

MILITARY BANKERS: FACT OR FICTION? THE ROLE OF THE MILITARY
IN REESTABLISHING A BANKING SYSTEM DURING A
MILITARY STABILITY OPERATION

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General Studies

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The opinions and conclusions expressed herein are those of the student author and do not necessarily represent the views of the U.S. Army Command and General Staff College or any other governmental agency. (References to this study should include the foregoing statement.)

ABSTRACT

MILITARY BANKERS: FACT OR FICTION? THE ROLE OF THE MILITARY IN REESTABLISHING A BANKING SYSTEM DURING A MILITARY STABILITY OPERATION, by LTC Jan Willem Maas, 106 pages.

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TABLE OF CONTENTS

	Page
MASTER OF MILITARY ART AND SCIENCE THESIS APPROVAL PAGE	iii
ABSTRACT.....	iv
TABLE OF CONTENTS.....	v
ACRONYMS.....	vii
ILLUSTRATIONS	viii
TABLES	ix
CHAPTER 1 INTRODUCTION	1
Background.....	1
Research question	4
Secondary research questions	4
Assumptions.....	4
Definitions of Terms.....	5
Limitations	6
Scope and Delimitations	6
Significance	7
CHAPTER 2 LITERATURE REVIEW	11
Introduction.....	11
Most important institutions	12
The facilitating role of a banking system.....	12
The role of military stability operations	22
Banking in a historical perspective.....	25
Conclusion	28
CHAPTER 3 RESEARCH METHODOLOGY	30
Introduction.....	30
Research questions.....	30
Research methodology.....	31
The economic assessment variables	32
The banking system assessment variables	33

CHAPTER 4 ANALYSIS	38
Introduction.....	38
Activities of international organizations in Kosovo	39
Activities of the World Bank	40
Activities of the International Monetary Fund.....	42
Activities of United States Agency for International Development	44
Sustainable economic growth in Kosovo.....	45
Effectiveness of the banking system in Kosovo	49
Efficiency of the banking system in Kosovo	55
Activities of International Organizations in Afghanistan	58
Activities of the World Bank	59
Activities of the International Monetary Fund.....	62
Activities of United States Agency for International Development	63
Sustainable economic growth in Afghanistan	65
Effectiveness of the banking system in Afghanistan	66
Efficiency of the banking system.....	71
Activities of the military in Kosovo and Afghanistan	73
Possible military tasks in Kosovo and Afghanistan.....	74
CHAPTER 5 CONCLUSIONS AND RECOMMENDATIONS	78
Introduction.....	78
Conclusions.....	78
Recommendations.....	82
BIBLIOGRAPHY	86
INITIAL DISTRIBUTION LIST	97

ACRONYMS

AFHQ	Anglo-American Allied Forces Headquarters
AMGOT	Allied Military Government of Occupied Territory
AMIK	Association of Microfinance Institution of Kosovo
CBK	Central Bank of Kosovo
CBAK	Central Bank Authority of Kosovo
DAB	Da Afghanistan Bank
FYROM	Former Yugoslav Republic of Macedonia
GDP	Gross Domestic Product
HHI	Herfindahl-Hirschman Index
IMF	International Monetary Fund
ISAF	International Security Assistance Forces
KBA	Kosovo Bankers' Association
KFOR	Kosovo Force
UN	United Nations
UNAMA	United Nations Assistance Mission in Afghanistan
UNDP	United Nations Development Programme
UNMIK	United Nations Interim Administration Mission in Kosovo
USAID	United States Agency for International Development
World Bank	The World Bank Group

ILLUSTRATIONS

	Page
Figure 1. Control of Corruption in Kosovo	54
Figure 2. Rule of Law in Kosovo	54
Figure 3. Amount of Reserves of Kosovo banking system	57
Figure 4. Control of Corruption in Afghanistan	70
Figure 5. Rule of Law in Afghanistan	70

TABLES

	Page
Table 1. Assessment variables	36
Table 2. Assessment variables efficiency banking system	37
Table 3. Annual percentage growth rate of GDP at market prices based on constant local currency	45
Table 4. Annual percentage growth rate of real GDP at market prices based on constant local currency (GDP minus inflation)	46
Table 5. Annual percentage of inflation.....	47
Table 6. Annual percentage of money growth.....	48
Table 7. Net inflow of foreign direct investment per capita to acquire a lasting management interest	49
Table 8. Annual credit provided by banking sector as percentage of GDP	49
Table 9. Financing of firms in Kosovo in 2009 in percentage of total firms.....	51
Table 10. HHI for assets, loans and deposits (in points).....	56
Table 11. Economic assessment variables for Afghanistan.....	66
Table 12. Financing of Afghan firms in percentage in 2009	68

CHAPTER 1

INTRODUCTION

Background

Economic development is not the primary field of expertise of the military. It is the expertise of other governmental and non-governmental organizations such as the United States Agency for International Development (USAID), the International Monetary Fund (IMF), the World Bank Group (World Bank) or regional international financial organizations like the Asian Development Bank.

However, development of sustainable economic growth and security are interrelated and interdependent. Without sustainable economic growth, stability will be hard to achieve.¹ Although the traditional assumption is that security should precede development, the central theme in this thesis is economic development and therefore the development of capacity for the banking system should start as early as possible.² Even before the cessation of hostilities.

In the August 1998 issue of Journal of Money, Credit and Banking appeared an article written by Ross Levine, titled “The Legal Environment, Banks, and Long-Run

¹United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, *Guiding Principles for Stabilization and Reconstruction* (Washington, DC: United States Institute of Peace Press, 2009), 9-133.

²Jonathan Haughton, “The Reconstruction of War-torn Economies” (Technical Paper, Harvard Institute for International Development, June 1998), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.116.6026&rep=rep1&type=pdf> (accessed 9 October 2010), 3.

Economic Growth.”³ In the article, Levine describes the empirical research he did in forty-nine different countries between 1976 and 1993.⁴ He states that the development of the banking system is strongly associated with growth per capita, physical capital accumulation and growth of productivity.⁵ This means that the banking system is important to create sustainable economic growth.

To facilitate economic growth, there should be a form of financial intermediation. According to Levine, the banking system should be this mechanism for financial intermediation.⁶ The banking system facilitates a sustainable economy by providing payment services, mobilizing deposits, and easing investment financing. An effective financial system provides funds and connects lenders and investors.⁷

In the May-June 2010 issue of *Foreign Affairs* appears an article written by Carl J. Schramm titled “Expeditionary Economics, Spurring Growth After Conflicts and Disasters.”⁸ In the article, Schramm states that during the beginning of a post conflict or

³Ross Levine, “The Legal Environment, Banks, and Long-Run Economic Growth,” *Journal of Money, Credit and Banking* 30, no. 3 (August 1998, Part 2): 596.

⁴*Ibid.*, 597.

⁵*Ibid.*, 596.

⁶R. Levine et al., “Financial Intermediation and Growth: Causality and Causes,” *Journal of Monetary Economics* 46 (2000): 34.

⁷International Finance Cooperation of The World Bank Group, *Afghanistan Country Profile 2008* (Danvers, MA: The World Bank Group, 2008), <http://www.enterprisesurveys.org/documents/EnterpriseSurveys/Reports/Afghanistan-2009.pdf> (accessed 24 December 2010), 11.

⁸Carl J. Schramm, “Expeditionary Economics, Spurring Growth after Conflicts and Disasters,” *Foreign Affairs* (May/June 2010): 3.

disaster relief phase of military operations, economic reconstruction is a task for the military, because others are not capable of executing this task. In most cases, there is a lack of security in the early stages of a stability operation. Therefore, Schramm looks to the military because of a continuous need for security not found with development promoting entities. However, having the responsibility of providing security at this stage of operations, does not mean the military must develop the banking system.

The development of a sustainable economy requires integrating numerous interrelated and interdependent facets. However, for the purposes of this thesis, we will focus on the best way to rebuild the banking system's capacity of a country in order to facilitate economic development. The question is whether the military can play a role in re-establishing a banking system in a country undergoing stabilization and reconstruction. What are current lessons learned in other operations? Should the development of capacity start before the military operation in order to have the ability to rebuild the banking system as soon as the military operation starts? What should be done to safeguard the momentum of the development of capacity after the military hands over the mission responsibility to civilian representatives?

The military operation must be successful in contributing to the development of a sustainable economy in order to make the transition from (post-)conflict to peace. Because a healthy banking system is indispensable for sustainable economic development, there should be a focus on how to empower the host country to manage and operate a banking system during stability operations. This research will determine the best way to incorporate lessons learned from contemporary stability operations and

historical examples in building a healthy and reliable financial system in order to facilitate a sustainable economy growth.

Research question

Is there a viable role the military can play in re-establishing a banking system in a country undergoing stabilization and reconstruction?

Secondary research questions

To answer the primary research question, four secondary questions must be answered. The first question is; how does the World Bank, IMF and USAID rebuild capacity for a banking system? To answer this question, two case studies from the development of the banking system in Afghanistan and Kosovo will be used. The second question is how to evaluate its success. For this question, assessment variables will be determined and applied to analyze the banking development activities of the World Bank, the IMF and USAID in Kosovo and Afghanistan. The third question is; what has been done by the military to facilitate the development of the banking system in both countries? The final question is; what post-conflict role has the military performed in re-establishing banking systems in previous conflicts.

Assumptions

The main assumption for this thesis is that economic development and security are complementary. Each are required to rebuild a nation and re-establish stability in a country. The result of this assumption is that a way has to be created to achieve both goals simultaneously, recognizing that economic development will always be hampered if security is lacking and that security is difficult to achieve if there is not enough

economic improvement and opportunities to offer a reasonable livelihood for people. The second assumption is that military stability operations and economic development activities are not standalone activities. Both are part of a comprehensive approach. This means both instruments are part of a wide range of civil and military instruments to reconstruct and stabilize war torn countries.⁹ The result of this assumption is that this thesis will focus on how to match military and economic development activities, knowing both are very different professions.

Definitions of Terms

Purchasing power of money: The purchasing power of money means that money is the commodity to trade goods and services.¹⁰

The effectiveness of the banking system: The banking system fulfills its role as financial mediatory, based on the assessment variables in the right column of table 1.

The efficiency of the banking system: The banking system is profitable, the revenues of the banking system exceed the costs.

The operational concept: operational concept frames the way in which operations will be executed. The operational concept encompasses four different operations

⁹North Atlantic Treaty Organization, *A Comprehensive Approach*, 3 November 2010, http://www.nato.int/cps/en/natolive/topics_51633.htm (accessed 17 November 2010), 1.

¹⁰Dr. Frank Shostak, “Fractional Reserve Banking and Boom-Bust Cycles,” Ludwig von Mises Institute, August 2009, <http://mises.org/journals/scholar/shostak2.pdf> (accessed 24 November 2010), 6.

(offensive, defensive, stability and civil support operations), which can be executed simultaneously.¹¹

Limitations

This research has four major limitations. First, research will be limited to how to build capacity for a banking system during stability operations, as part of the operational concept for the U.S. Army, as described in chapter 3 of Field Manual 3-0.¹² According to doctrine of the U.S. Army, a military campaign consists of six different phases.¹³ The second limitation is that this research will be limited to the two final phases being; the stabilization phase and the phase to enable civil authorities. The third limitation is that this research will only focus on the development of the banking system in order to set the foundation for sustainable economic development as part of the national strategic end state of the stability operation.¹⁴ The fourth limitation is that this research will only look at the ways to provide capacity to operate and manage the banking system in a country.

Scope and Delimitations

The scope of this thesis is to do research into activities, which can be implemented into a military stability operation, in order to contribute to the development of an effective, reliable and secure banking system. This means that research will be done

¹¹Department of the Army, Field Manual (FM) 3-0, *Operations* (Washington, DC: Headquarters Department of the Army, February 2008), 3-1.

¹²Ibid.

¹³Ibid., 3-21.

¹⁴United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 2-8.

investigating ways to develop an effective, reliable and secure banking system after a conflict has taken place in a country. Currently this is mainly an activity or responsibility of international organizations like the IMF and the World Bank. Also USAID as a governmental representative of the United States and Regional development Banks are involved. Therefore, the practice of these institutions will provide an overview of the current way to develop a banking system.

Significance

Economic stability is an important factor in promoting peace and security. One only has to look at countries or regions like Bosnia, Gaza, or the Lakes district in Africa to know that without economic stability there is no peace.¹⁵ A study by the World Bank underlines this by proving that in six out of nine country cases (Bosnia and Herzegovina, Cambodia, El Salvador, Eritrea, Haiti and Uganda) there was economic stagnation or severe economic stress in the years leading up to the respective conflicts.¹⁶ In five (Bosnia and Herzegovina, El Salvador, Rwanda, Haiti and Sri Lanka) of these nine cases, economic issues were important factors leading to the conflict.¹⁷ Recent analysis also

¹⁵James D. Wolfenson, —Address to the 1997 World Bank Annual Meeting” (Speech, Hong Kong, 23 September 1997), <http://www.imf.org/external/am/speeches/pdf/PR04E.pdf> (accessed 14 December 2010).

¹⁶Kreimer et al., *The World Bank's Experience with Post-Conflict Reconstruction* (Washington, DC: The World Bank, June 1998), http://www.wds.worldbank.org/external/default/main?pagePK=64193027&piPK=64187937&theSitePK=523679&menuPK=64187510&searchMenuPK=64187283&theSitePK=523679&entityID=000178830_98111703551072&searchMenuPK=64187283&theSitePK=523679 (accessed 22 September 2010), 22.

¹⁷Ibid.

indicates that forty percent of all post-conflict countries return to violent conflict within a decade because of economic instability.¹⁸

Without broad economic improvements, stability is difficult to achieve.¹⁹

Common features of war torn economies are vulnerability to external economic shocks, –fragmented markets, limited access to credit, reduced confidence, depleted human capital, increased illicit economic activities” and debilitated economic institutions.²⁰ As a result, these circumstances increase both the costs and risks of commercial activities and investments, therefore increasing the risk of delay in establishing sustainable economic solutions to conflict.²¹ In order to achieve sustainable economic development, the host nation needs financial laws/regulations and policies, as well as an effective banking system consisting of commercial banks that are supervised by an independent central bank. The banking system should provide credit to businesses and individuals, perform financial transactions, and safeguard people’s savings.²²

¹⁸Paul Collier, “Post-Conflict Recovery: How Should Policies Be Distinctive?” (Centre for the Study of African Economies, Department of Economics, Oxford University, 2007), <http://users.ox.ac.uk/~econpco/research/dfs/PostConflict-Recovery.pdf> (accessed 8 October 2010), 2.

¹⁹United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-133.

²⁰United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries* (Washington, DC: USAID, January 2009), http://pdf.usaid.gov/pdf_docs/PNADO408.pdf (accessed 9 October 2010), 4.

²¹United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-132.

²²United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, 73.

Levine conducted empirical research into the relationship between the legal environment, banks, and long-run economic growth.²³ He states that in countries where the legal system emphasizes the rights of creditors and where contracts are rigorously enforced, there will be better-developed banks. However, more important is that he also states that the development of the banking system is strongly related to growth per capita, physical capital accumulation and growth of productivity.²⁴ This means that the legal system is important for the development of the banking system and that the banking system is important to create sustainable economic growth. These results are in agreement with the results of other well-known scholars.²⁵

The problem is that in most war torn countries, infrastructure has been greatly damaged or neglected, the economy has been marginalized and the financial system has become ineffective during the conflict. This happened in Afghanistan, Cambodia and the Democratic Republic of the Congo.²⁶ In addition, skilled human capacity is in short supply, when the environment is not safe and secure. Zimbabwe, South-Africa, and Iraq

²³Levine, 596.

²⁴Ibid.

²⁵Dimitris K. Christopoulos and Efthymios G. Tsionas, "Financial Development and Economic Growth: Evidence from Panel Unit Root and Cointegration Tests," *Journal of Development Economics* 73 (2004): 69.

²⁶Staff of the Monetary and Financial Systems Department, *Background Paper for MFD Technical Assistance to Recent Post-conflict Countries* (Washington, DC: International Monetary Fund, 13 December 2004), www.imf.org/external/np/ta/2005/eng/022805.htm (accessed 17 November 2010), 4, 8, and 12.

all suffered a lack of skilled people after the violence subsided.²⁷ Although the traditional assumption is that security should precede development, the central theme in this thesis will be that economic development and therefore the development of capacity for the banking system, should start as soon as possible, and quite possibly, before the cessation of hostilities.²⁸

²⁷Ronald W. Johnson and Syedur Rahman, “Improved Budgeting and Financial Management as a Tool for Enhancing the Performance of Local Government in Developing Countries,” *International Journal of Public Administration* 15, no. 5 (1992): 1241-1261.

²⁸Haughton, 3.

CHAPTER 2

LITERATURE REVIEW

Introduction

The first purpose of the literature overview is to become familiar with the subject. Information has been gathered from different sources as listed in the bibliography. Useful institutions are; The World Bank, The International Monetary Fund, The United Nations Development Program and the United States Agency for International Development. In addition, information from the Army War College and the Combined Arms Research Library (CARL) at Fort Leavenworth has been gathered. The second purpose of the literature overview is to gather information for the comparative case study in order to find similarities and differences. This should lead to the development of alternatives on how to build capacity for a banking system during a stability operation. This literature review will show that there is some information available, but it is in most cases very much focused on a specific country with its specific circumstances. The advantage is that there is enough freedom of maneuver to make analysis and to come up with conclusions.

The first section provides an overview of the most important institutions for the development of a banking system in the context of this thesis. The second section gives an overview of how a banking system can contribute to stability operations in order to facilitate sustainable economic growth. The third section will give an overview of the role of the military element of national power in a stability operation.

Most important institutions

For this thesis, the main actors facilitating the development of banking systems are The World Bank, The International Monetary Fund (IMF) and USAID. The World Bank is an international organization consisting of 187 countries and its mission is to provide technical and financial assistance to ~~de~~developing countries by providing resources, sharing knowledge, building capacity and forging partnerships in the public and private sectors,” in order to fight poverty.²⁹ The IMF is a supranational organization, consisting of 187 countries. The mission of the IMF is ~~to~~ foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.”³⁰ USAID is a governmental organization and part of the Department of State of the United States. ~~Its~~ mission is to support long-term and equitable economic growth and advances United States foreign policy objectives by supporting economic growth, agriculture and trade, global health, and democracy, conflict prevention and humanitarian assistance.”³¹

The facilitating role of a banking system

Reviewing the literature about the facilitating role of banking systems in stabilization and reconstruction operations is crucial to understanding how to build

²⁹World Bank, ~~–About Us,~~” <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,pagePK:50004410~piPK:36602~theSitePK:29708,00.html> (accessed 24 November 2010).

³⁰The International Monetary Fund, ~~–About the IMF,~~” November 2010, <http://www.imf.org/external/about.htm> (accessed 24 November 2010).

³¹United States Agency for International Development, ~~–About USAID,~~” November 2010, http://www.usaid.gov/about_usaid/ (accessed 24 November 2010).

capacity to manage and operate a banking system. According to the United States Institute of Peace and the United States Army Peacekeeping and Stability Operations Institute, five end states have to be met in order to achieve successful stabilization and reconstruction of a nation after conflict. These end states are; a safe and secure environment, a rule of law, a stable government, social well-being of the population and a sustainable economy.³² Although there are other organizations, that have analyzed the dimensions of stabilization and reconstruction, all come to similar conclusions. An example is the African Union. In their African Post-Conflict Reconstruction Policy Framework they mention five dimensions; –security; political transition, governance and participation; socio-economic development; human rights, justice and reconciliation; and coordination, management and resource mobilization.”³³ Overall, the same areas and subjects are covered and in all cases, a sustainable economy is part of stabilization and reconstruction.

The United States Institute for Peace and the United States Army Peacekeeping and Stability Operations Institute have formulated a sustainable economy as the ability for the people to pursue opportunities for livelihoods within a viable economic system supported by law.³⁴ As a result; to achieve a sustainable economy, four conditions have to

³²United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 2-9.

³³NEPAD secretariat, –African Post-Conflict Reconstruction Policy Framework,” New Partnership for Africa’s Development, June 2005, [http://www.reliefweb.int/rw/lib.nsf/db900sid/PANA-794D7A/\\$file/nepad-jun2005.pdf?openelement](http://www.reliefweb.int/rw/lib.nsf/db900sid/PANA-794D7A/$file/nepad-jun2005.pdf?openelement) (accessed 11 December 2010), IV.

³⁴United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-132.

be met. These conditions are; macro-economic stabilization, control over illicit economic activity, a sustainable market economy and employment possibilities, especially for military-age youth.³⁵ Although a banking system cannot achieve these goals alone, an effective, safe and reliable banking system is an absolute necessity to be successful.

The two different organizations for a banking system are a two tier banking system with a network of banks and a branchless banking system. If a banking system consists of a central bank and commercial banks, it is called a two tier banking system. In such a system, the central bank pursues price stability, facilitates an efficient and reliable payment system, provides economic advice to the government, and ensures that financial institutions like commercial banks have sufficient funds to meet their obligations.³⁶ The central bank will also issue banknotes and coins.³⁷ According to Haughton the primary task of the central bank is to keep oversight over commercial banks in order to create and maintain confidence in the financial system.³⁸ To develop sustainable economic growth an efficient financial system is therefore needed. The RAND Cooperation as well as United States Institute for Peace and the United States Army Peacekeeping and Stability

³⁵Ibid., 9-133.

³⁶De Nederlandse Bank, *Guardian of Financial Stability* (The Netherlands: De Nederlandse Bank, December 2008), http://www.dnb.nl/en/binaries/Guardian_tcm47-210328.pdf (accessed 11 December 2010), 4-5.

³⁷Rene Smits, *The European Central Bank: Institutional Aspects* (The Hague, The Netherlands: Kluwer Law International, 1997), 203.

³⁸Haughton, 3.

Operations Institute have underlined the importance of a central bank for a sustainable economy in a stabilization and reconstruction phase.³⁹

A branchless banking system is a system in which there is no traditional bank network. Bank services are provided at lottery houses or retail outlets. A branchless banking system entails at least four elements.⁴⁰ The first element is the use of technology to identify customers and record transactions. The second element is the use of third party outlets that can act as an agent and provides the services that needs physical customer contact. The third element is to offer at least basic cash deposit and withdrawal system, in addition to transactions and payment services. The fourth element is that it has formal backing by a licensed bank. Branchless banking is not only a low cost solution, it also provides financial services to people who normally would not be reached by the traditional banking network. The system is operational in different countries around the world and can be used in mature economies as well as in developing economies. Examples are Afghanistan, Brazil and the Philippines.⁴¹

³⁹Crane et al., –Guidebook for supporting Economic Development in Stability Operations” (Technical Report, RAND Cooperation, 2009), http://www.rand.org/pubs/technical_reports/2009/RAND_TR633.pdf (accessed 24 November 2010), 79; United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-155.

⁴⁰Gautam Ivatury and Ignacio Mas, –The Early Experience with Branchless Bankin,” *CGAP Focus Note* no. 46 (April 2008), <http://www.cgap.org/p/site/c/template.rc/1.9.2640/> (accessed 16 December 2010), 1.

⁴¹Ibid., Annex A.

To facilitate economic growth, there should be a form of financial intermediation. The banking system can provide in financial intermediation.⁴² This means providing payment services, mobilizing deposits, and easing investment financing. An effective financial system provides funds and connects lenders and investors.⁴³ In a discussion paper from Miwa and Ramseyer of the Harvard Law School, it is stated that banks promote growth.⁴⁴ According to the World Bank and for example the Federal Reserve Bank of Minneapolis, banks facilitate growth.⁴⁵ However, according to Fisher and Shostak, the focus should not be on money itself, but on the effect, that money can have on promoting sustainable economic growth. It focuses on the purchasing power of money to develop sustainable economic growth. This means that money is the commodity to trade goods and services.⁴⁶ It is therefore the reciprocal of the level of prices and the

⁴²R. Levine et al., 34.

⁴³International Finance Cooperation of The World Bank Group, 11.

⁴⁴Yoshiro Miwa and J. Mark Ramseyer, "Banks and Economic Growth: Implications from Japanese History" Discussion paper no. 289 (Cambridge MA: Harvard Law School, August 2000), http://www.law.harvard.edu/programs/olin_center/papers/pdf/289.pdf (accessed 11 December 2010), 2.

⁴⁵World Bank Group, "The World Bank Should Facilitate, Not Provide," *Beyond Transition* 8, no. 2 (April 1997), <http://www.worldbank.org/html/prddr/trans/apr97/pg18.htm> (accessed 12 December 2010), 1; Federal Reserve Bank of Minneapolis, "Economic Growth," 1997-1998 Essay Contest Topic, http://www.minneapolisfed.org/community_education/student/essay/topics/topic98.cfm (accessed 11 December 2010).

⁴⁶Shostak, 6.

banking system should at least facilitate the re-establishment of the purchasing power of money.⁴⁷

Money has purchasing power when property rights are safeguarded or at least at such a level that the perceived risk of trade and ownership is as low as possible or at least acceptable.⁴⁸ It is more than properties rights alone, it is also about preventing corruption. Detragiache, Gupta and Tressel have stated in an IMF working paper that financial system performance, especially in low-income countries, is influenced negatively by corruption. This raises the cost of doing business, and implies uncertainty about property rights while decreasing the efficiency of the system.”⁴⁹

To promote sustainable economic growth there should be some degree of price stability. According to USAID, this means that inflation must be controlled.⁵⁰ Additionally, to the USAID, inflation is subordinate to conflict prevention, which means

⁴⁷Dr. Irving Fisher, *The Purchasing Power of Money, Its Determination and Relation to Credit, Interest, and Crises* (New York: MacMillan Co., 1911), <http://www.econlib.org/library/YPDBooks/Fisher/fshPPM2.html#> (accessed 12 December 2010), 6- Ch II.1.12.

⁴⁸United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-152.

⁴⁹Enrica Detragiache, Poonam Gupta, and Theirry Tressel, Working Paper 05/167, *Finance in Lower-Income Countries: An Empirical Exploration* (Washington, DC: International Monetary Fund, August 2005), http://www.econdse.org/faculty/poonam/papers/Finance_21.pdf (accessed 14 December 2010), 1.

⁵⁰Kiertisak Toh, *South Sudan: Post Conflict Economic Recovery and Recovery and Growth, An agenda for USAID Engagement* (Washington, DC: Management Systems International Office, August 2009), http://pdf.usaid.gov/pdf_docs/PNADR011.pdf (accessed 12 December 2010), 7.

that moderate inflation should be tolerated.⁵¹ Research in Latin America has shown that countries with stable price levels, instead of high and volatile price levels, experience the largest growth rates.⁵²

According to the literature, there are two primary ways to influence inflation during a stabilization and reconstruction operation. The first way to influence inflation is by liberalizing trade and a second way is to influence the amount of money available. According to Cline and Weintraub in *Economic Stabilization in Developing Countries*, trade interacts with inflation. This means that by decreasing trade regime distortions like tariffs, quotas, export subsidies and customs limitations, inflation can be reduced. However, to be effective, these policies should be voluntarily adopted by the domestic authorities.⁵³ The findings of Cline and Weintraub are in line with the findings of USAID. They state that investments, and especially foreign direct investments, are enormously important for a country's long-term economic growth.⁵⁴ At the same time there are also scholars who disagree with the direct relation between foreign direct

⁵¹ John F. E. Ohiorhenuan and Frances Stewart, *Post-Conflict Economic Recovery, Enabling Local Ingenuity* (New York: United States Development Programme, 2008), http://www.undp.org/cpr/content/economic_recovery/PCERreport.pdf (accessed 12 December 2010), xxiii.

⁵² Howard S. Ellis, —The Importance of Price Stability,” In *Economic Development, Challenge and Promise*, ed. Stephan Spiegelglas and Charles J. Welsh (Englewood Cliffs, NJ: Prentice-Hall, Inc., 1970), 242.

⁵³ William R. Cline and Sidney Weintraub, —Introduction and Overview,” In *Economic Stabilization in Developing Countries*, ed. William R. Cline and Sidney Weintraub (Washington, DC: The Brookings Institute, 1981), 11-12.

⁵⁴ United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, 13.

investments and economic growth. A research at the United Nations University, found that there can be a positive relation between foreign direct investments in zones of conflict and economic growth, but only if the investments are carefully managed and part of a comprehensive investment strategy.⁵⁵ A second possibility to influence inflation is to limit the amount of money available in the market or by influencing the exchange rate of the money in relation to other currencies. Both activities are typical tasks for a banking system.⁵⁶ Influencing the exchange rate can be done by pegging the local currency to another, pegging it to a basket of currencies, or to have a floating exchange rate.⁵⁷

At the same time, the financial system can only be effective if there is some degree of confidence in the financial system.⁵⁸ If confidence is low, the RAND Cooperation predicts that citizens will avoid local currency and people who have the possibilities will put their savings in foreign hard currencies.⁵⁹ The IMF suggests the establishment of an emergency payment system to preserve or develop confidence in the

⁵⁵Nicholas Turner, Obijiofor Aginam, and Vesselin Popovski, *Post-Conflict Countries and Foreign Investment* (United Nations University Policy Brief, no. 8, 2008), <http://unu.edu/publications/briefs/policy-briefs/2008/pb08-08.pdf> (accessed 15 December 2010), 2.

⁵⁶United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-155.

⁵⁷Crane et al., 79.

⁵⁸Ake Lönnberg, *Restoring and Transforming Payments and Banking Systems in Post-Conflict Economies* (Washington, DC: International Monetary Fund, May 2002), <http://www.imf.org/external/np/leg/sem/2002/cdmfl/eng/lonnb.pdf> (accessed 24 November 2010), 3.

⁵⁹Crane et al., 77.

financial system if a functioning banking system is lacking.⁶⁰ People will only be willing to invest if the risks of their investments are acceptable for the potential return promised. High risk typically demands high returns. Establishing a banking system that helps reduce the risk, lowers cost, and open more opportunities. If not, the costs of trade may become too high for most people, effective pricing of assets will be hard, if not impossible to establish and a sustainable economic development will be more difficult to achieve. Confidence has therefore a subjective and an objective element.⁶¹ It is subjective because it is up to the people to decide whether they judge the system reliable and whether they are willing to invest and deposit funds with the bank. On the other hand, confidence has also an objective element that relates to accountability according to internationally recognized standards. The World Bank has emphasized the importance of accountability and transparency in a country study executed in Nepal.⁶² The financial system should be transparent to promote accountability and the confidence of the people. Accountability requires the establishment of international financial system standards. Finally, there should also be a system in place that facilitates the flow of money.⁶³ Money has to be readily accepted as the means of exchange between sellers and buyers and borrowers and lenders, both foreign and domestic.

⁶⁰Lönnberg, 3.

⁶¹Crane et al., 77-79.

⁶²World Bank, *Financial Accountability in Nepal: A Country Assessment*. (Washington, DC: The World Bank, 2003), 107-110.

⁶³Crane et al., 79.

The role of an effective, reliable and safe banking system is to facilitate the financial system and the purchasing power of money in order to build sustainable economic growth. According to the RAND Cooperation, a banking system should execute five primary tasks.⁶⁴ The first task is to establish and maintain a stable currency. In most cases this is a task for the Central Bank in cooperation and coordination with the national equivalent of the Department of Treasury.⁶⁵ The second task is to facilitate money exchange, both nationally and internationally. The third task is to maintain an effective system to enable payments between buyers and sellers. The fourth task is to fulfill the role of a mediatory between borrowers and lenders. The last task is to establish and maintain transparency and accountability of the system, governed by law. USAID concludes that the banking system should provide liquidity, core financial services, such as deposits and facilitating of payments. This should be established in a very early stage of the stabilization and reconstruction.⁶⁶ According to the United States Institute for Peace and the United States Army Peacekeeping and Stability Operations Institute, banks have two major functions. –To provide a trusted institution for people to deposit financial savings and to provide a means to pay for goods and services to promote commerce.”⁶⁷

⁶⁴Ibid., 79-82.

⁶⁵Ibid., 79.

⁶⁶United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, 73.

⁶⁷United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-155.

The role of military stability operations

Full Spectrum Operations is the U.S. Army operational concept for conducting military operations.⁶⁸ In this concept, Army forces combine offensive, defensive, and stability operations simultaneously, as part of an interdependent joint force to seize, retain, and exploit the initiative, accepting prudent risk to create opportunities to achieve decisive results.”⁶⁹ Through stability operations, military forces help to set the conditions that enable the actions of the other instruments of national power to succeed in achieving the broad goals of conflict transformation.”⁷⁰ In this way, the Army contributes to the military end state of the Joint Forces Commander.⁷¹ As a result, stability operations leverage the coercive and constructive capabilities of the military force to establish a safe and secure environment; facilitate reconciliation among local or regional adversaries; establish political, legal, social, and economic institutions; and facilitate the transition of responsibility to a legitimate civil authority.”

FM 3-0 outlines the tasks to be conducted during stability operations. When these operations have to contribute to the end state, five primary tasks must be achieved.⁷² The first task is to provide civil security in order to protect the population from external and

⁶⁸Department of the Army, Field Manual (FM) 3-07, *Stability Operations* (Washington, DC: Headquarters Department of the Army, October 2008), 2-1.

⁶⁹Ibid.

⁷⁰Department of the Army, Field Manual (FM 3-07), *Stability Operations* (Washington, DC: Headquarters Department of the Army, October 2008), 2-2.

⁷¹Department of the Army, Field Manual 3-0, 3-1.

⁷²Ibid., 3-13.

internal threats. The second task is to provide civil control in order to regulate behavior and activities of individuals and groups. The third task is to restore essential services in order to restore the most basic services and to protect them until a civil authority or the host nation can provide them. The fourth task is to support local governance in order to establish the conditions that actions by civilian and host-nation agencies can succeed. The fifth task is to support economic and infrastructural development in order to help the host-nation to develop capability and capacity in these areas.⁷³

According to the U.S. Army Field Manual 3-07, which explains planning and execution of Stability Operations, and the Handbook for Military Support to Economic Stabilization of the U.S. Joint Forces Command, the military is not the primary actor to stabilize the financial sector. The importance of the financial and banking system is acknowledged, but their tasks are limited to securing and protecting of key assets and processes like providing secure logistical support, and providing support to governmental and non-governmental agencies whose primary function it is to stabilize and develop the financial system.⁷⁴ This means that the military understands the importance of a functioning financial and banking system, but that it considers itself not as a primary actor within this field of expertise.

The RAND Cooperation also described some possible tasks the military can execute in order to support the host government or civilian organizations during this

⁷³Ibid., 3-13 and 14.

⁷⁴Ibid., 3-5 – 3-17; Joint Warfighting Center, *Handbook for Military Support to economic Stabilization* (Washington, DC: U.S. Joint Forces Command, 27 February 2010), Ch IV.

process.⁷⁵ These tasks are in line with the tasks in the above-mentioned Field Manuals and the Handbook of the U.S. Joint Forces Command. The military can identify key financial institutions, persons and infrastructure within the area of responsibility during the Intelligence Preparation of the Battlefield process. This process enables the military to gain insight in local business and financial activities, to build networks, and it creates insight in the threats and vulnerabilities of the local financial system.⁷⁶ The military can also secure looted or diverted stockpiles of currency or state-owned precious metals. Ensure security for critical financial institutions, infrastructure, and personnel. This should be a high priority task and should focus on government financial institutions, banks and key personnel.⁷⁷ If the purchasing power of money has to be increased to enable sustainable economic growth, security for the elements of the financial system is, according to the RAND Cooperation, indispensable. This is especially true in the first phase of a stability operation, when security is at its lowest. The military can support government financial transactions.⁷⁸ The military can help to ensure the timely and secure distribution of a new currency, if one is introduced.⁷⁹ The military can use local currency to make payments.⁸⁰ This will not only instill confidence in the local currency, it can also

⁷⁵Crane et al., 82-83.

⁷⁶Ibid., 83.

⁷⁷Ibid., 84.

⁷⁸Ibid., 85.

⁷⁹Ibid.

⁸⁰Ibid., 86.

influence local prices and therefore help local price stability if payments and investments are coordinated with local financial policies. The military can support by using electronic payment systems, if available.⁸¹ A last possible task is to ensure efficient border crossings and other ports of entry.⁸² Although this does not directly influence financial policies, it probably influences foreign direct investments and therefore it encourages more trade and more economic growth.

Whatever the role and the responsibilities of the military will be to facilitate the development of the capabilities to manage and operate a banking system, according to USAID, it will always require clear goals, sensitivity to the context, a pragmatic approach and host-nation ownership to be successful.⁸³

Banking in a historical perspective

It is difficult to compare current military involvement in banking with historical examples. Such historical examples are scarce and most of the examples are based on a military force as part of an occupation. This creates very different legal circumstances and therefore different responsibilities for the military force. However, the necessity of banking, as part of military government and civil affairs has been described in Field Manuals of the United States Army and Navy in 1940 and later in Field Manuals of 1943

⁸¹Ibid., 87.

⁸²Ibid., 88-89.

⁸³United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, vii.

and 1947.⁸⁴ In addition these manuals, the Supreme Headquarters Allied Expeditionary Force also issued in 1944 a handbook for military government in Germany. The handbook provided background information of Germany.⁸⁵

The role of the Allied Forces before and during the invasion of Sicily I on 10 July 1943 serves as an example. The Allied Forces foresaw a civil affairs problem prior to the invasion of Sicily, because Sicily required governmental involvement.⁸⁶ To insure security of the occupying forces and to prevent an economic collapse and as a result, disorder, the Anglo-American Allied Forces Headquarters (AFHQ) establish on 1 May 1943 the Allied Military Government of Occupied Territory (AMGOT).⁸⁷ The AMGOT was placed under direct supervision of the military commander of the invading force.⁸⁸ AMGOT consisted of a headquarters and six staff divisions. These staff divisions were; public health, legal, public safety, civilian supply and resources, enemy property and finance. For the pre-operational period, AMGOT consisted of a planning staff, an executive staff and a school. It is remarkable to see that few military officers were

⁸⁴War Department of the United States, Field Manual (FM) 27-4, *Military Government and Civil Affairs* (Washington, DC: War Department, 22 December 1943), 2 and 18.

⁸⁵Supreme Headquarters Allied Expeditionary Forces, *Handbook for Military Government in Germany Prior to Defeat or Surrender* (Washington, DC: Office of the Chief of Staff, December 1944).

⁸⁶Robert W. Komer, *Civil Affairs and Military Government in the Mediterranean Theater* (Washington, DC: Office of the Chief of Military History, 1950), Ch II-1.

⁸⁷*Ibid.*, Ch II 13-16.

⁸⁸*Ibid.*, Ch II 27.

capable for such a unit and that most of its personnel were recruited from private life. Before these specialists were deployed, military training was conducted.⁸⁹

AMGOT controlled the Sicilian society by indirect control. This means that local Sicilians were used as much as possible.⁹⁰ For the facilitation of the banking system, the financial division of AMGOT played a crucial role. According to the Allied analysis, the major long-term problem was the control of inflation. Therefore, AMGOT created a plan, which included tax increases and overhaul of the tax system, price stability and rationing, import of basic commodities and resistance to pressure for wage increases.⁹¹ This plan resulted in supplementing the Italian Lire with Allied Military Lire to ensure enough currency.⁹² To prevent high inflation, the exchange rate was fixed and prices were fixed at the level the day before the invasion. To control the currency and the banking system, local banks were seized and put under Allied supervision (indirect control) and an Allied Banking Institution was established. This Allied Military Financial Agency fulfilled the role of the central bank. It served as a depository, a clearinghouse, a provider of funds for local banks, and an accounting office for the Allied Forces and especially for AMGOT. The Allied Military Financial Agency used the Bank of Sicily, under direct control of the

⁸⁹Ibid., Ch II 28-30

⁹⁰Ibid., Ch II 17-18.

⁹¹Ibid., Ch II 21-22.

⁹²Ibid., Ch II 25.

Military Governor, as an agent for the Allied Military Financial Agency to finance local banks. All financial transactions had to be approved by AMGOT.⁹³

Although the Allied Forces achieved a tremendous result, there are some lessons to be learned. First, there had been inadequate cooperation and coordination between civil affairs and combat commanders. Combat commanders did not even know the fundamental principles of military government. Secondly, the experience showed that the greater the reliance upon Italian/Sicilian officials the more successful was local administration.⁹⁴

Conclusion

A banking system alone cannot achieve sustainable economic growth. An effective, safe and reliable banking system is an absolute necessity to lay the foundation for a strong, stable, economy and be successful in a post-conflict situation. The role of an effective, reliable and safe banking system is to facilitate the financial system, including the purchasing power of money, in order to build sustainable economic growth. Through stability operations, military forces help to set the conditions for the broad goals of conflict transformation.⁹⁵ The military task to support economic and infrastructure is linked to the strategic economic end state of a sustainable economy. Although facilitating sustainable economic growth will probably not be the first objective military

⁹³Ibid., Ch II 25-26.

⁹⁴Ibid., Ch II 41-43

⁹⁵Department of the Army, FM 3-07, 2-2.

commanders will think of, there are some possible tasks for the military force to support the host government or civilian organizations during this process.⁹⁶

The development of a banking system should start as soon as possible.⁹⁷ In most cases, there is a lack of security in the early phase of a stability operation. The military force will therefore have the lead, because other organizations, like the IMF, World Bank or USAID will not always be present to support or assist in the development of the local banking system. In fact, little evidence is found of integrated efforts between the military force and civilian banking organizations to develop the financial systems in the crucial early phase of an operation in order to facilitate sustainable economic growth. Therefore, it becomes even more interesting to examine how this capacity should be built, what is the best way to operate a banking system in a country undergoing stability operations that can best facilitate sustainable economic growth?

⁹⁶Crane et al., 82-83.

⁹⁷Haughton, 3.

CHAPTER 3

RESEARCH METHODOLOGY

Introduction

Development of sustainable economic growth and security are interrelated and interdependent. Without sustainable economic growth, stability is hard to achieve.⁹⁸ Although the traditional assumption is that security should precede development, the central theme in this thesis is that economic development and the development of capacity for a banking system should start as soon as possible.⁹⁹ In other words, begin the process of creating a banking system, before the cessation of hostilities. How should capacity be built to manage and operate a banking system in a country undergoing stability and reconstruction operations that best facilitates sustainable economic growth? This chapter introduces the research methodology and the assessment variables used to assess the effectiveness of a viable banking system.

Research questions

The primary research question to be answered is; is there a viable role the military can play in re-establishing a banking system in a country undergoing stabilization and reconstruction? To be able to answer the primary research question, four secondary questions have to be answered. The first question is; how does the World Bank, IMF and USAID rebuild capacity for a banking system? To answer this question, two case studies

⁹⁸United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-133.

⁹⁹Haughton, 3.

from the development of the banking system in Afghanistan and Kosovo will be used. The second question is how to evaluate its success. For this question, assessment variables will be determined and applied to analyze the banking development activities of the World Bank, the IMF and USAID in Kosovo and Afghanistan. The third question is; what has been done by the military to facilitate the development of the banking system in both countries? The final question is; what post-conflict role has the military performed in re-establishing banking systems in previous conflicts.

Research methodology

This section describes the methodology used to analyze the data in order to formulate the conclusions and recommendations in relation to the research questions. Two different, but interrelated research methodologies will be used to answer the research questions. First, a majority of the research is based on a comparative case study analysis of Afghanistan and Kosovo. These two studies focus on the activities of the World Bank, IMF and USAID as they relate to the development of banking systems. Secondly, assessment variables (AV) will help to determine the progress with sustainable economic growth. A separate set of AVs will be identified, to determine the success of the development of the local banking system. In the end, this information, and the lessons learned, will lead to the development of a set of best practices that can be used to create a formula to establish a functioning banking system of a country during stability and reconstruction operations.

The economic assessment variables

Building a sustainable economy is critical to stability and represents as one of five end states that have to be met in order to achieve successful stabilization and reconstruction of a nation after conflict.¹⁰⁰ Before the effectiveness of the banking system can be assessed, a method for identifying progress in sustainable economic growth must be determined.

Although apparently a money centered issue, the focus should also focus on the effect that money can have on promoting sustainable economic growth.¹⁰¹ This suggests that increasing the Gross Domestic Product (GDP) of a state is paramount and should be assessed during stability operations. Therefore, our first economic AV is the annual growth of GDP. Because foreign investments and availability of credit are enormously important to facilitate sustainable economic growth.¹⁰² The second AV concerns the annual increase in foreign investments. The third AV represents credit provided by banks as percentage of the GDP.

To promote sustainable economic growth, there should be a degree of price stability.¹⁰³ Because of the post-conflict circumstances, a moderate level of inflation can

¹⁰⁰United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 2-9.

¹⁰¹Shostak, 6.

¹⁰²United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, 13 and 73.

¹⁰³Kiertisak Toh, 7.

be tolerated.¹⁰⁴ As long as this moderate level of inflation is stable, there is an excellent chance that there will be real economic growth.¹⁰⁵ An additional fourth economic AV is therefore required, which is the annual rate of inflation.

There are two effective ways to influence inflation during a stabilization and reconstruction operation, liberalizing trade by reducing trade barriers and manipulating the supply of money. The AV used to determine the success of the liberalization of trade barriers is the increase or decrease in foreign investments.¹⁰⁶ The second AV, related to inflation is the annual percent increase in the total volume of money supply.

The banking system assessment variables

An effective, safe, and reliable banking system is absolutely necessary to create the economic foundation in which to build a stable and prosperous economy.¹⁰⁷ In assessing the effectiveness of a banking system, additional AVs have to be developed. Table 1 gives an overview of the AVs. To be effective, the financial system depends heavily on confidence of the population and banking firms.¹⁰⁸ The first AV is whether the banking system uses an international recognized system for accountability.¹⁰⁹ The second

¹⁰⁴Ohiorhenuan and Steward, xxiii.

¹⁰⁵Ellis, 242.

¹⁰⁶Turner, Aginam, and Popovski, 2.

¹⁰⁷United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, 73.

¹⁰⁸Haughton, 3.

¹⁰⁹World Bank, *Financial Accountability in Nepal*, 107-110.

AV is; the percentage of firms that have a line of credit with financial institutions.¹¹⁰ The third AV is the increase of deposits during the development of the banking system.¹¹¹ The fourth AV is; the amount of investments during the development of the banking system.¹¹² The fifth AV is; the percentage of firms using banks to finance their investments.¹¹³ The sixth AV is the percentage of firms using internal finance for investments. The seventh AV is the value of collateral needed for a loan.¹¹⁴ The eighth variable is the percentage of firms identifying access to finance as a major concern.¹¹⁵ Confidence will also be measured by looking at the confidence in the rule of law, the protection of property rights and the effort of the government to fight corruption.¹¹⁶

Two organizational banking structures exist; a two-tier banking system comprised of a central bank with a network of local banks or branchless banks with local outlets for banking services. In both situations, it is important to have a central bank that pursues price stability, facilitates a reliable payment system, provides independent economic

¹¹⁰United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, 20 and 73.

¹¹¹Ibid.

¹¹²United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-152.

¹¹³United States Agency for International Development, *A Guide to Economic Growth in Post-Conflict Countries*, 20 and 73.

¹¹⁴United States Institute for Peace and United States Army Peacekeeping and Stability Operations Institute, 9-152.

¹¹⁵Ibid.

¹¹⁶Detragiache, Gupta, and Tressel, 1.

advice to the government and ensures the availability of banking funds. Five internationally recognized banking characteristics must be present in any central banking system. These are; oversight of the central bank over the local network of banking services or banks, the pursuit of price stability, the facilitation of a stable system of payments, providing independent economic advice to the government, and ensuring commercial banks have sufficient financial funds to meet their obligations.¹¹⁷ These five criteria will be assessed by using the central bank policies and regulations in Kosovo and Afghanistan.

¹¹⁷De Nederlandse Bank, 4-5.

Table 1. Assessment variables	
Economic variables	Banking System variables
The annual growth of the GDP	The banking system uses an international recognized system for accountability
The credit provided by banks as percentage of the GDP	The percentage of firms that have a line of credit with financial institutions
The annual rate of inflation	The increase or decrease of deposits during the development of the banking system
The increase or decrease in foreign investments	The increase or decrease of investments during the development of the banking system
The annual percent increase in the total volume of money	The percentage of firms using banks to finance their investments
	The value of collateral needed for a loan
	The percentage of firms identifying access to finance as a major concern
	The confidence in the rule of law
	The protection of property rights by the government
	The effort of the government to fight corruption
	Five internationally recognized banking characteristics

Source: Created by Author.

Finally, the efficiency of the banking system will be determined by using AVs, which are based on reports of the central Bank of Afghanistan and Kosovo (see table 2).¹¹⁸ Since both countries are in a different phase of development, different AVs are

¹¹⁸Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009* (Kabul, Afghanistan: Da Afghanistan Bank, August 2009), http://www.centralbank.gov.af/pdf/DAB_QB_Annual-1387%282008-2009%29.pdf (accessed 9 February 2011), 94-101; Central Bank of the Republic of Kosovo, *Annual Report 2009* (Prishtina: Central Bank of the Republic of Kosovo, 8 July 2010), <http://www.bqk-kos.org/repository/docs/Annual%20Report%202009.pdf> (accessed 8 February 2011), 42-43.

available to determine the efficiency of each banking system. For Afghanistan, five AVs will be used. The first AV is the breakdown of state-owned, private and foreign banks. The second AV is the growth in assets. The third AV is the growth in loans. The fourth AV is the growth in deposits. The last AV is the return from average assets in 2008 and 2009. For Kosovo, six AVs will be used. The first AV is the total amount of reserves, including gold. The second AV is to measure the concentration of assets among banks.¹¹⁹ The international recognized AV to measure this is the Herfindahl-Hirschman Index (HHI). This will also be done for loans and deposits. The fifth AV is the return on average equity in 2008 and 2009. The final AV is the return on average assets in 2008 and 2009.

Table 2. Assessment variables efficiency banking system	
Afghanistan	Kosovo
Breakdown of banks	Total amount of reserves
Growth in assets	HHI assets
Growth in loans	HHI loans
Growth in deposits	HHI deposits
Return on average assets	Return on average assets
	Return on average equity

Source: Created by Author.

¹¹⁹This AV can be used to determine whether assets, loans, or deposits are divided among banks or concentrated with a limited amount of banks.

CHAPTER 4

ANALYSIS

Introduction

In 1998, The World Bank, as well as other organizations and scholars addressed the importance of achieving sustainable economic growth in order to restore stability in a post-conflict environment.¹²⁰ Additionally, scholars like Ross Levine and others pointed out the importance of a functioning banking system to achieve sustainable economic growth. No evidence was found that the military, besides support (e.g. providing logistical support and security), actively participated in the development of the banking systems in Kosovo and Afghanistan. It is therefore even more interesting and worthwhile to study the development of the banking system in both countries, to determine what the military actually provided and what the military could have provided to facilitate sustainable economic growth. In the end, the military force is an element of national power that must contribute to the success of a stability operation. It is the whole of government approach, which makes a stability operation to a success.

In order to better understand how capacity should be built, this chapter examines the case studies of Kosovo and Afghanistan. The first part of this chapter describes what has been done by the World Bank, the IMF and USAID to develop the banking system in both countries. The second part describes whether economic growth has been achieved. The third part describes whether the activities of the World Bank, IMF and USAID resulted in an effective banking system. This means; does the banking system fulfill its

¹²⁰Kreimer et al., 22.

role as financial mediatory. The fourth part determines whether the banking system is efficient. In other words, is the banking system profitable? The fifth question is to determine what the actual involvement of the military was. Unlike the previous parts, this will be answered for Kosovo and Afghanistan simultaneously. The above mentioned questions are answered by using the AVs as determined in chapter 3 (table 1 and 2). The last part of this chapter is different from the rest of the chapter and will describe the tasks the military could have conducted to facilitate the development of the banking system.

Activities of international organizations in Kosovo

On 10 June 1999, after the cessation of the Kosovo War, the United Nations Security Council authorized, by United Nations Security Council Resolution 1244, the Secretary General to establish an international civil presence and the member states to establish an international security presence.¹²¹ The international civil presence, chartered as the United Nations Interim Administration Mission in Kosovo (UNMIK), provided an interim administration for Kosovo to –establish and oversee the development of provisional democratic self-governing institution. The institutions ensured conditions for a peaceful and normal life for all inhabitants of Kosovo.”¹²² Security was provided by the

¹²¹United Nations Security Council, *Resolution 1244*, 10 June 1999, <http://daccess-dds-ny.un.org/doc/UNDOC/GEN/N99/172/89/PDF/N9917289.pdf?OpenElement> (accessed 8 February 2010), 2-3.

¹²²United Nations Interim Administration Mission in Kosovo, *Special Representative of the Secretary-General and the Head of the UN Interim Administration Mission in Kosovo*, http://www.unmikonline.org/UNMIKONLINE2009/head_unmik.htm (accessed 8 February 2011); United Nations Security Council, *Resolution 1244*, 3

Kosovo Force (KFOR).¹²³ KFOR is an international force, led by the North Atlantic Treaty Organization (NATO).¹²⁴ In conjunction with support of wider international efforts, KFOR helped ~~maintain~~ maintain a safe and secure environment and freedom of movement for all citizens, irrespective of their ethnic origin.”¹²⁵

Activities of the World Bank

International financial institutions, like the World Bank, play an important role in the stabilization and reconstruction of Kosovo, until UNMIK and KFOR entered Kosovo, when other institutions are not available.¹²⁶ Since 1999, the World Bank committed about US\$ 150 million through 30 operations in a broad range of sectors, including public administration, law and justice, industry and trade, education, and finance. The World Bank also leveraged an additional US\$ 70 million from other external partners. Today, the World Bank completed most of these projects.¹²⁷

¹²³North Atlantic Treaty Organization, ~~“Kosovo Force,”~~ 17 September 2010, <http://www.nato.int/kfor/structur/welcome/> (accessed 8 February 2011).

¹²⁴North Atlantic Treaty Organization, ~~“NATO’s Role in Kosovo,”~~ 10 November 2010, http://www.nato.int/cps/en/natolive/topics_48818.htm (accessed 8 February 2011).

¹²⁵Ibid.

¹²⁶World Bank, ~~“Implementation Completion Report on Two Grants in the Amount of US\$ 5 Million each to the United Nations Interim Administration in Kosovo for the Benefit of Kosovo,”~~ 20 June 2001, http://www-wds.worldbank.org/external/default/WDSP/IB/2001/08/04/000094946_01072504014322/Rendered/PDF/multi0page.pdf (accessed 8 February 2011), 2.

¹²⁷World Bank, ~~“World Bank Program,”~~ The World Bank Group, October 2010, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/KOSOVOEXTN/0,,contentMDK:20629286~menuPK:297777~pagePK:141137~piPK:141127~theSitePK:297770,00.html#wba> (accessed 8 February 2011).

In early 2000, the World Bank provided two Economic Assistance Grants to support the Kosovo economic reform program by providing UNMIK with financial resources. Only the first Economic Assistance Grant supported the ~~re~~establishment of a fully functioning and effective bank licensing and supervision capability.”¹²⁸ The purpose of this grant was to facilitate the improvement of the banking system, because the commercial banking system and local payment bureau ceased to exist in 1999.¹²⁹

Research indicated that the World Bank provided technical assistance to financial institutions to facilitate economic growth and improvement of the financial sector in three main areas.¹³⁰ The first area consisted of direct assistance to the Central Bank of Kosovo (CBK) using two main components.¹³¹ The first, strengthened the CBK by assisting the preparation of development strategies on market development trends, the development of a medium term staffing plan, and the campaign to raise population awareness on financial products, returns and risks.¹³² The second, strengthened the framework for regulations and supervision of the CBK.¹³³ Specific examples include the implementation of a regulatory database, support on financial analysis, training of banking personnel in

¹²⁸The World Bank, ~~Implementation~~ Completion Report,” 2.

¹²⁹Ibid.

¹³⁰The World Bank, ~~Procurement~~ Plan,” The World Bank Group, 4 November 2009, http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2010/07/05/000333038_20100705013319/Rendered/PDF/554140PROP0p1010Plan0040November009.pdf (accessed 8 February 2011), 2-4.

¹³¹Ibid.

¹³²Ibid.

¹³³Ibid.

European supervisory agencies and review of licensing procedures of the CBK.¹³⁴ The second area of assistance by the World Bank supported the Association of Microfinance Institution of Kosovo (AMIK) and others in developing microfinance industry in Kosovo. This consists of training in technical issues, management, planning and assessment.¹³⁵ The World Bank also provided technical assistance is to the Kosovo Bankers' Association (KBA).¹³⁶ The KBA is a non-profit, non-governmental organization, established in 2002. All commercial banks operating in Kosovo are members of KBA. The KBA's goal is to support the development of a sound banking system and to promote a long-term economic development of Kosovo.¹³⁷ The World Bank provides training for KBA members in trade finance, operational risk management, credit policy, and audits.¹³⁸

Activities of the International Monetary Fund

The IMF is another main contributor to the development of the Kosovo banking system. The IMF started assisting Kosovo in 1999 by preparing four draft laws. These drafts instituted the use of currencies, banking, payment transactions and the establishment of Banking and Payment Authority of Kosovo (BPK).¹³⁹ The next step

¹³⁴Ibid.

¹³⁵Ibid., 3.

¹³⁶Ibid., 4.

¹³⁷Kosovo Bankers' Association, "Short History," 22 July 2010, <http://www.bankassoc-kos.com/?cid=2,41> (accessed 8 February 2011).

¹³⁸The World Bank, "Procurement Plan," 4.

¹³⁹International Monetary Fund, *Annual Report 2000: Making the Global Economy Work for All* (Washington, DC: International Monetary Fund, 30 April 2000),

involved the IMF providing technical assistance for the establishment of the BPK in November 1999. The BPK, established a system for domestic payments, licensed and supervised domestic banks, and ensured liquidity, solvency and effective functioning of the local banks.¹⁴⁰ The development of the BPK further increased with the introduction of the Euro in Kosovo in 2002.¹⁴¹ In September 2006, the BPK, with support of the IMF, transformed into the Central Banking Authority of Kosovo (CBAK), in order to strengthen its role as the central bank.¹⁴² In June 2008, Kosovo established, with technical assistance of the IMF, the current Central Bank of Kosovo (CBK).¹⁴³

Since 1999, the IMF also assisted the development of the Kosovo banking system in different ways. The IMF assisted in the development of a banking supervision framework in line with international standards. The IMF also assisted in the development of research and statistical capabilities as well as in the development of an accounting and

http://books.google.com/books?id=JTnjIFlvfkC&pg=PA86&lpg=PA86&dq=IMF+MAE+kosovo&source=bl&ots=ONJMzburvH&sig=I0P_OlJZQ_vpOwmiuhw66S0EwDA&hl=en&ei=EbI3TeiWKYvSsA0OIYmOAaw&sa=X&oi=book_result&ct=result&resnum=1&ved=0CBYQ6AEwAA#v=onepage&q=IMF%20MAE%20kosovo&f=false (accessed 8 February 2011), 86.

¹⁴⁰Dimitri G. Demekas, Johannes Herderschee, and Davina F. Jacobs, *Kosovo, Institutions and Policies for Reconstruction and Growth* (Washington, DC: International Monetary Fund, 2002), <http://www.imf.org/external/pubs/ft/Kosovo/2002/eng/iprg/iprg.pdf> (accessed 8 February 2011), 3.

¹⁴¹*Ibid.*, 11.

¹⁴²United Nations Interim Administration Mission in Kosovo, *Kosovo*, June 2008, http://www.unmikonline.org/docs/2008/Fact_Sheet_July_2008.pdf (accessed 8 February 2011), 10.

¹⁴³International Monetary Fund, “Mission Concluding Statement,” 16 September 2009, <http://www.imf.org/external/np/ms/2009/091609.htm> (accessed 8 February 2011).

control framework. The IMF also provided advice in order to develop financial services for the population and the government and to manage foreign exchange reserves. Finally, the IMF provided external managing directors for the central bank.¹⁴⁴

Activities of United States Agency for International Development

USAID started to provide support to Kosovo in 1999. However, support was mainly focused on the return and integration of refugees and the rebuilding of infrastructure. USAID also assisted Kosovo in establishing a government, rule of law, civil society and independent media. Additional support built functional institutions through technical advisors.¹⁴⁵ Although USAID was not deeply involved in the development of the banking system of Kosovo, USAID provided credit and initiated a project for small and medium enterprises to access credit through the creation of the Kosovo Business Finance Fund. This fund facilitates economic growth by providing credit to small and medium enterprises in Kosovo.¹⁴⁶ The development of the Kosovo Business Finance Fund led to the establishment of the American Bank of Kosovo, which now operates as a financial institution managed primarily by Kosovo citizens.¹⁴⁷

¹⁴⁴Piero Ugolini, *Kosovo: Assessment of MFD's Technical Assistance Program* (Washington, DC: International Monetary Fund June 2006), <http://www.imf.org/external/np/pp/eng/2006/063006k.pdf> (accessed 8 February 2011), 7.

¹⁴⁵United States Agency for International Development, *Kosovo Strategic Plan 2010-2014* (Washington, DC: USAID, June 2006), http://pdf.usaid.gov/pdf_docs/PDACQ298.pdf (accessed 8 February 2011), 3.

¹⁴⁶United States Agency for International Development, *Transforming Banking System in Kosovo* (Washington, DC: USAID 12 May 2009), http://www.usaid.gov/stories/kosovo/ss_kosovo_loan.html (accessed 8 February 2011).

¹⁴⁷*Ibid.*

Sustainable economic growth in Kosovo

Kosovo achieved an average annual GDP increase of approximately 4.4 percent from 2005 to 2009 (see table 3). Although Kosovo did not achieve the region's best results, it managed stable GDP growth and even maintained growth of at least 4.0 percent between 2007 and 2009. This is remarkable, due to the financial and economic crisis in the world. In the region, only Albania managed to achieve an increase in GDP (2.5 percent). When comparing real GDP, which means GDP minus inflation, then Kosovo's performance is even better, although the economic and financial crisis negatively influenced real GDP in 2007 and 2008. Growth in real GDP seems to indicate a positive economic development during the post-conflict phase.

Table 3. Annual percentage growth rate of GDP at market prices based on constant local currency					
	2005	2006	2007	2008	2009
Kosovo	3.4	4.9	4.0	5.4	4.0
Albania	5.5	5.0	6.0	7.5	2.5
Bosnia and Herzegovina	5.0	6.2	6.8	5.4	-2.9
Montenegro	4.2	8.6	10.7	6.9	-5.7
FYROM	4.1	4.0	5.9	4.8	-0.7
Serbia	5.6	5.2	6.9	5.5	-3.0

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

Table 4. Annual percentage growth rate of real GDP at market prices based on constant local currency (GDP minus inflation)					
	2005	2006	2007	2008	2009
Kosovo	4.8	4.3	-0.4	-4.0	6.4
Albania	3.1	2.6	3.1	4.1	0.3
Bosnia and Herzegovina	n/a	0.1	5.3	-0.2	-2.5
Montenegro	n/a	n/a	n/a	n/a	n/a
FYROM	3.9	0.7	2.3	2.4	0.4
Serbia	-10.5	-6.5	0.5	-7.4	-10.8

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

At the same time, Kosovo’s annual rate of inflation can be characterized as volatile, which is consistent with the rest of the region. As discussed in chapter 2, inflation for countries in a post-conflict phase does not have to be zero percent. However, the challenge is to achieve a moderate and stable inflation. Research of other countries proved that countries with stable price levels will have the largest growth rates.¹⁴⁸ However, this does not seem to apply to Kosovo and the rest of the region, because Albania maintained the most stable and moderate annual rate of inflation, but did not have the largest growth of GDP. Kosovo had volatile inflation, but also had positive growth in GDP (see table 3, 4 and 5).

¹⁴⁸Ellis, 242.

Table 5. Annual percentage of inflation					
	2005	2006	2007	2008	2009
Kosovo	-1.4	0.6	4.4	9.4	-2.4
Albania	2.4	2.4	2.9	3.4	2.2
Bosnia and Herzegovina	n/a	6.1	1.5	7.4	-0.4
Montenegro	n/a	n/a	n/a	n/a	n/a
FYROM	0.2	3.3	3.6	7.2	-0.3
Serbia	16.1	11.7	6.4	12.9	7.8

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

To explain the relationship of constant annual growth of GDP and a volatile annual inflation, the next set of AVs is evaluated. Maybe other factors can explain economic growth. AVs are evaluated to determine how Kosovo liberalized trade, influenced the annual increase for money and what was the availability of credit provided by banks to influence inflation. Therefore, the figures of annual money supply as percentage of GDP, annual foreign direct investments and credit provided by banks as percentage of the GDP will be evaluated.

Kosovo had a considerable growth in money supply from 2005 until 2008. In 2008 the growth of money supply was the largest of all Balkan countries (see table 6).¹⁴⁹ At the same time, Kosovo attracted a relatively low amount of foreign direct investments

¹⁴⁹ “Money and quasi money as referred to in Table 6, comprises the sum of currency outside banks, demand deposits other than those of the central government, and the time, savings, and foreign currency deposits of resident sectors other than the central government. This definition is frequently called M2.” World Bank, “Money and quasi money growth (annual %),” <http://data.worldbank.org/indicator/FM.LBL.MQMY.ZG?display=default> (accessed 1 February 2011).

within the region (see table 7). Credit provided by banks, as percentage of GDP remained also remarkable low compared to the other regional countries (see table 8).

Because money supply is considerable, even compared to the rest of the region, it seems to indicate that Kosovo did not have a well-designed monetary policy to limit money supply. At the same time, Kosovo fails to attract foreign direct investments. Although foreign direct investments are normally not locally financed, when foreign direct investments and credit provided by banks are low, it could be an indicator that local banks do not fulfill the role of financial mediatory. A failing financial system could hamper the willingness for foreign direct investments and the provision of credit for local investments. The next question is whether the banks in Kosovo were effective or is a further improvement of the banking system required to facilitate a sustainable economic growth?

Table 6. Annual percentage of money growth					
	2005	2006	2007	2008	2009
Kosovo	20.3	5.5	23.4	23.6	n/a
Albania	14.1	16.0	13.7	7.7	n/a
Bosnia and Herzegovina	18.7	25.7	32.7	-0.1	-0.7
Montenegro	83.4	119.2	98.8	-10.1	-8.9
FYROM	15.9	24.8	30.7	10.9	n/a
Serbia	42.1	38.3	42.5	9.8	n/a

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

Table 7. Net inflow of foreign direct investment per capita to acquire a lasting management interest					
	2005	2006	2007	2008	2009
Kosovo	n/a	n/a	n/a	278 mil	222 mil
Albania	n/a	n/a	n/a	287 mil	316 mil
Bosnia and Herzegovina	n/a	n/a	n/a	239 mil	53 mil
Montenegro	n/a	n/a	n/a	1.45 bil	2.1 bil
FYROM	n/a	n/a	n/a	294 mil	98 mil
Serbia	n/a	n/a	n/a	408 mil	260 mil

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

Table 8. Annual credit provided by banking sector as percentage of GDP					
	2005	2006	2007	2008	2009
Kosovo	11.3	7.0	3.3	10.5	n/a
Albania	48.6	54.5	61.3	66.9	n/a
Bosnia and Herzegovina	43.6	47.4	54.3	58.5	58.0
Montenegro	17.5	35.9	78.2	88.0	77.2
FYROM	20	23.5	34.4	42.7	n/a
Serbia	29.1	25.7	31.4	39.4	n/a

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

Effectiveness of the banking system in Kosovo

Using the AVs in chapter 3, Kosovo's banking system is not effective enough to facilitate sustainable economic growth. Although Kosovo made impressive progress following their independence from Serbia, the banking system must be improved in order to be an effective financial system capable of facilitating economic improvement. In

response, Kosovo instituted formal structures within the banking system and codified them by law. An example is the establishment of the CBK in June 2006. The CBK was established by Law No. 03/L-074 and approved by the Kosovo Assembly. Currently, the CBK functions as a regular internationally recognized central bank, has full authority as a legal personality according to Kosovo law, and it reports to the Kosovo Assembly.¹⁵⁰ Article 8 of Law No. 03/L-074 describes the tasks for the central bank. These tasks meet the internationally recognized banking standards as described in chapter 3, and remain consistent with the AVs for the banking system. Article 58 of Law No. 03/L-074 also requires the bank to fulfill the international recognized standards for accountability in accordance with the International Financial Reporting Standards, as adopted by the International Accounting Standards Board. Today, the central bank meets the internationally recognized standards that may be expected from a central bank.

However, the banking system in Kosovo fails to fulfill the role of financial intermediary. According to research by the Enterprise Analysis Unit of the World Bank, only 15 percent of the firms in Kosovo have a line of credit or loan with a financial institution. A large number of firms, 85 percent, use internal ways to finance their investments using contributions from friends, family or employees. Finally, only 25 percent of the firms use banks to finance investments.¹⁵¹ When compared to other countries in the region, Kosovo's results remain extremely low. Based on the research of

¹⁵⁰The Central Bank of the Republic of Kosovo, *Functions and Responsibilities* (Prishtina: Central Bank of the Republic of Kosovo, 2009), <http://www.bqk-kos.org/?cid=2,2> (accessed 8 February 2011).

¹⁵¹The World Bank, *Enterprise Surveys*, 2010, <https://www.enterprisesurveys.org/CustomQuery/ViewCustomReport.aspx> (accessed 8 February 2011).

the Enterprise Analysis of the World Bank, financial intermediation is lowest in Kosovo. This research also shows that the amount of risk, and therefore, the lack of confidence in the financial system is lowest in Kosovo. To get credit in Kosovo, a lender has to provide 236 percent collateral. That is almost 50 percent more than the average of the other Balkan countries. In contrast, it is striking to determine that only 13 percent of the firms in Kosovo identify access to finance as a major concern (see table 9).

Table 9. Financing of firms in Kosovo in 2009 in percentage of total firms					
	Line of credit with financial institutions	Internal finance	Bank finance	Value of collateral	Finance a major constraint
Kosovo	15	85	25	236	13
Albania	42	77	36	154	17
Bosnia and Herzegovina	65	44	60	173	25
Montenegro	50	25	76	151	10
FYROM	61	62	47	176	28
Serbia	68	53	43	137	28

Source: World Bank, “Enterprise Surveys,” <https://www.enterprisesurveys.org/CustomQuery/ViewCustomReport.aspx> (accessed 1 February 2011).

Although, the foreign direct investments remain low, the amount of banking deposits has increased from 837 million Euro in 2005 to 1.7 billion Euro in 2009.¹⁵² That is an increase of over 200 percent. That seems to contradict previous results. However, it

¹⁵²Central Bank of the Republic of Kosovo, *Monthly Statistics Bulletin No. 111* (Prishtina: Central Bank of the Republic of Kosovo), November 2010, <http://www.bqk-kos.org/repository/docs/2010/MSB%20no%20111.pdf> (accessed 8 February 2011), 11.

is possible that the introduction of the Euro could have had a positive influence on trust in the currency. Still trust in the currency does not automatically mean trust in the financial system and ultimately causality cannot be determined.

A financial system, and therefore the banking system, depends on confidence in the system.¹⁵³ In Kosovo there seems to be a lack of confidence in the financial system. As described in chapter 2, it is interesting to look into the perception of the rule of law, protection of property rights and the efforts of the government to fight corruption (see figures 1 and 2) to determine the level of confidence. According to the Kosovo Progress Report 2010 by the European Union, Kosovo made progress and improved the rule of law. The judiciary has been reformed, but there is still political and other interference. There is a lack of efficiency and coordination between the different agencies within the judicial system.¹⁵⁴ In addition, property rights are not fully ensured, especially because of weak enforcement capabilities within Kosovo. It is one of the key priorities of the European Union.¹⁵⁵ The Kosovo courts are improving procedures to fight corruption. However, because the legal framework is weak and enforcement capabilities are scarce, Kosovo's financial and economic systems remain hampered by corruption.¹⁵⁶ Figures 1 and 2 depict the aggregated views of enterprises, citizens and experts on the quality of

¹⁵³Lönnberg, 3.

¹⁵⁴European Commission, *Kosovo 2010 Progress Report*, 9 November 2010, http://ec.europa.eu/enlargement/pdf/key_documents/2010/package/ks_rapport_2010_en.pdf (accessed 8 February 2011), 11.

¹⁵⁵*Ibid.*, 18.

¹⁵⁶*Ibid.*, 35.

governance on the control of corruption and the rule of law in Kosovo.¹⁵⁷ Although both seem to be improving, they are still low when compared to other Balkan countries.

Kosovo has a percentile rank of 30 in 2008 for the control of corruption and 33 for the rule of law in 2008.¹⁵⁸ As a result, 30 respectively 33 percent of all other countries (163 in total) score worse than Kosovo. This means a relatively low score for the quality of governance on the control of corruption and the rule of law in Kosovo.

¹⁵⁷—Percentile rank indicates the percentage of countries worldwide that rate below the selected country. Higher values indicate better governance ratings. Percentile ranks have been adjusted to account for changes over time in the set of countries covered by the governance indicators. The dashed lines indicate the statistically-likely range of the governance indicator. For instance, a percentile rank of 75 percent with the dashed lines at 60 percent to 85 percent has the following interpretation: An estimated 75 percent of the countries rate worse and an estimated 25 percent of the countries rate better than the country of choice. However, at the 90 percent confidence level, only 60 percent of the countries rate worse, while only 15 percent of the countries rate better.” Daniel Kaufman, Aart Kraay, and Massim Maztruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues*, September 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp# (accessed 1 February 2011).

¹⁵⁸The World Bank, “Worldwide Governance Indicators,” 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp (accessed 8 February 2011).

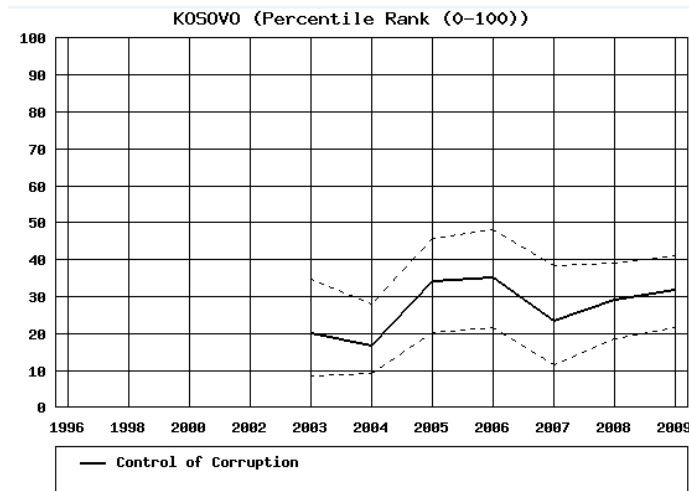


Figure 1. Control of Corruption in Kosovo

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

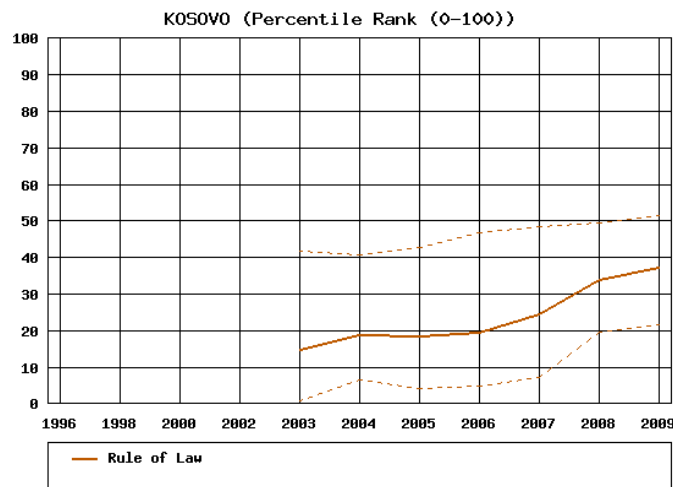


Figure 2. Rule of Law in Kosovo

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

The evaluation of the AVs mentioned in the right column of Table 1 shows that the banking system in Kosovo must become more effective and must step into the role of

financial mediatory. Too many firms rely on internal ways to finance investments. Few firms have a line of credit with financial institutions and use banks to finance their investments. Lenders have to provide a high amount of collateral to get credit. The risk for providing credit is high, and apparently, there are enough informal ways to finance investments. A lack of trust and confidence in the banking system as depicted by the AVs, is in line with and seems also to be influenced by a weak rule of law, the difficulty to enforce property rights and the fact that corruption is still present in Kosovo. All these severely hamper the development of a reliable banking system and therefore limit the possibility for sustainable economic growth.

Efficiency of the banking system in Kosovo

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

Concentration of assets, loans and deposits is still high in Kosovo. According to the 2010 Financial Sector Bulletin of the CBK, the three largest banks in Kosovo have approximately 82 percent of the assets. However, since 2008 there is a decline in the concentration of assets as well as loans and deposits. This could indicate an increase in smaller banks. Table 10 depicts differences in percentages between the HHI for assets, loans, and deposits for 2008 and 2009. The largest decline is in loans. This indicates,

according to the CBK, an increase in loans provided by smaller banks because the assets, loans and deposits are spread among more banks.

Table 10. HHI for assets, loans and deposits (in points)			
	2008	2009	Difference in percentage
Assets	2887	2575	-11
Loans	3014	2572	-15
Deposits	3016	2647	-12

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

Deposits are the main source of finance in Kosovo.¹⁵⁹ This may explain why the global financial crisis did not have the same amount of influence in Kosovo as it had in other Balkan countries (see table 3). Although there was a decline in reserves in 2009, overall the banking system maintained sufficient reserves (see figure 3).

¹⁵⁹Central Bank of the Republik of Kosovo, *Financial Stability Report*, 40.

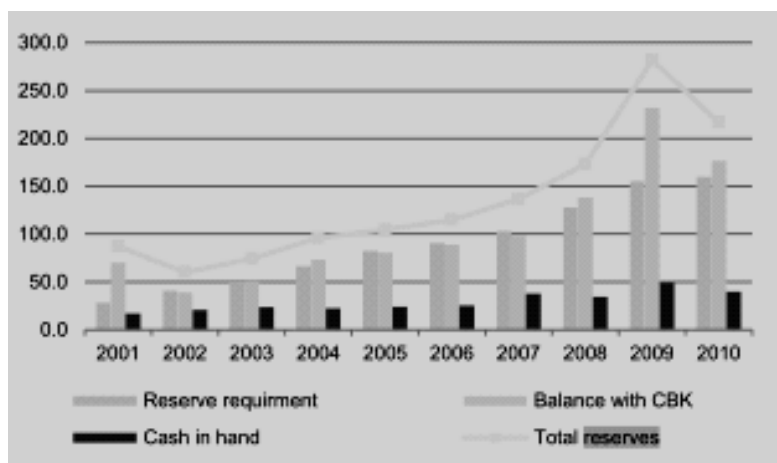


Figure 3. Amount of Reserves of Kosovo banking system

Source: Central Bank of the Republic of Kosovo (2010), *Banking Sector Reserves in million of Euros*, <http://www.bqkkos.org/repository/docs/Financial%20Stability%20Report%20No.%201.pdf> (accessed 1 February 2011).

The return from average assets and equity decreased between 2008 and 2009. This indicates that expenditures grew faster than income from financial activities.¹⁶⁰ This parallels the economic circumstances and consequences of the global financial crisis. The evaluation of the AVs shows that Kosovo's banking system is profitable, but also highly concentrated within three large banks that account for approximately 82 percent of total assets. Because the banking system relies heavily on domestic deposits for finance, it lacks an international focus. This could explain the relatively low amount of foreign direct investments as described in the previous paragraph. Analysis suggests that the banking system could be more efficient if it would exploit additional international solutions to improve the efficiency of the banking system in order to improve the national economic results and especially foreign direct investments.

¹⁶⁰Central Bank of the Republic of Kosovo, *Annual Report 2009*, 42-43.

Activities of International Organizations in Afghanistan

After the defeat of the Taliban, Afghan factions attended the United Nations (UN) sponsored conference in Bonn, Germany (The Bonn Conference) during December 2001.¹⁶¹ The attendees sought to create stability and governance for Afghanistan.¹⁶² Because of the Bonn Agreement, an Afghan Interim Authority was established. The Interim Authority was headed by Hamid Karzai.

The participants of the conference requested the international community to provide an UN mandated security assistance force to help the Afghan authorities maintain security.¹⁶³ On 20 December 2001, the United Nations Security Council authorized the establishment of the International Security Assistance Forces (ISAF) under Chapter VII of the UN Charter.¹⁶⁴ The mission of ISAF is to support the government of Afghanistan in providing a secure, sustainable and stable environment. ISAF therefore conducts operations to reduce the capabilities of the insurgents, support growth in capacity and

¹⁶¹Pam O'Toole, "Key Groups to Attend Afghan Talks," 25 November 2001, <http://www.institute-for-afghanstudies.org/AFGHAN%20CONFLICT/Bonn%20Meeting/UN/UN%20News%20on%20Bonn%20Meeting.htm> (accessed 8 February 2011).

¹⁶²U.S. Department of State, "Background Note: Afghanistan," 6 December 2010, <http://www.state.gov/r/pa/ei/bgn/5380.htm> (accessed 9 February 2011).

¹⁶³International Committee of the Red Cross, *Agreement on Provisional Arrangements in Afghanistan Pending the Re-establishment of Permanent Government Institutions*, 5 December 2001, <http://www.afghangovernment.com/AfghanAgreementBonn.htm> (accessed 9 February 2011), 6.

¹⁶⁴United Nations Security Council, *Resolution 1386*, 20 December 2001, <http://daccess-ddsny.un.org/doc/UNDOC/GEN/N01/708/55/PDF/N0170855.pdf?OpenElement> (accessed 9 February 2010), 1.

capabilities of the Afghan National Security Forces, and to facilitate improvements in governance and socio-economic development.”¹⁶⁵

On 18 March 2002, the Secretary General of the UN advised the United Nations Security Council to authorize the establishment of the United Nations Assistance Mission in Afghanistan (UNAMA).¹⁶⁶ On 28 March, the United Nations Security Council endorses the establishment of UNAMA according to the report of the Secretary General of 18 March 2002.¹⁶⁷ The current mandate of UNAMA is to support the Government of Afghanistan in its efforts to improve critical areas, including security, governance and economic development, and regional cooperation.”¹⁶⁸

Activities of the World Bank

The World Bank stated that after more than twenty years of conflict, Afghanistan was one of its poorest members.¹⁶⁹ Afghanistan lost most of its infrastructure and human

¹⁶⁵International Security Assistance Force, “About ISAF,” 9 February 2011, <http://www.isaf.nato.int/mission.html> (accessed 9 February 2011).

¹⁶⁶United Nations General Assembly Security Council, *The Situation in Afghanistan and Its Implications for International Peace and Security*, General Assembly 56th sess., 18 March 2002, <http://daccess-dds-ny.un.org/doc/UNDOC/GEN/N02/289/20/PDF/N0228920.pdf?OpenElement> (accessed 9 February 2011), 15.

¹⁶⁷United Nations Security Council, *Resolution 1401*, 28 March 2002, <http://daccess-dds-ny.un.org/doc/UNDOC/GEN/N02/309/14/PDF/N0230914.pdf?OpenElement> (accessed 9 February 2010), 2.

¹⁶⁸United Nations Security Council, *Resolution 1917*, 22 March 2010, <http://unama.unmissions.org/LinkClick.aspx?link=Publication%2Fmarch222010SCUNAMAmmandate.pdf&tabid=2109&mid=2474> (accessed 9 February 2010), 4-5.

¹⁶⁹The World Bank, “Afghanistan World Bank Approach Paper,” November 2001, <http://siteresources.worldbank.org/INTAFGHANISTAN/Resources/afgApproach.pdf>, (accessed 9 February 2011), 1.

capital.¹⁷⁰ The countries' financial sector no longer operated and commercial banks were dysfunctional. The domestic, and the international formal banking system was also disrupted.¹⁷¹ Many activities were taken over by the informal system, better known as the *Hawala* system.¹⁷² The *Hawala* system is an informal financial transaction system executed outside of the formal financial sector. The local exchange dealers provide banking services like currency exchange, money transfers and, deposit services to the local population. All activities occur outside the official banking system.¹⁷³

In June 2010, The World Bank had 32 active projects in Afghanistan with a commitment of over US\$ 2.7 billion.¹⁷⁴ The World Bank continued to provide advice to the government of Afghanistan. The World Bank's development of Afghanistan is based on three pillars. The first pillar is to build the capacity and accountability of the Government of Afghanistan in order to provide affordable, accessible, and adequate services to its citizens. The second pillar is designed to promote growth of the rural

¹⁷⁰Ibid.

¹⁷¹The World Bank, "International Development Association Program Document for a Proposed Credit in the Amount of SDR 54.7 million (US\$ 80 million equivalent) to the Islamic Republic of Afghanistan for Programmatic Support for Institution Building," 6 July 2004, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2004/07/12/000160016_20040712102143/Rendered/PDF/281920AF.pdf (accessed 9 February 2011), 1.

¹⁷²Ibid., 2.

¹⁷³Samuel M. Maimbo, *The Money Exchange Dealers of Kabul* (Washington, DC: The World Bank, August 2003), 2-3.

¹⁷⁴The World Bank, "Afghanistan: Supporting State-Building and Development," July 2009, <http://siteresources.worldbank.org/IDA/Resources/IDA-Afghanistan.pdf> (accessed 9 February 2011), 3.

economy. The third pillar supports growth of a formal, modern and competitive private sector.¹⁷⁵ Within the scope of these three pillars, the World Bank focused on the restructuring the banking system. The World Bank provided technical assistance for the development of the necessary infrastructure in the financial sector and strengthening the capacity of the central Bank of Afghanistan, *Da Afghanistan Bank* (DAB). The World Bank also provided assistance to implement changes in the financial sector.¹⁷⁶ The World Bank assisted in improving human resource management, accounting and auditing, and assistance for the development of a system to supervise commercial banks according to international standards.¹⁷⁷ An additional task was to improve credit risk assessments in order to reduce risk and increase credit based lending.¹⁷⁸ To facilitate credit risk assessment, the World Bank assisted in the development of a collateral registry for movable and immovable property.¹⁷⁹ Finally, the World Bank assisted the DAB and the

¹⁷⁵The World Bank, *Afghanistan: Interim Strategy Note*, 5 May 2009, <http://www.worldbank.org.af/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/AFGHANISTANEXTN/0,,contentMDK:22216104~menuPK:305990~pagePK:2865066~piPK:2865079~theSitePK:305985,00.html> (accessed 9 February 2011).

¹⁷⁶The World Bank, *Financial Sector Strengthening Project*, 17 September 2008, http://www-wds.worldbank.org/external/default/WDSCContentServer/WDSP/IB/2008/09/17/000076092_20080918160815/Rendered/PDF/Project0Inform1cept0Stage0F0SEPT017.pdf (accessed 9 February 2011), 4-7.

¹⁷⁷*Ibid.*, 4-5.

¹⁷⁸*Ibid.*, 6.

¹⁷⁹*Ibid.*

Afghanistan Bank Association in the development of bankers training.¹⁸⁰ These programs focused on improving the efficiency and reliability of the banking system.

Activities of the International Monetary Fund

The start of the reform of the banking system started in January 2002, when the IMF visited Afghanistan for the first time after the defeat of the Taliban.¹⁸¹ The IMF provided policy advice and technical assistance in order to ensure a solid foundation for economic management and macroeconomic stability.¹⁸² The IMF support included the rehabilitation of the central bank (DAB). The IMF provided assistance for currency reform, central bank modernization and new financial and banking legislation.¹⁸³ In addition, an IMF staff team assisted the authorities in developing “a macroeconomic framework to guide economic decision-making” in order to achieve sustainable economic growth.¹⁸⁴ A specific example of IMF assistance to limit inflation is to limit the growth of the money supply.¹⁸⁵ Furthermore, the IMF assisted in establishing an emergency

¹⁸⁰Ibid., 6-7.

¹⁸¹Staff of the Monetary and Financial Systems Department, 4.

¹⁸²Ibid., 7.

¹⁸³Ibid., 8.

¹⁸⁴Bennett et al., *Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth* (Washington, DC: International Monetary Fund, September 2003), <http://www.imf.org/external/pubs/ft/scr/2003/cr03299.pdf> (accessed 9 February 2011), 8.

¹⁸⁵International Monetary Fund, Country Report No. 09/319, *Islamic Republic of Afghanistan: Afghanistan National Development Strategy: First Annual Report 2008/09* (Washington, DC: International Monetary Fund, November 2009), <http://www.imf.org/external/pubs/ft/scr/2009/cr09319.pdf> (accessed 9 February 2011), 10.

payment system, based on a system of six DAB locations in Afghanistan. Additionally, the IMF assisted in the currency reform by replacing old banknotes with new ones. The United States and the UN provided logistical assistance for the currency reform.¹⁸⁶ In 2003, the IMF prepared new banking and central bank laws, new payments laws, currency laws, and financial services laws.¹⁸⁷ Technical assistance was provided to DAB concerning the organization, accounting, financial reporting, internal auditing, and an appropriate central bank building facility.¹⁸⁸ It is remarkable that the role of the IMF changed when the government of the United States provided considerable budgets for the restoration and development of the central bank through USAID. The IMF limited its assistance to targeted advice and participation in expert committees to review the balance sheet structure and capital adequacy of the central bank.¹⁸⁹

Activities of United States Agency for International Development

USAID began assistance to the Afghan financial sector in 2003.¹⁹⁰ USAID focused on empowering Afghan institutions to lead in development and reconstruction in

¹⁸⁶Staff of the Monetary and Financial Systems Department, 5.

¹⁸⁷International Monetary Fund, Country Report No. 02/219, *Islamic Republic of Afghanistan: Report on Recent Economic Developments and Prospects, and the Role of the Fund in the Reconstruction Process* (Washington, DC: International Monetary Fund, October 2002), <http://www.imf.org/external/pubs/ft/scr/2002/cr02219.pdf> (accessed 10 February 2011), 39.

¹⁸⁸Staff of the Monetary and Financial Systems Department, 5.

¹⁸⁹*Ibid.*

¹⁹⁰United States Agency for International Development, *Fact Sheet Afghanistan* (Washington, DC: USAID, June 2010), <http://afghanistan.usaid.gov/documents/document/document/1004> (accessed 9 February 2011).

order to improve the livelihood of its own citizens.¹⁹¹ At that moment, the legislation that was prepared by the IMF was not yet in place and the financial sector was not functioning properly. USAID focused on three main areas within the financial sector; central bank oversight, retail banking and small and medium enterprise finance, and microfinance.¹⁹² To enable the central bank to execute oversight over commercial banks, USAID assisted the central bank to develop a payments and clearing house system, in conjunction with computerizing its operations. USAID also provided advice on how to implement on-site examinations of commercial banks using trend analysis and methods to bring the accounting system in line with international recognized standards.¹⁹³ To develop retail banking and small and medium enterprise finance, USAID assisted in the enactment of financial laws and regulations.¹⁹⁴ To facilitate growth of small and medium enterprises, USAID supported the ability of the bank to provide loans to these enterprises. Microfinance was supported by USAID providing capital and technical assistance in order to facilitate the banking system and to develop Sharia compliant loans and transactions.¹⁹⁵

¹⁹¹United States Agency for International Development, *Afghanistan Strategy*, 9 February 2011, http://afghanistan.usaid.gov/en/about/country_strategy (accessed 9 February 2011).

¹⁹²United States Agency for International Development, *Fact Sheet Afghanistan*.

¹⁹³*Ibid.*

¹⁹⁴*Ibid.*

¹⁹⁵*Ibid.*

Sustainable economic growth in Afghanistan

Poverty and a lack of economic activities is widespread in Afghanistan after decades of war. This makes Afghanistan inappropriate to compare with the rest of the region. The AVs for Afghanistan will therefore not be compared to data from other regional countries, because the circumstances are too different to compare. Notably opium is excluded from the economic data, despite the international nature of its trade. According to annual growth of GDP results (in percentage), Afghanistan achieved a tremendous increase in GDP growth, even though the global financial and economic crisis negatively impacted GDP in 2007 and 2008 (see table 11). However, the annual rate of inflation is not only very high, but also very volatile (see table 11). This could explain why the increase in GDP is not consistent. The high rate of inflation is not remarkable if compared to the annual growth of money (M2).¹⁹⁶ The annual increase in money ranges from 46 percent in 2007 to 27 percent in 2008 (see table 11). Inflation is possibly also influenced by the fact that Afghanistan received, since 2001, US\$ 29 Billion in international aid. According to the Afghan Ministry of Finance, 77 percent of the international aid was spent with little or no involvement of Afghan government officials.¹⁹⁷ If the low amount of credit provided by banks as part of the GDP (see table 11) is added to this analysis, together with the high amount of international aid and the

¹⁹⁶Money and quasi money as referred to in table 6, comprises the sum of currency outside banks, demand deposits other than those of the central government, and the time, savings, and foreign currency deposits of resident sectors other than the central government. This definition is frequently called M2.

¹⁹⁷Zarif Nazar and Charles Recknagel, “Kabul Wants To Change The Way Foreign Aid Is Spent,” Relief Web, 19 July 2010, <http://www.reliefweb.int/rw/rwb.nsf/db900SID/VVOS-87HL4N?OpenDocument&RSS20=18-P> (accessed 9 February 2011).

tremendous growth in GDP, then it seems that Afghanistan is doing a tremendous job to improve its economy. According to Economic Watch, economic growth seems to be based on foreign international aid alone.¹⁹⁸

Table 11. Economic assessment variables for Afghanistan					
	2005	2006	2007	2008	2009
Growth GDP in Percentage	14.5	11.2	-0.2	2.3	40.8
Rate of inflation in percentage	12.1	3.5	17.0	22.7	-13.2
Growth of money in percentage	n/a	n/a	46.0	27.0	n/a
Net inflow of FDI in millions US\$	271 mil	238 mil	243 mil	300 mil	185 mil
Credit provided by banks as percentage of GDP	n/a	-1.7	0.2	3.5	n/a

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

Effectiveness of the banking system in Afghanistan

With assistance from the IMF, World Bank, and USAID, the government of Afghanistan enacted the DAB Law of 2003. By implementing this law, Afghanistan created an autonomous central bank for Afghanistan, with the objective of achieving and

¹⁹⁸Economy Watch, "Islamic Republic of Afghanistan Economic Statistics and Indicators," *Economy, Investment and Financial Reports*, 9 February 2011, <http://www.economywatch.com/economic-statistics/country/Afghanistan/> (accessed 9 February 2011).

maintaining domestic price stability.¹⁹⁹ Its tasks, as formulated in Article 2 of DAB Law, are in line with the five internationally recognized standards for a proper functioning central bank. These tasks are; oversight of the central bank over the local network of banking services or banks, the pursuit of price stability, the facilitation of a stable system of payments, the ability to provide independent economic advice to the government, and the capability to ensure commercial banks of having sufficient financial funds to meet their obligations. According to USAID, DAB accounting and reporting in 2009 and 2010 remains consistent with International Financial Reporting Standards, as adopted by the International Accounting Standards Board. Therefore, DAB formally fulfills the international recognized standards for a central bank and meets internationally recognized standards. However, the effectiveness of the banking system as a whole seems to be very poor. According to the Enterprise Analysis Unit of the World Bank, only 3 percent of the firms have a line of credit with a financial institution compared to 35 percent of 125 countries worldwide (see table 12). From all firms, 90 percent use internal ways to finance investments and only 1 percent use banks. The respective average percentages for all countries that have been surveyed are 69 and 23 percent (see table 12). If a firm needs a loan, collateral requirements equal 254 percent of the loan. That is almost twice the average percentage of 125 countries surveyed by the World Bank (see table 12). It is surprising to note that only 37 percent of the businesses identify access to finance as a major constraint, while the average percentage is 31 percent (see table 12).

¹⁹⁹Da Afghanistan Bank, *The Afghanistan Bank Law*, 1-2.

Table 12. Financing of Afghan firms in percentage in 2009					
	Line of credit with financial institutions	Internal finance	Bank finance	Value of collateral	Finance a major constraint
Average	35	69	23	144	31
Afghanistan	3	90	1	254	37

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

As previously indicated, the foreign direct investments are low. However, the increase in deposits in Afghanistan is considerable high. It went from US\$ 270 million in March 2008 to US\$ 947 million in March 2009.²⁰⁰ This is based on the closing exchange rate of 51.76 Afghani per US Dollar on 19 March 2009.²⁰¹ This is an increase of 300 percent within a year. In conjunction with the findings of the previous paragraph, that banks are not very effective, it seems as if banking deposits are only used to store money. This is remarkable because one would expect that if banks were used to store money, they would also be used for other financial services and transactions.

Although the tremendous growth in GDP and deposits contradicts with the other AVs, the AVs in Table 12 clearly depicts a lack of confidence in the financial system. That is not surprising, given the current situation in Afghanistan. According to the November 2010 Report to Congress on progress toward security and stability in Afghanistan, judicial progress is slow, the government’s ability to provide the rule of law

²⁰⁰Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009*, 99.

²⁰¹Ibid., 42.

must be improved, and corruption is still a problem. Last year showed an almost 7 percent decline in the confidence of the Afghans in their government's ability to establish a reliable formal justice system.²⁰² This lack of confidence is confirmed by the World Bank (see figures 4 and 5).²⁰³ According to figures 4 and 5 almost all other countries surveyed by the World Bank achieve better results than Afghanistan.²⁰⁴

²⁰²U.S. Department of Defense, *Report on Progress Toward Security and Stability in Afghanistan* (Washington, DC: Government Printing Office, November 2010), http://www.defense.gov/pubs/November_1230_Report_FINAL.pdf (accessed 9 February 2011), 59.

²⁰³The World Bank, "Worldwide Governance Indicators," 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp (accessed 8 February 2011).

²⁰⁴—Percentile rank indicates the percentage of countries worldwide that rate below the selected country. Higher values indicate better governance ratings. Percentile ranks have been adjusted to account for changes over time in the set of countries covered by the governance indicators. The dashed lines indicate the statistically-likely range of the governance indicator. For instance, a percentile rank of 75 percent with the dashed lines at 60 percent to 85 percent has the following interpretation: an estimated 75 percent of the countries rate worse and an estimated 25 percent of the countries rate better than the country of choice. However, at the 90 percent confidence level, only 60 percent of the countries rate worse, while only 15 percent of the countries rate better." Daniel. Kaufman, Aart Kraay, and Massim Maztruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues*, September 2010, http://info.worldbank.org/governance/wgi/sc_chart.asp# (accessed 1 February 2011).

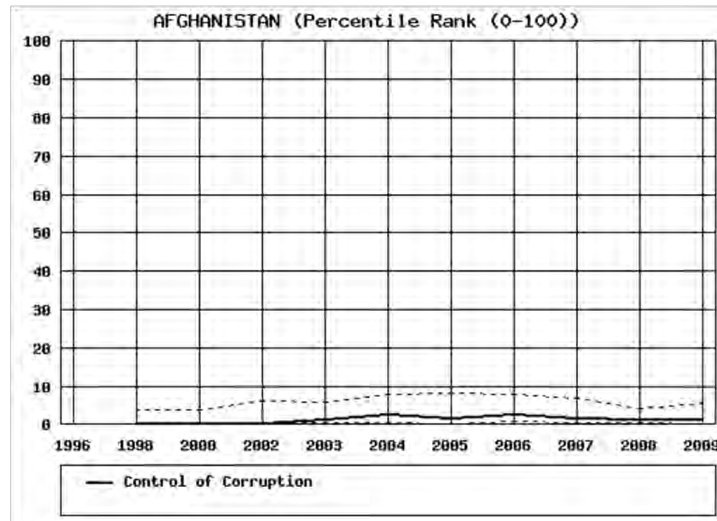


Figure 4. Control of Corruption in Afghanistan

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

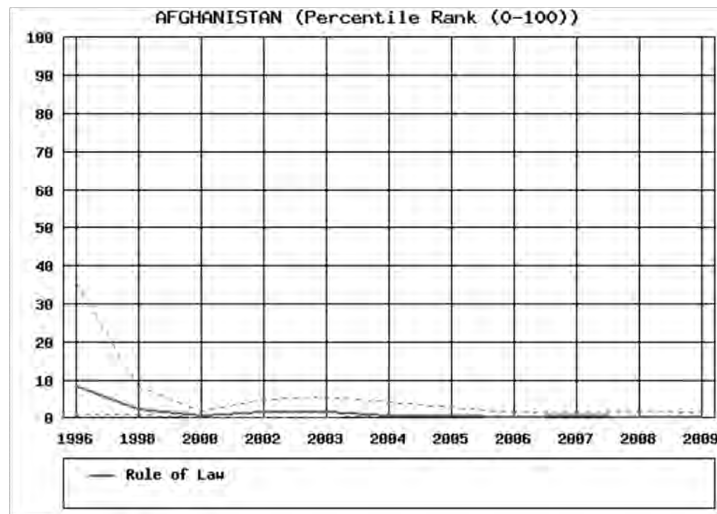


Figure 5. Rule of Law in Afghanistan

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

Despite implementing new banking laws, achieving a tremendous growth in GDP, and increasing the amount of deposits with 300 percent, it appears that Afghanistan's remains immature and ineffective. There is a lack of confidence in the government to provide a rule of law, as well as a perceived inability to protect property rights and to decrease the amount of corruption. As a result, confidence in the financial and banking system is very low. It is therefore justified to state that the banking system of Afghanistan is not fulfilling the role of mediatory. The banking system seems to be immature and not properly functioning as an effective banking system to facilitate sustainable economic growth.

Efficiency of the banking system

In February 2011, the Afghan banking system consisted of 17 licensed banks.²⁰⁵ According to the DAB's 2008-2009 Annual Bulletin, 19 percent of the assets belonged to state owned banks, 20 percent to branches of foreign banks in Afghanistan, and 61 percent to Afghan private banks.²⁰⁶ In March 2009, only 15 percent of the assets were owned by state owned banks, 17 percent by branches of foreign banks and 68 percent by private banks.²⁰⁷ This shows a major shift in favor of the privately owned banks in Afghanistan. Privately owned banks gained 11 percent of the assets, where state owned banks lost 27 percent and branches of international banks lost 15 percent.

²⁰⁵Da Afghanistan Bank, "Licensed Financial Institutions," <http://www.centralbank.gov.af/licensed-financial-institutions.php> (accessed 9 February 2011).

²⁰⁶Da Afghanistan Bank, *Annual Bulletin Da Afghanistan Bank 2008-2009*, 94.

²⁰⁷Ibid.

The total assets of the banks in Afghanistan went from US\$1.62 billion in March 2008 to US\$2.8 billion in March 2009.²⁰⁸ This is an increase of 73 percent within one year. The amount of loans also achieved growth. The total amount increased from US\$ 773 million in March 2008 to US\$ 966 million in March 2009.²⁰⁹ This is an increase of 25 percent. Striking was the fact that 83 percent of this growth has been achieved by the privately owned banks.²¹⁰ The increase in deposits is, as described in the previous paragraph, considerably high. It went from US\$ 270 million in March 2008 to US\$ 947 million in March 2009.²¹¹ Most surprising were the profitability figures, the so-called return on average assets. The Afghan banking system was profitable in 2009, although it decreased from 1.8 percent in March 2008 to 1.69 percent in March 2009.²¹² However, if the figures are broken down for state owned, privately owned and branches of foreign banks, than a different picture starts to evolve. State owned banks made a profit of US\$ 11 million in March 2008 and a loss of US\$ 58,000 in March 2009. Privately owned banks were still profitable in 2009, but profits had fallen by 37 percent in March 2009. However, foreign banks increased their profits by 10 percent in March 2009.²¹³ This remarkable result can be explained by research done by Jelena Pavlović and Joshua

²⁰⁸Ibid.

²⁰⁹Ibid., 96.

²¹⁰Ibid.

²¹¹Ibid., 99.

²¹²Ibid., 100-101.

²¹³Ibid.

Charap.²¹⁴ In general, they concluded that major differences exist between foreign owned and domestically owned banks. –Foreign owned banks seem to be more profitable, have little or no involvement in domestic lending, adhere to stricter and more traditional procedures, and have a higher profitability.”²¹⁵ Domestically, privately and state-owned banks, are less profitable or are even making losses, have substantial domestic lending activities, and have non-conventional procedures for assessment of borrowers.²¹⁶ Therefore, the challenge for DAB is to balance the efficiency of the foreign-owned banks with the financial mediation of the domestically owned banks in order to facilitate sustainable economic growth with a healthy and reliable banking system.

Activities of the military in Kosovo and Afghanistan

There is no evidence that the military helped develop the banking systems in Kosovo or Afghanistan. This is in line with the literature review as described in chapter 2. The military recognizes the importance of a functioning financial and banking system. However, it does not consider itself as the primary actor to stabilize the financial and banking system.²¹⁷ As a result, the military activities are limited to providing security and protection to key assets and processes, and providing logistical support to distribute new

²¹⁴Jelena Pavlović and Joshua Charap, Working Paper 09/150, *Development of the Commercial Banking System in Afghanistan: Risks and Rewards* (Washington, DC: International Monetary Fund, July 2009), <http://www.imf.org/external/pubs/ft/wp/2009/wp09150.pdf> (accessed 9 February 2011), 19-20.

²¹⁵Ibid.

²¹⁶Ibid.

²¹⁷Joint Warfighting Center, Ch IV.

banknotes as part of the currency reform.²¹⁸ The military does not consider itself part of the development of the banking system. Therefore, it is logical that no documents are found that describe these tasks.

Possible military tasks in Kosovo and Afghanistan

As explained in the beginning of the chapter, this section is different from the rest of the analysis. Instead of describing what has been done, it describes possible tasks the military could have conducted in order to facilitate the development of the respective banking systems. The Kosovo and Afghanistan case studies demonstrate that the military did not actively participate in the development of the banking system. In fact, there are no known examples in the literature of any integrated efforts between the military force and civilian banking organizations to facilitate the development of the banking system.

In Kosovo, as well as Afghanistan, there was a lack of security in the early phase of stability operations. In order to be effective, the military force must therefore do what it can to facilitate this process. Other organizations, like the IMF, World Bank or USAID will not always be present to assist in the development of the local banking system.

In almost every operation, the military can provide security and logistical support to facilitate the development process. Specific examples of military support to the development of the banking system are scarce. However, a specific example occurred in October 2002 when the military provided logistical and security support to the IMF in Afghanistan to replace banknotes.²¹⁹ In addition, the Handbook for Military Support to

²¹⁸Staff of the Monetary and Financial Systems Department, 5.

²¹⁹Ibid.

Economic Stabilization of the U.S. Joint Forces Command and a Technical Report of the RAND Cooperation, also describe possible military support.²²⁰ For example; it could be used to protect key infrastructure (e.g., banks themselves), or to protect key personnel which lead or operate banks. This is especially important when a shortage of capable personnel exists. As long as there is a security issue, the military assists the government and supporting international financial institutions like the World Bank and the IMF, to facilitate the training of personnel and function of banks.

Another possible task for the military is to facilitate the repair of banks and the financial infrastructure. This particularly applies to Afghanistan where most of the infrastructure was damaged or destroyed after decades of war. Beyond infrastructure, the military could establish an (emergency) payment system. Such a system is, according to the IMF, one of the first banking functions necessary in restoring a banking system.²²¹ Repairing infrastructure further contributes to the local economy when local personnel and facilities are integrated into the military's economic development plan.

The military can use its Intelligence Preparation of the Battlefield process and its intelligence assets to gather information about the status of the financial and banking system.²²² U.S. Army Field Manual 3-07 specifically describes the possibility for the military to conduct detailed assessments of physical infrastructure. Gathering information about public systems, services, and facilities supports the planning efforts and facilitates

²²⁰Joint Warfighting Center, Ch IV; Crane et al., 84.

²²¹Lönnberg, 3.

²²²Crane et al., 82-83.

economic activity.²²³ For example, the Kosovo conflict caused a significant outflow of human capital. Before the conflict, most positions were held by Serbians. During the conflict, they fled to Serbia leaving a severe shortage of skilled workers and professionals.²²⁴ In order to be effective, international financial institutions, like the World Bank and the IMF, must empower the military with the financial information it needs to develop the local banking system. The military could provide this information by using their intelligence collection assets. This can provide valuable information for the World Bank, the IMF and USAID.

The military could have used local Afghan currency instead of US Dollars.²²⁵ The authors' personal experience in 2003 points out that because the military used US Dollars on a large scale, the Afghan population was reluctant to trade in Afghan currency. Spending by the military, using national currency, can "shore up" the Afghan currency. According to the World Bank's Afghanistan Economic Update of April 2010, there is military spending, especially in imports.²²⁶ By using local currency, it could also stimulate confidence in local currency. However, the decision to use a specific currency must always be advocated by the IMF and the (future) currency policy of the local government. In addition, the military should prevent, by participating in the local

²²³Department of the Army, FM 3-07, 2-12.

²²⁴Demeka et al., 84.

²²⁵Crane et al., 86.

²²⁶Policy and Poverty Team South Asia Region, —Afghanistan Economic Update," The World Bank, April 2010, http://siteresources.worldbank.org/AFGHANISTANEXTN/Resources/305984-1264608805475/Afghanistan_Spring_Brief_April.pdf (accessed 23 February 2011), 7.

economy and therefore increasing the demand for goods and services, to cause a considerable raise of prices and thus inflation. Prices for products and services should therefore remain in line with local price levels.

If there is consensus that economic development should start as early as possible and that an effective banking system is indispensable for sustainable economic growth, the military should have financial knowledge available to facilitate the development of the banking system as soon as possible. ISAF and KFOR should therefore have had an integrated financial staff support element, comparable to the financial staff division of AMGOT.²²⁷ This does not mean that the military becomes the primary responsible actor for the development of the banking system or that military personnel should be trained to be bankers. It means that financial knowledge should be incorporated in the military task organization because the military is in most cases the first governmental foreign (aid) provider. In Kosovo and Afghanistan, an integrated financial staff support element could have integrated the support of the military to the economic and infrastructural development in an economic development plan. In addition, this staff element could also use US government funds to provide credit to small and medium enterprises. This was an extremely successful operation of USAID in Kosovo.²²⁸ It may even prevent local economies from depending too much on foreign aid at the expense of real economic growth.

²²⁷Komer, Ch II-21.

²²⁸United States Agency for International Development, *Transforming Banking System in Kosovo*.

CHAPTER 5

CONCLUSIONS AND RECOMMENDATIONS

Introduction

This chapter describes research conclusions and recommendations for the facilitating role of the military. The conclusions focus on the activities of the World Bank, the IMF and USAID to develop the banking system in Kosovo and Afghanistan. Secondly, the success or failure of these activities is determined by examining economic growth, the effectiveness, and the efficiency of the banking system. Finally, the activities of the military to facilitate the development of the banking system are described. In the second part of this chapter, recommendations describe how the military can facilitate the development of the banking system in order to succeed in stabilization and reconstruction and to achieve sustainable economic growth.

Conclusions

The development of a viable banking system is a prerequisite for facilitating sustainable economic growth and should start as early as possible during a military operation. However, the military should not be the primary actor in developing the banking system.

The study shows that the activities of the World Bank and IMF mainly focused on high-level institutions, regulations and laws. The World Bank and the IMF provided grants, credit, and technical assistance to financial and governmental institutions in order to rebuild the financial sector in Kosovo and Afghanistan. They mainly focused their efforts on strengthening the central bank capabilities of the CBK in Kosovo and DAB in

Afghanistan. In contrast, the activities of USAID, were more practical in nature. USAID provided for example assistance to implement on-site examinations of commercial banks. In addition, USAID's main effort was to provide credit to small and medium enterprises in both countries. The development of the Kosovo Business Finance Fund even led to the establishment of the American Bank of Kosovo. This bank now operates as a financial institution managed primarily by Kosovo citizens. Despite the enormous efforts of the World Bank, the IMF and USAID, the study generally indicates that the activities of the World Bank, the IMF and USAID to develop the banking system in Kosovo and Afghanistan were not completely successful. Although the development of the Kosovo Business Finance Fund led to the establishment of the American Bank of Kosovo, the banking system in Kosovo and Afghanistan is ineffective. Too many firms rely on internal ways to finance investments. Limited amount of firms have a line of credit with financial institutions and use banks to finance their investments. Lenders have to provide a high amount of collateral to get a credit. There is a lack of trust and confidence in the financial system. The risk for providing credit is high, and apparently, there are enough informal ways to finance investments.

In stark contrast to the ineffectiveness of the banking system is the fact that both countries achieved economic growth. Based on the analysis, economic growth should not have occurred due to the illogical combination of limited amount of credit provided by banks, the relatively high level of inflation, a lack of foreign direct investments and the annual increase in the total volume of money. Based on the evaluation, there should not even be real economic growth, especially because of the inflationary effect of the increase the annual percent increase in the total volume of money in both countries.

In addition, the study shows that the banking system in both countries, does not fulfill its role as financial mediatory to facilitate sustainable economic growth, despite the efforts of the World Bank, IMF and USAID. The evaluation of the banking system in Kosovo and Afghanistan indicates an informal system to finance investments and the fact that banks are only used to store money. As a result, they are not used as part of an integrated financial system. The evaluation of the banking system in both countries also shows that in both countries, the formal role and tasks of the central bank are described by law and there is even a considerable rise in deposits. However, a low percentage of firms have a line of credit with banks, the percentage of firms that use banks to finance investments, and foreign direct investments are low. It is therefore surprising that the percentage of firms that identify access to finance as a major concern, is also low. It is remarkable that both countries have a considerable rise in deposits and economic growth, although they exist in complete different circumstances. This seems to indicate that economic growth is not solely based upon economic variables, but the result of international aid and assistance.

Although the banking system does not fulfill its role as financial mediatory, banks in Kosovo are efficient. Efficient means that a bank makes a profit. Kosovo banks are profitable because they have highly concentrated assets, loans and deposits. This results in higher returns on average assets and equity because the overhead costs are lower. The disadvantage of Kosovo banks is that they lack an international focus. This could explain the relatively low amount of foreign direct investments. Although the concentration of assets, loans and deposits decreases, it is up to the CBK to improve the international

focus and further expand the commercial banking system in Kosovo to facilitate sustainable economic growth.

The Afghan banking system is partly efficient. It depends on the ownership of the bank. There is a remarkable difference between foreign and domestically owned banks. Foreign owned banks are more profitable, have little or no involvement in domestic lending, adhere to stricter, and more traditional lending procedures. Domestically, privately and state-owned banks, are less profitable or are even have a negative balance sheet, but do conduct a lot of domestic lending, and have non-conventional procedures for risk assessment.²²⁹ Therefore, the challenge for DAB is to balance the efficiency of the foreign-owned banks with the financial mediation of the domestically owned banks in order to create a banking system that facilitates sustainable economic growth.

The study also shows that the military does not consider itself the primary actor to develop the banking system during stabilization and reconstruction. However, it does recognize the importance of the banking system for sustainable economic growth.²³⁰ That explains why there are no specific documents describing a specific military role in the development of the banking system. The current role of the military is therefore limited to providing logistical or security support for key infrastructure and personnel.

Development of a banking system is a complex operation that requires substantial financial knowledge. The study also shows that the banking system is not always focused on the effectiveness of the financial system. The Afghanistan case study even

²²⁹Pavlović and Charap 19-20.

²³⁰Joint Warfighting Center, Ch IV.

demonstrated that it is possible to have highly profitable banks that do not fulfill the role of financial mediators in order to facilitate economic growth in a country. Both case studies underwrite the important role of a well functioning central bank. Finally, the study shows that the main reason for an ineffective banking system in these two countries is a lack of confidence in the rule of law, the difficulty to enforce rules and the overall presence of corruption. This leads to recommendations for the military to facilitate the development of a banking system in order to develop sustainable economic growth.

Recommendations

Although the military is not the primary actor in developing the banking system, development of the banking system is necessary to facilitate sustainable economic growth, and therefore, contributes to the success of stabilization and reconstruction efforts. The military is not responsible to develop the banking system. This seems logical because the main purpose of the armed forces is to provide security, to include the use of force, and not to develop an economy. Therefore, it is also logical that the armed forces do not have the knowledge needed to develop a banking system. In an effort to leverage a whole of government approach, all elements of national power should be applied to achieve or secure national or international interests. Ultimately, two questions remain. What can the military do and how do planners integrate these military capabilities to facilitate the development of a banking system.

The first recommendation is to continue the security and (logistical) support military forces provide to financial institutions and developmental organizations like the World Bank and the IMF. It is a simple but effective way to facilitate the work of these organizations. However, the military activities should be synchronized with the activities

of the World Bank and the IMF. In addition, the military can do more than just providing security and logistical support.

The second recommendation is to incorporate, as early as possible, some liaison personnel from the World Bank, IMF or USAID with financial knowledge into the military task organization for stability and reconstruction operations. An alternative could be to militarize civilian personnel or contractors, linked to the World Bank, the IMF or USAID, with banking system development knowledge into the military organization or staff of the responsible commander. This will provide the military commander the knowledge that is needed to assess the situation, shape the development of the banking system and synchronize military efforts with activities of other financial and development-focused organizations. If these organizations are represented in the military operation, then they do not have to wait to expand their activities until it is safe and secure. In addition, the military commander can start improving the local economy in an early stage, which will benefit the success of stabilization and reconstruction.

The third recommendation is to implement successful USAID microfinance activities of small and medium size firms into military operations. The implementation of small and medium size firms provides an excellent opportunity to start the development of a banking system at a local level instead of waiting until the centrally organized developments of the World Bank and IMF take effect on the rest of the country's economy. However, this requires the existence of local small and medium size firms within the operating area. If the economic development or commercial activities are not mature enough to finance small and medium size firms, an alternative could be to provide a safe place to store money and a location to trade currency. This could be facilitated on a

military installation by providing a vault and a location to trade the currency. Because the money will be safe, it will facilitate economic development and confidence in a financial system. It also facilitates the process to license informal financial activities of traders of currency within the *Hawala* system, into the formal banking system. This requires close cooperation with the World Bank and the IMF, which develop the central bank, and as part of it, the way to license banks.

The fourth recommendation is that military spending should be integrated in the development plan of the banking system. This means that funds should not only provide immediate and tangible relief, they should also be used to shape the banking operation. As an example, the Commander's funds of the Emergency Response Programs could be synchronized with an overall banking development plan. This effectively forces them to use local banking systems to conduct payments to contractors. To complement these reforms, local currency should be used, or new currency if there is a currency reform plan. Additionally, the military should demand for accountability from local contractors and banks to facilitate the development of the banking system.

The fifth recommendation is that the military force can also facilitate the development of the banking system by promoting the rule of law, assist the local government in establishing the enforcement of property rights and fight corruption where possible. This will not be a task for the military alone. It is an example of the whole of government approach. By improving the rule of law, the enforcement of property rights and diminishing corruption it will directly contribute to confidence in the government, lower risk for banks to lend money, therefore, lower collateral, more possibilities for people to start a business to develop economic growth.

The last and most important recommendation is that all elements of national power should be more integrated and synchronized. A possibility is to use the Intelligence Preparation of the Battlefield process and the military intelligence assets to facilitate the assessment of the financial and banking system. The military can provide valuable information, if empowered with the information necessary to support the World Bank, the IMF, and USAID. This information is valuable because it can be used by the World Bank, the IMF and USAID to facilitate the development of the banking system.

This study shows that military bankers will remain fiction, but it also shows that the military can do more than just provide security or logistical support to facilitate the development of the banking system. If the military integrates and synchronizes its activities and funding with other organizations like the World Bank, the IMF and USAID, the overall success of stabilization and reconstruction can be achieved earlier and more effectively.

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