

Restoring and Transforming Payments and Banking Systems in Post-Conflict Economies

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Abstract

This note presents an operational framework for restoring and transforming payments and banking systems in post-conflict economies based on critical events and milestones in practical applications from MAE technical assistance to Kosovo and East Timor. It underscores that the sequencing of actions in a graduated approach is crucial, including early decisions on the choices of a legal tender and exchange rate regime; operation of a rudimentary payment system on an emergency basis; preparation of financial legislation in line with international best practices; the licensing, regulation, and supervision of banks and nonbank financial institutions; and the eventual restoration of central banking functions in a two-tier banking system.

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I. SUMMARY

This note generalizes lessons from work on restoring and transforming the payment and banking systems in Kosovo and East Timor. It recommends that at an early stage, efforts should be devoted to preparing for the transition out of the emergency phase into normal conditions through a graduated approach. A transition plan identifies the strategically important issues relating to institution-building in the context of the specific conditions in the post-conflict economy. It defines the sequencing of actions needed for restoring and transforming the banking and payments systems in five stages over a period of two years:

- Stage I—by the first month—a joint Fund mission (area department, MAE, FAD) makes an early diagnostic visit. Contacts are made with the United Nations (UN), donors, and any remaining local authorities. Work is coordinated with the World Bank and other IFIs. Based on the findings, the particular modifications that are needed in a strategic transition plan for dealing with the post-conflict economy are explored and the need for technical assistance is appraised. A report is prepared for Fund Management and the Executive Board. Technical assistance experts are selected.
- Stage II—by the first three months—urgent humanitarian efforts are directly supported by early and transparent decisions on pressing financial matters. Strategic choices are made regarding the legal tender and an exchange rate regime to regain confidence in money. In the absence of functioning banks, an emergency payment system is established through a Central Payments Office. Transfers of funds to and also within the economy are facilitated. Work is initiated on key financial legislation, and statutes for the Central Payments Office are enacted.
- Stage III—by the first twelve months—the Central Payments Office is transformed into a Banking and Payments Authority with a wider mandate in terms of elementary central bank functions. Banks are licensed, regulated, and supervised. The banking system takes over an increasing share of payments and the emergency payment system is reduced and gradually phased out. Statutes for the Banking and Payments Authority are adopted, a new banking law is promulgated and prudential rules and banking regulations drafted and enacted.
- Stage IV—by the first twenty four months—the Banking and Payments Authority is transformed into a traditional central bank. The re-establishment of a two-tier banking system is completed. The emergency payment system is totally eliminated in favor of a modernized payment system in line with international best practices handled through the banking system with a national clearing and settlements system supervised by the central bank. A central bank law is promulgated.
- Stage V—by the first thirty months—is the exit phase within which the exceptional technical assistance provided by MAE is phased out and is replaced with what may be considered a normal engagement.

II. INTRODUCTION

During the 1990s, significant Fund technical assistance was assigned to post-crisis and post-chaos economies with a view to re-establishing critical monetary, fiscal, and financial functions. MAE took the lead in restoring or transforming the central banking function and the payment and banking systems.

This note summarizes the approach used in MAE's work in addressing these issues in Kosovo and East Timor. In evaluating the lessons learned, the note discusses a number of technical aspects which arise while addressing fundamental problems in the monetary, banking, and payments areas. It provides a summary of the issue-oriented problems that MAE faced when providing technical assistance to Kosovo and East Timor at the special request of the UN. The note also formulates proposals on primary steps to be taken toward re-establishing a monetary authority and financial system in a post-conflict economy.

In dealing with post-conflict situations that have been deprived of a functioning monetary authority, MAE recommends a graduated approach for re-establishing key functions in areas where a central bank typically has responsibilities. At that level, when the need is to fundamentally restore functions that have been destroyed or severely disrupted, an integrated approach is required both in the country in question as well as for the provider of the technical assistance. Thus, MAE's work in Kosovo and East Timor took place in close coordination not only with the relevant area department but also with FAD and LEG.

III. POST-CONFLICT SETTINGS

Fund staff often deal with troubled economies going through crises and chaos. The type of post-conflict situations discussed in this note tend to differ from other post-crises/post-chaos situations in several respects:

- Social and military conflicts—internal or in combination with external interference—have created emergency conditions.
- Great social turmoil exists with large sections of the populations having been killed and/or dislocated, thereby, severely impairing human capital.
- Central administrative, economic, and political functions have been destroyed or significantly disrupted.
- Local capacity and capabilities have been so fundamentally reduced that they would be unlikely to recover on their own.
- Broad consensus exists that the international community should become involved to re-establish peace, law and order and to take steps to rebuild the economy.

- Existing needs for institution-building exists which may well go beyond merely restoring the previous order and aiming to building up new permanent institutions in some important ways different from the old ones.

Together, these factors create a complex situation, characterized by inter-related weaknesses that render the post-crisis economy incapable of handling its own problems. In such cases, the international community—often represented by a UN interim administration—is called upon to intervene during a transitory period to cope with the immediate emergency humanitarian situation, and to act as transitional government, laying the foundations for the restoration of civil society, for an economic revival, and for an eventual return to a constitutional political system.

In such post-conflict situations, traditional central authorities—including the central bank—would have, by and large, ceased to function. Public institutions as well as banks and many private enterprises may have been physically destroyed and further incapacitated, when staff has been forced to move and in many cases will never return.

Institution-building is thus a key element of reform in post-conflict economies, but the mix of recovery and reform is one of the key policy issues and judgments that must be made. In one extreme form, the task may also involve assistance in nation-building, which is even more complex. In the other extreme form, the inclination would be to re-establish old—even if inefficient—structures before moving on with much reform. Whatever the scope of work, it is typically neither possible, nor appropriate, to re-establish old structures in post-conflict cases if the fundamental preconditions for those old structures have changed irreversibly. Given the inevitability of change, the opportunity should not be missed to form new structures that are more effective, more transparent, and characterized by better governance than the previous ones. In this task of transforming the old institutions, or establishing new ones, local participation and acceptance of the reforms are critical.

There are several examples of such post-conflict economies during the 1990s. Most similar to Kosovo and East Timor is Bosnia and Herzegovina. In several western African countries and in Somalia, post-conflict situations have often proven to be unstable and internal conflicts have tended to reappear. Following the break-up of the Soviet Union, many new republics in the Caucasus and central Asia found themselves without adequate national public institutions which, combined with economic chaos and in some cases internal military conflicts, quickly propelled them into post-conflict situations. Afghanistan in early 2002 is an example of a particularly complicated post-conflict situation.

IV. TRANSITION STRATEGY

In many of these cases, the Fund assisted in institution-building through technical assistance provided by MAE, FAD, LEG, and STA. Based largely on MAE's advice to former Soviet Union republics, an MAE staff team prepared, in 1995, a paper on the topic of what was required to establish a minimal structure of monetary/exchange arrangements, laws, organizational structures, instruments, and information systems in a post-crisis situation

as part of a UN project (Sundararajan and others, 1995). Such a minimal system should support the restarting of production and trade and should provide for the following:

- Credible internal means of payment and capabilities for external payments;
- Reasonably stable prices (i.e., reasonably firm monetary control);
- Efficient utilization of foreign aid and foreign exchange resources, generally;
- Efficient mobilization and allocation of savings (credit); and
- Effective financial services to execute the government's budget (means to collect revenue, make payments, finance deficits, etc.).

This paper provided an initial outline to a strategic transition plan for dealing with post-conflict economies which was important when MAE teams became involved in Bosnia and Herzegovina in 1996 and Kosovo and East Timor in late 1999. A number of elaborations have resulted which are presented in the following.

In post-conflict cases that no longer have a functioning monetary authority, MAE recommended a graduated approach for re-establishing key functions in areas where a central bank typically has responsibilities. The overall objectives would be to rebuild capacity for formulating and implementing monetary and exchange rate policies, and to restore a functioning banking and payment systems within an appropriate institutional framework. Through these actions, the foundations would be laid for a sound monetary and financial system, which is critical for promoting economic recovery.

The primary steps to be taken towards re-establishing a monetary authority and financial system in a post-conflict economy rest on the formulation of a strategic transition plan in five phases; the timeframe will vary depending on local circumstances. However, due to the linkages and sequencing requirements, the need to keep the momentum in the reform process is imperative, arguing in favor of implementation over a two-and-a-half-year period. These stages may be identified as: the diagnostic phase; the emergency phase; the institution-building phase; the two-tier banking system phase, and the exit phase. The main characteristics of these five stages are summarized in Box 1.

Box 1. Main Features of the Strategic Transition Plan				
Stage	Duration	Main Tasks	Key Decisions	Key Legislation
I	During first month	<ul style="list-style-type: none"> • Explorative and fact-finding • Briefings within the Fund • Secure technical assistance funding • Selection of experts 	<ul style="list-style-type: none"> • Division of labor and forms of cooperation with others major donors • Fund decisions on magnitude of staff engagement 	<ul style="list-style-type: none"> • Rule by UN decree (continuing)
II	During first 3 months	<ul style="list-style-type: none"> • Emergency payment system • Agent to the central fiscal authority 	<ul style="list-style-type: none"> • Central Payments Office established • Legal tender selected • Exchange rate regime selected 	<ul style="list-style-type: none"> • Payments legislation • Service contract agreed with Central Fiscal Authority
III	During first 12 months	<ul style="list-style-type: none"> • Licensing, regulation, and, supervision of banks • Increasing payments via banks • Management of financial assets • Licensing, regulation, and supervision of foreign exchange bureaus • Licensing of nonbank financial institutions 	<ul style="list-style-type: none"> • Banking and Payments Authority established • Interbank clearing system set up 	<ul style="list-style-type: none"> • Banking legislation • Prudential rules and banking regulations • Agency agreement with Central Fiscal Authority • Legislation on foreign exchange bureaus • Legislation on nonbank financial institutions
IV	During first 24 months	<ul style="list-style-type: none"> • Revisit issues on legal tender and exchange rate regime • Traditional central bank operations 	<ul style="list-style-type: none"> • Central bank established 	<ul style="list-style-type: none"> • Central bank legislation
V	During first 30 months	<ul style="list-style-type: none"> • Exit from the post-conflict situation • Return to a normal relationship with the Fund 	<ul style="list-style-type: none"> • Expatriate staff leave line positions • MAE resident staff are advisors 	

The necessary reforms would have a strong bearing on the fiscal side with respect to the restoration of a treasury and ministry of finance. In this work, as well as in the establishment of financial institutions, one would encounter important legal issues. MAE advice should therefore be closely coordinated with technical assistance from FAD and LEG. Moreover, close coordination would be needed with the World Bank, regional development banks, and other multilateral or bilateral donors that may be involved. This coordination effort should start early, even before the first visit to the post-conflict country, if possible.

Finally, it should be noted that the difficulty of defining reasonable and practical time frames for each of the stages described in this note presents a major problem. As experienced in Kosovo, East Timor, and elsewhere, every technical assistance mission generated action

plans whose milestones proved to be overly optimistic and had to be moved forward in time. This was due as much to unrealistic expectations as to post-conflict stress and cultural misunderstandings with local staff operating within an unfamiliar work environment. To some extent, control over change exercised by newly established institutions providing rudimentary central bank functions was at times compromised by external forces, for example, the UN interim administration, jurisdictional disputes with other agencies and institutions, and a lack of expertise or funds. These unforeseen events continue to be a problem and threaten to stretch the financial and physical commitments of international donors beyond their capacities. Experience would tend to indicate that an early estimate of a planned timeframe needs to be doubled for a more accurate approximation to reality. At the same time, however, there is value in setting a challenging time table; it is generally better to aim for three months and take five than to aim at six months and make it. Accordingly, the periods specified in this note should only be taken as indicative and would need to be modified as the situation unfolds on the ground.

V. STAGE I—DIAGNOSTIC PHASE

The starting point is to collect the available information, coordinated through the area department. Prior coordination with the World Bank and similar relevant institutions should also be undertaken as soon as possible. In addition, the MAE paper from 1985 should be consulted, as well as subsequent technical assistance reports in this area. Early engagement would be critical to assess the situation and address the emergency aspects. Within one month, a joint mission with representation from the area department, MAE, and FAD should visit the country, carry out its exploratory assignments, and return to headquarters, apprising Fund Management and the Executive Board of its early findings and recommendations for future action. MAE should also continually support the area department with information, analysis, and an assessment of developments within MAE's core areas. This would enable the area department to prepare reports to the Fund Executive Board in advance of international donors' meetings.²

In contact with local representatives, UN's local interim administration, and other relevant institutions, the exploratory visit would need to provide the answers to a number of questions on the state of the current situation. In that context, the following questions are important:

- What are the key steps in the monetary and financial areas that should be taken to facilitate the urgent humanitarian efforts that are needed?
- Is there, in effect, still a legal tender? Are several currencies co-circulating? Is the economy being demonetized?

² Some of these reports have subsequently been published; for East Timor, see Valdivieso and others (2000) and for Kosovo, see Corker, Rehm, and Kostial (2001).

- Is any formal exchange rate regime being maintained?
- What relevant institutions and resources are intact?
- What parts—if any—of the pre-conflict institutions and policy set ups should be restored for re-establishing a monetary authority?
- Is there anything worth keeping from what remains of the previous payments and banking systems?

Keeping the prevailing situation in mind, the mission should additionally make early attempts to define the framework in which future decisions would be made. An outward-looking approach relying on the market mechanism would underpin the efforts to restore the financial system. Moreover, it would need to prioritize the many existing substantial short-term needs for technical assistance.

Although MAE can be expected to take the lead in providing technical assistance in the money, banking, and payment areas to post-conflict economies that have received broad support from the international community, there would always be a need for close coordination with local authorities, other international financial institutions, and major donors, in order to avoid the duplication of work and other inefficiencies. During the diagnostic and emergency phases, this prerequisite will be more pronounced, given the general scarcity of resources and the urgency for action.

To address this, the initial exploratory MAE mission should take the initiative to pre-visit inter-agency briefings in Washington with the World Bank to reach an early understanding on the division of labor. In those discussions, the Fund (through the area department, MAE, and FAD) would typically argue in favor of taking responsibility for the macroeconomic issues in addition to those relating to monetary, banking, and fiscal affairs. In these discussions, the question of possible benefits of a joint mission should also be dealt with. Following the pattern that emerged in Kosovo and East Timor, donors' conferences would be organized at regular intervals, often twice a year. In preparation for such conferences, the need for coordination between the Fund and the World Bank would be particularly great. All such coordination should include discussions on policy choices as well as information sharing.

Early channels of contact should also be opened up with major donors and the relevant regional development bank. Major donors would include not only USAID, the Japanese Government, and the European Union, but also neighboring countries, as well as other countries with which the post-conflict country may share a common language.

Technical assistance to post-conflict economies will often include providing resident experts for line positions, which is very uncommon in normal technical assistance work. The identification and selection of appropriate resident or peripatetic experts to fill line positions,

or to operate as advisors, are areas that would need urgent attention, and that could benefit from financial and/or staff contributions from different institutions. In three post-conflict cases, Fund Management agreed to let MAE provide the incumbent and the financing of the top positions in the central bank or quasi-central bank.³ In all these cases, the assignments were financed, in part, with the Japanese Administered Account,⁴ and in East Timor also with a contribution from UNTAET.⁵

When agreeing on the delineation of assignments between providers of technical assistance, one would need to be aware of potential problems arising between local agencies if different institutions—due to secondment and other forms of staffing—appear to be dominated by—or even controlled by—one particular external party. It would be essential to avoid the creation of a permanent rift between key institutions. In particular, this could be an issue between newly established institutions such as the one providing rudimentary central bank functions and the Central Fiscal Authority, which would partly be an early reflection of traditional rivalries between central banks and ministries of finance/treasuries in other countries.

Other lessons learned from the work in Kosovo and East Timor to keep in mind during this stage are:

- (i) Understanding and taking into consideration earlier conditions and institutional set-up is essential; there is no such thing as starting with a blank slate.
- (ii) Every emergency measure should be taken with a relatively clear view of where the system should go in the medium term, so that the emergency measures do not complicate achieving the medium-term goals.
- (iii) Initially, there is a clear danger that there will be too many technical assistance resources available from everywhere compared to what can readily be absorbed, underscoring the need for paying attention to early coordination.

³ These three cases occurred in Bosnia and Herzegovina in 1997 and Kosovo and East Timor, both in 2000.

⁴ This was called “Administered Account for Selected Fund Activities—Japan Technical Assistance Projects.”

⁵ The case of East Timor is also special in the respect that no less than all four key positions in the CPO/BPA—General Manager; Deputy General Manager for Supervision; Deputy General Manager for Payments; and Chief Accountant—are provided and funded in the same fashion, as is the position of Head of the Central Fiscal Authority. In Kosovo, MAE also funds a resident expert in the line position as Chief Internal Auditor of the BPA.

- (iv) To ensure effective technical assistance, it is critical that the new interim administration (from the UN or somewhere else) follows the agreed division of labor from the beginning so that no interference takes place.

VI. STAGE II—EMERGENCY PHASE

During the emergency phase (approximately the first three months), the immediate humanitarian aspects—starvation, disease, clothing, shelter, sanitation—would dominate the concerns of the international community. To ensure that the necessary humanitarian assistance would reach those in need and also be effective, an emergency payment system should be established to be responsible for the transfer of funds to, and within, the country in question. To support this, recommendations should be made for key decisions to be taken on the legal tender and exchange rate regime. Key issues in this area are:

- Payments through banks would probably have ceased to exist, and would have been replaced by cash transactions in multiple currencies. With different currencies co-circulating, the pricing system would have been negatively affected, contributing to an inefficient monetary system. In the immediate term, that situation will prevail, but it is important for the near term to establish more settled monetary conditions. To address this, early efforts should be directed at establishing one single legal tender to be commonly accepted. Measures should be taken to have the legal tender replace competing monies. However, rather than outlawing competing convertible currencies which would normally lead to other inefficiencies, it would be better to provide incentives to encourage the use of the nominated legal tender.
- In order to re-establish confidence in money rapidly, alternatives such as full dollarization, a currency board arrangement, another fixed exchange rate system, or a free-floating exchange rate regime should be considered. Local authorities and the UN interim administration may not have clear preferences for any particular alternative and may look to the Fund for guidance.
- Although a free floating exchange rate may be considered theoretically, it would typically require a high degree of discipline in economic policy, with tight fiscal norms and restraint in issuing money. With official reserves gravely depleted and human capital severely impaired, the possibilities for adopting a free floating exchange rate regime would seem rather remote.
- A currency board arrangement could be considered a better option to provide a barrier against the excessive printing of money, and could be established with limited reserves and relatively few resources.

- An alternative would be full dollarization, that is, officially adopting the currency of another country for all financial transactions. In the cases of Kosovo and East Timor, the dollarization alternative was, on balance, considered to be the most appropriate, and early decisions were made to make the deutsche mark (DM) and the U.S. dollar, de facto legal tender in Kosovo and East Timor, respectively.
- In Kosovo and East Timor, it was recognized that the legal tender previously used could also be utilized for paying taxes and making other compulsory public payments. The specific conditions for this varied greatly between these two cases.⁶

In parallel with efforts to support the immediate humanitarian measures, it would be crucial to take actions to recreate or restore the minimal essential payment and banking functions, recognizing to help the economy to start working again, recognizing that the financial system, by and large, no longer exists and something needs to be put in its place until banks and other financial institutions can be re-established.

To ensure that key payments and other essential financial services are carried out in the absence of a functioning banking system, an emergency payment system should be set up. It could be organized in a Central Payments Office (CPO), a transitional institution that in some respects could be seen as an embryonic central bank.

⁶ Since Kosovo formally remains a territory within the Federal Republic of Yugoslavia (FRY), the legal tender of the FRY—the new Yugoslav dinar (dinar)—continues formally as legal tender. However, in September 1999, the Head of the United Nations Interim Administration Mission in Kosovo (UNMIK) decreed that UNMIK’s budget would be in DM and that all payments from the budget as well as compulsory payments to the budget (such as taxes, customs duties, public charges and fees) would be made in DM. These payments were also permitted to be made in dinars provided that a fee of 10 percent was added to cover handling and transactions costs. Until the second half of 2001, the DM was exclusively the dominant currency in all parts of Kosovo, except for the Serb-dominated enclaves where the dinar was also used. Since January 2001 in East Timor, the U.S. dollar has been de jure sole legal tender but for most of the period from early 2000 until mid-2001, the Indonesian rupiah (rupiah) continued to be used as cash currency by most Timorese, while expatriate staff tended to use the Australian dollar. On a transitory basis, compulsory payments to the Timorese budget were allowed to be made in rupiah subject to a transaction fee of 20 percent. In July 2001, the Head of the United Nations Transitional Administration in East Timor (UNTAET) decided to introduce measures to strengthen the dollarization in East Timor (UNTAET 2001).

- Initially, the CPO should pay particular attention to establishing correspondent accounts, reconcile earlier accounting records of funds held abroad (if feasible), and set up a system for receiving and channeling foreign funds.
- The CPO should act as a depository and cashier, accept and channel international emergency assistance, ensure that payments related to essential public services are maintained, transfer payments to major places nationally, and handle payment of civil servants, utility staff, health and school sectors, etc.
- In addition, the CPO should provide a system for payment of public expenditures through collection of budgetary revenue. Establishing the CPO would thus have important implications for the restoration and transformation of the fiscal system. As a counterpart to the CPO (and its successors) a transitional institution on the fiscal side should be established. This Central Fiscal Authority would be a combined treasury and future ministry of finance. In Kosovo and East Timor, FAD took the lead in establishing this institution.
- The CPO should discuss with the Central Fiscal Authority the expectations in both institutions regarding what needs to be done in terms of cooperation during the emergency phase. The resulting agreement should take the form of a service contract, defining the services that the CPO would provide and the reimbursement it would receive for services provided.
- On this basis, the CPO should accept deposits from public authorities as well as from foreign banks, international financial institutions, and donors. Until banks are re-established, the CPO should be able to accept demand deposits on behalf of persons and legal entities in currencies it determines, receive and disburse money; and provide payments and collection services.
- The CPO should accept the role of monitoring the activities of organized foreign exchange bureaus and money-changers prior to setting up a supervisory function for financial institutions in Stage III.

An appropriate payment legislation would be needed to support the emergency payment operations and to prepare for the return of more normal conditions. To this end, the existing payments law should be evaluated and used to the extent possible and when appropriate, be amended. If no acceptable legislation exists, a new payment decree should be enacted by the interim UN administration. MAE should assist in the preparation of such a legislation, which should be in compliance with international best practice (Bank for International Settlements, 1999). MAE prepared a draft for such legislation in Kosovo (UNMIK, 2001).

Although the CPO should be seen as an interim body—entrusted with specific temporary functions of providing emergency services in the payments and banking area in

the absence of functioning banks—its operations should be governed by specific, transparent statutes. The UN decree establishing the CPO of East Timor in January 2000 is an example of the MAE model (UNTAET, 2000a).

In Kosovo and East Timor, MAE played the leading role in establishing the functions of the CPO, provided substantial technical assistance from headquarters and in the field, and assisted in identifying senior staff positions.

MAE also assisted in Kosovo and East Timor in preparing the terms of reference for all key positions in the CPO. Whenever professionally qualified local staff was not available, MAE helped in the recruiting and—in exceptional circumstances arranged the financing—for some of the senior managers and key expatriate staff in line positions.

Staffing CPO operations with experienced expatriate experts is not an easy task. It should be recognized that it is very difficult to recruit talented and experienced people to work in an environment where living conditions may be strenuous and local attitudes toward foreign experts may be strained or openly hostile. In these cases, turnover and burnout among the experts have tended to be high, further challenging technical assistance management, which was already unusually complicated and time consuming.

Acquisition of sufficient and suitable physical accommodation in which to conduct CPO operations is critically important and should be addressed and solved at the earliest possible opportunity. The lessons from the experiences in Kosovo and East Timor⁷ indicate that expertise in planning central bank facilities (adequate buildings, vaults, etc.) could be helpful earlier rather than later in the recovery cycle, to prevent “acquisition by first occupancy” among the available alternatives.

Having acquired physical space, the matter of a start-up kit providing computer capabilities for the fledgling CPO deserves urgent attention. This may entail nothing more than assuring delivery of 5 to 10 personal computers with Windows NT/Office software to the CPO, as early as the beginning of Stage II when expert staff begins to appear on the scene. This would assure that the early collection of records, reports, and statistical analyses is captured in machine-readable form by field staff. To accomplish this, a donor should pledge/earmark sufficient funds and installation help (\$50,000–\$75,000) and commit to deliver the units in Stage II.

⁷ In Kosovo, the situation was complicated by the sudden and total abandonment of the former payment bureau sites by Yugoslav authorities with loss of vault keys and combinations, whatever cash had been on hand, and all official records. In the case of East Timor, the issue was the disagreement between the Fund and the Bank on the future use of the former Bank Indonesia branch building with a restorable vault which ended up as offices of the World Bank Resident Mission while the CPO had to make do with a less suitable former commercial bank building.

The CPO's proposed major responsibilities are summarized in Box 2.

Box 2. Specific Functions of the Central Payments Office

- Recommend broad policy guidelines to Head of UN interim administration in areas under the responsibility of the Central Payments Office
- Own and operate one or more payment systems
- Ensure adequate supply of banknotes and coins of legal tender for settlement of cash transactions
- Provide temporary payment and storage services to the Central Fiscal Authority and other public authorities
- Provide payment and storage services for foreign governments, foreign banks, foreign central banks, public international organizations, and other international institutions
- Open accounts abroad
- Maintain a depository for safe keeping of currency
- Act as banker to the Central Fiscal Authority and provide financial advice at its request
- Act as fiscal agent of the Central Fiscal Authority and other public authorities
- Do not trade in foreign currencies
- Publish foreign market exchange rates on a daily basis
- Prepare legislation for payments transactions
- Prepare banking legislation
- Prepare legislation for foreign exchange bureaus
- Train local staff

VII. STAGE III—INSTITUTION-BUILDING PHASE

During this phase (approximately during the first 12 months), more normal conditions should gradually be returning, making the restoration of the financial system a key priority. Any interim government—be it administered by an interim UN administration or by a local authority—would need an institution that can serve as its fiscal agent and its banker, to provide payments, storage and safekeeping services, and to manage financial assets and reserves at home and abroad, etc. Initially, the CPO would have to shoulder some of these responsibilities, but as the demands on it increase with social and economic recovery, the CPO—primarily established to set up and run the emergency payment system—would become too limited an institution.

The CPO should, therefore, be transformed into a Banking and Payments Authority (BPA) as a step toward re-establishment of a central bank. The principal objectives of the BPA should be to foster an efficient and safe system for domestic payments and foster the liquidity, solvency, and efficient functioning of a stable market-based banking system. The fully developed BPA should have significantly wider responsibilities than the CPO which would be reflected in a decree of the UN interim administration, establishing the BPA. This legislation for Kosovo was prepared by MAE and LEG in close consultation with the World Bank and USAID (UNMIK, 1999a).

The BPA's proposed major responsibilities are summarized in Box 3.

Box 3. Specific Functions of the Banking and Payments Authority

Payment Services

- Own and operate one or more payment systems
- Ensure adequate supply of banknotes and coins of legal tender for settlement of cash transactions
- Provide payment and storage services to the Central Fiscal Authority and other public authorities
- Provide payment and storage services for foreign governments, foreign banks, foreign central banks, public international organizations, and other international institutions
- Regulate and supervise payment and settlement systems in legal tender
- As commercial bank operations reassume, phase out the role of the Banking and Payments Authority in commercial cash and noncash services

Banking Operations

- Expand correspondent banking
- Hold foreign currency deposits of banks and other entities
- Maintain depository for safe keeping of currency and securities

Services for the Government

- Act as banker to the Central Fiscal Authority and provide financial advice at its request
- Act as fiscal agent of the Central Fiscal Authority and other public authorities
- Safekeep and administer foreign currency for the Central Fiscal Authority and other public authorities
- Maintain official reserves
- Recommend broad policy guidelines to Head of UN interim administration in BPA areas of responsibility
- Conduct regular economic and monetary analysis of the economy; make public the results; submit proposals and measures to UN interim administration on basis of such analysis.

Supervisory Activities

- License, regulate, and supervise banks
- Issue prudential rules
- Perform off-site surveillance
- Perform on-site examinations
- Supervise bank receivership
- License, regulate, and supervise foreign exchange bureaus
- License micro-credit institutions

Sundry Tasks

- Prepare central bank legislation
- Train local staff

In this stage of recovery, the economy as a whole also requires institutions for financial intermediation, and the re-establishment of a banking system to restore public confidence is an urgent task.

An early step should be to modernize the banking law, or, if that would not be appropriate, to enact a UN decree. MAE and LEG, in close cooperation with the World Bank, should be prepared to take the lead in that task. The corresponding UN decrees for Kosovo and East Timor, drafted through Fund technical assistance, can be referred to as models (UNMIK, 1999b and UNTAET, 2000b, respectively).

- The new legislation should stipulate that institutions with fit and proper owners and managers, sufficient capital, and an appropriate business plan would not be denied a banking license. Depending on the circumstances, institutions that previously were licensed and operated as banks should either be required to file a new license application in accordance with the new legislation and formally be approved to continue operating, or be allowed to continue operating under existing licenses.
- The banking legislation should apply only to institutions taking deposits from the general public (except those below a low threshold). The operations of the banks should be based solely on commercial considerations. State-ownership and influence on banks' lending decisions should be restricted. Rules on bank insolvency should be elaborated.
- All licensed institutions would be under the regulation and supervision of the BPA. They would be required to comply with a number of prudential rules and banking regulations that the BPA issues, all of which should be in compliance with the Basel Core Principles (Basel Committee on Banking Supervision, 1997). MAE could assist either in the drafting of such rules or in reviewing work being done in the field or by expatriate experts. The prudential rules should, inter alia, include the following:

Box 4. Prudential Rules to Be Adopted by the Banking and Payments Authority

- Risk-asset capital ratios
- Bank asset classifications/provisioning
- Interest non-accruals and compounding
- Minimum required liquidity reserves/liquidity ratios
- Credit documentation
- Large credit exposures
- Transactions with related persons
- Qualifications of significant shareholders
- Reporting of banks
- Audits and publication of auditor's opinion
- Supervision on a consolidated basis
- Liquid asset holdings
- Restrictions on non-liquid holdings
- Banks' foreign exchange activities
- Clearing and operation of settlement accounts
- Credit concentration
- Credits to employees of banks
- Holding equity interests in bank
- Governance of banks
- Retention of accounting and transaction records
- Anti money-laundering

Supervision should not be the only instrument for monitoring the financial soundness of a bank. It is equally important that the institution's internal governance is sound and that the bank is transparent in its reporting and disclosure to the market of its performance.

Newly licensed banks might not immediately be able to extend services outside major urban centers. For commercial reasons, the banks may initially focus primarily on trade financing, foreign direct investments, and currency exchange operations or service the wealthier communities and expatriates in the post-conflict territory.

It would, therefore, be essential to promote the establishment of nonbank financial institutions such as micro-credit institutions as a means to attracting savings and channeling financial resources to rural or deprived areas. The BPA should be in charge of licensing such institutions and empowering them to accept deposits from members, and to a limited extent from the general public. Before passing that level, a micro-credit institution should apply for and obtain a normal banking license.

In Kosovo and East Timor, MAE helped prepare the decrees enacted by the UN interim administration, establishing micro-credit institutions. However, in an agreed delineation of work, the lead for the development of such institutions rests with the World Bank (in the case of Kosovo) and the Asian Development Bank (in the case of East Timor).

The BPA should not be in charge of regulating and supervising micro-credit institutions; this is a task that should be assigned to an appropriate meta-institution, that the BPA would liaise with. In several post-conflict economies, a considerable donor interest has been registered for financially and administratively supporting micro-credit institutions, and for sponsoring the establishment of meta-institutions.

In addition, other commercial legislation would need to be reviewed such as the company law, and collateral and bankruptcy legislation. In this connection, it would be desirable for the World Bank to conduct an overall review of the legal system to enable legal reform to be prioritized and carried out in a coordinated manner.

The payment area should pass through a major transition during this stage of development, moving closer to a conventional order where payment transactions are carried out by banks and between banks on behalf of their customers.

- Banks should be expected to play a key role in the re-development of the payment system, replacing the emergency-oriented payment bureau operations of the CPO. This transformation would likely be a gradual process, where major urban centers would first see the change.
- The BPA should encourage this development through its pricing policy for payment services, so as to encourage banks to become aggressively involved in the payment system. In parallel, the BPA, in cooperation with the financial community, should take the initiative of establishing an interbank clearing house and provide rules for the settlement of payment transactions. As long as the emergency payment system is maintained, the BPA would be a member of

the clearing house, but over time, its role should shift to that of supervisor of the payment system.

- In Stage III, any form of interbank payment system should not commence without money being deposited with a trusted intermediary—the BPA—for settlement purposes. Settlement accounts should be defined in terms of currency, value, and procedure. In the absence of this, interbank exchanges would need to be netted and settled with suitcases of currency with obvious security risks.
- A key element of Stage III is the introduction by the CPO of a formal chart of accounts using international standards. Assuming that simple spreadsheet recording covered the Stage II accounting requirements, such methods and procedures should be upgraded as soon as possible thereafter, enabling both the appearance and substance of disciplined internal financial controls.
- In order to avoid replacing one monopoly with another, the BPA should not stop providing CPO-oriented payment services in any area unless at least two banks are competing in that area. For the areas that are likely not to be covered by bank branches, the BPA should take the initiative for discussions with the financial community, the Central Fiscal Authority, the postal service, the UN interim administration and any local authority on other ways to provide deposit, payments, and credit services. The objective should be that at the end of this phase—within the first full year—the emergency payment system initiated by the CPO would be eliminated.

In its role as fiscal agent and banker to the interim government,⁸ the BPA should be ready to manage financial assets of public entities and be prepared to manage the foreign reserves of the country. The latter highly specialized function should be carried out in accordance with best international practices as defined by guidelines organized by the Fund (International Monetary Fund, 2001). Again, MAE should be available to advise on suitable arrangements.

The service contract entered into by the CFO and the Central Fiscal Authority in Stage II should in Stage III be expanded to a formal agency agreement, covering the additional services provided. Based on the experience of Kosovo,⁹ special attention should be

⁸ Providing credits to the UN interim administration or any local governmental authority should not be included in this role.

⁹ In Kosovo, internal accounting weaknesses in the BPA in combination with coordination problems between the central CPA and its subsidiary units led to seemingly endless challenges raised by the Central Fiscal Authority regarding the safekeeping of its collections inflows and proper handling of its disbursement outflows.

devoted to ensuring that a transparent agreement concerning the accounting rules to be applied does exist.

In this context it should be noted that the newly licensed banks should be considered as alternative providers of services that may previously only have been available through the CFO. This development and the emerging competition should be welcomed.

VIII. STAGE IV—TWO-TIER BANKING SYSTEM PHASE

In this phase of assisting a post-conflict economy (approximately within the first two years), the objective should be to reach conditions that could be deemed normal. On the political front, this would imply that any previous UN interim administration would have given way to a national government. On the economic front, the legislative reforms should have taken hold, encouraging a revival of commercial activity.

- In the financial sector, the objective should be the establishment of a traditional two-tier banking system. However, the exact functions of a future central bank would importantly depend on the outcome of two decisions that would to be made.
- The issue of legal tender should be revisited. This issue would have been decided early on in the emergency phase based on the situation at hand. Now, with the reappearance of a national government, national priorities could be different. This would, in particular, tend to be the case if full dollarization had previously been decided upon. On the one hand, the desire of a country to have a currency of its own as a national symbol is not difficult to understand. On the other hand, there may be considerable risks in trying to pursue an independent monetary policy if weaknesses in staffing and political difficulties, etc., do not fully allow for it. The early discussions with the local authorities on this matter should be led by the area department while taking MAE's views into consideration.
- Another critical issue to be revisited would be the choice of an exchange rate regime. Again, the early decision would have been taken during the emergency phase, but the opinion of the local leadership may have shifted. In many respects, this would be a very technical issue, but could have great impact if expectations had grown for a sudden or unplanned change. It would be important to ensure that whatever decision is made, the exchange rate regime would have a reasonable chance to be maintained. In this way, the prospects for monetary stability would not be threatened, as they would in the case of major shifts in policy in economies with troubled pasts.

Based on what decisions were made regarding legal tender and exchange rate regime, a monetary authority with central bank functions should evolve from the BPA. For this, an

appropriate central bank law should be prepared well in advance with considerable MAE and LEG assistance. There is considerable experience in drafting such laws, recognizing the importance of making revisions from different models to allow for the special national circumstances. Moreover, there is an increasing set of international best practices that should be recommended. These include the primary objective for the central bank (with the possibility of having secondary objectives as well) and strong provisions for central bank autonomy and accountability.

Success in Stage IV would indicate that the economy no longer needs to be treated as a special case—as a post-conflict economy.

IX. STAGE V—EXIT PHASE

In the final stage of assisting a post-conflict economy (approximately within the first 2½ years), progress in restoring normal conditions would have reached so far that the exceptional technical assistance provided by MAE could be phased out. A summary specification of the actions taken by MAE in the case of East Timor is provided in Box 5 as an illustration of the scope of that technical assistance.

Box 5. Summary of Actions Taken by MAE—the Case of East Timor

From October 1999 to July 2000

- Three technical assistance missions
- Provided for eight expert visits
- Financed consultants for three resident positions in the Central Payments Office
- Consultations with UNTAET
- Drafted legislation establishing the Central Payments Office
- Drafted organizational structure for the Central Payments Office
- Drafted policies, procedures, and detailed work program to facilitate emergency payments by the CPO
- Drafted terms of reference for and recruited the CPO General Manager, and the Deputy General Managers for Supervision and Payments, respectively
- Drafted legislation governing commercial banks, foreign exchange bureaus, and nonbank financial institutions
- Developed detailed work program for financial system supervision
- Drafted the budget of the Central Payments Office for financial year 2000/2001
- Assisted in negotiating agreement with Bank Indonesia for exchange of unfit rupiah banknotes
- Arranged for shipments of U.S. dollar currency to the Central Payments Office

From July 2000 to May 2001

- One technical assistance mission and one staff visit
- Consultations with UNTAET and the Senior Management of the Central Payments Office
- Monitoring and assisting in the Central Payments Office's institutional development
- Reviewed an expanded work program of the Central Payments Office
- Reviewed policies, procedures, and delegation of authority in the Central Payments Office
- Drafted terms of reference for a resident position as Chief Accountant to the Central Payments Office and recruited the incumbent
- Continued negotiating technical agreements with Bank Indonesia
- Drafted policies and procedures for reserves management

Among the many important factors in creating such a situation, advancement in capacity-building would be crucial. In a post-conflict economy, the significance of the development of skills is critical to the success of capacity-building efforts. Shortage of adequately trained local staff for policy management as well as hands-on skills in banking operations, constitutes a severe flaw that must be addressed.

Technical assistance provided by MAE should in all areas contain a training component aimed at strengthening core activities in central banking operations. In matters outside (but still important to) MAE's core area, attempts should be made to mobilize alternative providers in coordination with other international financial institutions and major donors. Training programs should be formulated and implemented in Stages II, III and IV, affecting the CPO and the BPA, as well as the future monetary authority. The aim would be to build critical capacities in the payments, banking operations, and supervisory tasks.

The starting point would be the operational work at hand through on-the-job training. Over time, the development of skills should include exposure to other aspects that typically

are part of the institutions' responsibility. This training may take place within the framework of a particular ongoing activity or could be provided by outside donors.

Each department would develop a relevant program for achieving these aims and providing the necessary training and mentoring. Such programs could also be supported by technical assistance provided by other international financial institutions or donors by setting up specific courses or regional workshops, etc. The language question could be of critical importance. Some donors may be in a better position than the Fund to provide trainers able to communicate with local staff, thereby providing a competitive edge.¹⁰

It would be important to train local staff for middle- and senior-ranking positions. The increasing mobility of higher skilled staff would be likely continually to fuel a scarcity of critical skills. Selected local staff having the appropriate macroeconomic qualifications and work experience would benefit from direct mentoring as well as taking part in seminars outside the country. Any selection process should ensure that equal opportunity is given to the participation of appropriately qualified women and any national minorities. At the end of the training programs, written evaluations should be made of the participants' capabilities and progress which can be used for career development purposes.

X. SUMMARY OF GOOD PRACTICES

In view of the issues that have been discussed in this note, good practices for technical assistance to post-conflict economies are summarized in Box 6.

¹⁰ In the case of East Timor, training in Portuguese and Bahasa is being considered through the Portuguese government, the Asian Development Bank, and regional banking institutions.

Box 6. Good Practices for Technical Assistance to Post-Conflict Economies

Coordinate Possible Assistance within the Fund and with Other Institutions

- Interact in the Fund with relevant area department, FAD, LEG and (at a later stage) with STA and INS
- Cooperate closely with the World Bank and relevant regional development bank
- Coordinate with major donors (USAID, Japanese Government; European Union, etc.)

Diagnose Post-Conflict Situation

- Determine damages and shortfalls
- Assess institutional capacity

Formulate Transition Plan

- Support the setting up of a competent UN interim administration
- Establish monetary stability through the currency and exchange rate policy and eradicate disruptive practices and unfit financial actors
- Safeguard essential payments

Determine Currency Fundamentals

- Choose legal tender; draft and enact legislation
- Choose exchange rate regime; draft and enact decision

Establish Emergency Payment System

- Define which payments have highest priority:
Incoming: from donors; budgetary revenues (taxes, customs duties, utility charges, fees)
Outgoing: for essential public services (utilities; hospitals; schools; legal system; customs; pensions)
- Organize a cash-based emergency payment system through the Central Payments Office
- Establish storage and safekeeping of cash currency
- Have the Central Payment Office act as the banker (without lending capacity) and fiscal agent for the nascent Central Fiscal Authority

Revise Financial Legislation and Regulation

- Draft legislation setting up the Central Payment Office
- Draft legislation on payments transactions
- Draft legislation setting up the Banking and Payment Authority
- Draft banking legislation
- Assist in drafting legislation for micro-credit institutions
- Draft legislation for foreign exchange bureaus
- Draft legislation for insurance companies
- Prepare prudential and supervisory regulations for licensed financial institutions

Restore Financial Institutions

- License banks, micro-credit institutions, foreign exchange bureaus, and insurance companies
- Regulate and supervise licensed institutions (excluding micro-credit institutions)

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