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Draft discussion paper for Round Table

"Banking, remittances, and the role of the central bank in promoting financial and private sector development in Somalia"

A. Introduction and main messages:

Somalia's financial system has been decimated by two decades of conflict. In January 1991, all state institutions that provided services and regulated the economy collapsed, including the Central Bank of Somalia and the entire banking system. The commercial bank liabilities that had survived the 1989 bankruptcy of the only commercial bank in the country disappeared. The country has also been suspended from accessing global financial markets, a situation that compromises the leverage of the Transition Federal Government (TFG) in domestic as well as international financial markets.[1] In addition, past circulation of counterfeit currency (by individuals) has led to inflation and hyperinflation and an increasingly dollarized system within the Somali economy.

In December 2006, the Central Bank of Somalia reopened its offices in Mogadishu and Baidoa, but it continues to have limited functionality. It is operating under Decree Law No 6 of 18 October 1968 (although a draft Central Bank Bill and Banking Bill have been developed). An incipient central banking authority has evolved in Puntland and Somaliland, through two regional banks. These have several branches and offer some commercial banking services, such as deposit accounts and trade finance. While their primary function as central banks remains (as it should be) acting as the treasurer of their respective regional governments, the fact that they also offer commercial banking services creates an undesirable conflict of interest with their role as central banks.

B. Financial Sector Development:

Overall financial sector development is dependent on a sound legal and regulatory framework and the ability of central banks to provide the necessary support and supervisory functions. Without a clear legal framework enforced by a functional regulator, there is little scope for attracting private sector investors to set up banks and other financial institutions in Somalia. The international community can work with the Somali authorities to establish the necessary legal framework and build the capacity of the central banking structures, focusing on a set of core priority functions. Investors have expressed an interest in establishing formal banking operations in Somalia, but have been constrained by the absence of a sound legal and regulatory framework, a strong property rights culture, enforceable collateral contracts, accessible credit information systems and related financial infrastructure.

In this context, the Somali financial sector remains underdeveloped, informal and unsupervised, with limited access to credit and savings, and no protection for consumers and financial institutions. Apart from the limited banking services offered by the Central Bank, the main actors in Somalia's financial sector are the Somali remittances companies, which have extensive networks of agents that service all towns and villages in the country, as well as major cities in countries populated by Somali diaspora. The limited functioning of the Central Bank also constrains private sector development as it constitutes a serious risk factor to the investment climate for ordinary Somalis and business operating in the country. A significant demand for financial services from both individuals and small-medium enterprises (SMEs) remains unsatisfied, even at basic levels.

The situation in Somaliland provides a more detailed view of the incipient nature of financial services in Somalia. The Bank of Somaliland, which was in its inception a regional arm of the Central Bank of Somalia, currently operates itself under a Somaliland 1994 "Constitutive Law". So far, the Bank of Somaliland is not in a position to perform key central bank functions, as it has not developed the typical

[1] Somalia relations with international creditors were frozen in late 1980s. As of 2007, Somalia's national debt stood at US$ 3.3 billion (of which 81% is arrears), comprising 40% owed to multilaterals, 46% owed to Paris Club creditors and 14% owed to non-Paris Club creditors**.**

instruments necessary to conduct monetary policy. The money issued by the Bank of Somaliland is not used in a uniform manner within Somaliland and is used only to a very limited extent by Somalilanders as a means of exchange or value storage, functions basically fulfilled by the US dollar. The Bank of Somaliland is to the largest extent involved in elementary treasury and government payment functions and at the same time offers rudimentary commercial banking activities, mainly offering national remittance services through its network of 14 branches and savings and current accounts to a limited number of clients, especially government bodies. So far no legal framework for commercial banks or Islamic banks has been created by the Somaliland Government, and no banking supervision function and regulatory know-how has been built-up within the Bank of Somaliland. The principal pillar of the current financial system in Somaliland is the remittance companies, which offer money exchange, remittance services, checking accounts as well as overdraft facilities for a small number of trusted customers. The largest remittance company, Dahabshiil, is estimated to handle more than 50% of remittance transactions as well as the money supply for most international organizations operating in Somaliland. Although no statistics are available it is clear that the remittances companies by far handle the largest part of the money flows within Somaliland. There is currently a new banking law under consideration before the Somaliland legislature that, *inter alia*, strengthens its regulatory functions in support of a commercial banking system. This is something that the remittance companies have requested, in order further to evolve their financial services in the region.

In light of these facts, there is a need to re-establish the Central Bank to a level that increases its operability on regular monetary policy functions (including as monetary agent of the government in its fiscal policy), while enabling it to assume its responsibilities towards the financial system, including setting up an environment conducive to developing the financial sector and private sector development. In the longer term, political and financial support will be indispensable for Somalia to settle its arrears with international creditors and eventually access international financial markets, closed since late 1980s.

(ii)Regulation and Supervision of the financial sector: Role of the Central Bank:

Although the initial absence of a role for monetary policy lessens the urgency for establishing the full array of central bank functions, there is an urgent need to strengthen the role of the central bank as the monetary agent of the government (a role currently being performed by commercial banks in Djibouti and Kenya for a fee) in order to re-establish commercial banking. Providing technical assistance to the Central Bank and establishing fiscal legislation for the government is needed to create a robust economy conducive to sustainable development. Developing a capacity for monetary policy at some stage will be crucial for the reconstruction and development of Somalia. The introduction of new and larger denomination of Somali shilling currency notes should carefully be reviewed and managed (on a ‘do no harm’ basis) by the Central Bank, and should be part of a longer term process, preferably after the transitional period.

The absence of an effective central banking authority also means that prospects for further financial sector development and monetary policy at large remain extremely limited. Under the circumstances, there is need for the reinvigoration of the Somali Central Bank to a standard where it can support Somalia through:

- Developing sound monetary and exchange rate policies and regulating money supply;
- Providing advice on macroeconomic issues to government and monitoring monthly economic indicators;
- Acting as a financial agent of the TFG in the issuance of debt; and
- Providing the groundwork/foundation for commercial banking services to operate legitimately in Somalia and also providing legal protection for their operations.

The Central Bank has received, in the last few years, capacity-building support and hardware such as bankers safes, currency valuators and currency counters. The Central Bank now has a SWIFT membership and net connectivity. Capacity building has included training within the Central Bank of Kenya for 16 professionals, and there are six technical assistants embedded within the Central Bank. As noted earlier, a draft Central Bank Bill and Banking Bill have been developed.

Support to the Central Bank of Somalia in the next few years, to enable it to undertake monetary policy, act as a financial agent of the government, and support financial sector development, would include training and systems development in the following areas, in order of priority:

- Drafting a new Central Bank Act and developing a monetary policy;
- Drafting a new Commercial Banking Law;
- Adopting a legal framework and undertaking training on Anti-Money Laundering and anti-terrorism financing; and
- Setting up payment systems;

Once this framework is in place, further work would focus on:

- Drafting regulations related to priorities such as: the bank licensing process; the definition of a standard chart of accounts; minimum capital reserves; and liquidity management; and
- Undertaking a comprehensive training program on bank supervision, banking business and financial analysis.

Beyond these areas, further work could be done to establish a debt management system, with adequately trained staff, and finally to undertake economic research and enhance the use of statistics.

(iii) Remittances in Somalia and their contribution to peace and security
In 2004 (the last year for which reliable estimates are available), remittances amounted to at least $1 billion, equal to about 70 percent of GNP. This amount was almost three times the average of $370 million in the 1980s and 1990s. It is estimated that remittances in Somalia constitute about 40 percent of the income of urban households. Most remittance transactions consist of relatively small amounts ($132 median), sent regularly to cover basic family needs, although some transactions are larger and are meant for investment. Most beneficiaries live in urban areas, with only 8 percent of transactions destined for rural villages. Both senders and recipients are evenly divided between men and women.

Most remittance companies that are active in Somalia have a transparent approach to (and abide by) regulations in the host countries where they operate. Within Somalia, the remittance companies are open to such regulation being better formalized. Through appropriate regulation of the remittance sector, anti-money laundering and combating financing of terrorism could be strengthened, greatly contributing towards security and stability.

Remittances currently finance many private sector activities in Somalia, providing some basic social services and other services such as electricity, telecommunications, domestic water supply and urban waste disposal. Whether invested or consumed, remittances have important macroeconomic impacts. They generate positive multiplier effects, while stimulating various sectors of the economy. This is particularly true for remittances that enter the country for real estate development, thus going beyond the 'remittance lifeline' approach (i.e., to serve basic needs) as they help to create jobs and indicate a vote of confidence in the country as remitters having a 'vested' interest in creating and maintaining stability.

Remittances and access to financial services, in as far as they present a source of income to ensure the provision of basic needs and financing for activities that contribute to poverty reduction and employment, contribute to a more peaceful and secure environment. This role is particularly relevant in Somalia, as alternative opportunities must be provided for vulnerable and disaffected youth to turn away from extremism or banditry. Especially in times of economic depression and external shocks, remittances have been extremely important to the Somali economy, because they tend to smooth consumption and thus create a "buffer" against volatility. Data show that remittance inflows have risen during times of hardship, such as drought, the Saudi livestock ban, and inter-clan warfare. There is also evidence that remittances are put to good uses, not only supporting the livelihoods of those that receive them, but also in helping to finance essential services such as education and health services as well as investments. For example, children in households of people receiving remittances have relatively good school attendance rates. With a reported 80 percent of Somalia's skilled population having left the country since the conflict began, the provision of education is clearly an urgent priority.

D. Conclusion:

The absence of a functional Central Bank in Somalia is a critical issue that needs to be addressed as matter of urgency. A functioning central bank is needed to execute monetary policy, act as a financial agent of the government, and support financial sector development that will enable longer-term investments and private sector led growth and development. In the longer run, a central bank will also be important to enabling Somalia to take the necessary steps to access international financial markets by settling arrears with creditors and then building a track record of public financial management over time that would warrant eventual debt relief.