

**USAID ECONOMIC GROWTH OFFICERS CONFERENCE**  
**OCTOBER 15-19, 2007**  
**WASHINGTON, D.C.**

Session Title: Economic Restructuring and Financial Sector Development in Kosovo and Other Post-Conflict Countries

Date and Time: Tuesday, Oct. 16: 4:00 – 5:15 p.m.

Type of Session: Breakout

Speaker(s): Hajdar Korbi, Douglas Todd, Steve Lewarne, Lori Bittner

Moderator: David Dod

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Overview of Session:



Douglas Todd addresses workshop attendees. Photo by Paul Goodman.

1) In post-conflict countries, financial deposit and payment systems can become operational relatively quickly, but it takes longer to develop regulatory systems and credit/lending operations. Foreign banks can be quite helpful, given that they are supervised from their home country and have higher capital levels. Key long-term goal is to gain the public's confidence, and to develop risk management capacities. You cannot move too fast; many felt it takes at least 10 years to have a fully developed financial system in place with local administration.

2) Kosovo's pension plan is working well. It is universally applied; has a fixed contribution that is low enough to keep firms competitive (5% employee; 5% employer); has transparent investment requirements allowing considerable investment overseas; has understandable payment formulas that are indexed by wage growth. A

key is to focus on viable objectives: social safety net and poverty alleviation; savings. Programs that attempt to use pension funds to develop capital markets in post-conflict environments do not work well.

3) It is a challenge as to how foreign administration of government operations in post-conflict environments can be transferred to full host country management. How much of the strong institutional and policy structure is sustainable under full independence? This relates partly to programs to train local staff, but of course also to political will in the new independent country that, of course, may still have many of the problems that led originally to the conflict.

4) Donors play a key role in developing financial sectors in post-conflict environments, especially by adding stability and confidence, introducing best practice, and providing funding and training.

5) Foreign banks often play a lead role in developing the new financial system, since they can meet high capital requirement limits and are supervised by their home country, which reduces the risk involved with immature local prudential supervision.

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**Speaker's Remarks:**

**Hajdar Korbi** – Focused on Kosovo and spoke about the financial sector, privatization, social policy and capacity building.

**Financial sector:**

Kosovo developed an entirely new financial sector, completely independent of the past system under Yugoslavia. At first stage of transition, the German Mark was used as currency, it was a fully cash system with no banks. Key objective in setting up the new system was to restore confidence. Foreign banks, one from Germany and one from the US (encouraged by USAID) helped to gain confidence. Now there are six banks (4 foreign and 2 with local capital), which is enough for the size of the economy. There has been a steady trend of higher deposits into the banking system from 2001 to 2007. There is now a decent array of banking services available. But interest rates are quite high, reflecting high risk and high operating costs. Nevertheless, credit activity is increasing steadily, after some initial reluctance by banks to lend funds. The Central Bank does bank supervision, but has no monetary or ER policy and does not provide lender of last resort functions because the Euro is used as the local currency. One bank failed in 2006, but there was no contagion or systematic run, which raised further confidence in the overall banking system.

**Privatization:**

Was done by the Kosovo Trust Agency. There were regular and special spin-offs, with special cases involving additional conditions. These improved corporate governance in the firms. The trust fund got the assets of the state-owned firms, but not the liabilities. 20% of assets went to the employees, the rest to the fund. The key to the success of the privatization process was the strong political will of the government, and of the donors – the public accepted the importance of privatizing. Privatization attracted some FDI and created some new jobs. Most of the increase in exports has come from the privatized firms. Key challenges: a) need to set priorities, especially for energy; b) need to stop subsidizing SOEs; c) telecom industry is important.

**Social policy:**

After the conflict, unemployment was at 35-40%. They are doing a universal, flat-rate pension, so that everyone gets the same rate, regardless of whether a person worked in the old or the new system. They do not use a pay as you go.

**Capacity building:**

There is a limited supply of good public workers, public salaries are low, but the tax administration unit is good. There is a need to reduce the number of workers and increase the salaries. Officials are getting better training and there is an increased capability among Kosovo people to carry out government functions effectively.

**Doug Todd** – On the financial sector, the Euro as the currency of Kosovo is an asset of the central bank, not a liability. Given the constraints on the availability of the Euro, it is not possible to use monetary policy as a macro instrument. The economy has grown around 3%, but needs to

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grow at around double that rate. If the economy could grow at 6% for around 15 years, then Kosovo just might be able to halve the current rate of unemployment.

The public finance system is built around a medium-term expenditure framework, using a macro model to project growth. This has developed into a strong and effective budgetary system that will help the Government to protect from back-sliding. The USAID program has had a major impact on this.

Privatization has brought in some FDI that has been good for growth. On capacity building, USAID has worked hard to train and build capacities of people for key types of skills and positions. USAID has supported higher salaries in key institutions and positions. But, it will probably take 10-20 years to have a comprehensive and fully functioning government structure.

**Steve Lewarne** – Steve reviewed the use of funds, including oil funds and pension funds. Oil funds involve large amounts of money, which need to be used to avoid Dutch disease, need good oversight, have to deal with competing goals, and often invest in foreign assets. They often are used to develop infrastructure. They also can be invested for future use. Examples of oil funds include: Norway, Alaska, Kuwait, Saudi Arabia, and Azerbaijan. The Norway fund is considered the best, and Kuwait's is pretty good. Alaska and Kuwait are savings funds, aiming to build wealth for the future, with some transfer to the current budget. Chile and Venezuela have stabilization funds built around a heavy reliance on one commodity, which helps to stabilize financial management. Any fund is hard to do if there is corruption

On pension funds, there are similarities with oil funds, including on demands for corporate governance and investment clauses.

The old pension system in Kosovo had a lot of evasion, fraud, and low pay-out rates. The new system is much better. Steve stressed that it is not effective to use pension funds to drive development of capital markets – pensions need to focus on welfare for retired and disabled people. It is important to keep the tax rate reasonable. Kosovo uses a mandatory, defined contribution: 5% of the gross salary. The Kosovo pension administration had good governance and little corruption. It will eventually be run fully by Kosovo people. Kosovo has an effective and well-managed social safety net.

Key elements of a good pension system include low taxes, coverage for all elderly, pay-out rates linked to changes in wages, invest assets abroad to increase L-T stability, has a clear division of roles between poverty avoidance and savings, and should not have as a major function to build capital markets.

**Lori Bittner** – Lori focused on financial market development in Afghanistan. They like Kosovo had to develop an entirely new financial system. They started with a focus working with the Central Bank on a single currency, improving intermediation and transfer of funds, developing a money and operations unit, and having the state-owned commercial banks to do commercial banking. There are now 16 commercial banks, 2 state-owned and 14 private, a number of which are foreign owned. There are 30 licensed foreign exchange dealers and 80 money service

**USAID ECONOMIC GROWTH OFFICERS CONFERENCE**  
**OCTOBER 15-19, 2007**  
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providers. They are creating capital notes that can be used for liquidity and inter-bank markets. There has been a stress on developing inter-bank transfer and payments systems. A number of major laws were passed, and training provided.

Key next steps include: push financial activities fully to the commercial banks, need to encourage more lending and the use of collateral, need a next generation payment system, need to strengthen prudential supervision, and need to develop a safety net if there is a systematic problem.

**Key Points Discussed During Question & Answer Segment:**

Q. Are there different laws for foreign and domestic banks in Kosovo?

A. No, the legal framework for banking is basically the same for domestic and foreign banks. Foreign banks have helped to lead the way. They introduce new services and the domestic banks follow. The foreign banks have higher capital levels, so they can do long-term loans. In Afghanistan, most bank lending is for trade, and mainly in Kabul. There is no use of collateral; loans are made based on relationships. They are working on a collateral law.

Q. How does the Kosovo Privatization Fund invest their money?

A. The fund is kept to cover claims against the privatized firms, and then will go directly into the budget.

Q. Was Kosovo's social policy gradually phased in over time?

A. No, in Kosovo, it was done all at once. It was noted that Armenia is phasing in its pension contribution, which may be more relevant for the Ukraine.

Q. Who determined which foreign banks could operate in Kosovo?

A. Foreign bank applications were evaluated. Domestic banking rules actually favor foreign banks. For example, it is easier for them to meet high capital requirements and as branches, they are supervised from their home country. This limits the need for supervision by the host country, which can be good during the initial stages of post-conflict development when supervision capabilities are weak. In 1999, the foreign banks were run fully by foreigners; now, banks are run much more by Kosovo people. For Afghanistan, there is a trend to move from foreigners running the banks to working and training with Afghans. It will take around 10 years for banks to be fully run by Afghans.

David Dodd concluded the session by noting that you cannot go too fast in developing the financial sector in a post-conflict environment. Particularly credit systems are slow to re-build, especially longer-term lending. It is possible to develop deposit and payment systems faster. Also, privatization is a key opportunity for bringing in FDI, but FDI is typically slow in post-conflict environments. Real rates of return in post-conflict environments usually have to be at least 15-20 percent to induce investment. Pension portfolio diversification is key, with major

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OCTOBER 15-19, 2007  
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amounts invested in diversified foreign assets (against this advice, the Ukraine requires around 70% to be invested in the domestic economy, and 30% abroad). Donors play a key role in reconstructing financial sectors in post-conflict environments – confidence, funds and training are key.