Reconstructing and Reforming the Financial System in Conflict and 'Post-Conflict' Economies

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Reconstructing the financial system in countries affected by violent conflict is crucial to successful and broad-based recovery. Particularly important tasks include: currency reform, rebuilding (or creating) central banks, revitalising the banking sector, and strengthening prudential supervision and regulation. Encouragement of private capital into the banking sector must be balanced by protection of the public interest, a task made more difficult by the nature of war-to-peace transition. Bank crises can destabilise economies in recovery from war, and their fiscal burden takes resources away from development and poverty spending – thereby threatening 'post-conflict' reconstruction itself.

I. INTRODUCTION

Discussions of economic policy traditionally sideline the phenomenon of violent conflict as if it were a minor occurrence. But there were at least 115 armed conflicts over the period 1989–2001, with effects that increasingly

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The Journal of Development Studies, Vol.41, No.4, May 2005, pp.703 – 718
ISSN 0022-0388 print/1743-9140 online
DOI: 10.1080/00220380500092861

cross borders.[1] Violent conflict influences the behaviour of state and private sector actors in addition to its considerable institutional damage; it cannot therefore be ignored as a factor shaping economic policy.[2]

The financial sector is no exception. The looting of financial institutions is common (for example, Afghanistan, Iraq, and Rwanda) as is physical damage and loss of life (for example, the Tamil Tiger attack on Sri Lanka's central bank in 1996). The scale of these effects depends on the nature of the conflict itself, varying from guerrilla insurrections that disrupt rural financial institutions, but not the system as a whole (for example, Colombia today and Guatemala during its civil war), to military revolts that cause temporary shutdowns in the financial system (for example, Guinea-Bissau in 1998) to civil wars that destroy central banks and most formal financial institutions (for example, Somalia 1992–94).

In addition to direct disruption and destruction, conflict has two important indirect effects on the financial system. First, conflict alters preferences for different types of asset – as between precious metals and deposit accounts for instance – and for domestic versus foreign currency (the longer and more intense the conflict, the greater the incentive to substitute into real stocks of value and into foreign currency). Second, conflict affects the governance of financial institutions, including the behaviour of their managers as well as those who regulate them. Stealing from banks by insiders and elites is one manifestation of the more general breakdown in governance that characterises the slide into civil war. Again, countries show considerable variation in outcomes with policy responses being an important determinant of how badly the financial sector is affected. Some states may resort to the printing press to finance war and they may be unable to prevent the breakdown of the banking system and its regulation – or unwilling if state actors themselves steal from banks (the case of Mobutu's Zaire in the 1990s) – while other states may manage the wartime economy reasonably well thereby retaining the public's confidence in the currency and the financial system as a whole (largely the case in both Eritrea and Ethiopia during their 1998–2000 war).

In contemporary conflicts, the effects on the financial system are largely negative, and these negative effects increase with the *intensity* of conflict [*Addison, Chowdhury and Murshed, 2002*]. This is similar to conflict's impact on other economic variables such as fiscal measures which also tend to deteriorate as conflict intensifies [*Gupta et al., 2002*].[3] These negative effects can persist after a peace agreement because there is often no hard dividing line between 'war' and 'peace', and the contending parties may repeatedly break any agreement, thereby generating considerable uncertainty for financial decision makers. This is not to say that some kind of workable peace cannot be achieved – the recent peace agreements in Angola and Sri

Lanka are promising – but applying the label 'post-conflict' to the Democratic Republic of the Congo and Liberia has been largely futile. And for territories such as Eritrea and East Timor (now Timor Leste) that successfully secede, new financial institutions must be created – notably a central bank as well as a currency.

This article focuses on selected issues in the reconstruction of the domestic financial sector, together with financial reform, in conflict-affected countries (both those in war and those which may be 'post-conflict'). It highlights the choices that must be made, and the tensions that exist, in financial-sector policy. The analysis starts with a discussion of currency reform and the reconstruction (or creation) of a central bank, both important tasks in providing the monetary framework for reconstruction (Section II). We then discuss the revitalisation of the banking system, including its recapitalisation (Section III). Section IV highlights the problems encountered in strengthening prudential financial regulation and supervision in conflict countries. Section V concludes by re-emphasising the importance of avoiding bank crises to post-conflict recovery, as well as the importance of taking a conflict perspective on financial-sector policy.

II. CURRENCY REFORM AND CENTRAL BANKS

States facilitate market exchange by acting as a monopoly supplier of a currency. When state authority collapses, wholly or partially, private suppliers of currency will emerge. If their currency becomes widely accepted, then private suppliers will enjoy the seigniorage revenue that normally accrues to states. Following the collapse of the Somali state in 1991, contending warlords have periodically printed new currency and introduced it into circulation alongside the old notes of the Siad Barré regime, sometimes through their own commercial banks [*Mubarak, 2002*]. In Afghanistan at least seven versions of the currency (the afghani) circulated until 2003, including those printed by successive Kabul governments as well as warlords. About three-fifths of the money printed between 1996 and 2001 was not authorised by Afghanistan's central bank.[4]

Currency reform can be undertaken by states during conflict – as part of programmes to restore some measure of macro-economic stability – and it is often essential to programmes of post-conflict recovery. Currency reform itself can take a variety of forms: introducing new currencies for new states; introducing a new version of the national currency; legalising the parallel circulation of foreign currencies; and replacing the national currency with a foreign currency [*Brück, 2001*]. It also has a variety of motivations, political as well as economic.

New Currencies for New States

A currency is as much a symbol of statehood as a national flag, a factor that motivated Somaliland to introduce a new currency when it broke away from the rest of Somalia in the 1990s (a secession that is not yet internationally recognised). Similarly the rebel movement in southern Sudan has printed its own currency, and the Kurdish areas of Iraq have used their own foreign-printed version of the dinar (the so-called 'Swiss dinar') since 1991. But in addition to its role as an assertion of independence, a new currency also provides seigniorage revenue (an important supplement to often meagre indirect and direct tax revenues); it permits the use of monetary policy to target growth and inflation objectives, and it provides scope for assigning the exchange rate to offset external shocks or to act as a nominal anchor to curb high inflation. Hence, new countries may use the currencies of others as a transitional arrangement, but most eventually see it as desirable to introduce their own. Thus, after independence, Eritrea continued to use the Ethiopian birr, but introduced its own currency (the nakfa) in 1997, once the Bank of Eritrea had built up sufficient capacity to run an independent monetary policy [*Hansson, 2003*].

Introducing a New Version of the National Currency

The new Afghan authorities have restored a measure of confidence to the financial system by withdrawing the many versions of the afghani in circulation and replacing them by new notes that carry special security devices. Similar security considerations, as well as the need to restore economic activity, motivated Rwanda's 1995 currency reform. Members of the former Hutu government responsible for the genocide fled to Zaire (now the Democratic Republic of the Congo) with over 30 billion francs (two-thirds of the monetary base) including cash from the vaults of the National Bank of Rwanda, intending to finance their planned insurgency [*Kayizzi-Mugerwa, 2000: 9*]. However, the rapid introduction of new notes rendered the looted cash worthless, offset the deflationary impact of the stolen monetary base, and increased the policy credibility of the new government.

The introduction of a new national currency must be implemented carefully, both to avoid excessive and inflationary expansion of the monetary base, as well as destruction of household wealth when households are unable to convert their old currency before it is rendered illegal tender. The Angolan government's confusing and chaotic currency reform of the early 1990s destroyed much of the country's monetary savings, particularly those of poor households many of whom were unable to convert their old currency before the deadline. The government made vague promises of restitution, but these were worthless given the country's hyperinflation at the time.

Legalising the Parallel Circulation of Foreign Currencies

Conflict is usually associated with the increased domestic use of foreign currencies, reflecting both loss of confidence in the national currency as well as disruptions in its supply. Governments may find it advantageous to make this de facto situation de jure. In 1999, Montenegro adopted the deutsche mark as legal tender alongside the Yugoslav dinar (and introduced an inter-bank market in deutsche marks), thus formalising the long-standing parallel market. The intention was to lessen the destabilising impact of the hyperinflation in Serbia, associated with the economic turmoil of the Milosevic regime. The government was also politically distancing itself from Belgrade, and the Yugoslav federation in turn responded to what it saw as an act of secession by declaring the currency reform illegal.

Replacing the National Currency with a Foreign Currency

In January 2000, the UN Transitional Administration in East Timor (UNTAET) established the US dollar as the official currency, replacing the Indonesian rupiah [*Valdivieso et al., 2000*]. The currency reform was motivated by the desire of the Timorese to rid the country of a colonial symbol, the rupiah's collapse (the result of Indonesia's own political and banking crises), together with the increased importance of dollar transactions in economic activity, itself the result of large aid inflows [*Valdivieso, 2000*]. The rupiah and the Australian dollar continued to be used in some private transactions, but the US dollar's acceptance was encouraged by mandating its use for all compulsory payments to the public authorities [*IMF, 2000a*]. Introducing a national currency remains on the agenda for the future [*McLeod, 2000*].

In summary, the menu of options is large and the type of currency reform must be carefully thought through, balancing economic and political concerns. Dollarisation improves policy credibility, but eliminates the seigniorage revenue associated with a national currency. Devaluation to offset either adverse terms of trade shocks or the potential 'Dutch disease' effects of aid inflows (or a natural resource boom) is no longer possible; the tradable goods sector will then lose competitiveness and this can hinder overall economic recovery. Introducing a national currency increases policy flexibility, but political uncertainties may add a large risk premium to the domestic interest rate (thereby slowing private investment in reconstruction) and cause destabilising (inflationary) runs on the currency.

One further option for gaining credibility while avoiding dollarisation is a currency board under which changes in the country's monetary base are determined by changes in the reserves of a major convertible currency, in support of a fixed exchange rate [*Williamson, 1995*]. A currency board will therefore build confidence in the domestic currency provided that the public believe that the authorities will hold to this monetary rule. But gaining credibility in this way comes at a cost; the authorities have no discretionary power to change the monetary base to affect the level of economic activity or to act as a lender of last resort to distressed banks. These are especially important considerations in conflict-affected economies where ensuring buoyancy in the real economy is crucial to reducing social unrest and achieving/securing peace, and where the banking system is often in considerable turmoil (see Section III).

The currency board system often arises in discussion of conflict-affected countries and territories, most recently in the cases of Iraq and Palestine [*Naqib, 1999; Svejnar, 2003*]. But Bosnia and Herzegovina is the only contemporary example of its implementation; the 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).[5] This has been generally successful in helping to stabilise the post-war economy. Evidence on effectiveness otherwise comes from the British colonies which operated currency boards before independence (mostly with success), and also from a mixed group that ranges from Argentina (failure) to Hong Kong (success). It is difficult to generalise from this diverse evidence for the conflict-affected group, but one conclusion does stand out; currency boards are not sustainable unless other elements of the policy framework, in particular fiscal policy, are supportive. Thus conflict-affected countries should only consider a currency board after a coherent macro-economic framework is in place.

Whatever the final choice of currency system, the capacity of the monetary authorities to implement the necessary reform effectively is of critical importance. The central bank may reopen relatively quickly following conflict; Rwanda's central bank reopened within a year of the genocide. But Somalia's central bank remains closed after its looting in 1991. In Liberia, the pre-war National Bank of Liberia was moribund until replaced by the Central Bank of Liberia in 1999 (three years after the end of the war) under an IMF staff-monitored programme before its operations were again shut down by the intensification of conflict over 2002–2003 [*IMF, 2000b*]. In many cases central banks continue to function, but with varying degrees of effectiveness, during high-intensity internal conflict (for example, Angola) and likewise during most recent inter-state wars (for example, the Eritrea–Ethiopia war of 1998–2000). In a few cases the institution may strengthen rather than degrade; for instance technical assistance was provided to the Bank of Mozambique as part of the adjustment programmes that began in the mid-1980s during the war.

Creating a central bank is high on the list of priorities for institution building in newly independent countries. Eritrea established a central bank in 1993 shortly after independence from Ethiopia [*Hansson, 2003*] as did breakaway Somaliland. In these two cases, domestic political processes initiated the creation of a central bank. But in Bosnia and Herzegovina and Timor Leste the initial impetus came from the international community, and was part of the peace process itself. Thus, the Dayton Peace Agreement that ended the Bosnian war in 1995 authorised the creation of a central bank, and stipulated that for the first six years of its life, the bank governor should not be a citizen of Bosnia or of a neighbouring country.[6] During the transition to independence in Timor Leste, UNTAET created the Banking and Payments Authority (BPA) which is the institutional foundation stone for an eventual central bank.

III. REVIVING THE BANKING SYSTEM

The efficient clearing of domestic and foreign payments, the use of deposit accounts by households and enterprises, and the provision of loans for private investment are all essential for the resumption of normal economic activity. The business of the financial sector also has an important poverty dimension. For example, foreign remittances as well as financial transfers within countries are a crucial part of the informal safety net in many conflict-affected countries (the Afghan, Eritrean and Somali diasporas remit substantial sums home).

Restarting bank lending can be highly problematic, with constraints on both the supply and demand sides of the credit market. On the supply side, banks may suffer losses of both capital and personnel. In Rwanda, the mortgage bank, the Caisse Hypothécaire de Rwanda (CHR) was completely plundered. Civil war had very damaging effects on rural banking services in Angola and Mozambique and some US$ 7 million in cash was transferred from Rwanda's network of rural bank cooperatives (the Union des banques populaires du Rwanda, or UBP) to the camps of the 'genocidaires' in Zaire (DRC). Only 20 per cent of UBP's staff remained by the end of the genocide and UBP's accounts were still in disarray five years after the genocide since many of the bank's records were lost [*IMF, 2000d: 22*].

On the demand-side, war can create large numbers of distressed borrowers among previously sound enterprises through the loss of markets together with the destruction of equipment, accounts, and the death or flight of key personnel. Uncertainties in ownership of collateral, delays in the restitution of property, and the collapse of insurance markets together impede the resumption of a functioning market in bank credit. The problems of asymmetrical information between borrower and lender that characterise credit markets are greater in post-conflict economies due to the loss of financial records, and this can crowd out all but the largest and most well-established borrowers. Small- and medium-sized enterprises – a potentially powerful source of post-war employment growth – can find themselves entirely reliant on retained profits and informal credit (including remittances) for their investment finance (although, as in Timor Leste, donor aid may support some small enterprise development).

The Rwanda genocide, for example, led to widespread financial distress among domestic enterprises. Borrowers who had lost their collateral asked banks for further loans to rebuild. Some borrowers defaulted, safe in the knowledge that creditors were unlikely to pursue them through a judiciary system that was in any case overburdened in dealing with the genocide itself [*Kayizzi-Mugerwa, 2000: 14*]. Legal disputes also arose over unauthorised withdrawals from bank accounts during the genocide, and this further paralysed the banking system. As a result, conflict leaves banks with substantial levels of bad debt. Some 30 per cent of the loans of Rwanda's commercial banks were classified as non-performing in 1995 [*IMF, 2000d*]. In Liberia, 78 per cent of commercial bank loans were classified as non-performing at end-1998 – two years after the cessation of fighting [*IMF, 2000c*].

Furthermore, state-owned banks and private banks are often in deep distress *prior* to the outbreak of violent conflict due to their pillage by politically-connected insiders (examples include Burundi, Indonesia, Zaire/DRC, Somalia and the former Yugoslavia). Wholesale reform and recapitalisation of the financial system are therefore likely to be on the policy agenda irrespective of any eventual violent conflict.

Recapitalising state-owned financial institutions entirely from public funds runs into the objection that there are many competing and higher priorities for the use of public money including urgent humanitarian and poverty reduction programmes (and revenues are often meagre until the tax base starts to recover). Fiscal pressures therefore provide an impetus for complete or partial privatisation, which accordingly features strongly in the conditionality of donor-financed reconstructions (for example, Bosnia and Herzegovina and Mozambique).[7] Given the large infusions of private capital and technical skills needed to resuscitate banks, most conflict-affected countries have sought foreign investment through both privatisation and licensing new banks, often involving joint ventures with foreign capital (Afghanistan, Bosnia and Herzegovina, Timor Leste, and Mozambique are examples).

The exception is Ethiopia where the government has resisted IMF pressure for privatisation, opting instead to restructure and improve the managerial accountability of the largest state bank [*Addison and Alemayehu Geda, 2003*]. New private banks have been created with domestic capital, but the

Government of Ethiopia has resisted opening the system to foreign banks citing its need to first build the appropriate regulatory capacity. While foreign banks can bring much-needed capital and skills – and in the case of Bosnia and Herzegovina they offer competition to locally-owned banks, some of which are connected to organised crime and war criminals – foreign capital is certainly no guarantee against bank crises, especially when regulatory capacity is weak (see Section IV on the bank crises eventually experienced by Mozambique's privatised banks).

Whatever the route chosen to reinvigorate the banking system, it must be sequenced with appropriate reform of the legal system [*World Bank, 2001: 57*]. Banks in conflict-affected countries often hold excessive levels of reserves reflecting a reluctance to lend when the legal system is under-developed and property rights are insecure. In Timor Leste, for example, the banks prefer to invest the bulk of their deposits abroad rather than lend at home [*IMF, 2002a*]. And when they do lend, banks in conflict-affected countries add a large risk premium because they know that most bad loans are unrecoverable through the courts; the interest rate is then higher, and the level of private investment lower, than under a well-defined system of property rights. But even the best written legislation will be ineffective when democratic oversight of the judicial system is weak, a major issue in the nascent democracies of many post-conflict countries.

In summary, a large measure of financial reform is almost always necessary to ensure economic recovery, and while the basic outlines of the reforms are similar to those in non-conflict countries, the tasks are tougher, the resources are scarcer, and the political constraints are more severe. Furthermore, the task of prudential regulation and supervision is much more challenging in the conflict-affected group for reasons that we now discuss.

IV. STRENGTHENING PRUDENTIAL FINANCIAL REGULATION AND SUPERVISION

Historically, post-conflict reconstruction often involved an increase, not a decrease, in the state's control over the allocation and cost of credit – examples include Japan and Western Europe after World War II, and South Korea after the Korean war [*Addison, Le Billon, and Murshed, 2001*]. In contrast, contemporary reconstructions favour financial liberalisation; this reflects the generally greater weakness of state capacities (and often extreme rent-seeking in state-controlled financial systems), fiscal pressures, and the conditionality attached to IMF and World Bank lending.

At the same time it is widely recognised that a market-based financial system must be subject to effective prudential regulation and supervision.[8] However, the latter needs considerable institutional investment (usually in the central bank) and takes time, but often lags market liberalisation. The result is a perverse sequencing whereby '... often more visible aspects of reform, such as complete interest rate deregulation, bank recapitalisation, or more recently, the creation of stock exchanges, have been pursued before basic infrastructure in finance – auditing, accounting, legal systems and basic regulations – have been prepared' [*Caprio, 1996: 1*]. This weakness then shows up in a variety of ways. Brownbridge and Kirkpatrick [*2000: 8*] group problems in the reformed prudential systems of developing countries into three categories: (i) banking legislations that omit important prudential regulations, or which are insufficiently precise; (ii) shortages of supervisory skills in financial authorities and; (iii) 'regulatory forbearance' whereby supervisors are unwilling or unable to enforce prudential regulations, often due to political interference, so that an early response to emergent banking problems is inhibited resulting in the eventual eruption of severe bank crises. The latter factor lies behind the finding by Kane and Rice [*2001*] that the duration of African banking crises increases with the level of government corruption.

Conflict-affected countries are particularly prone to the perverse sequencing problem, in part because private banks can typically reopen for business and manoeuvre much faster than the authorities can build regulatory capacity. The private sector typically has greater resources than the public authorities, and the state faces many other urgent priorities for its funds, including poverty reduction, which compete with the need to strengthen the central bank. Indeed, the private sector can use its greater resources to bid skills away from the authorities. Considerable technical assistance is therefore needed, and this has been provided by the IMF and the treasury departments and central banks of donor countries to Afghanistan, Mozambique and Sierra Leone among others. But as Caprio [*1996: 4*] notes for developing countries as a whole: '... experienced supervisors estimate that it could take many countries 5–10 years of substantial training before their supervisory skills would be near the capacity found in industrial countries'. The time lag before full effectiveness is achieved can be very long for conflict-affected countries.

This is not to say that progress cannot be made. Timor Leste's nascent central bank (the Banking and Payments Authority) started to develop a prudential regulatory framework based on Basel Core Principles during the transitional period to independence [*Valdivieso, 2000*]. But generally, prudential supervision remains very weak in conflict-affected countries. Not surprisingly, conflict countries are concentrated in the lowest group (at the 'initial stage of building supervisory structures') in the classification by Mehran *et al.* [*1998*] of progress towards better banking sector supervision in sub-Saharan Africa.

Regulatory forbearance is a major problem in developing and transition economies, but can become acute in the conflict-affected group. Powerful elites straddle the public and private sectors and while banks in all countries eagerly recruit the politically well connected to their boards, the countervailing powers of parliamentary oversight and an independent media are stronger in non-conflict countries. Such elites can therefore exercise considerable influence over the licensing of banks, the nature of privatisation, and can ensure that private interests prevail over the public interest in the conduct of financial regulation. In extremis, warlords may use war booty to capitalise banks that they own [see *Reno, 1995* on Liberia]. War criminals were linked to Bosnia and Herzegovina's payments bureaus (an institutional legacy of the socialist era) which exercised a lucrative monopoly on domestic payments transfers that initially stalled financial reform (these were eventually shut down, but banks linked to alleged war criminals continue to operate in the Republika Srpska).[9] The international community's High Representative to Bosnia and Herzegovina imposed legislation to protect bank regulators from intimidation, but the influence of organised crime is pervasive. In Cambodia, a number of private banks established during the war-to-peace transition allegedly engaged in money laundering relating to drug trafficking and illegal logging, with the central bank exercising often weak supervision [*Addison, Le Billon, and Murshed, 2001*].

Furthermore, the legal framework in which to pursue bank fraud is often grossly inadequate, reflecting slowness in legal reform and corruption within the judiciary. In 2000, Mozambique's president sacked the attorney-general, in response to parliamentary allegations that his office had been slow to investigate the theft of US$ 14 million from the former state-owned bank Banco Comercial de Moçambique (BCM) before it was privatised. In November 2000, the independent journalist and editor of the well-respected newsletter *Metical*, Carlos Cardoso, was shot dead while investigating fraud at BCM, and allegations of a link from his assassination to elements in the country's elite emerged during the 2003 trial of his killers.

Licensing is often on highly favourable terms, and this can impede international efforts to combat money laundering and the global financial flows associated with conflict, aside from the adverse effects on the country's own financial stability. Lebanon has seen the creation of 83 banks since the end of the civil war in 1992 in an effort to re-establish itself as a regional banking centre. Unfortunately, Lebanon's tradition of bank secrecy facilitated money laundering, including flows from other conflict-affected countries such as the profits of 'blood diamonds' mined in Angola and Sierra Leone. Lebanon was placed on the G7's blacklist of 15 countries whose banks are suspected of money laundering. The central bank subsequently tightened its regulations but it remains to be seen how effective these are.

In summary, banks in conflict-affected countries display in acute form all three weaknesses identified by Brownbridge and Kirkpatrick [*2000*] for developing countries as a whole. Moreover, inadequate financial records and loss of staff, often linked to the pillage of banks before and during conflict, impede the construction of accurate and timely accounts. Thus, the application of the developed-country model of prudential regulation – with its emphasis on capital adequacy and loan loss provisions – is severely constrained by often gross inaccuracies in asset valuations, and chaotic recording of loans and payments.

Not surprisingly, bank collapses are frequent in conflict-affected countries, including both privatised banks and new banks. Fourteen of Bosnia and Herzegovina's banks have collapsed since the end of the war in 1995, including one which held a number of NGO and donor accounts. In 2000 Mozambique's two largest banks, BCM and Bank Austral, which were created in the post-war bank privatisation programme, announced substantial losses from non-performing loans; one independent estimate puts the scale of the losses at US$ 400 million [*Hanlon, 2002: 53*].[10]

Bank crises have major fiscal implications when the government is the sole owner or a part-shareholder (as is the case in Mozambique). The government of Mozambique will have to contribute at least US$ 100 million (about 3 per cent of GDP) to the recapitalisation of the two distressed banks, with the finance provided by the issue of treasury bonds [*IMF, 2002b: 5*]. Although Mozambique's internal debt is low – and thus the issue of the additional treasury bonds does not endanger the government's overall solvency – the resources used in the recapitalisation do have a significant opportunity cost; this borrowing could have been undertaken to fund poverty reduction instead. Moreover, the crisis has placed aid donors in a very uncomfortable position since they are providing Mozambique with considerable budget support as well as external debt relief under the Heavily Indebted Poor Country (HIPC) Initiative, and both forms of assistance are highly fungible. Donors therefore have a direct interest in seeing a proper and transparent resolution of the banking crisis, including the recovery of money lent improperly, so that the final fiscal bill is reduced.

Bank collapses threaten macro-economic stability when the contraction in bank lending induces recession and as the exchange rate comes under pressure from loss of confidence in the financial system. The social costs can be large, with serious effects on low-income groups. Diwan [*1999*] finds that labour bears a disproportionate share of the cost of financial crises – when the economy goes into recession and unemployment rises – while taxpayers partially compensate capital (private shareholders) when the government contributes to the eventual bank recapitalisation. In one of the worst cases, Albania in 1997, the collapse of the country's pyramid financial schemes destroyed a substantial part of household savings, and played a direct role in precipitating the outbreak of conflict [*Bezemer, 2001*].

V. CONCLUSIONS

This article has discussed some of the principal issues relating to the reconstruction and reform of the financial sector in conflict-affected countries, focusing on currency reform, the rebuilding (or creation) of central banks, the revitalisation of the banking system, and the strengthening of its prudential supervision and regulation. We have not discussed the provision of micro-credit nor the problems of 'odious' debt or public finance issues such as taxation, although these are obviously important to successful recovery.

The following problems repeatedly occur in the reconstruction and reform of the financial sector in conflict-affected countries. First, central banks often remain weak and under-resourced. The consequence is haphazard and lenient supervision of the financial system, which is compounded by the frequently lax accounting and reporting standards of commercial banks. This hinders the application of international models of prudential supervision, such as the Basel Core Principles. Second, regulatory forbearance is common, reflecting both the technical weakness of central banks, but also the pressure of powerful interests – sometimes including war criminals – that straddle both state institutions and the financial sector. The consequences include leniency in the licensing of banks, insider-lending, excessive risk exposure, and a general failure to curb emergent bank crises. These in turn destabilise economies in recovery from war, and the fiscal burden of bank crises limits development and poverty spending – thereby threatening 'post-conflict' recovery itself.

In summary, unless the state completely disintegrates conflict-affected countries will continue to face policy choices regarding the financial sector, and these can be good or bad for the country's development prospects. And 'post-conflict' countries will need to rebuild and to reform the financial system as they seek to achieve a recovery from conflict that is 'broad-based' – benefiting the majority of people, particularly the poor [*Addison, 2003*]. Those working on the financial sector in conflict countries therefore need to be aware of how conflict affects policy reform as well as its chances of success and how problems that beset all financial systems can be especially severe in conflict countries. Similarly those working on the financial sector in what appear to be 'non-conflict' countries need to be aware that such problems as fraud and cronyism in bank lending may be one step on a downward slope into eventual violent conflict, and that 'technical solutions' – such as legislating for better financial regulation – may be undermined by deeper political forces. And those concerned with creating the conditions for peace should be aware that the financial system is a crucial factor in achieving broad-based recovery from war.

NOTES

1. The figure for the number of armed conflicts is from Gleditsch *et al.* [*2002: 616*] which also discusses alternative definitions and measures of conflict.
2. Conflict is a feature of all societies; the key issue is whether it is channelled into peaceful institutions (both formal and informal) for its expression and resolution, or whether the parties resort to violence to settle their differences [*Murshed, 2002*]. In what follows it should be understood that conflict refers to *violent* conflict.
3. The negative financial and fiscal effects of contemporary conflicts, which are mostly civil wars, stand in contrast to the historical role of inter-state wars in stimulating financial and fiscal development in Europe in the eighteenth and nineteenth centuries [*Addison, Le Billon, and Murshed, 2001*].
4. Estimate provided by Afghanistan's central bank governor and reported in Turner [*2002*].
5. One historical example of a currency board in a conflict country is the North Russian currency board that operated between 1918 and 1920 during the Russian civil war [*Hanke and Schuler, 1991*].
6. A New Zealander was the first governor of Bosnia and Herzegovina's central bank.
7. Moreover, compensation payments to war-victims have been funded from the proceeds of privatisation in Bosnia and Herzegovina, adding to the pressure to privatise rapidly.
8. 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'. This includes the licensing of commercial financial institutions together with off-site surveillance and on-site inspection, including the adoption of international standards such as the Basel Committee's Core Principles for effective banking supervision.
9. In 2000 the IMF made the extension of its standby credit conditional on the transfer of the functions of the payments bureaus to the commercial banks [*IMF 2000e*]. Regulation is impeded in Bosnia and Herzegovina by the complex political structure which consists of three entities – the Federation of Bosnia and Herzegovina, the Bosniac-Croat Federation, and the Republika Srpska – and the deep distrust that exists between them. Banks located in the Muslim-Croat Federation and the Serb Republic are separately regulated by the respective authorities.
10. The largest bank, the BCM (Banco Comerçial de Moçambique) was privatised in 1996. Portugal's Mello Bank took 51 per cent of the shares, with the government retaining the rest (Mello Bank was subsequently taken over by Portugal's largest bank, BCP, in late 1999). In 1997, the second largest bank, Banco Popular de Desenvolvimento (BPD) was sold to a consortium headed by Malaysia's Southern Bank Berhard (SBB) and a Mozambican company, Invester, with the government retaining a 40 per cent share. It was renamed Bank Austral. Following its insolvency Bank Austral was sold in 2001 to Amalgamated Banks of South Africa. BCM was merged with Banco Internacional de Moçambique [*IMF, 2002b: 3*].

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