Building a Financial System in Afghanistan

Prepared by Åke Lönnberg[1]

Senior Economist
Monetary and Financial Systems Department
International Monetary Fund

May 29, 2003

Abstract

This paper is a summary case study of the efforts to build a new financial system in post-conflict Afghanistan. It focuses on IMF technical assistance that was carried out from October 2001 to May 2003 when staff of the Monetary and Financial Systems Department and contracted experts provided comprehensive advice and support in restoring and transforming central banking services as well as setting up emergency payment systems. The paper outlines the operational framework that was used for reforming the payments and banking systems in post-conflict economies, drawing upon critical events and milestones in practical applications from previous IMF technical assistance to Kosovo and East Timor. It emphasizes that the sequencing of actions within 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 as adapted to local legal traditions; the licensing, regulation, and supervision of banks and nonbank financial institutions; and eventual restoration of central banking functions in a two-tier banking system.

---

[1] This paper is meant to serve as a background material for the author's presentation in Bonn on May 31, 2003, at the Symposium on *State Reconstruction and International Engagement in Afghanistan*, jointly arranged by the Crisis States Programme of the Development Research Centre of the London School of Economics and Zentrum für Entwicklungsforschung, Universität Bonn. The paper reflects the views of the author and are not necessarily endorsed by the IMF. Comments on the present text are welcomed by alonnberg@imf.org

Contents Page

I. Introduction

Since the early 1990s, the International Monetary Fund (IMF) has provided significant technical assistance to post-crisis economies with a view to reestablishing and transforming critical monetary, fiscal, and financial functions.[2] In this effort, the IMF's Monetary and Financial Systems Department (MFD)[3] has taken the lead in restoring or transforming the central banking function and the payment and banking systems.

This paper summarizes the work undertaken to restore and modernize the financial system in Afghanistan. The approach taken is built upon earlier experience of IMF work in other post-conflict situations. The most recent cases prior to Afghanistan were Kosovo and East Timor, both starting in the second half of 1999 and continuing through May 2003. In evaluating the lessons learned, the paper discusses a number of technical aspects that arose while addressing core issues in the monetary, banking, and payment areas.

II. Role of Technical Assistance

A. IMF's Activities

The objective of the IMF's technical assistance program is to contribute to the development of the productive resources of member countries by enhancing the effectiveness of economic policy and financial institutions and management. Providing technical assistance to member states has been one of many tasks assigned to the IMF by its Articles of Agreement.[4] During the financial year ending in 2002, the IMF devoted 347 person-years to technical assistance, of which MFD accounted for 116 person-years.

Support to member states from MFD is provided as direct technical assistance through MFD-led missions, staff and expert visits, expert secondment and headquarters research. The scope of this assistance can be illustrated in different ways. For Afghanistan, technical assistance by MFD has included: (i) one brief initial visit to open contacts (with two MFD staff); (ii) one diagnostic and two advisory missions (two MFD staff and four experts per mission); (iii) one advisory staff visit (with one MFD staff); and (iv) one workshop (with one MFD staff and two experts). In addition, (v) seven MFD-contracted experts have made a total of 18

---

[2] These include, among others, Cambodia 1991–95, Albania 1991–94, Rwanda 1994–99, Bosnia and Herzegovina since 1996, Sierra Leone since 1998, Kosovo and East Timor since 1999, Afghanistan since 2001.

[3] The IMF's Monetary and Exchange Affairs Department was renamed the Monetary and Financial Systems Department as of May 1, 2003. The new name has been used throughout the paper.

[4] International Monetary Fund (1944). Article I(ii) reads: "To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy."

separate visits to Kabul. This technical assistance is in part funded by the Sweden Technical Assistance Sub-Account, set up by Sida at the IMF. The first visit was preceded by three months of preparatory work within the Fund and with the World Bank and others.

The IMF provides technical assistance only at the explicit request of the national authorities. The “authorities” will vary depending on the situation at hand. In Kosovo and East Timor, the authorities were initially the respective Special Representatives of the Secretary-General of the UN, who as Transitional Administrators were in charge of the interim UN administration. In Afghanistan, the relevant local authorities were identified in the course of the Bonn Conference in December 2001 when Afghan nationals were provisionally nominated as Acting Finance Minister and Acting Governor of the central bank of Afghanistan, Da Afghanistan Bank (DAB).[5]

B. Technical Assistance Coordination

The rebuilding of an Afghan financial system has a strong bearing on the fiscal side to restore an operative Treasury function of the Ministry of Finance. In this work and in the restoration of commercial banks and nonbank financial institutions, key legal issues must be addressed. The advice should, therefore, be closely coordinated with assistance also from experts in those areas. Moreover, close coordination is needed with several other international financial institutions and major technical assistance providers. In this context, the UN often plays an essential role, in particular in the cases where that organization serves as an interim government. Other institutions are the World Bank, regional development banks, and other multilateral or bilateral donors such as USAID and the U.K.’s DFID. The coordination effort should start early, even before the first visit to the post-conflict country, if possible. Clear agreement on roles will contribute to more effective and efficient assistance down the line.

Another issue of importance for technical assistance coordination arises from the very possible limited capabilities of the authorities to formulate, prioritize, and handle technical assistance. This can also include limitations on the counterparts’ physical capability. Even for this, external advice and assistance may be needed. On occasion, the authorities will request the IMF or another major technical assistance provider to take the lead in coordinating the assistance to avoid duplicating efforts.

C. Technical Assistance in Post-Conflict Settings

IMF staff often deals with economies going through difficult times, which in some cases leads to crises and chaos. A post-conflict situation tends to differ from other troubled situations in several respects, including the following:

---

[5] These were Messrs. Hedayat Amin Arsala and Abdul Qadeer Fitrat, respectively. In the beginning of May 2003, the positions were held by Messrs. Ashraf Ghani Ahmadzai and Anwar ul-Haq Ahady.

(i) Social and military conflicts, internal or in combination with external interference, almost always have created emergency conditions.

(ii) Great social turmoil has killed or dislocated large sections of the population, thereby, severely impairing the effective efforts of human capital.

(iii) Central administrative, economic, and political functions have been destroyed or significantly disrupted.

(iv) Local capacity and capabilities have been so fundamentally reduced that they would be unlikely to recover on their own.

(v) Broad consensus exists that the international community should become involved to reestablish peace, law and order and to take steps to rebuild the economy.

(vi) Existing needs for institution-building may well go beyond merely restoring the previous order and call for new permanent institutions to be constructed in some important ways different from the old.

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—sometime represented by a UN transitional administration—is called upon to intervene during a transitory period to cope with the immediate emergency humanitarian situation, and to act as interim 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 by large-scale desertion of management and trained staff. Institution-building is thus a key element of reform in post-conflict economies, but the mix of recovery and reform is one of the critical 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 reestablish old—even if inefficient—structures before moving on with much reform. Whatever the scope of work, it is typically neither possible, nor appropriate, to reestablish old structures in post-conflict situations if the preconditions for those former 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 to replace the previous ones. In this task of transforming the old institutions, or establishing new ones, local participation and acceptance of the reforms are critical. Without local ownership, the reform process is unlikely to be implemented with any success.

III. Development of the Afghan Financial Sector

A. Background

The first bank in the modern sense in Afghanistan was established in April 1931 when Banke Millie Afghan (Afghan National Bank) was established. During its first eight years, this privately-owned institution served as a mono-bank for the country, combining central banking activities with commercial operations. In 1939, DAB was formally founded as a state-owned central bank. In 1948, the Mortgage & Construction Bank was established as the first specialized bank, followed in 1955 by the Agricultural Development Bank. The same year, Pashtany Tejaraty Bank (Pashtun Commercial Bank) was started in response to the growing needs for trade finance. The 1970s was a dynamic period for the Afghan financial sector with the launching of the Industrial Development Bank of Afghanistan in 1973 and the Export Promotion Bank in 1975 with an increasing number of branches being set up in the main regional centers. However, as the political system was decisively moving to the left during that decade, the private banks were socialized during 1974–76. During the subsequent period of Soviet control of Kabul (1980–88), DAB and the banking system as a whole were transformed into the Soviet model.

The victory of the Mujahiddin over the Soviet-backed government and the establishment of Interim Islamic Government in Afghanistan in April 1992 triggered a new phase of volatile conditions with an intensified civil war. During the period of Taliban control from about September 1996 to November 2001, conditions stabilized but DAB and the banking system were never allowed to play their normal roles. The Taliban regime was basically cash-based and as it did not print banknotes, it had very limited recourse to central bank financing. On the other hand, DAB continued in a limited way to carry out certain commercial banking operations, such as the issuing of letters of credit.

B. Situation in 2002 and 2003

At the time of the first visit of the IMF in late January 2002, the official financial system consisted of DAB and six state-owned institutions with valid banking licenses.[6] Three of the institutions were formal commercial banks,[7] and the other specialized development banks.[8] It soon became clear that in reality, none of these financial institutions had been operating in a normal fashion for years. Among the banks, financial intermediation had in effect come to a halt. Having experienced exceptionally difficult conditions over many years with episodes of

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

[7] Banke Millie Afghan, Export Promotion Bank, and Pashtany Tejaraty Bank.

[8] Agricultural Development Bank, Mortgage & Construction Bank, and Industrial Development Bank of Afghanistan.

hyperinflation and exchange rate collapse, it was hardly surprising that the banks were suffering. In an analysis, in early 2003, of the Agricultural Development Bank's balance sheet, the value of the average loan in the banks portfolio amounted to \$0.65 per borrower. In another example, the leading bank, Banke Millie Afghan, had already ceased financial intermediation in 1992, but during 2002 had managed to extend a total of six commercial loans.

As of May 2003, the lack of cash remains an acute and severe problem for all banking institutions in Afghanistan, resulting in only few of the staff being paid. Another problem is the quality of the balance sheets of the institutions. Since the accounts had not been kept up to date during the Taliban regime, most banks have not finalized their 1997 financial accounts while previous ones have not been audited for years. It is obvious that most bank assets have disappeared or are severely depreciated with two exceptions—any frozen accounts in foreign currency that had been kept abroad during the Taliban era, as well as the value of the banks' real estate holdings in Kabul and elsewhere in Afghanistan. In both cases, these assets cannot readily be disposed of and the income stream from them is quite limited—basically rent from NGOs for using part of the banks' premises. DAB also lacks a recent balance sheet.

An additional, more fundamental problem is the question of management and professional competence in the banking system, something that had not properly been tested for decades. Regarding this difficulty, in May 2003, the situation remains largely unchanged in the banking system, although DAB's operations in many ways have improved. In early 2002, using information dating from before the Taliban take-over, DAB reportedly had roughly 3,500 staff, of which about 1,200 were at the Kabul headquarters and the remainder in 89 branches in some 30 provinces of Afghanistan. Given the political and infrastructural situation, DAB did not then, and even in May 2003 does not have control of all its branches, and thus it is impossible to assess the number of individuals actually working. Estimates from the second half of 2002 suggested that about one-third of the branches no longer existed, or had practically ceased to operate for various reasons. Another third were under the control of warlords or regional leaders and were not able always to carry out instructions originating from DAB in Kabul. The final third of the branches, mostly around greater Kabul and in the northeast part of the country were under the control of the head office, but were units suffering from various weaknesses and problems.

Against this background, an immediate task for DAB in the first quarter of 2002 was to handle cash payments for the civil service, provided cash in the local currency was available. In practice, this meant intermittently serving the civil service in Kabul and the immediate surrounding regions. Another urgent task for the central bank was to address the complicated currency situation with three local currencies co-circulating in the country. In addition to the currency that had been issued by DAB and what remained in DAB's vaults when the Taliban took power, the internationally recognized government in exile had ordered new banknotes from the country's regular printer and issued these in the northern parts of Afghanistan. Some of these banknotes had the same serial numbers as previously used, making those new banknotes undistinguishable from those in circulation. Counterfeits of the official currency also circulated, trading at a discount.

C. Hawala System

In parallel with the official financial system, Afghanistan has for a long time had an informal system of unregulated moneychangers. This system has been an integral part of the *hawala*, the traditional informal funds transfers and money changing system in the Middle East and South Asia. The *hawala* comprises both cash and noncash payments. It is reported that their accounts are ultimately cleared in U.S. dollars or gold in Dubai, which is the center of the *hawala* in the region.

The Afghan *hawala* came into focus in recent years in the context of money laundering from the opium trade and the financing of terrorist activities. Because of this reputation, arguments were raised to either outlaw the *hawala* or to subject the unregulated moneychangers to strict DAB licensing, regulation, and supervision. The IMF made the case that such measures were likely to simply drive the system underground and suggested another approach. The recommendation was that in the absence of functioning banks, DAB should accept the unregulated moneychangers, get to know them better, and find ways to combine their interests with DAB's objective of improving the payment system. This approach worked, and the unregulated moneychangers have played a constructive role in the development of orderly monetary conditions. In the Afghan experience, the *hawala* has been used in the following ways by the central bank:

(i) The moneychangers are transferring funds to more remote parts of the country, areas that do not have access to the formal financial system. Also, in the absence of banks, the moneychangers are providing essential currency exchange services.

(ii) Since May 2002, DAB has on a fairly regular—often on a weekly basis—offered U.S. dollar cash currency through an auction system to moneychangers in Kabul. The auction rate reflects the open market rate but is not used to set the market or DAB-quoted rate. Amounts offered are based on an assessment of the need to sterilize the monetary impact of budgetary expenditures injected in the economy. The budget is largely financed by international donors in dollars. In the third quarter of 2002, before the banknote exchange when a sufficient supply of banknotes became available, the auctions were primarily used by DAB to obtain sufficient local currency banknotes to provide the needed cash currency to carry out budget expenditures.

(iii) DAB obtains U.S. dollar rates from the Kabul *hawala* market place where registered (by DAB) and unregulated moneychangers operate. Every morning at 9:00 am, the rates are collected from 10 registered moneychangers. The mathematic average is made public as the exchange rate being quoted by DAB for that day; however, the rate in the open market is left free to fluctuate during the day.

(iv) Moneychangers in all parts of Afghanistan played a critical role in the banknote exchange that took place in the last quarter of 2002. Without them, the currency reform would likely have failed.

During 2002, two studies were made by the IMF and the World Bank about the *hawala* system, providing more comprehensive background information on funds transfer and money changing systems in Afghanistan.[9]

IV. Transition Strategy

In many post-conflict cases, the IMF assisted in institution-building through technical assistance provided not only by MFD but also by other functional departments in the IMF in charge of legal, fiscal, and statistical issues. In fact, given the interdependencies of post-conflict problems, the integration of assistance between these areas is critical to making progress, as is the integration of the work of other major technical assistance providers.

Based on past experience, a transition strategy has been formulated in MFD on what is required to establish a minimal structure of monetary and exchange arrangements, key financial legislation, organizational structures, instruments, and information systems in a post-crisis situation.[10] Such a minimal system should support the restarting of production and trade and should provide for the following:

(i) Credible internal means of payment and capabilities for external payments;

(ii) Reasonably stable prices, calling for convincingly firm monetary control;

(iii) Efficient utilization of foreign aid and foreign exchange resources;

(iv) Efficient mobilization and allocation of savings (credit); and

(v) Effective financial services to execute the government budget (means to collect revenue, make payments, finance deficits, etc.).

In post-conflict cases that no longer have a functioning monetary authority, MFD normally recommends a graduated approach for reestablishing 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 toward reestablishing a monetary authority and a financial system in a post-conflict economy are usefully grouped into five phases. The timeframe for these time periods will vary depending on local circumstances; however, due to the linkages

[9] See Maimbo (2002) and El Qorchi, Maimbo, and Wilson (2003).

[10] Sundararajan and others (1995) and Lönnberg (2001).

and sequencing requirements, the need to preserve the momentum of the reform process is imperative, arguing in favor of implementation over a period of up to five years. 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 few months (starting before the end of the conflict)	▪ Explorative and fact-finding ▪ Briefings within the IMF ▪ Secure technical assistance funding ▪ Selection of experts	▪ Division of labor and forms of cooperation with other major donors ▪ IMF decisions on magnitude of staff engagement	▪ Rule by Presidential Decree (continuing)
II	During first 6 months	▪ Emergency payment system ▪ Agent to the Ministry of Finance	▪ Legal tender selected ▪ Exchange rate regime selected	▪ Revised/new central bank legislation (including payments section) ▪ Service contract agreed with Treasury Department
III	During first 18 months	▪ Licensing, regulation, and, supervision of banks ▪ Increasing payments via banks ▪ Management of financial assets ▪ Licensing of nonbank financial institutions	▪ Enhanced central bank ▪ Interbank clearing system set up	▪ Revised/new banking legislation ▪ Prudential rules and banking regulations ▪ Agency agreement with Ministry of Finance ▪ Legislation on nonbank financial institutions
IV	During first 30 months	▪ Revisit issues on legal tender and exchange rate regime ▪ Traditional central bank operations		
V	During first 60 months	▪ Exit from the post-conflict situation ▪ Return to a normal relationship with the IMF	▪ Expatriate staff leave line positions, become advisors	

It should be noted that defining reasonable and practical timeframes for each of the stages described above does present a major problem. As experienced in Afghanistan, East Timor, and Kosovo, every technical assistance mission generated action plans whose milestones proved to be overly optimistic and had to be moved forward in time. This may be due as much to unrealistic expectations as to post-conflict stresses and cultural misunderstandings with local staff operating within an unfamiliar work environment. To some extent, control

over change handled by newly established institutions providing rudimentary central bank functions can at times be compromised by external forces, for example, jurisdictional disputes with other agencies and institutions, as well as a lack of sufficient expertise. These unforeseen influences can continue to be a problem and threaten to stretch the financial and physical commitments of international donors beyond their expectations.

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 an advantage 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 succeed. Accordingly, the periods specified in this note should only be taken as indicative, and would need to be modified as the situation unfolds.

V. Stage I—Diagnostic Phase

The starting point for the work on Afghanistan was to collect the information available in Washington well before the security situation permitted staff to visit Kabul. Contacts were also made with other potential major technical assistance providers, donors, and interested institutions. Questionnaires as well as previous technical assistance reports from similar post-conflict cases were consulted. Since early engagement in the field is critical in assessing the situation and addressing the emergency aspects, the work on mobilizing technical assistance resources was undertaken simultaneously with the early work in Washington.

In coordination with a World Bank mission, a mission from the Fund made an early exploratory visit to Kabul to seek the answers to a number of questions on the state of the post-conflict situation. Contacts were made with the local authorities as well the UN's local interim administration and other relevant institutions. Among the key findings and suggestions were:

(i) To facilitate the urgent humanitarian efforts, payments within the country and between Afghanistan and the rest of the world should be facilitated.

(ii) The official legal tender was de facto freely floating without any formal exchange rate regime being maintained. A banknote exchange reform should urgently be carried out to unify the national currency.

(iii) The relevant institutions in the monetary, fiscal and financial areas—DAB, the Ministry of Finance, and the banks—were all suffering from acute problems with few functioning resources left intact. Very little of the pre-conflict policy functions appeared appropriate to be restored for reestablishing a monetary authority. Similarly, very little appeared to be worth retaining from what remained of the previous payment and banking systems in Afghanistan.

In the course of the IMF exploratory mission, a framework was defined in which future decisions would be made. An outward-looking approach was selected, relying on the market

mechanism that would underpin the efforts to restore the financial system. Moreover, it was necessary to prioritize the many substantial short-term needs for technical assistance.

Throughout of 2002, the IMF continued to take the lead in providing advice to the Afghan authorities in matters relating to monetary, banking, payment, and fiscal areas. This changed during 2003, when USAID started providing massive support to DAB and the Ministry of Finance as part of an ambitious program for the next five years. Close coordination was achieved with other international financial institutions and major donors during 2002 in order to avoid duplication of work and other inefficiencies. Experience from work in similar situations indicated that agreeing on clear roles early on with respect to support from the international community would avoid losing time on turf battles later on. Accordingly, early channels of contact were opened with the World Bank and the Asian Development Bank, in addition to USAID and DFID. Other early donors and technical assistance providers to Afghanistan included neighboring countries, for example, India and Iran, as well as a few European countries, including Germany (GTZ) and Sweden (Sida).

Experience gained in Afghanistan during this stage suggests that:

(i) Earlier conditions and institutional set-up should be kept in mind in developing a plan going forward—there is no such thing as starting with a blank slate.

(ii) Every early action recommended or taken should be chosen with a relatively clear view of where the system should go in the medium term, so that early actions do not complicate achieving the medium-term goals.

(iii) Initially, there could be a clear danger of too many technical assistance resources being available, compared to what could be readily absorbed, underscoring the need for paying attention to early coordination.

(iv) To ensure effective technical assistance, it is critical that the agreed-upon division of labor is followed from the beginning so that friction is limited.

VI. Stage II—Emergency Phase

During the emergency phase of a post-conflict country (approximately the first six months), clearly the immediate humanitarian aspects—starvation, disease, clothing, shelter, and sanitation—would dominate the concerns of the international community. To ensure that the necessary humanitarian assistance reaches those in need and is also effective, an emergency payment system must be established immediately to take care of the transfer of funds to and within the country. To support this, recommendations should be made for key decisions to be taken on the legal tender and exchange rate regime.

Prompt settlement of government obligations such as salaries, pensions, etc., is not only important in its own right, but also for lending credibility to the central government. Such credibility is crucial for supporting the government's other political objectives.

As previously noted, in the case of Afghanistan, payments through banks had ceased to exist, and had been replaced by cash transactions in multiple currencies. With different currencies circulating at the same time, the pricing system had been negatively affected, contributing to welfare losses and to an inefficient monetary system.

To address this, the IMF recommended that early efforts be directed at establishing one single legal tender to be commonly accepted. In that context, measures were taken to have the legal tender replace competing monies. However, rather than outlawing competing convertible currencies which would normally lead to other inefficiencies, the IMF recommended that it was better to provide incentives to encourage the use of the nominated legal tender.

In order to rapidly reestablish confidence in money, alternatives such as full dollarization, a currency board arrangement, another fixed exchange rate system, or a free-floating exchange rate regime all needed to be considered. In Afghanistan, an early political decision was taken by the Interim Government to retain the national currency, the Afghani. However, at the beginning of 2002, at least three local varieties of the Afghani were co-circulating, two of which were not issued in the proper manner. Accordingly, DAB could only guess how much currency was in circulation and from where it came. Viewing the Afghani as an important symbol of sovereignty and unity, priorities were set to regain control of the issuance of the Afghani by opting to introduce new banknotes as soon as was technically possible. After considerable technical assistance from the IMF, Deutsche Bundesbank, Sveriges Riksbank and USAID, the banknote exchange started on October 7, 2002 and was successfully concluded on January 2, 2003. As a result, the foreign exchange market has since stabilized, reflecting increasing confidence in the new currency.

In parallel with efforts to support the immediate humanitarian measures and to help the economy to start working again, it was crucial to take actions to recreate or restore the minimal essential payment and banking functions, recognizing that the financial system, by and large, no longer existed and something needed to be put in its place until banks and other financial institutions were fully functional again.

To ensure that key payments and other essential financial services were operational in the absence of a functioning banking system, an emergency payment system had to be set up. In some cases it could be organized as a Central Payments Office, a transitional institution that in some respects could be seen as an embryonic central bank. In Afghanistan, the IMF recommended that the emergency payment system be integrated in DAB with the following key tasks. In the list, the key tasks in italics are followed by a summary of actions taken and lessons learned (in plain print):

(i) *Initially, DAB should pay particular attention to establishing correspondent accounts, reconcile earlier accounting records of funds held abroad, and set up a system for receiving and channeling foreign funds.*

By the middle of 2002, DAB was a member of SWIFT, and was increasingly regaining control of the foreign currency account held abroad that had been frozen during the Taliban regime.

(ii) *DAB should act as a depository and cashier, accept and channel international emergency assistance, ensure that payments related to essential public services are made, arrange transfer payments to major places nationally, and handle payments to utility staff, health and school sectors, civil servants, etc.*

Over time, substantial progress has been made in these areas. It should, however, be recognized that the existing de facto political divisions in Afghanistan, in combination with the major deficiencies in transportation and communications infrastructure, have severely limited DAB's ability to service the whole country with the required facilities.

(iii) *DAB should support not only a system for payment of public expenditures but also for the collection of fiscal revenue. Reestablishing such systems would have important implications for the restoration and transformation of the fiscal system.*

The problems mentioned immediately above also have had a strong impact on this task. As a counterpart to DAB, the Treasury Department of the Ministry of Finance has taken important initiatives to improve the system from its side supported by technical assistance from the World Bank. After the success with the banknote exchange—an essential prerequisite to progress in many areas—DAB has during the first part of 2003 given more attention to this area.

(iv) *DAB should discuss with the Ministry of Finance the expectations in both institutions regarding what needs to be done in terms of cooperation during the emergency phase.*

Discussions have started on an agency agreement that should take the form of several service contracts, defining the services that DAB would provide the Ministry of Finance and the reimbursement it would receive for services provided.

(v) *On a contractual case-by-case basis, DAB should be prepared to accept deposits from public authorities as well as from foreign banks, international financial institutions, and donors.*

This should be seen as a temporary service that the central bank should only provide until at least two banks are functioning again in Kabul. In other regions of the country where no bank branches exist, DAB's branches may again provide some of these services if it has the

capabilities of doing so. Accordingly, DAB 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.

(vi) *DAB should accept the role of monitoring the activities of organized foreign exchange bureaus and moneychangers prior to setting up a supervisory function for financial institutions in Stage III.*

Traditionally, DAB's role with respect to the moneychangers was restricted to registration against a modest fee. During the first two post-conflict stages, the interactions have become more important and interesting. Through the weekly auctions (see Section IV.C.(ii)), where DAB is providing the moneychangers millions of U.S. dollars against Afghani cash currency, DAB has gotten to know an increasing number of players. Moreover, during the intensive work on the banknote exchange, DAB was able to establish a well-functioning collaboration with the moneychangers, not only in Kabul but in other parts of the country as well. As a result of these improved relations, a few leading moneychangers have expressed an interest in applying for full banking licenses. This is a major contrast from the situation at the beginning of 2002, when suggestions were made from several corners to either outlaw the hawala dealers or to impose far-reaching requirements on the moneychangers, which would have pushed most of the unofficial funds transfers and foreign exchange operations underground.

(vii) *Work on an appropriate payment legislation should be initiated to promote more normal conditions.*

As previously mentioned, the existing 1994 Law on Money and Banking does not provide a suitable framework for any important financial sector activity. As a response, through technical assistance from the IMF's Legal Department and MFD, a comprehensive draft payments law was prepared by the middle of 2002. After further consultations with the Afghan counterparts, it became clear that a special payments law would not be given priority in the enactment of new legislation for Afghanistan for a very long time. It was therefore agreed to insert appropriate key provisions on payments in line with international best practices[11] in the draft DAB law, including the necessary authority for DAB to regulate and issue guidelines for the operation and monitoring of payment systems.

Staffing the operations of an emergency payment system as outlined above is not an easy task. In Afghanistan, few of the local staff had the necessary expertise to be able to play a leading role in that work. It was also recognized that it would be difficult to recruit talented and experienced expatriate people to work in an environment where living conditions were difficult and insecure.

---

[11] According to the Bank for International Settlements (1999).

In addition, acquisition of sufficient and suitable physical accommodations in which to conduct the emergency payment operations was a difficult problem. In Afghanistan, it was obvious that DAB's headquarter premises were not suited for these tasks. Moreover, the lack of DAB branches capable of supporting the emergency payment system increased the challenges.

Apart from physical space, the issue of use of computers for the payment system also raised problems. Given the recent history in Afghanistan, it was not surprising that DAB staff was initially totally computer illiterate. However, DAB's management has made it a priority to train staff internally to provide potential for future automation.

DAB's major responsibilities during Stage II are summarized in Box 2.

Box 2. DAB's Functions in Stage II

- Own and operate one or more payment systems.
- Ensure adequate supply of banknotes of the legal tender for settlement of cash transactions.
- Provide temporary payment and storage services to the Treasury 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 safekeeping of currency.
- Act as banker to the Ministry of Finance and provide financial advice at its request.
- Act as fiscal agent of the Ministry of Finance and other public authorities.
- Publish foreign market exchange rates on a daily basis.
- Prepare legislation for payments transactions.
- Prepare banking legislation.
- Train local staff.

VII. Stage III—Institution-Building Phase

During this phase (approximately the first 18 months), with more normal conditions gradually returning, the restoration of the financial system becomes a key priority in post-conflict Afghanistan. The interim government needed an institution that could 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. It was natural for DAB to shoulder these responsibilities.

The principal objectives of DAB at this stage would 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 major responsibilities are summarized in Box 3.

Box 3. DAB's Functions in Stage III

Monetary Policy
- Conduct a rudimentary monetary policy (possibly also exchange rate policy).

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 Treasury of the Ministry of Finance and other public agencies.
- 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 DAB's role 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 Government and provide financial advice at its request.
- Act as fiscal agent of the Ministry of Finance and other public authorities.
- Safekeep and administer foreign currency for the Government and other public authorities.
- Maintain official reserves.
- Recommend broad policy guidelines to the Government on general economic policy.
- Conduct regular economic and monetary analysis of the economy; make public the results; submit proposals and measures to the Ministry of Finance on the 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.

Sundry Tasks
- Prepare central bank and banking legislation.
- Train local staff.

In this stage of recovery, the economy as a whole urgently requires functioning institutions for financial intermediation and the reestablishment of a banking system to restore public confidence. An early step would be to enact new banking legislation by Presidential Decree. The Legal Department of the IMF together with MFD and in cooperation with the U.S. Financial Services Volunteer Corps have prepared such legislation. Key points are that:

(i) The new legislation should stipulate that institutions with "fit and proper" owners and managers, sufficient capital, and viable business plans would not be denied banking licenses. Institutions that were previously licensed as banks should be required to file new license applications in accordance with the new legislation and formally be approved to continue operating.

(ii) 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 upon.

(iii) All licensed financial institutions would be under the regulation and supervision of DAB. They would be required to comply with prudential rules and banking regulations issued by DAB, all of which should be in compliance with the Basel Core Principles.[12]

(iv) Supervision is not the only instrument for ensuring the financial soundness of a bank. It would be 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.

Realistically speaking, newly licensed banks might not be able or willing 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 also of nonbank financial institutions, such as microfinance institutions, as a means of attracting savings and channeling financial resources to rural or deprived areas. No license from DAB should be necessary for microfinance institutions as long as they only accept deposits from members, and to a limited extent from the general public. However, before crossing the latter threshold level stated in the banking legislation, a microfinance institution would need to apply for and obtain a normal banking license from DAB. DAB should not be in charge of regulating and supervising microfinance institutions; this task should be assigned to an appropriate meta-institution, that DAB would liaise with. In several post-conflict economies, considerable donor interest has been registered for financially and administratively supporting microfinance institutions, and for sponsoring the establishment of meta-institutions.

In Stage III, the payment system would be changed and moved closer to a conventional order where payment transactions are carried out by banks and between banks on behalf of their customers. So far, no progress has been recorded in Afghanistan in this area.

In its role as fiscal agent and banker to the Government, DAB 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 provided by the IMF.[13] Also, the service

[12] Basel Committee on Banking Supervision (1997).

[13] International Monetary Fund (2001).

contract entered into by DAB and the Treasury Department in Stage II should in Stage III be expanded to a formal agency agreement with the Ministry of Finance, covering the additional services provided. 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 DAB. This development and the emerging competition should be welcomed.

VIII. Stage IV—Two-Tier Banking System Phase

Afghanistan has not yet reached this stage and, consequently, the presentation will be more generic than focused on actual achievements. In this phase of assisting a post-conflict economy (approximately within the first two-and-a-half years), the objective should be to reach conditions that could be deemed normal. On the political front, this would imply that any previous 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 broad commercial activity.

In the financial sector, the objective should be the establishment of a traditional two-tier banking system. In Afghanistan, the exact functions of DAB would depend also on the outcome of two decisions that would have to be made. The first is whether the issue of legal tender should be revisited or not. With the reestablishment of a government that is no longer transitional, national priorities could be different. The other issue to be revisited would be the choice of an exchange rate regime. Again, an early decision was taken during the emergency phase, but the opinion of the new leadership may have shifted. In many respects, this is a highly technical issue and should not be addressed in a sudden or unplanned manner. It would be important to ensure that whatever decision is made, the exchange rate regime should have a reasonable chance of success, thus helping to maintain monetary stability in the face of major shifts in policy often experienced in economies with troubled pasts.

Based on decisions made regarding legal tender and exchange rate regime, a review of the central bank legislation may also be necessary. In that work, the objective should be to observe international best practices in the area. These include, among other things, strong provisions for central bank autonomy and accountability and an explicit primary objective for the central bank to achieve and maintain low domestic prices.

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 five years), progress in restoring normal conditions should be sufficient to indicate that exceptional technical assistance provided by MFD and other donors could be phased out.

Among the many important factors leading to such a situation, advancement in capacity-building would be crucial. In a post-conflict economy, the development of skills is critical for the success of capacity-building efforts. Shortage of adequately trained local staff for policy management, as well as hands-on skills in banking operations, constitute a severe problem that must be addressed. Technical assistance should in all areas contain a pronounced training component aimed at strengthening core activities in financial operations. Training programs should be formulated and implemented in Stages II, III and IV with the aim of building 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.

It would be important to train local staff for middle- and senior-ranking positions as increased mobility of highly skilled staff would most likely result in a chronic shortage of critical skills. Selected local staff having the appropriate macroeconomic and banking qualifications and work experience would benefit from direct mentoring. 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 to be used for career development purposes.

References

Bank for International Settlements, 1999, *Core Principles for Systemically Important Payment Systems,* Basel.

Basel Committee on Banking Supervision, 1997, *The Core Principles Methodology* (Basel: Bank for International Settlement).

El Qorchi, Mohammed, Samuel Munzele Maimbo, John F. Wilson, 2003, "Informal Funds Transfer: An Analysis of the Hawala System," (Washington: International Monetary Fund and World Bank).

International Monetary Fund, 1944, *Articles of Agreement of the International Monetary Fund*, Washington.

———, 2001, *Guidelines for Foreign Exchange Reserve Management*, Washington.

Lönnberg, Åke, 2001, "Post-Conflict Economies: Lessons from Restoring and Transforming Payments and Banking Systems in Kosovo and East Timor," (unpublished; Washington: International Monetary Fund).

Maimbo, Samuel Munzele, 2002, "The Money Exchange Dealers of Kabul—A Study of the Hawala System in Afghanistan" (Washington: World Bank).

Sundararajan, V, W. Alexander, T. Baliño, W. Coats, R.B. Johnston, C.J. Lindgren, T. Nordman, J. Dalton, and A. Hook, 1995, "The Design of a Minimal Monetary and Exchange Structure for Countries in Post-Chaos/Post-Conflict Situations," (unpublished; Washington: International Monetary Fund).