

SM/06/257
Supplement 5
Revision 1

November 6, 2006

To: Members of the Executive Board

From: The Secretary

Subject: **Kosovo—Assessment of MFD's Technical Assistance Program**

The attached revised supplement, provided by the Monetary and Financial Systems Department, contains a corrected evaluation report on technical assistance to Kosovo. It serves as background information to the paper on the Technical Assistance Evaluation Program—Findings of Evaluations and Updated Program (SM/06/257, 7/17/06 and SM/06/257, Rev. 1, 11/6/06). A redlined version is attached for the convenience of Executive Directors

It is intended that this supplement, together with the main paper and the other supplementary evaluation reports, will be published on the Fund's external website after **Monday, November 13, 2006**.

Questions may be referred to Mr. Enoch, MFD (ext. 35372).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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Kosovo: Assessment of MFD's Technical Assistance Program

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June 2006

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GLOSSARY

BPK	Banking and Payments Authority of Kosovo
DM	Deutch mark
EU	European Union
EUR	European Department (IMF)
IAIS	International Association of Insurance Supervisors
MD	Managing Director (BPK)
MFD	Monetary and Financial Systems Department (IMF)
PTK	Post and Telecommunications of Kosovo
RTGS	Real Time Gross Settlement System
TA	Technical Assistance
UNMIK	United Nations Mission in Kosovo
USAID	The United States Agency for International Development
ZPP	Zavod za Platni Promet, the Payment Bureau with headquarters in Belgrade
ZOP	Zavod za Obracune o Placanja, Bureau for Accounting and Payment (Pristina was a branch of the Belgrade ZOP)

EXECUTIVE SUMMARY

IMF technical assistance (TA) to Kosovo has been provided under special circumstances, since it is not a member of the IMF or of the World Bank. Following the conflict with Serbia, Kosovo has been administered by the United Nations Mission in Kosovo (UNMIK). In order to fully appreciate the capacity-building work performed by the Monetary and Financial Systems Department (MFD) in the Banking and Payments Authority of Kosovo (BPK), it is important to emphasize the low base from which TA delivery started in 1999. The region was affected by war disruptions, and lack of infrastructure, financial and human resources. There was no functioning financial sector—central bank or banks—and all transactions were made on a cash basis.

In a few years, with the support of the international community, Kosovo has been able to lay the economic foundation over which to build a market economy in due course. One key step in the reconstruction program has been the creation of the BPK, which started as a payments center and has gradually evolved into a *de facto* central bank. The Managing Director (MD) of the BPK has been provided by MFD since its creation, and five MDs have been appointed so far. Since Kosovo uses the euro as its currency, MFD's TA has focused on building capacity in all key operational areas that are typical of a central bank without independent monetary policy. Most of the ongoing MFD assistance is provided in banking and insurance supervision, and in the payments system.

Considerable progress has been made in developing a financial sector and in building capacity at the BPK, but a lot remains to be done. The economy is still largely cash-oriented, although a giro system for mass payments was recently introduced, and the use of credit cards is slowly taking off. Accounting and audit operations are conducted by the BPK, and a safe international reserve management program ensures most of the BPK's revenue. A supervisory system for banks and insurance companies is in place, and the research department publishes a monthly bulletin with data and analysis of the financial sector.

The overall evaluation is very positive. MFD TA program helped foster financial sector development and build local capacity, thus contributing to the overall turnaround of economic performance. Although there has been no full ownership of the TA program (as expatriate experts have been in charge of BPK management), gradually Kosovar officials have become increasingly prominent in the BPK.

Most of the program objectives have been achieved, albeit with some delays in virtually all areas, owing to initial logistic and capacity problems. TA was delivered in an efficient fashion, but some questions are raised in the area of research (overly ambitious initial objectives) and supervision (~~more monitoring of USAID work would have been helpful~~) (insufficient interagency coordination). The selection of experts is somewhat difficult to evaluate. Some questions are raised regarding the choice of some of the BPK MDs, and whether or not an MD with banking supervision background would have been a more appropriate choice at the outset. Coordination with the European Department (EUR) and other TA providers has been very good. Currently, MFD is (a) providing assistance in the

area of on-site inspections to avert potential systemic problems in the banking sector, and (b) placing greater emphasis on coordinating TA delivery by the mix of MFD and non-MFD supervision experts at the BPK.

MFD's TA program could have been more effective in the area of banking supervision. In the view of the evaluator, loose licensing policies in an environment without regulatory and supervisory experience have affected overall bank soundness. More recently, enforcement actions have been stepped up to ensure banking system soundness, and a decision was taken to close one of the small banks in March 2006. MFD increased TA delivery in the area of banking supervision in 2004/2005, when USAID scaled back its TA program with the BPK. Currently, two USAID experts remains in the BPK, working very closely with MFD experts and the current MD, who has supervision experience. One lesson to be learned from the recent bank failure for MFD's TA program is to further strengthen coordination of technical assistance providers, in particular when there are large changes in resource commitments. monitoring the work of non-MFD supervision experts at the BPK.

~~The TA program could have been more effective in the area of banking supervision. Certain loose policies in licensing and supervising the five domestic banks (all licensed in 2001) have affected overall bank soundness. One small bank was liquidated in March 2006, and some rehabilitation programs are under way with MFD's TA to address the other four banks. MFD took over the task of assisting the BPK in the area of banking supervision in 2004/2005, after the three USAID experts terminated their program. Currently, only one USAID expert is in the BPK, working very closely with MFD experts and the current MD, who has supervision experience. To what extent is MFD also accountable for the questionable performance of the USAID experts who operated in the BPK and had full control of this area until 2004? While this is a difficult question, it does provide some useful lessons for the future. Perhaps more monitoring should be performed by MFD in similar circumstances through an expert MD, or advisory missions to coordinate work and ensure support. This is also relevant in the event that, after other TA providers terminate their programs, MFD has to take over from them and continue the TA.~~

On the basis of the Kosovo experience some suggestions for consideration in future TA are proposed. These include: (i) the selection of managing director, and close coordination with and the monitoring work of other TA providers when MFD is in charge of the central bank or a similar institution; (ii) less emphasis on research activities in the case of currency board or dollarized economies; (iii) enhanced coordination with area department staff, especially regarding peripatetic experts visits; and (iv) less turnover of MFD missions chiefs, to ensure continuity in the TA program.

I. INTRODUCTION

1. MFD technical assistance to Kosovo has been provided under special circumstances, since it is not a member of the IMF or of the World Bank. As a region within the former Federal Republic of Yugoslavia severely affected by the war with Serbia, Kosovo has been administered by the UNMIK on the basis of UN Security Council Decision 1244 of June 10, 1999. After the end of the war, the UNMIK requested technical assistance from the IMF. The IMF's Executive Board approved this request, and MFD began providing TA in late 1999.

2. MFD had to face the challenge of helping to develop a financial sector in a region that was not officially recognized as a country, with no financial infrastructure, and limited local skills and human capital. At the end of the conflict there was no central bank nor any banks operating in the country. All transactions were made in cash. As stated in the introduction to the legislation for the BPK, "there were no banks and infrastructure of the financial sector and everything had to be built from zero. The first IMF technical assistance focused all efforts on building a sound legal, regulatory and supervisory framework for the financial sector, and in creating the conditions for the development of sound financial institutions. UNMIK, with close support from the IMF technical assistance, introduced a legal, regulatory and supervisory framework for the financial sector which is in line with EU standards."

3. In a few years, with the support of the international community, Kosovo has been able to lay the economic foundation over which to build a market economy in due course. One key step in the reconstruction program has been the creation of the BPK, which was grafted on the former Yugoslav payments bureau (ZPP/ZOP) as a payments center and gradually evolved into a *de facto* central bank. The Managing Director of the BPK has been provided by MFD since the BPK was established, and five MDs have been appointed so far. Since Kosovo uses the euro as its currency, MFD's TA has focused on building capacity in all key operational areas that are typical of a central bank without independent monetary policy. MFD has gradually increased its involvement in banking and insurance supervision through the engagement of peripatetic experts. It should be noted that USAID provided significant assistance and support to the BPK in the area of banking supervision since its inception; a USAID expert acted as Deputy Managing Director in charge of Supervision until February 2006, when he became a BPK Advisor. Similarly, an EU expert acted as Deputy Managing Director in charge of Operations until end-2005, and the EU has also provided TA in the payments systems area, mainly to manage the giro project (Kos-Giro). ~~It should be noted that USAID provided assistance and support to the BPK in the area of banking supervision until 2004/2005 with a Director of the Supervision Department and three long-term experts. Thereafter, MFD took over the main responsibility for this area, and the ongoing MFD assistance is currently provided in banking and insurance supervision. USAID is providing two long-term banking supervision experts who work under the supervision of the IMF-appointed BPK/MD. Also, the EU is providing TA in the payments systems area (Kos-Giro).~~

4. This report summarizes the findings of an evaluation of the technical assistance delivered by MFD to the BPK, covering the period 1999–2005.¹ The assessment was conducted during a visit to Pristina in March 20–22, 2006 (see Appendix for a list of contacts). As background for the assessment, all MFD reports prepared by MFD missions and selected experts were reviewed. During the visit in Kosovo all the main responsible officials of the various departments that received MFD assistance were interviewed. In addition, several MFD and USAID experts were contacted to provide feedback and views on the TA delivered to the BPK. Finally, Fund staff associated with MFD’s TA from MFD and other IMF departments were contacted. In all cases, full cooperation was received.

5. The rest of the report is organized as follows: Section II provides an evaluation of the TA delivered (ownership, objectives, delivery modalities, and coordination within IMF departments and with other TA providers). Section III presents an analysis of TA effectiveness, and Section IV concludes with some lessons for future TA.

II. TA EVALUATION

6. The overall assessment is largely positive. Considering the low levels of institutional capacity from which MFD’s TA started, the progress achieved so far is remarkable. Together with other TA providers, MFD has succeeded in laying down the foundation of a modern financial sector and in building human capacity to manage the system in due course. As a cornerstone to this progress, it is important to emphasize the role and operations of the BPK as a *de facto* central bank.

7. Since the euro (previously the Deutsche mark) is the official currency in Kosovo, MFD’s TA efforts have been devoted primarily toward building institutional and operational capacity in the areas of (a) management, (b) central bank accounting and auditing, (c) international reserves management, (d) research activities, (e) payments system, (f) banking regulation and supervision, and (g) insurance supervision. TA delivery encountered great difficulties during the initial phase of implementation (Table 1) owing to the lack of human and financial resources, and to poor economic infrastructure. A large staff turnover at the BPK, in particular in the area of banking supervision, was also a major impediment to the delivery and implementation of TA. As a result, delays in TA implementation have occurred in almost all areas considered.

8. After overcoming the initial difficulties caused mostly by the post-war disruptions, a slow but steady progress has been observed in the financial sector and other economic areas. Kosovo has gradually recovered from the post-war economic deterioration, and positive growth was recorded in 2004. Currently, Kosovo is experiencing low inflation, and

¹ The evaluation was prepared by Piero Ugolini, a retired MFD staff. To ensure impartiality in the assessment, the author was never involved in missions or related TA activities in Kosovo.

increasing financial intermediation, with growing bank deposits and credit to the private sector.

9. Notwithstanding the positive evaluation, some issues are raised in this report regarding the role of BPK management in the area of banking supervision. This affects the evaluation of the achievement of TA program objectives, TA delivery, and coordination with other TA providers. Some minor points related to ownership and modalities of TA delivery are also highlighted in the report.

A. Ownership of the TA Program

10. There has been less than full ownership of the TA program in Kosovo, but ownership is increasing over time. Partial ownership of the program by Kosovar officials can be evidenced by the fact that Fund-appointed expatriates have managed the BPK since its inception. In view of Kosovo's peculiarity as a region administered by the UNMIK, many important decisions are made by expatriates, either on behalf or in consultation with Kosovar officials. The Kosovar authorities were involved in the creation of BPK and in the use of the DM/euro as a domestic currency, but are not fully involved in the management of the BPK. The involvement of Kosovar officials has, nevertheless, increased continuously since 1999, and more decisions are now made by them. The Chairman of the BPK Board has always been a Kosovar official; in addition, there are now two Kosovar Deputy Managing Directors for payments system and cash transactions, and bank supervision, respectively. They are also members of the five-member Board. Finally, all BPK departments are now managed by Kosovar officials.

B. Objectives of the TA Program

11. Overall, most of the program objectives have been achieved, with some reservations regarding banking supervision. While the broad framework of the TA program and its objectives were made clear to country officials, implementation was largely in the hands of expatriates. Nevertheless, BPK staff had the opportunity to interact with MFD staff and experts and share with them results and problems to be addressed.

Table 1. Kosovo: MFD Technical Assistance since 1999

Main Objective	Action Plan	Status/Comments
<i>Management of BPK</i>	Five MFD-recruited external experts as Managing Directors (1999-present)	The results have been mixed. However, they have all contributed to the progress made by the BPK.
<i>Central Bank Accounting and Internal Auditing</i>	MFD missions and short-term experts (2001-03) and long-term advisor	Partly completed. Some activities are ongoing.
Establish an appropriate accounting and control	Advice was provided for: <ul style="list-style-type: none"> • Classification of 	Completed.

Main Objective	Action Plan	Status/Comments
framework for the development of BPK operations, and develop internal audit functions.	<p>transactions and daily balances of the general ledger and cash position;</p> <ul style="list-style-type: none"> • Reconciliation of balances and timely management information (foreign assets, cash holdings, and BPK budget performance); • Production of timely accounts, and finalization and audit of the annual financial statements within 3 months of end-financial year; • Improving the internal audit function of the BPK and the external audit process; • Training BPK staff in internal audit function (long-term advisor 2002/03). 	<p>Completed.</p> <p>Completed and accounts prepared on a regular basis.</p> <p>Partly completed and ongoing.</p> <p>Completed: very useful training.</p>
<i>International Reserves Management</i>	Two MFD missions (2000 and 2003)	Partly completed.
Provide advice in developing internal capabilities in managing foreign exchange reserves.	<p>Advice was provided in mission reports on:</p> <ul style="list-style-type: none"> • Organization of foreign assets management section; and • Operational activities such as currency chest and operating guidelines. 	<p>Partly completed.</p> <p>Completed and operational.</p>
<i>Research Activities</i>	Short-term experts (August 2002-July 2004)	Not fully completed. Lack of staff and low priority.
Develop research and statistics' functions in the BPK in order to prepare timely reports on the financial situation of BPK and the banking sector, and to implement policy actions.	<p>Assistance included:</p> <ul style="list-style-type: none"> • Review and evaluate role and staffing of the research department. • Recommendations for the reorganization of the department. • Advice to BPK managing director on policy implementation. 	<p>Partly completed, but delay in implementation to 2006.</p> <p>Delayed and ongoing.</p> <p>Initially, the Research Department only collected data and provided no policy analysis. Beginning in 2005, it also began providing policy advice.</p>

Main Objective	Action Plan	Status/Comments
	<ul style="list-style-type: none"> • Training for BPK staff • A study on financial sector's role in Kosovo (July 2004) 	<p>Partly completed.</p> <p>Completed.</p>
<i>Payments System</i>	MFD missions and short-term experts (1999-ongoing)	Mostly completed and some activities ongoing.
Establish a system capable of fostering a sound development of the banking system, and provide financial services to the population and the government	<p>Assistance was provided to:</p> <ul style="list-style-type: none"> • Choose the DM as the legal tender, and exchange currency. • Restore cash transactions. • Develop an interbank clearing and settlement system. • Upgrade the manual system to electronic media: Electronic Interbank Clearing System. • Develop a retail payment system. • Replace DM cash currency with Euro. • Address counterfeit cash issues; reorganize cash management and vault operations; and provide drafts of legislation for the implementation of the reforms. • Improve infrastructure to meet cash vault standards. • Introduce a giro-bill-payment facility. 	<p>Completed.</p> <p>Completed. System working since May 2001 with TA started March 2000. Started manually in 2001, and electronically in April 2002.</p> <p>Started in December 2004.</p> <p>Completed in February 2002.</p> <p>Completed in 2003.</p> <p>Project to begin April 2006 for one year. Project partly completed and training ongoing; some delays are created by problems of cooperation among stakeholders, mainly banks, on the billing fees.</p>
<i>Banking Regulation and Supervision</i>	MFD missions and short-term experts (2002-ongoing)	<p>Mixed results at the initial phase: not enough monitoring in the licensing of domestic banks and supervision. Ongoing MFD assistance focuses on restoring soundness in the banking system., <u>owing</u></p>

Main Objective	Action Plan	Status/Comments
		to laxity in enforcing banking rules and insufficient coordination with other TA providers. Ongoing MFD and USAID assistance focuses on ensuring soundness in the banking system.
Develop a banking supervision framework in line with best international practices, EU directive, and Base Core Principles	<p>Assistance has been provided to:</p> <ul style="list-style-type: none"> • prepare prudential reporting requirements • draft and revise prudential regulations • licensing requirements • implement appropriate controls to ensure fair enforcement actions • training supervision staff • conduct expert-assisted on-site examinations 	<p>First phase completed; ongoing revisions with assistance of a long-term expert financed by FIRST INITIATIVE.</p> <p>Ongoing with USAID support. First phase completed and additional TA planned in FY2007.</p>
<i>Insurance Supervision</i>	MFD mission and short-term experts (2001-ongoing)	Partly completed and ongoing.
Develop an appropriate supervisory structure in line with best international practices and IAIS principles	<p>Assistance has been provided to:</p> <ul style="list-style-type: none"> • Assess and address the financial situation of insurance companies licensed in 2000; • Assist BPK in taking over supervisory responsibilities; • Introduce accounting and auditing rules; • Revise insurance rules; • Design solvency regime; • Train staff on on-site inspections; • Introduce risk-based methodology. 	<p>Completed when BPK took over responsibility.</p> <p>Completed in November 2001.</p> <p>Completed.</p> <p>Completed.</p> <p>Ongoing.</p> <p>First phase completed in 2004 and began implementation in 2005.</p> <p>Ongoing, expect implementation in January 2007.</p>

12. Among the most relevant achievements is the progress made in ***developing the accounting and payments systems***. The economy still remains largely cash-oriented, but a giro system for mass payments has recently been introduced, and the use of credit cards is slowly taking off. Salaries and pensions are paid through bank accounts. ATM machines have started operating, and three commercial banks now have an extensive number of machines in the entire region. Local banks, as well as the BPK, are still performing transfers by fax since ~~Kosovo does not have SWIFT capacity~~ they opted not to adopt SWIFT. All banks have an account at the BPK, which performs the interbank clearing operations. Accounting and audit operations are conducted by the BPK.

13. By contrast, one objective that has been only partly achieved is the ***creation of a full-fledged Research Department***. The initial project of creating a “separate Kosovo Center for Monetary and Economic Research and Analysis” never materialized. Considering the euroization of the economy and the limited resources available, in retrospect this objective was too ambitious. The presence of an MFD expert in this area helped considerably in setting up research activities. However, due to lack of resources and low prioritization, the initial objective of building a full-fledged Research Department had to be scaled down. Even at present there is insufficient staff and resources in this area.

14. A different point has to be made in the area of ***banking supervision***. The objective of fostering a sound banking system has been jeopardized by emerging problems in the banking sector. Although this area received the largest share of TA resources, which were used to establish a supervisory framework from scratch, including licensing, regulations, off-site analysis, and on-site inspections, weaknesses have emerged that culminated in a recent bank failure (March 2006). In the view of the evaluator, these weaknesses are the result of poor licensing criteria and some shortcomings in the supervision practices of the BPK. Greater TA resources allocated for on-site supervision and better interagency coordination, particularly in the early stages, might have led to prompter corrective action, the poor performance of the five domestic banks, compared to the existing two foreign banks. It is important to note that, at the outset, the banking supervision department of the BPK was directed by USAID experts. These experts contributed significantly to establish a supervisory framework from scratch, including licensing, regulations, off-site analysis, and on-site inspections. However, some serious weaknesses have now emerged in this area as a result of poor licensing criteria and overall supervision of the five domestic banks, all licensed in 2001 by the BPK. One of them was liquidated in March 2006. This may result in a considerable loss of deposits for the Post and Telecommunications of Kosovo (PTK). Some monitoring by MFD would have been appropriate.

C. Modalities of TA Delivery

15. MFD adopted a combination of *ad hoc* missions, long-term experts, and short-term expert visits to deliver TA to the BPK (Table 2). Overall, this approach has worked well. Some issues were raised about the effectiveness of investing resources in research activities given the lower priority given by BPK management. In the area of banking supervision, the format of TA was adequate, but its implementation and modus operandi were questioned. A

key issue in this regard is the planning of the division of supervision responsibilities between the BPK Managing Director, MFD, and USAID.

Table 2. Kosovo: MFD TA Delivered during FY2000–FY2005

TA Activity	Number of Events/Visits	Field Time (Person/Years)
Multi-topic missions 1/	20	2.7
Long-Term Experts		
Management	5	5.5
Central Bank Accounting and auditing	1	1.0
Banking and Insurance Supervision		
Research Activities	1	0.1
Total	7	6.6
Short-Term Experts		
Organization/Information Technology	6	0.6
Research Activities	3	0.2
Payments System	50	3.1
Banking and Insurance Supervision	13	0.9
Total 2/	72	4.8

1/ Staff-led TA advisory missions, includes experts.

2/ An additional 0.473 years of TA was delivered by short-term experts in the topics of accounting, and AML/CFT Training.

16. There is general consensus regarding the good quality of the majority of the staff and experts that have contributed to the TA program. The authorities have appreciated their competence and expressed satisfaction with the quality of the advice delivered. However, there are some reservations about the performance and the modus operandi of certain MDs appointed by MFD. It is difficult to draw conclusions in this area, since the various parties provided completely different views on the performance and effectiveness of the managers. While there is consensus regarding the excellent performance and managerial skills of the current MD and the good performance of the third MD in closing BPK branches and reducing BPK personnel, the other three managers were not appraised as favorably. Some officials and staff were happy with their work, while others found that they were not fully prepared for the task and for handling contacts with BPK staff and foreign officials.

17. Considering that Kosovo uses the euro and has no independent monetary policy, one of the major responsibilities of the BPK is the supervision of the financial sector. Therefore, it seems that, in principle, an MD with a background in supervision (as the last two) would have been a better selection at the outset. Alternatively, if the MD was not an expert in supervision, some MFD staff visits should have been planned [to more actively coordinate and collaborate with USAID experts. MFD involvement in banking supervision increased in 2004 to monitor and coordinate the work of USAID experts. MFD direct involvement in banking supervision only began in 2004](#) with the recruitment of MD experts in supervision and with *ad-hoc* MFD missions. These missions, which have aimed at preserving the

soundness of the banking system and dealing with domestic banks in difficulty, have been largely successful in their tasks. Furthermore, the engagement of a peripatetic expert to assist the BPK in conducting on-site bank inspections has helped the BPK's efforts to build local examination capacity, and contributed to a timely resolution of one of the domestic banks.

D. Coordination of the TA Program

With other IMF departments

18. Coordination between EUR and MFD has been very good. The staffs of the two departments have worked together on all major issues at headquarters and in the field. The Fund resident representative has an office in the BPK and is informed and involved in the work of MFD missions. By contrast, EUR staff has not always been fully informed about short-term expert visits, and improvement in this area would be beneficial to further strengthen cooperation. Other issues of concern were the high turnover of MFD mission chiefs to Kosovo (four in six years) and the limited time available at headquarters for MFD mission chiefs to work on Kosovo.

With other TA providers

~~19.— One relevant issue to be reported in this area is the lack of coordination between the MD of the BPK, MFD staff, and the USAID experts in charge of supervision during December 1999–March 2005. It is clear that something went wrong with the licensing and supervision of the five domestic banks. The point here is to assess to what extent BPK management and MFD staff were responsible for the work performed by USAID experts since the amended UNMIK Regulation (No 2001/24) provided the BPK with the authority of licensing, supervision, and regulation of financial institutions.~~

~~20.— 19. Technical assistance in the area of banking supervision was provided by both MFD and other agencies' experts. As indicated above, MFD provided the Managing Director of the BPK; USAID provided the Deputy Managing Director in charge of supervision, as well as other supervision experts. MFD TA resources devoted to financial institution supervision gradually increased as USAID resources were scaled back, and as an expert with a supervision background took over as MD. MFD TA included advisory missions and the recruitment of one on-site expert to train BPK staff. Although it can be argued that such TA contributed to the discovery of weaknesses in some banks, the evaluator is of the opinion that these weaknesses could have been prevented by greater TA coordination and more TA to strengthen licensing and bank supervision (including on-site inspection). As indicated above, during the period 1999–2005 the BPK received technical support from USAID in the supervision of financial institutions. This included the use of USAID experts as Deputy Managing Directors with responsibility for this area. During this period, MFD (through the MD or through TA missions), paid relative little attention to the banking supervision area. Only in 2003/2004 when an expert with a supervision background took over as MD did MFD fully focus on this area. MFD TA has been provided by advisory missions and through the recruitment of one on-site expert to assess the status of the entire banking sector and train~~

~~BPK staff. This also coincided with the downsizing of USAID assistance to the BPK in this area from three experts to one. Since 2004 several weaknesses in the domestic bank have been discovered. It seems that licenses were granted even though some banks had only small and divided shareholders without the means or the interest to increase the banks' capital, if needed. The on-site inspections revealed misreporting, excessive loan concentration, high credit risks, little provisioning, large insiders' loans, and overall poor management and corporate governance.~~

III. TA EFFECTIVENESS

~~21.—20.~~ In this section an attempt is made to provide some concrete evidence of the impact that MFD TA has had on the BPK, the financial sector, and the economy as a whole. However, it is not possible to prepare a cost-effectiveness analysis since no data base is available to compare costs for TA in similar areas in other countries.

~~22.—21.~~ In order to better appreciate the impact of MFD TA on the BPK, it is important to note that no central bank and market-based financial sector existed in Kosovo at the end of the war. Kosovo was a disrupted region with little infrastructure and limited human resources and skills. Currently, Kosovo has a functioning BPK that has gradually taken over responsibility for supervision of banks and insurance companies. It has moved from a cash-only transaction economy to one with some interbank and giro payment systems. BPK accounting and international reserves management departments are working effectively, and despite limited resources, the Research Department provides useful data and information on the financial sector. Gradually Kosovar officials are taking over more functions at the BPK.

~~23.—22.~~ The gradual progress made in establishing the BPK and its activities in the financial sector have had an impact on the economy as a whole. As shown in Table 3, GDP stopped dropping in 2003 and positive growth was recorded in 2004. Inflation remains under control. Such progress was partly due to the increasing role of the financial sector in the economy. The degree of financial intermediation, as measured by the ratio of bank assets to GDP grew from 19 percent of GDP in 2002 to some 39 percent of GDP in 2005. Also, private deposits in the banking sector doubled from about 17 percent of GDP to 34 percent of GDP, and credit boomed from less than 4 percent of GDP to an estimated 21 percent of GDP.

Table 3. Kosovo: Macroeconomic Indicators, 2002–2005

	2002	2003	2004	2005
Real GDP Growth (in percent)	-2.9	-1.4	3.7	-0.5
Inflation (in percent)	3.6	1.6	3.4 <u>1.6</u>	2.6 <u>1.9</u>
M2/GDP (in percent)	41.0	42.6	44.9	47.6
Bank Assets/GDP (in percent)	19.3	24.0	31.8	39.2
Deposits of the Private Sector (in percent of GDP)	16.7	20.5	20.1	34.1
Credit to Private Sector (in percent of GDP)	3.5	9.6	14.9	20.9

Source: BPK

24.—23. At the BPK level, MFD TA has been very effective in building institutional and operational capacity, as shown below:

- **Management of BPK:** The BPK was created from scratch and the managers made a positive contribution in building capacity and managing TA implementation, despite some shortcomings, as noted above. Often under difficult circumstances and with limited resources, the various managers provided good guidance and ensured progress in building local capacity and in transforming the institution into a *de facto* central bank.
- **Central bank accounting and auditing:** Most of the projects started with MFD TA were completed, albeit with some delay. As a result, the BPK is able to prepare the monthly financial report within a week, while before it used to take about one month. The information in the accounts is now more accurate, transparent, and with all the relevant details. This also facilitates the task of the internal and external auditors. In the past external auditing was not possible because of lack of details in the BPK accounting system. Similarly, the more accurate and detailed accounts have allowed BPK to prepare a monthly cash flow report and monitor more accurately the execution of its budget.
- **International reserves management:** MFD TA has been extremely helpful in making it possible to design an investment policy. As a result, about 80 percent of BPK revenue is generated by the safe investment policy adopted by BPK. In addition, the capacity building efforts have paid off, and the department now operates without the assistance of foreign experts.
- **Research activities:** The work of the MFD expert has been greatly appreciated and effective. Despite the low priority assigned to this area, the BPK is now able to publish a monthly statistics bulletin with an analysis of the situation. Before, only data without comments and analysis were published. Two special bulletins on the

- banking sector and on the financial sector were issued recently. A first balance of payments is in the process of being finalized and is expected to be published in June 2006.
- **Payments system:** Advances in the payments system are the most remarkable achievement in the TA program in Kosovo. Kosovo has moved from a cash-based economy, with serious security issues, to a situation where it has a non-cash transfer system (Kos-Giro) and an interbank clearing system operated by the BPK, which performs immediate transfers among banks. Also the number of ATM machines and the use of credit cards have gradually increased, in particular in the capital, Pristina. As a result of the introduction of the interbank clearing and settlement system in May 2001, the volume of bank transactions increased from 301 transactions in 2002 to some 3,667 transactions in 2005, with a great impact on the economy as a whole. In addition to the TA provided for the switch from the DM to the Euro in 2001, it is important to emphasize the work done in addressing counterfeited currency and in reorganizing cash management and vault operations. The latter was one of the top priorities at the early stage. With MFD TA, BPK introduced the currency chest arrangement in 2003. This has allowed BPK to always meet its cash demand and to earn interest on investments abroad via deposits in reputable foreign banks. The “safety aspect and risk exposure” that was addressed by this arrangement cannot be overemphasized considering that in the past all cash was kept in local vaults, at very high security risk. Finally, it is important to note the cost-effectiveness of reorganizing the cash payments system and the closure of all 20 BPK branches leaving only the main office operating in Pristina in July 2002.
 - **Banking regulations and supervision:** With external technical support, the BPK has been able to ~~the BPK, with the support of USAID, has been able to~~ create a supervisory framework and introduce the basic regulations and structure for off-site analysis. As indicated above, some questions remain regarding the licensing and the effectiveness of off-site supervision of the banks. ~~supervision of the banks before MFD took full control of the supervisory system.~~ Since 2004/5, ~~MFD and~~ the BPK, supported by MFD’s TA, has been more attuned to ~~MD have been essential in~~ identifying emerging problems with the domestic banks by adopting a more aggressive supervisory policy and a well-focused program of on-site inspections. The latter have helped identify weaknesses in bank operations and contribute to restore soundness in the banking sector. One bank was liquidated in March 2006 and BPK, with MFD TA. MFD is ~~Following the liquidation of one bank in March 2006, the~~ BPK is addressing the remaining problems by urging recapitalization, change in management, transparency in the accounts, and compliance with supervisory regulations, with MFD and USAID TA. Finally, a monthly monitoring system for banks based on the CAMEL system to rate banks, identify deteriorating trends and take appropriate and prompt actions, is being developed.
 - **Insurance supervision:** Considerable work has been done in this area. As a result of MFD TA, the capital and reserves requirements have been increased in line with EU

requirements. Requirements for incorporated companies and branches have been harmonized, and a new regulation on reserve requirements based on a risk approach is under preparation in order to allow for the liberalization of insurance tariffs. Since October 2005, the BPK is a member of the IAIS.

IV. CONSIDERATIONS FOR FUTURE TA

~~25.~~—24. On the basis of the experience gained with MFD TA program in Kosovo, consideration should be given in the following areas for future TA to post-conflict countries:

- In the event the IMF is requested by the authorities to provide the management of the BPK, the selection of management positions should be carefully conducted to ensure that the expert has the skills, diplomacy, and experience to be effective and accepted by the local officials. In the case of Kosovo, considering that no independent monetary policy has to be implemented, supervision becomes prominent among all the central bank functions, suggesting the selection of a manager with supervision background. Also, it would be helpful to have an evaluation of the managers at the end of their assignments.
- In the case of countries that are dollarized or under a currency board, more emphasis is placed on areas such as accounting, supervision, payments system, and less on building up a full-fledged research department. Considering the limitation in implementing monetary operations, it would be better to gauge how much assistance is realistically needed at the early stage and consider using a peripatetic expert rather than a long-term advisor in the area of research activities.
- IMF Area Departments should be better informed about the visit of peripatetic experts and their assignments.
- Improved coordination with the work of other agencies' experts in the area of supervision is necessary when the responsibilities are shared. At the outset, some long-term planning should be agreed upon with other TA providers in order to have a better understanding of future MFD involvement. In the case of Kosovo, if it had been clear that MFD would have taken over the overall responsibility for the financial sector soundness after an initial period supported by USAID, some direct involvement of MFD staff or experts (including the MD) at an early stage would have been beneficial. This would have provided greater continuity in the TA program. More monitoring of the work of other agencies' experts (such as USAID in the case of BPK) in the area of supervision is necessary if an MFD expert is the MD of the institution responsible for supervision, or if MFD has to take over responsibilities from other TA providers. At the outset, some long-term planning should be agreed upon with other TA providers in order to have a better understanding of future MFD involvement. In the case of Kosovo, if it had been clear that MFD would have taken over the overall responsibility for the financial sector soundness after an initial period supported by USAID, some direct involvement of MFD staff or experts (including the MD) at an early stage would have been beneficial. This would have provided continuity in the TA program

~~and ensured that MFD experience regarding licensing and supervision in post-conflict/transition countries were also being implemented at the very outset.~~

- It would be desirable to limit the turnover of MFD mission chiefs.
- It would be helpful to build a database of MFD TA cost in TA areas in persons/years to establish benchmarks and facilitate cost/effectiveness comparisons.

APPENDIX
List of Contacts

BPK

Ajri Begu	Chairman
Michel Svetchine	Managing Director
Gani Gerguri	Deputy Managing Director for Payments System
Hashim Rexhepi	Deputy Managing Director for Financial Supervision
Florim Maxharraj	Cash and vault officials
Jeton Bajramaj	Cash and vault officials
Agim Tonuzi	Special Assistant to the MD (Reserve Management)
Shkendije Nahi	Reserve management official
Valentin Toci	Director of Research and Statistics Department
Hysni Rudi	Chief Accountant
Agron Dida	Inspector general Audit Department
Faton Ahmetaj	Acting manager Audit Department
Skender Klllokoqi	Legal Advisor
Edward Nolan	Advisor (Supervision)
Daniel Luczak	Advisor (Supervision)
Suzana Dervari	Chief Bank Examiner
Ibish Mazreku	Director Insurance Supervision Department

United Nations Mission in Kosovo

Alexander Borg-Olivier	Legal Department
Joachim Ruecker	Director General (member of BPK Board)
Chiara Bronchi	Head Fiscal Affairs Office (member of BPK Board)

USAID

David Leong	Deputy Mission Director
Besa Llazi	Program economist

IMF

Ake Lonnberg
Julia Majaha-Jartby
John Dalton
Karl Driessen
Scott Brown
Gerwin Bell
Dimitri Demekas
Rakia Moalla-Fetini

IMF Resident Representative

Marc Auboin

MFD Experts

Eddie Herron
Marko Skreb
Kim Rhee

Leonard Fernelius
Warren Coats