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Conflict and Financial Reconstruction

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The last ten years or so have seen 56 major armed conflicts in 44 different locations, most of them civil wars.[1] Although the number of conflicts has fallen from its peak in the 1990s, 2001 saw a major international escalation of the Afghanistan conflict. Meanwhile, longstanding conflicts continue to rage in Colombia, the Democratic Republic of the Congo (DRC), and Sudan (to name but three). And others are in reconstruction from earlier civil wars, including Bosnia and Herzegovina, Guatemala, and Mozambique.

Different types of conflict have different financial effects. These include: guerrilla insurrections that disrupt the rural financial system (e.g. Colombia today, and Guatemala during its long civil war); cronyism in bank lending linked to autocratic rule (e.g. the Yugoslav Federation in the 1990s and Zimbabwe today); and temporary shutdowns in the financial system caused by military revolt (e.g. Côte d'Ivoire in 1999-2000 and Guinea-Bissau in 1998) as well as successful or attempted secessions (most recently East Timor and Kosovo).

Other types of conflict and their financial effects include: the looting of banks to finance genocide and profit from it (e.g. Rwanda in 1994); civil wars that leave central banks intact but otherwise damage financial infrastructure (Angola from the 1970s onwards and Mozambique during its 16-year civil war); and civil wars that comprehensively destroy the formal financial-system (e.g. Cambodia in the 1970s and Somalia 1992-94). Finally, there are inter-state conflicts in which formal financial institutions are stressed but nevertheless continue to operate (e.g. the 1998-2000 war between Eritrea and Ethiopia).

National priorities for financial reconstruction therefore vary significantly depending on the scale and character of the destruction as well as the country's institutional resources and human capital. And the political dynamics of the conflict (as well as the war-to-peace transition) also play a role.

There is no hard and fast dividing line between 'war' and 'peace', and 'post-conflict' is often a misnomer.

Notwithstanding the political challenges, countries should aim for a broad-based reconstruction that benefits the majority of people (and not just a narrow elite). Rebuilding the domestic financial system, so that normal economic activity and investment resume, is critical to success.

Currency Reform is both a Political as well as an Economic Issue

A currency is as much a symbol of statehood as a national flag (representatives of the separate communities in Bosnia and Herzegovina argued for months over what symbols should appear on the new currency). Territories that secede often introduce their own currency. Somaliland which broke away from Somalia in the early 1990s (a secession that is not yet internationally recognised) is one example. Eritrea used the Ethiopian birr for several years after independence before introducing its own currency (a factor in the breakdown in relations that led to war between the two countries).

Security considerations also motivate currency reform. Members of Rwanda's Hutu government fled to Zaire (now the DRC) with over two-thirds of the monetary base, including cash from the vaults of the

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National Bank of Rwanda. The rapid introduction of new notes in 1995 rendered the looted cash worthless, offset the deflationary impact of the stolen monetary base, and increased the policy credibility of the new Rwandan government.

Currency reform must be carefully designed. Angola's chaotic currency reform of the early 1990s destroyed much of the country's monetary savings. Many of the poor were unable to convert their old currency before it ceased to be legal tender.

However, the supply of currency is not always in the hands of the central political authorities. Somalia's warlords have periodically printed new currency and issued it through their own banks. This circulates alongside the old notes of the Siad Barré regime as well as foreign currencies. The nascent central government is unable to exert its authority, and monetary policy is left in private hands, thereby causing considerable disruption to normal economic life. Afghanistan is in a similar situation (see Box 1).

Many transactions in conflict-affected countries are conducted in foreign currencies. In 1999, Montenegro adopted the deutsche mark (euro) as legal tender alongside the Yugoslav dinar (this formalised the long-standing parallel market). The aim was to offset the impact of Serbia's hyperinflation on Montenegro. The Milosevic regime saw the move as an act of secession and declared it illegal (in March 2002, Serbia and Montenegro agreed to remain part of a single federation each with a separate currency).

In extremis, the national currency may be replaced with a foreign currency to shore up confidence. In East Timor the US dollar replaced the Indonesian rupiah. This policy is known as 'dollarization', since it is the US dollar that is usually adopted (although the euro is now an option as well, Afghanistan included). A new national currency may be introduced at a later stage after appropriate institution building has taken place (including a central bank in East Timor's case).

Box 1: **Afghanistan: Rebuilding a Shattered Financial System**

Afghanistan has a comprehensive and highly active informal financial system that has survived decades of conflict. At its core are the moneychangers, who take deposits and operate the foreign exchange markets. Using the hawala system they are able to make international transfers across the world. The supply of foreign exchange originates from cross-border trade (including the opium and heroin trade), the activities of warlords, and now from aid inflows.

At least 7 versions of the currency (the afghani) circulate, including those printed by previous Kabul governments, but also by warlords (the latter are worth much less in the foreign exchange market than 'official' afghanis). Substantial amounts of afghanis are still being privately printed, thereby undermining trust in the currency. Dollarizing the economy is one option to restore confidence.

Shortly before leaving Kabul, the Taliban and Al-Qaida leaderships looted US$ 6-7 million from the central bank's reserves. The hawala system and couriers subsequently transferred the money abroad. The central bank has lost many of its staff (as has the Ministry of Finance). International sanctions on the central bank have now been lifted allowing it to normalise relations with the international financial system. Afghan government assets frozen in 1999 have now been released, thereby providing the new Afghan Interim Authority with some resources. But considerably more resources as well as technical assistance are needed to strengthen the central bank, as well as other core state-institutions (the Treasury, the tax and customs administration, statistics etc.).

Under the Bonn Accords, a national assembly (loya jirga) is planned for June, to formalise the transition from the present interim authority to a more representative administration, which will in turn implement national elections in 2004 to establish a democratic government. The situation is fraught with dangers, needless to say.

A broad-based political settlement must be underpinned by a broad-based economic recovery that benefits the majority of Afghanistan's 20 million people. Rural livelihoods collapsed as a result of the physical and human destruction wrought by war (including land mines which claim roughly 500 victims every month) together with the Taliban's erratic policies and a three-year drought. Urban poverty is also widespread. The World Bank puts the cost of reconstruction at US$ 10 billion over 10 years. About US$ 4.9 billion is needed for the period covering the interim and transitional administrations (donors have pledged US$ 4.5 billion so far).

Dollarization improves policy credibility, but the authorities lose seigniorage revenue (especially valuable to the public finances when conflict reduces income taxes and sales taxes), and the ability to devalue to offset adverse terms of trade shocks. A national currency increases policy flexibility, but political uncertainties can cause destabilizing (inflationary) runs on the currency (and may add a large risk premium to domestic interest rates, thereby slowing the recovery of investment).

A currency board system is a halfway house: it improves credibility while not being as rigid as dollarization. Bosnia and Herzegovina's central bank operates a currency board in which the convertible marka (introduced in 1997 at the bank's inception) is pegged to the euro (previously the deutsche mark). This has kept inflation low. However, currency boards do have drawbacks. For instance a currency board cannot act as lender of last resort to distressed banks. And currency boards will eventually collapse if other policies are not supportive (as Argentina recently demonstrated). In summary, there are no easy answers to the issue of currency reform in conflict-affected countries.

Institution-Building is Imperative

A country's central bank may remain operational during civil war (e.g. Angola and Mozambique), it may shut down temporarily but reopen relatively quickly (e.g. Congo-Brazzaville and Rwanda), or shut down completely (Somalia's central bank remains closed after its looting in 1991, although the self-proclaimed Somaliland Republic opened a central bank in 1995). Technical assistance can sometimes improve a wartime central bank (e.g. Mozambique), but generally the institution's ability to run a coherent monetary policy and supervise the financial system degrades, often alarmingly.

Creating a central bank is high on the list of priorities for institution building in countries that have seceded. Eritrea established a central bank in 1993 shortly after independence from Ethiopia. But institutional capacity may initially be too meagre to create a fully operational central bank. The UN Transitional Administration in East Timor (UNTAET) created the Central Payments Office (CPO) to facilitate official payments, and CPO now has responsibilities for prudential supervision and regulation of the financial system, thereby laying the foundations for a future central bank. A central bank's *modus operandi* can also be highly political in a country that has undergone civil war, and ethnic feuding can damage the institution's credibility. The

Dayton peace agreement authorised the creation of a central bank for Bosnia and Herzegovina. Another stipulation was that the bank governor cannot be a citizen of Bosnia and Herzegovina or of a neighbouring country for the first 6 years of the bank's life (the first governor is a New Zealander).

Capitalisation (or recapitalisation) of the central bank must compete with other expenditure priorities (including humanitarian and social spending), and it can be undermined by an inadequate fiscal framework (the taxation and public-expenditure management systems often need to be rebuilt or created from scratch). In Liberia, recapitalisation has been endangered by the government's failure to honour its debts to the central bank. This is due to high presidential outlays, limited revenues (estimated to be one-tenth of their pre-war level), and escalating conflict.

Reviving the Commercial Financial System is Critical to Recovery

Resuming normal economic activity will be severely impeded without a revival of commercial banks and insurance companies. The provision of bank finance for working capital, fixed investment, and residential reconstruction must also restart.

Banks may take considerable time to restore their capital base, restructure their bad debts, and re-equip and re-staff themselves. In Rwanda, US$ 7 million was transferred from the network of rural bank co-operatives and into the hands of those responsible for the genocide: the number of bank clients fell to 42,000 compared with 400,000 before the atrocities. Two years after the end of Liberia's civil war, 78 per cent of commercial bank loans were classified as non-performing.

On the demand-side, loss of collateral (compounded by delays in property restitution), the destruction of business records, and difficulties in obtaining insurance combine to intensify the credit-market problems that typically disadvantage any but the largest borrowers. This hits small and medium sized enterprises which otherwise constitute a potentially powerful source of post-war employment growth. Damaged judicial systems also make it difficult to enforce contracts, thereby deterring lenders. Some of Rwanda's borrowers defaulted safe in the knowledge that creditors were unlikely to pursue them through the courts, which were overburdened in dealing with the genocide's perpetrators.

Increased Private-Sector Participation in the Financial Sector is Essential but Problematic

As a result of the pillage of state and commercial banks by insiders (often connected to powerful elites), financial systems are often insolvent (or close to it) prior to the start of major violence (e.g. Congo-Brazzaville, Indonesia, and Somalia). Much of the money makes its way abroad, and some (but not all) rich-country governments have stepped up their efforts to trace and freeze illegal transfers (e.g. those made by the Abacha regime in Nigeria).

Fiscal transfers traditionally covered the losses of state banks. But expenditures for post-war reconstruction and poverty reduction make large demands on public funds (which typically remain low until the economy's tax-base starts to recover). Therefore little public money is available to recapitalise state banks, and infusing private capital (both domestic and foreign) by means of complete or partial bank privatization is favoured. Mozambique's two largest banks were created out of the former state banking system in this way.

Privatization is not necessarily the most important means for increasing private sector participation in the financial system. In Ethiopia the entry of private banks in competition with the state-owned banks has been more important. And in Mozambique, new banks now compete with the privatized state banks. Ethiopia has been reluctant to allow foreign ownership in the financial system, while Mozambique has been much keener on foreign banks and on the technical expertise they can provide.

Although privatization and the licensing of private banks helps to recapitalise the system, the process can be highly non-transparent, especially when it begins during war. Some of Yugoslavia's state-owned banks were 'informally' privatized during the country's civil war, resulting in large asset transfers to war criminals. After donor-financed reconstruction began in Bosnia and Herzegovina, a process of formal (transparent) bank privatization was agreed, but the pace has been slow and this has impeded the recovery of private investment (recent IMF and World Bank loans have conditionality to speed up the financial reforms).

Private banks in conflict-affected countries are often licensed on highly favourable terms, especially in nascent offshore financial centres. Over 80 private banks were set up in Lebanon after the end of the civil war in 1992. International pressure to lift the country's tradition of bank secrecy has been applied (some of the profits of 'blood diamonds' mined in Angola and Sierra Leone have been laundered through Lebanon and the former Yugoslavia).

Strengthening Financial Regulation is Crucial but also Politically Challenging

Conflict-affected countries have seen the relaxation of controls on deposit and lending rates (and practices). This is a feature of financial liberalization across the developing and transition economies (in part reflecting IMF and World Bank advice and conditionality, although both institutions have become more cautious about liberalization following the 1997-98 Asian financial crisis). Financial liberalization has considerable merit for economies that have otherwise failed in the strategy of directing credit to selected priority-borrowers (state-controlled financial systems and directed credit worked well in the reconstruction of Japan and some Western European economies after World War II, and in the post-war reconstruction of South Korea in the 1950s).

But financial-liberalization only works when financial regulation and supervision improves as well (as financial crises over the last two decades demonstrate). Legal reform must also create clear property rights (for collateral-based lending) and punish fraud.

The weaknesses prevalent in the financial systems of developing countries are seen in acute form in conflict-affected countries. These include: banking legislations that either omit important prudential regulations or are imprecise; shortages of supervisory skills in financial authorities; and supervisors unwilling to enforce prudential regulations.[2] Considerable technical assistance is required. Professional staff must also be paid a salary commensurate with their responsibilities (otherwise they will leave for the private financial-sector). This requires significant public funds.

Political interference in supervision is acute in conflict-affected countries, especially when the oversight provided by such democratic institutions as parliamentary committees and an independent media is weak or absent. Warlords may own private banks and other financial institutions, originally capitalised with war booty (e.g. Liberia and the countries of the former Yugoslavia). The international community's

High Representative to Bosnia and Herzegovina had to impose special legislation to protect bank regulators from intimidation. A number of Cambodia's private banks are alleged to have laundered money arising out of drug trafficking and illegal logging, and some regulators are also alleged to have received bribes connected to the licensing of these banks.

Furthermore, the legal framework in which to pursue bank fraud is often grossly inadequate and corruption is often rife. Mozambique's attorney-general was sacked in 2000 after allegations in parliament that his office had been slow to investigate the theft of US$ 14 million from a former state-owned bank before it was privatised, and that suspects had been tipped off to flee the country. An official of the central bank, and a widely respected journalist, were both recently murdered while investigating fraud in Mozambique's banking system.

Not surprisingly, bank crises are frequent in conflict-affected countries. Fourteen of Bosnia and Herzegovina's banks have collapsed since the end of the war in 1995, including one that held NGO and donor accounts. In 2000 two of Mozambique's largest banks reported losses totalling US$ 177 million for 1999.

Bank crises result in credit contractions which undermine growth. And their fiscal cost is often substantial (thereby taking resources from development spending, including pro-poor services and infrastructure). As a part shareholder in the country's two largest banks, the Government of Mozambique's share of the losses is estimated to be US$ 130 million (3 per cent of GDP).

Financial Reconstruction is Important for Broad-Based Recovery

The key challenge is therefore to rebuild economies so that the benefits of recovery are spread as widely as possible across society, and especially down to the poor. Such broad-based recovery requires considerable institution building, together with the reform of institutions that are not working well (and whose deficiencies may have contributed to the general economic decline that often precedes the outbreak of civil war). However, narrow reconstruction-which benefits a political and economic elite, sometimes including those who profited from war-will occur unless national authorities prioritise the poor. Democratic oversight of state-institutions to ensure that they act in the public interest is also critical. And the international community must provide adequate technical assistance, as well as external finance, to support national priorities.

When there are so many humanitarian needs and so much human misery connected to war, it might seem overly narrow to discuss currency reform, bank regulation, and all the other seemingly arcane issues of financial-sector policy. But there is little prospect for a fast recovery in output and employment without a well-functioning financial system. And without economic recovery, demobilised fighters will have few livelihoods other than war and crime, and economic hardship will enable demagogues to exploit ethnic rivalries and tensions, thereby undermining peace itself. ■

Box 2: **Key Points**

- *National priorities for financial reconstruction vary, depending on the type of conflict, the country's resources, and the characteristics of the war-to-peace transition*
- *Introducing a new national currency or adopting a foreign currency as legal tender is usually necessary and has both political as well as economic motives*
- *Central bank functions must be rebuilt, or created from scratch, and this demands considerable financial and human resources*
- *Reviving the commercial financial system is impeded by both damage to banks themselves, as well as the destruction of the records of borrowers as well as their collateral*
- *Recapitalising the banking system often requires privatization but this process can be non-transparent, and unsound private banks have sometimes been created*
- *Prudential regulation and supervision is crucial to protecting the public interest and for avoiding destabilizing financial crises*

Further Reading

Addison, T., A. R. Chowdhury, and S. M. Murshed (2002). 'By How Much Does Conflict Reduce Financial Development?', Paper presented at the 3rd Annual International Conference of the Finance and Development Research Programme, University of Manchester, April 2002 (paper available through www.wider.unu.edu).

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[1] Conflict data are from M. Sollenberg and P. Wallensteen (2001) 'Patterns of Major Armed Conflicts, 1990-2000', in Stockholm International Peace Research Institute *SIPRI Yearbook 2001: Armaments, Disarmament and International Security*, Oxford: Oxford University Press: 52-68.

[2] See M. Brownbridge and C. Kirkpatrick (2000). 'Financial Regulation in Developing Countries', *Journal of Development Studies*, 37 (1): 1-24.

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