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FINANCE IN CONFLICT AND RECONSTRUCTION

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Abstract

The relationship between an economy's financial sector and the occurrence and resolution of conflict may at first sight appear tenuous. Banking systems, financial regulation, and currency arrangements do not appear to be relevant in understanding why nations collapse or why people kill each other. However, the linkages between the financial sector and issues of conflict are closer than one might expect. Narrow development—development that fails to reduce poverty and which exacerbates initial inequalities—is an important cause of conflict (but, needless to say, not the only one). Narrow development must be financed—and it is financed in ways that increase poverty and inequality and raise a society's propensity to violent conflict. During conflict, finance (both internal and external) can be decisive in determining who wins, as well as the duration of war. Rebuilding the financial system is important to reconstruction from war, since otherwise private investment is constrained. But 'post-conflict' economies generally have weak regulatory authorities, and the financial system may be flooded with unsound loans, leading to economic problems that can endanger economic recovery and therefore peace.

JEL Classification: 010; 055
Keywords: aid; conflict; financial development; sub-Saharan Africa

'Nowadays that prince that can best find money to pay his army is surest of success' (Sir William Davenant, 1605-1668)[1]

'A dollar a day keeps the Woyane away' (anti-Ethiopian slogan in Eritrea, February 1999)[2]

1. INTRODUCTION[3]

There were at least 37 active conflicts in 1999, nearly all civil wars (Wallensteen and Sollenberg 2000). The causes of conflict are now the focus of intense debate, and attention to socio-economic causes—particularly high income inequality, economic instability, and the contest over natural resource wealth—has increased (Addison, Le Billon, and Murshed 2000a, Nafziger, *et al*. 2000).

The relationship between an economy's financial sector and the occurrence and resolution of conflict may at first sight appear to be tenuous. Banking systems, financial regulation, and currency arrangements (to name just three finance topics) do not appear to be relevant in understanding why nations collapse or why people kill each other.

However, the linkages between the financial sector and issues of conflict are closer than one might expect. Narrow development—development that fails to reduce poverty and which exacerbates initial inequalities—is an important cause of conflict (but, needless to say, not the only one). Narrow development must be financed, and the financial sector thereby plays a role in increasing poverty and inequality, both of which increase the probability of violent conflict (discussed in section 2). During conflict, both domestic and foreign finance affect the duration of conflict (and thus its humanitarian costs), and can be decisive in determining who wins (section 3). If peace can be achieved, then rebuilding the financial system is important to achieving broad-based reconstruction, since otherwise private investment is limited (section 4). And more public spending on reconstruction can be funded if domestic capital markets recover. Last of all, conflict and 'post-conflict' countries face difficult choices in currency reform, which are exacerbated by institutional weaknesses. Our conclusions emphasise the importance of strong financial regulation and supervision, which can only be truly effective in the context of democratization (section 5).

2. FINANCING NARROW DEVELOPMENT

Conflict countries generally have a history of 'failed'/'distorted'/'unbalanced' development that exacerbated initial inequalities (along class, regional, and ethnic lines) thereby fuelling relative deprivation and conflict. We label such development 'narrow' in order to distinguish it from 'broad-based' development that spreads its benefits widely across society, in particular to the poor. Resource-rich countries have a greater propensity to conflict, since they often fail to invest their resource rents in broad-based development (see Addison, Le Billon, and Murshed 2000a, 2000b).

This is not the place to rehearse how such narrow development contributes to conflict—see instead Nafziger *et al*. (2000) and Klugman (1999). However, we note that the financial sector plays a role in narrow development and therefore in the process of generating conflict. It does so in at least three ways.

First, agrarian societies with high income-inequality—for example El Salvador, Guatemala, and the Philippines—have high land-inequality and deep poverty, often involving discrimination against indigenous people. Agrarian elites use their collateral to further leverage their existing wealth through a financial system that they control by means of family/business cross-holdings. The coffee economies of Central America—which have had recurrent insurrections—display this nexus par excellence (Paige 1997).

Second, use of the state banking system to finance private accumulation increases a society's propensity to conflict. State banking systems in Congo-Brazzaville (civil war in 1997) and Somalia—to take just two examples—eventually collapsed under portfolios of bad loans, as state assets were eventually 'mined out' for personal gain. This contributed to the economic decline that fed into conflict, which in turn subsequently destroyed much of the financial system in Congo-Brazzaville (now in an uncertain recovery) and Somalia.

Third, weak financial regulation facilitates the accumulation of wealth by means of fraud, especially in newly liberalised financial systems. Fraud destroys savings and therefore living standards and thereby increases the risk of conflict. The collapse of Albania's financial pyramid schemes in 1997 is the major example. Many Albanians invested in these schemes, attracted by very high (and unsustainable) interest rates. Despite repeated warnings by IMF and the World Bank advisors, the central bank was unable to act given the political connections of the pyramid bankers (Kolodko 1999). Once the growth of deposits slowed (as eventually it must in all pyramid schemes), the banks were unable to meet their redemptions from new deposits, and they collapsed (their liabilities represented about half the country's GDP) leaving thousands destitute (Jarvis 1999). The resulting conflict wrecked the country, causing a major refugee crisis. Weapons from the large arsenals established by the previous communist regime were also looted and shipped into Kosovo.

Countries that have otherwise achieved some development success may also be undermined by financial distress. Indonesia, for example, has been widely applauded for its achievements in reducing poverty over the last thirty years. Yet, the financial crisis of 1997-99—due in large part to crony capitalism which undermined the quality of the financial system—sparked widespread violence against ethnic Chinese and intensified existing regional conflicts in Aceh, East Timor, and Irian Jaya.

In citing these examples we do not claim that narrow development (and the role of the financial sector in it) is the sole cause of conflict, or necessarily the most important. Conflict is far too complex a phenomenon for it be reduced to some mechanical causal process in which economic decline ignites social unrest. But we do emphasise that events in the financial sector can contribute to social catastrophe, a link that is little recognised.

3. FINANCING CONFLICT

The mobilization of resources affects both the incentive to engage in conflict (more resources increase the chance of winning) together with its duration, and is often decisive; Louis XIV of France famously remarked that 'the last guinea will always win' (Kindleberger 1993: 6). On the government side (either in inter-state wars or civil wars), a well-functioning financial system is crucial to mobilizing resources for the military. Consequently, wars are periods of major financial innovation; for example during the British-French wars from the late 17th century onwards, both sides established central banks, debt and money markets (Kindelberger, 1993: 7). Historically, states often increased their control over banks (by directing credits to the war effort, insisting on the purchase of public debt, and outright nationalization).[4] This is also evident in contemporary conflicts, but we also see financial reform as well when the state system is not up to the task or running a wartime financial system; the cases of Angola and Croatia.

External capital inflows to finance war include remittances from diasporas as well as commercial and official borrowing. Diasporas can provide substantial finance to rebels: Kosovar Albanian resistance is funded by a well-established informal payroll tax on Kosovar Albanians working in Germany. The LTTE (Tamil Tigers) in Sri Lanka use Hawala systems—trust-based international transfer mechanisms that are a popular means to circumvent exchange controls in South Asia (the governments of India and the UK have agreed to monitor Hawala transactions, and to take action to reduce illegal transfers through them). Remittances enabled Eritrea to cover its trade and fiscal deficits during the 1998-2000 war with Ethiopia: private transfers amounted to US$ 384.4 million in 1997, whereas official transfers were only US$ 41.4 million (IMF 1998). Given the number of recent wars, it would not be surprising if transfers by diasporas to finance both governments and rebels amounted to at least US$ 1 billion in 2000. Moving this amount of money through the international financial system—both legally and illegally—requires close knowledge of banking practice and sometimes technical assistance from international organised crime.

Commercial borrowing by belligerents is extensive. The Government of Angola has for over a decade borrowed on the basis of its oil revenues to buy arms and mercenaries. These loans peaked at US$ 2.2 billion in 1994, when the government was consolidating its military success over UNITA. With a maturity of about four years, they now have to be repaid and in the first quarter of 1999, more than 95 per cent of the Government’s oil share (i.e. US$ 260 million) was used in debt service (thereby limiting scope for development spending). With renewed fighting, new oil-collaterised loans have been disbursed in 1998 and 1999 (Le Billon 1999). Many established European banks have financed the Angolan government, but new players are evident as well: a Russian bank, (Menatep) has, reportedly, long been involved in 'oil for arms' deals organised by French companies.[5]

Rebels may raise large foreign loans on the basis of resource wealth; the confederacy obtained US$ 14 million from French bankers in 1862 using the cotton crop as collateral.[6] Today, Somali warlords who control the profitable banana-growing region and its exports, are able to maintain good credit with foreign banks (in both Kenya and Europe). Rebels can also mortgage future resource-revenues. Laurent Kabila's insurrection against Mobutu in Zaire/Democratic Republic of the Congo (DRC) was financed in this way (Balancier and de la Grange 1999). Once it became clear that the AFDL had a good chance of winning, private financiers were eager to stake a claim to the country's mineral resources; Kabila reportedly raised US$ 300 million in a few weeks, including finance from a Canadian mining company. Once in government, Kabila turned to the governments of Angola and Zimbabwe to provide military assistance as well as to finance his regime's defence against former allies (Uganda and Rwanda). A Zimbabwean company with close links to Zimbabwe's political leaders and senior military officers took control of Gecamines, while Angola's state oil company, Sonangol, took over the DRC's oil reserves: '... the 'invited countries' are repaying themselves the money Kabila borrowed during the AFDL war, funding the current war and making a profit into the bargain'.[7]

The existence of a national currency is important to war finance since its issue provides seigniorage revenue (especially important when external budget-finance is unavailable to the war-economy). Eritrea would have been seriously disadvantaged in its 1998-2000 war with Ethiopia if it had not, shortly before the war, replaced the Ethiopian birr with its own currency (a policy change that the Ethiopian government interpreted as a hostile act). Rebels may run a financial system in occupied areas and sometimes they issue a currency This may consist of informal 'chits' presented for future payment against goods and services supplied by the local population—often under duress—which then circulate as a means of payment. We return to currency issues, in the context of reconstruction, in section 4.

3.1 Cutting finance to war

Action to cut the external finance of wars (or to drive up its cost) may be one means to hasten their end. But any interventions by the international community must be carefully considered, since action is likely to have asymmetric effects on belligerents, which may not be predictable, leading to outcomes that are not welfare-improving. Indeed, by cutting financial flows to belligerents they may undermine legitimate rebellion against tyranny. Moreover, members of the international community are far from being disinterested actors; many continue to provide official financial flows (or turn a blind eye to private flows) to oppressive governments.

We now move on to make three basic points about what is a large and complex issue:

(1) The sums obtained from mining 'blood' diamonds and other 'point' resources (as well as 'diffuse' resources such as timber, ivory etc.) often require large transactions to be made through the international financial system, opening up the possibility of freezing accounts and confiscating the money. Since rebel movements and governments sometimes ally themselves with international organised crime (or become sophisticated criminal networks themselves), action against organised crime partly constitutes action against the finance of conflict (Bassiouni 1997). The profits from drugs and other illegal activities can be so large that they often change the nature of the conflict itself, reducing the importance of political goals, with rebels and government actors preferring a profitable low-intensity conflict to larger-scale warfare (as in Cambodia and Colombia for example).

Angola is a further illustration of these points. From 1992 to 1998 UNITA earned somewhere between US$ 2 billion and US$ 3.7 billion from diamond mining (Global Witness 1998). UNITA and the diamond brokers need sophisticated financial instruments to execute safe and rapid transfers to upstream providers, bank accounts in fiscal heavens, and downstream buyers. These instruments include front door companies (e.g. those operating in Côte d'Ivoire) and bank accounts held by 'friends' (who can plausibly deny UNITA connections). UNITA accounts are held in established banks (including some who also lend to the Angolan government); for example the six accounts held in UK high street banks mentioned—but not named—by the UK's Minister for Africa, Peter Hain, in 1999. Subsequently (in late 1999), the Bank of England froze UK accounts linked to UNITA in compliance with UN financial sanctions against the movement, introduced after UNITA went back to war (Le Billon 1999).

But the globalisation of finance eases UNITA's problems in parking its money, since modern communications technology, and the complicity of the authorities, enables transfers to be readily executed from countries with otherwise deficient infrastructure. For example, the recent report to the UN security council on the violation of Angolan sanctions specifically cited the absence of any action by Morocco to freeze UNITA assets which had been deposited with the knowledge of the authorities prior to the imposition of sanctions (UN 2000). UNITA also has powerful friends, both public and private. The UN panel concluded that President Eyadema of Togo and deposed President Bedié of Ivory Cost aided UNITA in circumventing the financial sanctions. Diamond buyers generally need bank loans since diamonds cannot easily and immediately be converted into cash on the Antwerp, London, or Tel Aviv markets. UNITA has also accessed international lenders by mortgaging future diamond production (through Swiss banks). Diamond sales themselves are used to launder the money of buyers through over-invoicing. Therefore, influential private interests are not anxious to cooperate with the authorities, and may actively subvert enforcement.

(2) Belligerents can also thwart sanctions by using financial centres in former 'third-party' conflict countries; these are keen to attract business and apply liberal rules to encourage inflows to revitalize domestic money and capital markets (with de jure or de facto encouragement by government authorities, equally keen to attract foreign capital inflow). Beirut is a case in point. Before the civil war, Lebanon was Middle East's pre-eminent financial centre, a position it is rapidly regaining (see section 4 for the implications for Lebanon's own reconstruction effort). Lebanon's banking regime is one of the most liberal in the world, and there are no restrictions on capital movement. Private banks provide strict bank secrecy for their clients, and are therefore attractive for any belligerent—both from within the Middle-East as well as outside it. Private and state banks may also be under the control of active or former belligerents, operating in countries with compliant governments, and therefore quite willing to take funds from other war financiers. Liberia is a case in point, and one we return to in section 4.

(3) In addition to action launched through money markets, intervention through capital markets is necessary. The case of the DRC-Zimbabwean diamond mining consortium Oryx Diamonds, which has links to the Zimbabwe Defense Force (ZDF) and possibly the DRC’s president, highlights the issues. In June 2000 Oryx tried to obtain a London stockmarket listing by a reverse takeover of Petra, a Bermuda-based diamond company with Zimbabwean and South African interests. Reportedly, Peter Hain, the UK’s Minister of State for Foreign Affairs, intervened to stop this launch through a 'deterring discussion' with Petra's financial advisers, accountants Grant Thornton, which later said that it would not act for Petra if the deal was approved. In preventing the company from listing on a

major stock exchange, this action raised the company's cost of capital, but it does not prevent Oryx applying to list on any other major stock exchange, or on an emerging market stock exchange.[8] Again, co-ordinated international action is necessary, but given the large number of financial centres available, it is unlikely to occur rapidly.

4. FINANCE IN RECONSTRUCTION

Obviously reconstruction is best facilitated by complete peace. But reconstruction often starts in conditions of 'incomplete peace' (Afghanistan, Chechnya before the resumption of war in 1999, Rwanda and—an extreme case—some regions/localities of former Somalia). As a result, reconstruction often stalls when war restarts (for example Angola). The boundary separating conflict from reconstruction is often murky, and high levels of violence may continue despite a peace agreement. Many observers therefore argue that the term 'post-conflict' is unhelpful (see Crisp 1998). This basic point must be kept in mind when discussing any facet of reconstruction, including the financial sector.

Many points could be made about reconstruction strategies, Here we make only two. First, reconstruction should not be about recreating the past, when previous patterns of development were narrow, and created conflict. Reconstruction is too often seen as a process of rebuilding infrastructure (banks, housing, roads, airports etc.)—which repeats previous patterns of development—and too little attention is given to changing societies and their institutions (Addison 2000a).

Second, economic policy is frequently a contributor to conflict favouring one socio-economic group over another. Moreover, if policies that distort investment decisions (and hence the allocation of credit) remain unreformed then the social return to reconstructing the financial system is low. Such policies include price disincentives, burdensome regulation etc. Therefore, changing economic policy—whether we call it reform, adjustment, or transition—is necessary for both conflict avoidance as well as effective reconstruction (Addison 2000b). But this leaves open major issues of reform design: for instance how should financial reform and fiscal reform be sequenced? Getting reform design wrong, imposes large costs on any society—but getting it wrong in a fragile 'post-conflict' society can be truly disastrous. Fundamentally, policy change, reconstruction, and the creation of peace should be the *same* agenda—not separate agendas. But this is often not the case, since state capacities are generally weak and the external agencies—the Bretton Woods Institutions (BWIs), the UN, the bilateral donors, the NGOs etc—have their own areas of responsibility. As Macrae (1999: 17) notes, these problems are not just managerial, but are often juridical in nature: when the state is weak, priorities are ill-defined, and there is no authority to ensure that all actors, including donors, adhere to them. Therefore opportunities for ensuring greater complementarity between policy change, reconstruction, and peace creation, are often missed.

To take our topic further, we discuss the reconstruction issue under two headings: (1) reconstruction of the banking system and capital markets, and (2) the issue of currency reform for a reconstructing economy. We do not discuss the role of finance (particularly micro-credit and micro-insurance) in reconstructing communities—crucial as this is (Mosley and Hulme 1998). Later work will encompass the community-finance issues.

4.1 Reconstructing the banking system and capital markets

A well-functioning financial system is important to reconstruction: private investment must be financed if growth is to be achieved, and private investment recreates markets (for goods and labour) in areas where conflict has destroyed market networks. To take one example, food-security in post-conflict Africa depends on private investment in trading and marketing (especially since fiscal pressures preclude the recreation of marketing authorities).

How conflict affects the financial system—and therefore the nature of the reconstruction task—very much depends on the nature of the conflict itself. Losing an inter-state war may leave the defeated nation with some financial infrastructure (including institutional capital), even if severely damaged: Germany's position in 1945, Serbia's in 1999 (but not Chechnya's in 1996).[9] Internal conflict can result in catastrophic damage to the financial system (Afghanistan, post-1973 Cambodia, and Somalia), severe damage (Bosnia and Herzegovina, Congo-Brazzaville, Lebanon, and Sierra Leone), confine damage to rural areas and smaller urban centres (Angola, Ethiopia, and Mozambique), or be limited to areas of guerrilla insurrection (El Salvador and Guatemala). Each category has different implications for financial reconstruction (and its cost).

A key policy question is how far the financial system should be decontrolled (liberalized) post-conflict, and the respective roles for state-owned versus privately-owned financial institutions. After World War Two, Western Europe gradually liberalized product markets (eliminating wartime rationing) but continued to exercise intensive state control over the banking system for a much longer period. Japan directed credit to priority sectors through the state-owned Reconstruction Finance Bank: in 1949 this institution was responsible for one-third of lending to industry (Hamada and Kasuya 1993: 161). Underlying such control is a strategy to allocate meagre post-war savings (together with Marshall Aid) to sectors identified as priorities by planners, which implies credit rationing for non-priority sectors. Countries that did not receive Marshall Aid—for example Finland—financed post-war reconstruction mostly out of domestic savings, and accordingly used a number of state controls over the banking system and flow of funds to achieve this (Paunio 1993: 147).

The modern context is very different; direct state control of the financial system is very much out of favour. In many contemporary conflict countries, controls were in place pre-conflict as part of state-led development strategies (for example Angola, Guinea Bissau, Mozambique) and centrally planned economies (for example the conflict countries of the former Soviet Union such as Armenia and Georgia). In some cases they were extended during wartime (Angola and Mozambique). Ceilings on interest and deposit rates as well as directed lending were typical, usually implemented through a state banking system (sometimes fusing together central bank, commercial bank and development bank functions in a single institutional network under state ownership). The effects of such financial repression are well known: negative real interest rates contributed to declining savings rates and to the slowdown in growth that preceded conflict. In the twilight of state socialism (both in the FSU and SSA), credit was increasingly directed towards enterprises in which political elites had personal interests, a contributing factor to some conflicts as we noted in section 2. This is not to imply that state intervention in the financial sector is always growth-inhibiting: there are well-known cases in which it has contributed to development, including the post-war reconstruction and subsequent high growth of South Korea. But in conflict countries, the track record of direct state control of the financial system is poor.

Therefore, many contemporary reconstructions include financial liberalisation, especially when reconstruction is BWI-financed. Deposit-rate ceilings are relaxed in order to raise the aggregate savings rate and to reduce the investment-savings gap that is generally very large post-conflict. At least some domestic investment in recovery can then be financed from domestic savings when intermediated through a rebuilt financial system. If deposit-rate ceilings are removed then loan rates must be liberalised as well (to maintain the profitability of the financial system). There is little discussion among today's policy-makers of resorting to post-WWII type recovery mechanisms to direct credit to priority sectors; this may be a reasonable position in countries with a history of extreme rent-seeking, but it is a policy recommendation that needs more thorough assessment.

In principle, the decision to move to market mechanisms in setting interest rates (and allocating credit) can be separated from the decision to privatise state banks, and allow new private banks (Brownbridge and Gayi 1999). In practice the two measures often go together; state banks usually need recapitalization (and may have collapsed entirely) and private sector money (often foreign) is used to capitalise and reinvigorate the management of former state banks (pressure on government budgets forces the pace of privatisation, in any case).[10] Although financial liberalisation and bank privatisation often go together under BWI-supported programmes—a good example is Mozambique[11]—some countries have been slower than others (for example Ethiopia) in yielding to IMF pressure on this issue (Addison and Alemayehu Geda 2000).

4.2 Prudential regulation and supervision

For financial liberalization to achieve its reconstruction and growth objectives, it must be complemented by large institutional investments, particularly in prudential regulation and supervision by the monetary authorities.[12] In the case of new states, such as Eritrea, this required the creation of a central bank from scratch. These are key investments that governments ignore at their peril. But they are often very difficult, given limited domestic expertise.

Moreover, regulatory capture is common in conflict/'post-conflict' societies. In the absence of democratic institutions to oversee and protect impartial financial regulation, banks are often free to act as they please. Private banks are often owned by powerful political actors, including present and former warlords. Liberia is a case in point. The bank serving the interests of warlord (and later president) Charles Taylor during the conflict was the 'Bong Bank', established by his brother, Gbatu Taylor. This was initially capitalized using the proceeds of equipment plundered from foreign mining companies. The Bong Bank was used to collect fees from Taylor's other businesses, including logging (Reno 1995). It is unlikely that any central banker will act against Taylor's interests.

Similarly, in Cambodia some 33 private banks were licensed to operate during the transition from war to peace in the 1990s. Of these, only 12 are considered to be 'legitimate' by industry observers. The others do not offer the usual retail banking services, but are reported to serve the interests of groups reportedly engaged in money laundering, drug trafficking, illegal logging, and other illicit activities. The National Bank of Cambodia (NBC) also had its own agenda in multiplying the number of banks despite its weak regulatory capacity since there are numerous official and informal fees and fines associated with the licensing of a bank. The NBC governor is alleged to have arranged for a government loan of US$ 3 million to capitalize a private bank, the Credit Bank of Cambodia (CBC) in 1994. In 1995, CBC's assets were frozen at the request of a Canadian securities firm trying to recover CBC's loss of US$ 1.5 million on the Chicago futures market. The investigation, impeded by both CBC and NBC's governor, revealed that one of CBC's main shareholders was under indictment in Canada for laundering drug money, and that NBC’s governor had authorised illegal transfers of CBC frozen assets to a close friend and high ranking official, as well as to a company in Paris owned by his nephew.[13]

4.3 The public debt market and the reconstruction of the state itself

The fiscal position of conflict/post-conflict countries is almost always precarious. Expenditures are high (military expenditures are high immediately after war, and then reconstruction expenditures rise after the immediate post-war demobilisation is achieved) and revenues are low (unless the country enjoys large resource-revenues: the case in Angola). Therefore fiscal deficits before aid grants (if these are available) are generally very high: in Mozambique's case the fiscal deficit before grants averaged 10-20 per cent of GDP in the five years after the end of war (Addison and de Sousa 1999). In some cases, the fiscal deficit is contained at a non-inflationary level but at the cost of low levels of public spending on essential social and economic infrastructure (for example Eritrea after independence but before the 1998-2000 war with Ethiopia).

Therefore it is important to develop a market for public debt, so that public spending on reconstruction can be financed without resorting to monetization of the fiscal deficit. Moreover, public debt provides an asset for nascent private institutions to hold and trade (and may attract foreign buyers, thereby encouraging private capital inflow). However, pre-conflict capital markets were often thin—especially in SSA's conflict countries—reflecting policies of financial repression, and inappropriate fiscal policies (which made public debt an unattractive asset). Hence, financial reform is critical to resurrecting (or creating from scratch) domestic capital markets. Lebanon has been successful—reflecting in part its history as a regional financial centre (noted in section 3). Sovereign debt readily found foreign buyers, and this in turn increased interest in corporate paper.

4.4 Currency issue

A key function for the state is to issue a currency: North (1997) reminds us that institutions such as currencies arose to reduce transactions costs in market exchange, thereby creating the need for states. Moreover, establishing a national currency is as much a symbol of nationhood as issuing passports or raising the national flag. But currency arrangements are often highly politicised in conflict/post-conflict societies. Negotiations to introduce a new currency in Bosnia and Herzegovina were stalled for months by disagreements between Bosnian Serbs and Muslims over what symbols to use on the new bank notes.[14] Political objectives—especially the need to secure peace—must be factored in alongside the economic technicalities in making choices.

Again, the starting point in contemporary conflicts is highly variable. Cambodia (in which money was, for a time, 'abolished') and Somalia (in which fighting destroyed the central bank) are extreme cases.[15] In Somalia, the dollar was widely circulated alongside the notes of the old Barre regime after the abortive US-led humanitarian intervention of 1992 (Mubarak 1998). In Somaliland—which is de facto independent—a very weak local currency circulates. At times, the various contending Somali warlords have attempted to issue their own currency (using notes printed outside the country) and to create banks.[16] If successful, warlords gain seigniorage revenue (thereby financing their military operations) but also gather around their own activities the symbols of a state, thereby increasing their chances of eventual international recognition. In this they have local business allies (warlords are themselves businessmen) who have an interest in reducing the high transactions costs associated with the present uncertain monetary arrangements. In effect Somalia's private sector is trying to create state institutions, in a process that resembles that described by North (1997) in other historical contexts.

Historically, monetary reform was essential to post-war recovery: many scholars cite the 1948 monetary reform in (West) Germany as critical to the resumption of economic growth (Milward 1984). When national currencies are very weak, and uncertainty is high, a currency board may be the appropriate solution (the case in Bosnia and Herzegovina). In extremis, it may be better to use a major convertible currency—which will in any case be in parallel circulation—thereby making de jure a de facto situation (until such time as a national currency can be introduced). Yet this has its costs: the credibility of economic policy is improved, but the post-conflict economy cannot adjust to external shocks via devaluation, and seigniorage revenue is forfeited.

5. CONCLUSIONS

In summary, our paper has emphasised the role of the financial sector in generating narrow development (or decline) that exacerbates existing social tensions and creates new ones. The finance of war is often a decisive factor in who wins, and therefore international action to reduce war-finance and increase its cost may be one way to encourage peace—provided that such action is implemented across the international community.

In 'post-conflict' economies, problems may arise in managing the loan portfolios of banks due to the fragility of economies (especially when agrarian based), the absence of credit histories of potential borrowers (when long wars have shrunk the private sector), the property speculation that accompanies post-conflict reconstruction (Beirut and Maputo are examples), political pressures on lending decisions, and—critically—incomplete peace which raises loan risks. In the context of central banks with only weak regulatory capacities (and subject to political pressure) this amounts to an explosive mix. The dangers of financial liberalisation when regulation is weak are emphasised by Stiglitz (1998, 1999) and Kolodko (1999) in the context of East Asian and transition economies.

Addressing these problems is even more urgent in conflict-prone economies since bank crises can impart massive economic shocks—which destabilize fragile societies—and their resolution typically entails large fiscal costs, to the detriment of reconstruction expenditures.

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[1] Quoted in Davies (1996).

[2] 'Ethiopia: Pride and Prejudice', *Africa Confidential*, Vol. 40 No. 4 (19 February 1999).

[3] Earlier versions of this paper were presented at the UNU/WIDER conference on 'Why Some Countries Avoid Conflict While Others Fail', Helsinki 20-21 October 2000, the International Political Science Association (IPSA) RC#40 Workshop, Lester Pearson International Centre, Dalhousie University, Halifax, Canada, August 8-11, 2000, and the conference and programme advisory group meeting of the DFID Finance and Development Research Programme, 9-10 July 1999, hosted by the Institute for Development Policy and Management (IDPM), University of Manchester. We are grateful for comments and discussion at those meetings, in particular comments from David Black, Jean Daudelin, Mari Fitzduff, Valpy FitzGerald, James Hentz, Jeff Herbst, David Hulme, Susan Johnson, Colin Kirkpatrick, Marianne Marchand, Philip Nel, Dorothy Rosenberg, Tim Shaw, and Ian Taylor.

[4] On the management of wartime economies, the classic analysis remains that of Keynes in 'How to Pay for War' (Keynes 1940). See Fitzgerald (1997) for a discussion of Keynes' themes in the context of contemporary conflicts.

[5] Lettre du Continent, ‘Angola: une affaire ‘franco-russe’?’, 30/09/1999.

[6] http://www.financialhistory.org/civilwar/1861-1865/south/securities.html

[7] http://www.crisisweb.org/projects/cafrica/reports/ca05maina.htm

[8] *Africa Confidential* Vol. 41 No. 11 (26 May 2000); *The Economist* 16 June 2000; and Global Witness, personal communication. 12 June 2000.

[9] Chechnya can be classified as an internal war or an inter-state war.

[10] Moreover, privatisation proceeds may be earmarked to provide for compensation for loss of property during conflict—the case in Bosnia and Herzegovina—and this intensifies pressures for rapid privatisation of all state enterprises.

[11] Foreign capital from Malaysia and Portugal has been used to recapitalize banks created out of the privatised state banks in Mozambique.

[12] Polizatto (1993: 174) defines prudential regulation as the '... codification of public policy towards banks, while banking supervision is the government's means of ensuring the bank's compliance with public policy'.

[13] *Phnom Penh Post*, 2 June 1995.

[14] A new currency also ends one means by which resources are transferred from an occupied territory to the occupier. For example, in the Israeli occupied West Bank and Gaza areas, the circulation of the Israeli currency provided seigniorage revenue (and therefore a resource transfer) to Israel. Hamed and Shaban (1993: 132) estimate that this resource transfer amounted to 1.6 to 4.2 per cent of Palestinian GNP over 1970-87 (in 1990 US dollars: US$ 0.7 billion to US$ 1.8 billion).

[15] After the Khmer Rouge seized power in Cambodia in 1973 they '... blew up the central bank and dumped the currency reserves in the street, as so much garbage' (Brogan 1998: 160). However, at least some of the currency reserves found their way into private bank accounts abroad, never to be seen again.

[16] In the latest attempt US$ 5 million worth of notes printed in Canada were imported during mid 1999. One attempt to establish a bank in Somalia using Malaysian capital ended in the assassination of Malaysian bank representatives.