59]Staff of the Monetary and Financial Systems Department, 4.

macroeconomic stability.[60] The IMF support included the rehabilitation of the central bank (DAB). The IMF provided assistance for currency reform, central bank modernization and new financial and banking legislation.[61] In addition, an IMF staff team assisted the authorities in developing "a macroeconomic framework to guide economic decision-making" in order to achieve sustainable economic growth, while keeping inflation in check.[62] Furthermore, the IMF assisted in establishing an emergency payment system, based on a system of six DAB locations in Afghanistan. Additionally, the IMF assisted in currency reform by replacing old banknotes with new ones. The United States and the UN provided logistical assistance for the currency reform.[63] In 2003, the IMF prepared new banking and central bank laws, new payments laws, currency laws, and financial services laws.[64]Technical assistance was provided to DAB concerning the organization, accounting, financial reporting, internal auditing, and an appropriate central bank building facility.[65] The role of the IMF changed somewhat when the government of the United States provided financing for the restoration and development of the central bank through USAID. The IMF limited its assistance to targeted advice and participation in expert committees to review the balance sheet structure and capital adequacy of the central bank.[66]

Activities of United States Agency for International Development

USAID began assistance to the Afghan financial sector in 2003.[67] USAID focused on empowering Afghan institutions to lead in development and reconstruction in order to improve the livelihood of its own citizens.[68] At that moment, the legislation that was prepared by the IMF was not yet in place and the financial sector was not functioning properly. USAID focused on three main areas within the financial sector, central bank oversight, retail banking and small and medium enterprise finance, and microfinance.[69] To enable the central bank to execute oversight over commercial banks, USAID assisted the central bank to develop a payments and clearing house system, in conjunction with computerizing its operations. USAID also provided advice on how to implement on-site examinations of commercial banks using trend analysis and methods to bring the accounting system in line with international recognized standards.[70] To develop retail banking and small and medium enterprise finance, USAID assisted in the enactment of financial laws and regulations.[71] To facilitate growth of small and medium enterprises, USAID

[60]Ibid., 7.
[61]Ibid., 8.
[62]Bennett et al., *Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth* (Washington, DC: International Monetary Fund, September 2003), http://www.imf.org/external/pubs/ft/scr/2003/cr03299.pdf (accessed 9 February 2011), 8.
[63]Staff of the Monetary and Financial Systems Department, 5.
[64]International Monetary Fund, Country Report No. 02/219, *Islamic Republic of Afghanistan: Report on Recent Economic Developments and Prospects, and the Role of the Fund in the in the Reconstruction Process* (Washington, DC: International Monetary Fund, October 2002), http://www.imf.org/external/pubs/ft/scr/2002/ cr02219.pdf (accessed 10 February 2011), 39.
[65]Staff of the Monetary and Financial Systems Department, 5.
[66]Ibid.
[67]United States Agency for International Development, *Fact Sheet Afghanistan* (Washington, DC: USAID, June 2010), http://afghanistan.usaid.gov/documents/ document/document/1004 (accessed 9 February 2011).
[68]United States Agency for International Development, *Afghanistan Strategy*, 9 February 2011, http://afghanistan.usaid.gov/en/about/country_strategy (accessed 9 February 2011).
[69]United States Agency for International Development, *Fact Sheet Afghanistan*.
[70]Ibid.
[71]Ibid.

supported the ability of the Afghan banks to provide loans to these enterprises. Microfinance was supported by USAID providing capital and technical assistance in order to facilitate the banking system and to develop Sharia compliant loans and transactions.[72]

Sustainable Economic Growth in Afghanistan

Poverty and the lack of economic activity are widespread in Afghanistan after decades of war. This makes Afghanistan inappropriate to compare with the rest of the region. The AVs for Afghanistan will therefore not be compared to data from other regional countries, because the circumstances are too different to compare. Notably opium is excluded from the economic data, despite the international nature of its trade. According to its GDP results, Afghanistan achieved a tremendous increase in annual growth in 2009, even though the global financial and economic crisis negatively affected GDP in 2007 and 2008 (see table 11). However, its annual rate of inflation is not only very high, but also very volatile. The high rate of inflation is not remarkable when compared to the annual growth of money (M2).[73] The annual increase in money ranges from 46 percent in 2007 to 27 percent in 2008. Inflation is also likely influenced by the US $29 billion that Afghanistan received in international aid since 2001. This aid figure is remarkable when considering that Afghanistan's GDP in 2010 was merely $14.5 Billion (in current US$).[74] If the low level of credit provided by banks as a percentage of the GDP (see table 11) is added to this analysis, together with the high level of international aid and the growth in GDP, it would seem that Afghanistan is doing a tremendous job improving its economy. However, economic growth is primarily a result of foreign international aid.[75]

Economic Assessment Variables for Afghanistan

	2005	2006	2007	2008	2009
Growth of GDP in Percentage	14.5	11.2	-0.2	2.3	40.8
Rate of inflation in percentage	12.1	3.5	17.0	22.7	-13.2
Growth of money in percentage	n/a	n/a	46.0	27.0	n/a
Net inflow of FDI in millions US$	271 mil	238 mil	243 mil	300 mil	185 mil
Credit provided by banks as a percentage of GDP	n/a	-1.7	0.2	3.5	n/a

[72]Ibid.
[73]Money and quasi money as referred to in Table 6, comprises the sum of currency outside banks, demand deposits other than those of the central government, and the time, savings, and foreign currency deposits of resident sectors other than the central government. This definition is frequently called M2.
[74]World Bank, "Data Indicators," http://data.worldbank.org/indicator/NY. GDP.MKTP.CD?display=default (accessed 4May 2011).
[75]Economy Watch, "Islamic Republic of Afghanistan Economic Statistics and Indicators," *Economy, Investment and Financial Reports,* 9 February 2011, http://www. economywatch.com/economic-statistics/country/Afghanistan/ (accessed 9 February 2011).

Source: World Bank, "Data Indicators," http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/countries/1w-KV-IQ-AF?display=default (accessed 1 February 2011).

Effectiveness of the Banking System in Afghanistan

With assistance from the IMF, World Bank, and USAID, the government of Afghanistan enacted the DAB Law of 2003. By implementing this law, Afghanistan created an autonomous central bank for Afghanistan, with the objective of achieving and maintaining domestic price stability.[76] Its tasks, as formulated in Article 2 of DAB Law, are in line with the five internationally recognized standards for a proper functioning central bank as discussed earlier. According to USAID, DAB accounting and reporting in 2009 and 2010 remains consistent with International Financial Reporting Standards, as adopted by the International Accounting Standards Board. Therefore, DAB formally fulfills the international recognized standards for a central bank.

However, the effectiveness of the banking system as a whole seems to be very poor. According to the Enterprise Analysis Unit of the World Bank, only three percent of the firms have a line of credit with a financial institution compared to 35 percent of 125 countries surveyed worldwide (see Table 12). For all firms, 90 percent use alternative means to finance loans and only 1 percent use banks. The respective average percentages for all countries that have been surveyed are 69 and 23 percent (see table 12). If a firm needs a loan, collateral requirements equal 254 percent of the loan. That is almost twice the average percentage of 125 countries surveyed by the World Bank (see table 12). It is surprising to note that only 37 percent of the businesses identify access to finance as a major constraint, while the average percentage is 31 percent of all surveyed countries (see table 12).

Financing of Afghan Firms in Percentage in 2009

	Line of credit with financial institutions	Internal finance	Bank finance	Value of collateral	Finance a major constraint
Average	35	69	23	144	31
Afghanistan	3	90	1	254	37

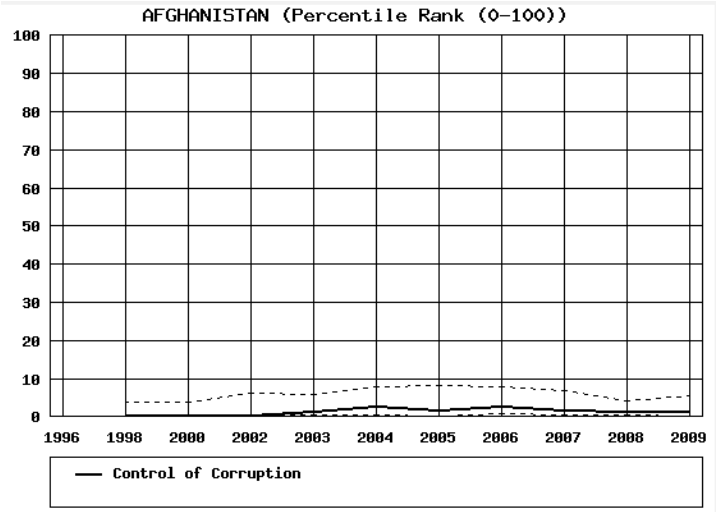
Source: World Bank, "Enterprise Surveys," https://www.enterprisesurveys.org/Explore Topics/?topicid=7 (accessed 1 February 2011).

As indicated earlier, foreign direct investment is low. However, the increase in deposits in Afghanistan is considerably high. Deposits rose from US$ 270 million in March 2008 to US$ 947 million in March 2009.[77] These figures are based on a closing exchange rate of 51.76 Afghani per US Dollar on 19 March 2009.[78] This is an increase of 300 percent within one year. In conjunction with the above findings, banks appear only be used to store money.

[76]Da Afghanistan Bank, *The Afghanistan Bank Law*, 1-2.
[77]Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009*, 99.
[78]Ibid., 42.

Although the tremendous growth in GDP and deposits conflicts with the other AVs, the AVs in Table 12 clearly depicts a lack of confidence in the financial system. That is not surprising given the current situation in Afghanistan. According to the November 2010 Report to Congress on progress toward security and stability in Afghanistan, judicial progress is slow, the government's ability to provide the rule of law must be improved, and corruption is still a problem. Last year showed an almost seven percent decline in the confidence of Afghans in their government's ability to establish a reliable formal justice system.[79] The World Bank (see figures 4 and 5) confirms this lack of confidence.[80] According to figures, 4 and 5 almost all other countries surveyed by the World Bank achieve better results than Afghanistan.[81]

Control of Corruption in Afghanistan



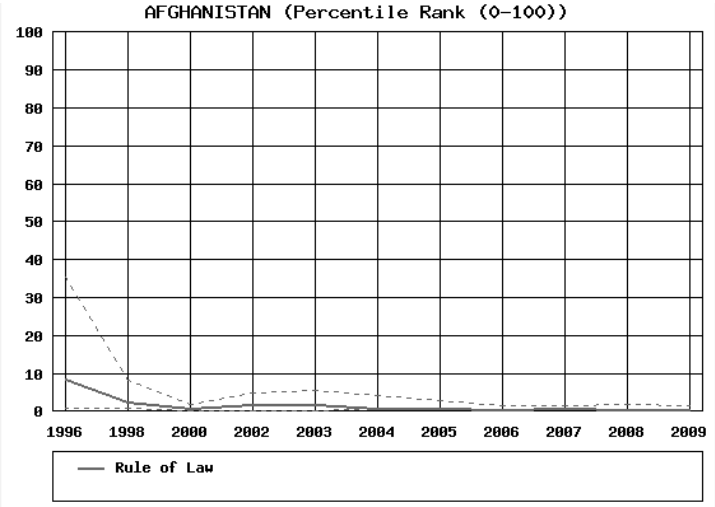
Source : Daniel. Kaufman, Aart Kraay, and Massim. Maztruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues,* September 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp# (accessed 1 February 2011).

[79]U.S. Department of Defense, *Report on Progress Toward Security and Stability in Afghanistan* (Washington, DC: Government Printing Office, November 2010), http://www.defense.gov/pubs/November_1230 _Report _FINAL.pdf (accessed 9 February 2011), 59.

[80]The World Bank, "Worldwide Governance Indicators," The World Bank, 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp (accessed 8 February 2011).

[81]"Percentile rank indicates the percentage of countries worldwide that rate below the selected country. Higher values indicate better governance ratings. Percentile ranks have been adjusted to account for changes over time in the set of countries covered by the governance indicators. The dashed lines indicate the statistically-likely range of the governance indicator. For instance, a percentile rank of 75% with the dashed lines at 60% to 85% has the following interpretation: an estimated 75% of the countries rate worse and an estimated 25% of the countries rate better than the country of choice. However, at the 90% confidence level, only 60% of the countries rate worse, while only 15% of the countries rate better".

Rule of Law in Afghanistan



Source: Daniel. Kaufman, Aart Kraay, and Massim. Maztruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues*, September 2010, http://info.worldbank.org/governance/ wgi/sc_chart.asp# (accessed 1 February 2011).

Despite implementing new banking laws, achieving tremendous growth in GDP, and increasing the amount of deposits by 300 percent, it appears that Afghanistan's banking system remains immature and ineffective. There is a lack of confidence in the government to provide rule of law, as well as a perceived inability to protect property rights and decrease corruption. As a result, confidence in the banking system is very low hampering its ability to meet its mediatory role. Although the circumstances leading to the challenges faced by the banking system of Afghanistan are different from those of Kosovo, the problems are nonetheless very similar. Therefore, Afghanistan requires similar international financial institutional support; however, with a significantly greater hands-on approach until Afghanistan is able to adequately govern, including the capacity to manage its own fiscal, monetary, and banking system affairs.

Efficiency of the Banking System

In February 2011, the Afghan banking system consisted of 17 licensed banks.[82] According to the DAB's 2008-2009 Annual Bulletin, 19 percent of the assets belonged to state owned banks, 20 percent to branches of foreign banks operating in Afghanistan, and 61 percent to Afghan private banks.[83] In March 2009, only 15 percent of the assets were owned by state owned banks, 17 percent by branches of foreign banks and 68 percent by private banks.[84] This shows a major shift in favor of privately owned banks.

[82]Da Afghanistan Bank, "Licensed Financial Institutions," http://www.central bank.gov.af/licensed-financial-institutions.php (accessed 9 February 2011).
[83]Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009*, 94.
[84]Ibid.

The total assets of the banks in Afghanistan went from US$1.62 billion in March 2008 to US$2.8 billion in March 2009.[85] This is an increase of 73 percent within one year. The amount of loans also grew. The total increased from US$ 773 million in March 2008 to US$ 966 million in March 2009.[86] This is an increase of 25 percent. Striking was the fact that 83 percent of this growth has been achieved by the privately owned banks.[87] Again, the increase in deposits was considerable going from US$ 270 million in 2008 to US$ 947 million in 2009.[88] Most surprising were the profitability figures, the so-called return on average assets. The Afghan banking system was profitable in 2009, although its profits decreased from 1.8 percent in March 2008 to 1.69 percent in March 2009.[89] However, if the figures are broken down for state-owned, privately owned and branches of foreign banks, than a different picture starts to emerge. State-owned banks made a profit of US$ 11 million in March 2008 and a loss of US$ 58,000 in March 2009.

Privately owned banks were profitable in both 2008 and 2009, but profits fell by 37 percent in March 2009. However, from March 2008 to 2009 foreign bank profits increased by 10 percent.[90] These results are supported by research conducted by Jelena Pavlović and Joshua Charap.[91] "Foreign owned banks seem to be more profitable, have little or no involvement in domestic lending, adhere to stricter and more traditional procedures, and have a higher profitability."[92] Domestic, private and state-owned banks are less profitable or losing money, have substantial domestic lending activities, and have non-conventional procedures for assessment of borrowers.[93] Therefore, the challenge for DAB is to balance the efficiency of the foreign-owned banks with the financial mediation of the domestically owned banks in order to facilitate sustainable economic growth with a healthy and reliable banking system.

A critical component of a viable banking system is profitability. The efficiency challenges posed in Afghanistan should start with the rectification of the effectiveness issues mentioned earlier.

Possible military tasks in Kosovo and Afghanistan

There is no evidence the military helped develop the banking systems in Kosovo or Afghanistan. In fact, there are few known examples in the literature of any integrated efforts between a military force, international financial institutions and civilian banking organizations to facilitate the development of the banking system. What follows are possible tasks the military can or could have conducted in order to facilitate the development of the Kosovo and Afghan banking systems.

The military can secure looted or diverted stockpiles of currency or state-owned precious metal reserves and ensure security for critical financial institutions, infrastructure, and personnel. This should be a high priority task and should focus on government financial institutions, banks and

[85]Ibid.
[86]Ibid., 96.
[87]Ibid.
[88]Ibid., 99.
[89]Ibid., 100-101.
[90]Ibid.
[91]Jelena Pavlović and Joshua Charap, Working Paper 09/150, *Development of the Commercial Banking System in Afghanistan: Risks and Rewards* (Washington, DC: International Monetary Fund, July 2009) http://www.imf.org/external/pubs/ft/wp/ 2009/wp09150.pdf (accessed 9 February 2011), 19-20.
[92]Ibid.
[93]Ibid.

key personnel.[94] This is especially important when a shortage of capable banking personnel exists.[95] For example, the Kosovo conflict caused a significant outflow of human capital. Before the conflict, Serbians held most positions. During the conflict, they fled to Serbia leaving a severe shortage of skilled workers and professionals.[96]

U.S. Army Field Manual 3-07 specifically describes the possibility of the military having to conduct detailed assessments of physical infrastructure. Gathering information about public systems, services, and facilities supports the planning efforts and facilitates economic activity.[97]

Another possible task for the military is to facilitate the repair of a banks physical infrastructure. This particularly applies to Afghanistan were most of the infrastructure was damaged or destroyed after decades of war. Repairing infrastructure further contributes to the local economy, particularly when local personnel and facilities are integrated into the military's economic development plan. Beyond infrastructure, the military could establish an emergency payment system. According to the IMF, this is one of the first banking functions necessary in restoring a banking system.[98]

The military could also use its Intelligence Preparation of the Battlefield process and its intelligence assets to gather information about the status of the financial sector.[99] This in turn, would empower the World Bank, IMF and USAID to effectively conduct their lead agent role as early as possible. In the meantime, implementing USAID microfinance activities in support of small and medium size firms into military operations would be a fruitful step. It would also provide an excellent opportunity to start the development of a banking system at the grassroots level, thus complimenting the centrally organized efforts of the World Bank and IMF on the rest of the country's economy.

Military spending should be integrated in the development plan of the banking system. Funds should not only provide immediate and tangible relief, they should also be used to shape banking operations. As an example, the Commander's funds of the Emergency Response Programs could be synchronized with an overall banking development plans. This effectively forces them to use local banks to conduct payments to contractors.
In Afghanistan, the military could have used local Afghan currency instead of U.S. dollars.[100] Personal experience in 2003 points out that because the military used U.S. dollars as its means of exchange, the Afghan population was reluctant to trade in Afghan currency. Military spending utilizing the local currency would promote confidence in the currency as a means of exchange for both the general population and the financial sector in general.

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[94]Joint Warfighting Center, *Handbook for Military Support to economic Stabilization* (Washington, DC: U.S. Joint Forces Command, 27 February 2010),, 84.
[95]Joint Warfighting Center, Ch IV. Crane et al., "Guidebook for supporting Economic Development in Stability Operations" (Technical Report, RAND Cooperation, 2009), http://www.rand.org/pubs/ technical_reports/2009/RAND_TR633.pdf (accessed 24 November 2010), 84.
[96]Demeka et al., 84.
[97]Department of the Army, Field Manual (FM 3-07), *Stability Operations* (Washington, DC: Headquarters Department of the Army, October 2008), 2-12.
[98]Lönnberg, 3.
[99]Crane et al., 82-83.
[100]Crane et al., 86.

As a whole of government approach, the military force can also facilitate the development of the banking system by promoting the rule of law; assist the local government in establishing the enforcement of property rights, and fight corruption where possible. Improvements in these areas directly contribute to confidence in the government and lower risk for banks in lending money, leading to lower collateral requirements and creating more business opportunities. Another possible task is to ensure efficient border crossings and other ports of entry.[101] Although this does not directly influence the financial sector, it does facilitate commerce.

Conclusion

The study shows that the activities of the World Bank and IMF focused their attention on higher order institutional matters (e.g., accountability regulations and laws). The World Bank and the IMF provided grants, credit, and technical assistance to financial and governmental institutions in order to rebuild the financial sector in Kosovo and Afghanistan. They primarily focused their efforts on strengthening the central bank capabilities of the CBK in Kosovo and DAB in Afghanistan. In contrast, the activities of USAID were more practical in nature. For example, USAID provided assistance to implement on-site examinations of commercial banks. In addition, USAID's main effort was to provide credit to small and medium size enterprises in both countries. The development of the Kosovo Business Finance Fund even led to the establishment of the American Bank of Kosovo. This bank now operates as a financial institution managed primarily by Kosovo citizens. Despite the enormous efforts of the World Bank, the IMF and USAID, the study generally indicates that their activities were not fully successful. Although the development of the Kosovo Business Finance Fund led to the establishment of the American Bank of Kosovo, the banking system in Kosovo and Afghanistan are short of being effective. Too many firms rely on alternative ways to finance their ventures. Very few firms have a line of credit with financial institutions and use banks to finance their investments. Borrowers have to provide significant collateral to get credit. There is a general lack of trust and confidence in the financial system and risk for providing credit is high.

In stark contrast to the ineffectiveness of the banking system of both countries is the fact that both countries achieved economic growth. Based on the analysis, economic growth should not have occurred due to the illogical combination of limited access to credit provided by banks, a lack of foreign direct investment, the relatively high level of inflation, and a substantial annual increase in the total volume of money supply.

In addition, the study shows that the banking system in both countries do not fulfill the role of financial mediatory to facilitate economic growth, despite the efforts of the World Bank, IMF and USAID. The evaluation of the banking system of these two countries reveals that an informal system of financing investments is utilized more so than their respective banks and that banks are only used to store money. The evaluation of the banking system in both countries shows that laws do exist that describe the formal role of the central bank and that there is a considerable rise in deposits. However, a low percentage of firms have a line of credit with banks and few use banks to finance their investments. It is therefore remarkable that both countries have a considerable rise in deposits and economic growth, although they exist under completely different circumstances. This would indicate that economic growth for both Kosovo

[101]Ibid., 88-89.

and Afghanistan was not solely based upon economic factors, but the result of international aid and assistance.

Although the banking system of Kosovo does not fulfill its role as financial mediatory, the banks are efficient in terms of profitability. Kosovo banks are profitable because they have highly concentrated assets, loans and deposits. This results in higher returns because overhead costs are lower. The disadvantage of Kosovo banks is that they lack an international focus. When coupled with the effectiveness problems associated with its banking system, this could explain Kosovo's lack of attractiveness in drawing foreign direct investment.

Afghan banking efficiency is largely dependent on the ownership of the bank. There is a remarkable performance difference between foreign and domestically owned banks. Foreign owned banks are more profitable, have little or no involvement in domestic lending, adhere to stricter and more traditional lending procedures. Domestically, private and state-owned banks are less profitable, or even have a negative balance sheet, but do conduct a lot of domestic lending and have non-conventional procedures for risk assessment.[102] Therefore, the challenge for DAB is to balance the efficiency of the foreign-owned banks with the financial mediation of the domestically owned banks in order to create a banking system that facilitates sustainable economic growth.

The study also shows that the Afghan banking system is not always focused on the effectiveness of the financial system. The Afghanistan case study even demonstrated that it is possible to have highly profitable banks that do not fulfill the role of financial mediatory in order to facilitate economic growth in a country. Finally, both case studies validate the importance of a well functioning central bank, the need for competent government, and the sustained supporting efforts of international financial institutions (i.e., World Bank and the IMF) and relevant foreign government entities such as USAID.

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[102]Pavlović and Charap 19-20.