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**Working Paper**

## Financial reconstruction in conflict and post-conflict economies

WIDER Discussion Paper, No. 2001/90

**Provided in Cooperation with:**

United Nations University (UNU), World Institute for Development Economics Research (WIDER)

*Suggested Citation:* Addison, Tony; Geda, Alemayehu; Le Billon, Philippe; Murshed, S. Mansoob (2001) : Financial reconstruction in conflict and post-conflict economies, WIDER Discussion Paper, No. 2001/90, ISBN 929190001X, The United Nations University World Institute for Development Economics Research (UNU-WIDER), Helsinki

This Version is available at:

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**WIDER**

World Institute for Development Economics Research

Discussion Paper No. 2001/90

## **Financial Reconstruction in Conflict and ‘Post-Conflict’ Economies**

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September 2001

### **Abstract**

This paper discusses some of the principal issues relating to the reconstruction of the financial sector in conflict-affected countries, focusing on currency reform, the rebuilding (or creation) of central banks, the revitalization of the banking system, and its prudential supervision and regulation.

Different types of conflict have different effects on the financial system. Country priorities for reconstruction therefore vary accordingly. Nevertheless, the following problems repeatedly occur in reconstruction. 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 Basle Core Principles. Second, regulatory forbearance is common, reflecting both the technical weakness of central banks, but also the pressure of powerful interests—including war criminals—that straddle both state institutions and the financial sector. The consequences are leniency in the licensing of banks, insider-lending, excessive risk exposure, and a general failure to curb emergent bank crises. These in turn destabilize economies in recovery from war, and the fiscal burden of bank crises limits development and poverty spending—thereby threatening ‘post-conflict’ reconstruction itself.

**Keywords:** aid; conflict; financial development; sub-Saharan Africa

**JEL classification:** O10; O55

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This study has been prepared within the UNU/WIDER project on Why Some Countries Avoid Conflict While Others Fail which is co-directed by Professors Tony Addison and S. Mansoob Murshed.

## Acknowledgements

Paper presented at the 'International Conference on Finance and Development: Evidence and Policy Issues', Kenya Institute for Public Policy Research and Analysis (KIPPRA) and the Finance and Development Research Programme, Nairobi 10-11 July 2001. The paper was also presented at the 5-6 April 2001 conference of the Finance and Development Research Programme on 'Development and Business Finance: Policy and Experience in Developing Countries', held at the Institute for Development Policy and Management, University of Manchester, and supported by the DFID Economic and Social Committee on Research (ESCOR) and ESRC Development Economics Study Group (DESG).

Research for this paper is supported by the Department for International Development (DFID) of the United Kingdom under the ESCOR funded Finance and Development Research Programme. The views expressed in this paper are those of the authors alone, and should not be attributed to DFID.

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Camera-ready typescript prepared by Janis Vehmaan-Kreula at UNU/WIDER  
Printed at UNU/WIDER, Helsinki

The views expressed in this publication are those of the author(s). Publication does not imply endorsement by the Institute or the United Nations University, nor by the programme/project sponsors, of any of the views expressed.

ISSN 1609-5774  
ISBN 92-9190-000-1 (printed publication)  
ISBN 92-9190-001-X (internet publication)

## 1 Introduction<sup>1</sup>

Discussions of economic policy, and its formulation, traditionally sideline the phenomenon of violent conflict. Yet, there were at least 37 active conflicts in 1999 (Wallensteen and Sollenberg 2000).<sup>2</sup> In addition, Bosnia and Herzegovina, Guatemala, Mozambique and other countries are reconstructing from civil wars. Conflict cannot therefore be ignored as a factor shaping economic policy, especially in sub-Saharan Africa, a region in which war is widespread.

This paper focuses on the reconstruction of the domestic financial-sector, together with financial reform, in ‘post-conflict’ countries. It highlights the choices that must be made, and the tensions that exist, in financial policy. Companion papers discuss other aspects of the finance and conflict issue.<sup>3</sup>

There is no hard and fast dividing line between ‘war’ and ‘peace’ in the modern world (Crisp 1998). The profitability of war encourages many belligerents to break peace agreements, which also fail because of the low credibility of the signatories—Angola is a case in point (Addison et al. 2000b, Addison and Murshed 2001). Thus when we write of ‘reconstruction’, or label a country as ‘post-conflict’, we must keep in mind the instability of many countries recovering from war, a characteristic that can profoundly affect economic policy (Collier and Hoeffler 2000, and Nafziger et al. 2000).

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 2). We then move on to discuss the revitalization of the banking system, including its recapitalization (section 3). Section 4 highlights the problems encountered in strengthening prudential bank supervision in conflict countries. Section 5 concludes the paper by re-emphasizing the importance to post-conflict reconstruction of avoiding bank crises, and their destabilizing macro-economic effects.

## 2 Currency reform and central banks

Currency reform is a good place to start our discussion since it has both technical and political-economy dimensions. Currency reform is widespread among conflict-affected

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<sup>1</sup> This paper has benefited from discussions and interactions with the following people: Tilman Brück, Chris Cramer, Valpy FitzGerald, Jeffrey Herbst, Stefan Ingves, Karl Livingstone, Dorothy Rosenberg, Hugo Slim, Malcolm Smart, Frances Stewart and participants at the UNU/WIDER project meeting ‘Why Some Countries Avoid Conflict While Others Fail’ held in October 2000, and the session on ‘Violence, War and Reconstruction’ held at the 2000 conference of the Development Studies Association, SOAS London.

<sup>2</sup> A country is defined as being in conflict in a given year if it has experienced 1,000 or more conflict-related deaths during that year.

<sup>3</sup> Addison et al. (2000a) discuss the contribution of the financial-sector to the occurrence and duration of conflict, as well as the international dimension. The public finance dimension is discussed in Addison and Murshed (2000) and the problem of external finance and debt relief is discussed in Addison and Ndikumana (2000).

countries, and it takes a variety of forms: introducing new currencies for new states; replacing old national currencies with new ones; legalizing 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 Somalia. But 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. 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 2000).

*Replacing old national currencies with new ones.* 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 (DRC) with over 30 billion francs or 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.

*Legalizing the parallel circulation of foreign currencies.* In 1999, Montenegro adopted the deutsche mark as legal tender alongside the Yugoslav dinar (and introduced an inter-bank market in deutsche marks), thus formalizing the long-standing parallel market. The intention was to lessen the destabilizing impact of the hyperinflation in Serbia, associated with the economic turmoil of the Milosevic regime. The currency reform was declared illegal by the Yugoslav federation, which viewed it as an act of secession.

*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 move was motivated by the rupiah's collapse (the result of Indonesia's political and banking crises), together with the increased importance of dollar transactions in economic activity—the result of the inflow of some US\$ 523 million in aid over the next three years (Valdivieso 2000). The rupiah and the Australian dollar continue to be used in private transactions, but all compulsory payments to public authorities must be paid in dollars, a requirement that encourages the dollar's acceptance (IMF 2000a). Once the Central Payments Office (CPO) is able to function as a central bank, a national currency may be introduced.

The type of currency reform must be carefully thought through. Dollarization improves policy credibility, but at the cost of reduced flexibility (e.g. devaluing to offset adverse terms of trade shocks) and loss of seigniorage revenue. Introducing a national currency increases policy flexibility, but political uncertainties may add a large risk premium to domestic interest rates—thereby slowing private investment in reconstruction—or to destabilizing (inflationary) runs on the currency. Some economists therefore favour a currency board system for conflict-affected economies as a means of gaining credibility while avoiding dollarization (see for instance Naqib 1999 on Palestine). 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 deutsche mark/euro. A currency board system does, however, prevent the central bank from acting as lender of last resort to distressed banks since the size of the monetary base is governed by the level of foreign exchange reserves. This constraint that may have contributed to the series of bank collapses in Bosnia and Herzegovina over recent years (see section 3).

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. In 2000, the Liberian government successfully introduced the new Liberian dollar, replacing the existing stock of JJ Roberts and Liberty banknotes under an IMF staff-monitored programme (IMF 2000b). In contrast, the Angolan government's confusing and chaotic currency reform of the early 1990s destroyed much of the country's monetary savings, particularly of poor households many of whom were unable to convert their old currency in time. The government made vague promises of restitution, but these were worthless given the country's hyperinflation (Aguilar 2000). In Somalia, 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. In 2000 this injection caused a sharp and disruptive drop in the shilling against the US dollar (which trades widely), an action that was condemned by the nascent central government. However, the latter is unable to exert its authority, and monetary policy is left in private (and competing) hands.

## **2.1 Rebuilding/creating central banks**

Conflict may shut down the central bank (e.g. Congo-Brazzaville, Rwanda and Somalia). It may reopen relatively quickly—Rwanda's central bank was to reopen by the end of 1994, the year of the genocide—or not at all. Somalia's central bank remains closed after its looting in 1991, although a central bank was opened in the self-proclaimed Somaliland Republic in 1995 (Mubarak 1996: 150).

In some cases the central bank continues to function during civil war (e.g. Angola and Burundi today) and it continues to function in most contemporary inter-state wars (e.g. 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 wartime adjustment programmes that began in the mid-1980s. Technical assistance has improved the day-to-day operations of the Bank of Angola, although Angolan monetary and financial policy remains chaotic (Aguilar 2000).

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 2000). Somaliland's central bank is fragile; donors have withheld technical assistance since Somaliland is not an internationally recognized state. In these two cases, domestic political processes initiated the creation of a central bank. But in Bosnia and Herzegovina and East Timor 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 authorized the creation

of a central bank, and stipulated that for the first 6 years of its life, the bank governor should not be a citizen of Bosnia or of a neighbouring country.<sup>4</sup>

In East Timor a donor created institution—the Central Payments Office (CPO)—is the foundation for the country's future central bank. CPO was established in January 2000 by the UN Transitional Administration in East Timor (UNTAET) to facilitate official payments including those of the East Timor Administration (ETTA). It now has a bank licensing function, and issues instructions on capital requirements and liquidity. CPO will evolve towards a central bank as technical assistance builds the necessary capacity, and as ETTA's tax reforms eventually yield the revenue sufficient to capitalize a central bank.

Capitalization (or recapitalization) of the central bank can be problematic since it must compete with other expenditure priorities (including humanitarian and social spending). Moreover, capitalization requires a supportive fiscal framework. In Liberia, for example, the government issued a negotiable, interest bearing note for US\$ 5.0 million in 2000 and rescheduled all its debt to the central bank into thirty-year loans under an IMF staff-monitored programme (IMF 2000b).<sup>5</sup> However, the recapitalization is endangered by the government's failure to meet its schedule on servicing these new loans, due to limited revenues (estimated to be a tenth of their pre-war level) and weakness in fiscal management. The latter result from presidential outlays that remain disproportionately high relative to development expenditures, as well as Liberia's involvement in the crisis in neighbouring Sierra Leone (which has led to a sharp rise in security-related outlays).

### **3 Reviving the banking system**

When conflict closes the banking system—as in Congo-Brazzaville in the 1997 civil war and Rwanda during the 1994 genocide—its reopening is a priority. Otherwise the resumption of normal economic activities, requiring the clearing of domestic and foreign payments and the use of deposit accounts, will be severely impeded. The provision of bank finance for working capital, fixed investment, and residential reconstruction must also restart. Otherwise, unemployment will remain high, thereby impeding the demobilization and absorption of soldiers into the peace-time economy, potentially endangering peace itself.

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. Conflict can hit rural banking hard (examples include Angola and Mozambique). Some US\$ 7 million in cash was transferred from Rwanda's network of rural bank co-operatives (the Union des banques

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<sup>4</sup> The first governor was from New Zealand.

<sup>5</sup> The war in Liberia ended in 1996, and democratic elections took place in 1997. However, the pre-war National Bank of Liberia remained moribund. In 1999 it was replaced by the Central Bank of Liberia (IMF 2000c: 13).

populaires du Rwanda, or UBP) to the camps of the ‘genocidaires’ in Zaire (DRC).<sup>6</sup> Only 20 per cent of UBP’s staff remained by the end of the genocide. UBP’s accounts are still in disarray since many of the bank’s records were lost; the last complete audit was completed in 1992 (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 characterize credit markets are attenuated in post-conflict economies (lost records etc.), and this can crowd out all but the largest and 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 East Timor, donor aid may support 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 overburdened dealing with the genocide’s aftermath (Kayizzi-Mugerwa 2000: 14). Legal disputes also arose over unauthorized withdrawals from bank accounts during the genocide, and this further paralysed the banking system.

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, the banking systems of conflict countries are often insolvent (or close to insolvency) *prior* to conflict due to the pillage of state and commercial banks by politically-connected insiders (examples include Burundi, Congo-Brazzaville, Indonesia, Zaire/DRC, Somalia and the former Yugoslavia). In Congo (Brazzaville) two of the largest banks collapsed in the 1990s—the result of fraud and insider lending—leaving three that must be recapitalized at a cost of CFA 50 billion.<sup>7</sup> The international community can assist bank recovery by tracing and freezing money plundered from banking systems; the UK’s Financial Services Authority is, for instance, presently pursuing funds illegally transferred by the Milosevic and Abacha regimes.

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<sup>6</sup> UBP was an association of 150 rural savings and loans co-operatives—modeled on Switzerland’s bank co-operatives. In 1994, UBP had 400,000 clients; by the end-1996 this figure was down to 42,000 (IMF 2000d: 22). UBP continued to operate in the camps until the Banyamulenge rebellion that ended Mobutu’s rule in 1997. The former head of UBP, Jean Kambanda, became the Prime Minister of the interim government which orchestrated the genocide. He was subsequently found guilty on 10 counts of genocide and crimes against humanity by the Arusha-based UN tribunal for Rwanda.

<sup>7</sup> Source: *Africa Research Bulletin*, 16 February –15 March 2000.



Traditionally, fiscal transfers from central government met the losses of state banks (Wuyts 1989). Given the large reconstruction and humanitarian demands on post-war public revenues (and the often meagre level of these revenues until the tax base recovers), it is usually undesirable to use public money to recapitalize the state banking system. Complete or partial privatization—involving infusions of both domestic and foreign private capital—therefore becomes a priority, and features strongly in the conditionality of donor-financed reconstructions (e.g. Bosnia and Herzegovina and Mozambique). Moreover, compensation payments to war-victims have been funded from the proceeds of privatization in Bosnia and Herzegovina, adding to the pressure to privatize rapidly.

The pace of bank privatization has nevertheless varied significantly across donor-financed reconstructions. In Mozambique, the pace was fast. The largest bank, the BCM (Banco Comercial de Mocambique) was privatised in 1996. Portugal's Mello Bank took 51 per cent of the shares, with the government retaining the rest.<sup>8</sup> In 1997 the second largest bank, Banco Popular de Desenvolvimento (BPD) was sold to a consortium headed by Malaysia's Southern Bank Berhad (SBB) and a Mozambican company, Invester, with the government retaining a 40 per cent share. It was renamed Bank Austral. BCM and Austral are the country's two largest banks. In contrast, the Government of Ethiopia has resisted IMF pressure for privatization, particularly of the largest state bank, the Commercial Bank of Ethiopia (CMB). Although CMB inherited problems from its role as the state bank for the Derg regime, its performance has improved, and the government has agreed with the IMF to restructure CMB further while retaining state ownership (Addison and Alemayehu Geda 2000).

Bank privatization has been especially problematic in Bosnia and Herzegovina. Six of the 14 state-owned banks operating in Bosnia and Herzegovina were 'informally' privatized during the war, including the transfer of assets to war-criminals. After the donor-financed reconstruction began—it is one of the world's largest with aid inflows amounting to US\$ 5.1 billion to date—a process of formal (transparent) bank privatization was agreed, but the pace has been slow and has impeded the recovery of private investment. Recent Bank and IMF loans to Bosnia and Herzegovina carry conditionality on the acceleration of financial reform.

Privatization is not necessarily the most important means for increasing private sector participation in the financial system. In Ethiopia the opening of 6 private banks in competition with the state-owned banks has been the main route for private capital to enter; some six private financial institutions now operate (Addison and Alemayehu Geda 2000). In Mozambique, 7 new banks now compete with the privatized state banks. Lebanon has seen the creation of 83 banks since the end of the civil war in 1992 (Hakim and Neaime 1999). Licensing is often on highly favourable terms, especially in nascent offshore financial centres; only US\$ 10,000 of initial capital is required to set up an offshore bank in Montenegro.<sup>9</sup> And private banks have taken advantage of conflict to develop their businesses. Lebanon's tradition of bank secrecy facilitates money laundering, including flows from other conflict-affected countries such as the profits of

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<sup>8</sup> Mello bank was subsequently taken over by Portugal's largest bank, BCP, in late 1999.

<sup>9</sup> 'Offshore Banks and Insurance Companies from the Republic of Montenegro', (<http://www.montenegro-banks.com/default.html>)

'blood diamonds' mined in Angola and Sierra Leone. Lebanon is now on the G7's blacklist of 15 countries whose banks are suspected of money laundering. The central bank recently tightened its regulations, and a law lifting bank secrecy in suspect cases is presently before parliament, but it remains to be seen how effective this is.

Given the large infusions of capital needed to resuscitate banks, many conflict-affected countries have tried to attract foreign investment. Foreign investors tend to be former colonial powers (e.g. Portugal in Angola and Mozambique) and/or neighbouring countries (e.g. Austria in Bosnia and Herzegovina, South Africa in Mozambique, and Australia in East Timor). But this is not always so. Mozambique has attracted British, French and Malaysian bank investment. Ethiopia is again the exception: new private banks have been created with domestic capital, and the government has resisted opening the system to foreign banks (see Addison and Alemayehu Geda 2000).

In summary, financial reform is necessary to economic reconstruction, and in many cases reform was required before conflict erupted (and could have contributed to preventing war when conflict is caused by economic decline and associated bank failure). Reform has typically involved an increase in private participation in the financial sector, and in this respect conflict-affected countries have followed a trajectory similar to non-conflict countries, although the risks for investors in the financial sector are usually greater in the conflict-affected group. As in the non-conflict group, however, there remain open questions about the merits of bank privatization and the role of foreign capital in banking i.e., about the design of financial reform itself. Moreover, the task of prudential regulation and supervision is much more challenging in the conflict-affected group for reasons that we now discuss.

#### **4 Strengthening prudential financial regulation and supervision**

As in non-conflict countries, the restructuring and privatization of state banks and the entry of new private banks in conflict-affected countries has occurred alongside the relaxation of controls on deposit and lending rates, and the movement away from directed credit—Mozambique has gone the furthest, Ethiopia has undertaken partial financial liberalization (Addison and Alemayehu Geda 2000). Historically, post-conflict reconstruction often involved an increase, not a reduction, in the state's control over the allocation and cost of credit—examples include Japan and Western Europe after World War Two, and South Korea after the Korean war (see Addison et al. 2000a). The greater role of financial liberalization in contemporary reconstructions reflects the weakness of states (and histories of extreme rent-seeking in state-controlled financial systems) but also the emphasis on financial liberalization in the conditionality of IMF and World Bank adjustment and sector lending.

However, there is now a stronger emphasis on institutional investment in the financial sector, especially in prudential regulation and supervision, not least because of the sharp increase in the number of financial crises in developing countries in recent years, often after financial liberalization (Kaminsky and Reinhart 1998). Thus, Stiglitz (1998: 16) concludes that '... the key issue should not be liberalization or deregulation but construction of the regulatory framework that ensures an effective financial sector'. Caprio (1996: 1) notes that disappointment with financial reform in Africa and the transition economies might be due to perverse sequencing, in particular '... often more

visible aspects of reform, such as complete interest rate deregulation, bank recapitalization, 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’.

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 Basle Committee’s Core Principles for effective banking supervision.

Among conflict and post-conflict countries some progress has been made. Ethiopia’s central bank has improved its capacity for on-site and off-site financial supervision (Addison and Alemayehu Geda 2000). In Liberia, the reinvigorated central bank suspended the operations of one illiquid bank in 2000, and relicensed the 4 remaining commercial banks (IMF 2000c). East Timor’s nascent central bank (the Central Payments Office) is developing a prudential regulatory framework based on Basle Core Principles (Valdivieso 2000). But generally, prudential supervision remains very weak in conflict-affected countries; African conflict countries are concentrated in the lowest group (at the ‘initial stage of building supervisory structures’) in the classification of progress in SSA banking sector supervision in Mehran et al. (1998).

Brownbridge and Kirkpatrick (2000: 8) group weaknesses 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) supervisors unwilling or unable to enforce prudential regulations, often due to political interference.

Regarding the first weakness, excessive lending on property and unhedged foreign-exchange exposure—in particular borrowing in foreign currency and then on-lending these funds for property investment—leaves banks exposed to unforeseen currency depreciation, a catalyst for many recent bank crises (Brownbridge and Kirkpatrick 2000: 9). Post-conflict banks are especially active in lending on urban residential and business property, since peace raises the value of prime real estate (e.g. Beirut, Maputo and Sarajevo), and property constitutes ready collateral. Hence, they are vulnerable to the bursting of speculative real-estate bubbles. Moreover, the gap between domestic and foreign interest-rates is usually large in post-conflict economies—especially when public borrowing for reconstruction is high—which encourages banks to borrow abroad, and lend at home. The entry of foreign banks may attenuate this risk, although they may be more experienced in hedging currency risks than domestic banks. Ethiopia has restricted entry by foreign banks partly out of concern that its regulatory apparatus is not yet able to monitor and assess complex currency risks (Addison and Alemayehu Geda 2000).

The financial authorities of conflict-affected countries are characterized by severe shortages of supervisory skills. Considerable technical assistance (often supplied by the IMF) is therefore needed but as Caprio (1996: 4) notes: ‘... 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’. And such

investment is only effective if the employment contracts of supervisors are competitive vis-à-vis private financial institutions, whose demand for skills is also high.

The third weakness of prudential supervision in developing countries is regulatory forbearance (Brownbridge and Kirkpatrick 2000: 8). Early response to emergent banking problems is often inhibited by political protection of unsound banks (Honohan 1997). Powerful elites straddle the public and private sectors; the business interests of political elites are a significant influence on the decision to liberalize and privatize banking systems, and new private banks have gone out of their way to recruit political elites to their boards (see Bigsten and Moene 1996 on Kenya, and Addison 2001 on Angola and Mozambique). These factors lie behind the finding, by Kane and Rice (2001), that the duration of African banking crises increases with the level of government corruption.

Political interference in supervision is especially acute in conflict-affected countries with the weakest democratic institutions. Warlords may own Private banks; for instance, during the civil war in Liberia, Gbatu Taylor (the brother of warlord, and later president, Charles Taylor) used war booty to capitalize the Bong bank (Reno 1995). War criminals are linked to Bosnia and Herzegovina's payments bureaux. These exercise a lucrative monopoly on domestic payments transfers that has stalled financial reform (and in 2000 the IMF made the extension of its stand-by credit conditional on the transfer of their functions to the commercial banks—see Government of Bosnia and Herzegovina 2000). The international community's High Representative to Bosnia and Herzegovina recently imposed legislation protecting bank regulators from intimidation when carrying out their duties.<sup>10</sup> In Cambodia, 12 of the 33 private banks licensed in the 1990s are engaged in laundering money related to drug trafficking and illegal logging according to informed local observers (Addison et al. 2000a). Senior staff of the National Bank of Cambodia (NBC) are alleged to have received substantial private payments connected to the licensing and 'supervision' of banks, and to be linked to drug syndicates.

Furthermore, the legal framework in which to pursue bank fraud is often grossly inadequate, reflecting slowness in legal reform and corruption. In July 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 BCM before it was privatised. Suspects had been allowed to flee the country. In November 2000, the independent journalist and editor of the well-respected newsletter *Metical*, Carlos Cardoso, was shot dead while investigating fraud at BCM.

In summary, banks in conflict-affected countries display in acute form all three weaknesses identified by Brownbridge and Kirkpatrick (2000) and other analyses. In addition, 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

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<sup>10</sup> Regulation is also 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 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.

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 privatized banks and new banks. Fourteen of Bosnia and Herzegovina's banks have collapsed since the end of the war in 1995, including the Sarajevo-based BH Banka which had a number of NGO and donor accounts, and whose owner has now been charged with fraud. In 2000 Mozambique's BCM and Austral reported losses for 1999 of US\$ 127 million and US\$ 50 million respectively, leaving their reserves below the Bank of Mozambique's minimum required levels (EIU 2000, ROM and IMF 1999).

Bank collapses threaten macro-economic stability since the contraction of lending induces recession—the Bank of Mozambique is currently injecting liquidity in response to the BCM and Austral crises—and as the exchange rate comes under pressure from loss of confidence in the domestic financial system. The social costs are large—Diwan (1999) finds that labour bears a disproportionate share of the cost while taxpayers partially compensate capital—and financial distress contributed directly to economic crisis and social breakdown in Albania and Indonesia (Bezemer 2001).<sup>11</sup> The high fiscal cost of resolving bank crises takes public money from much-needed development spending and social spending. As part shareholder in BCM and Austral, the Government of Mozambique's faces a bill of at least US\$ 80 million (to be raised by issuing treasury bonds), and possibly more if the banks' private shareholders cannot meet their share of the recapitalization (shareholder Southern Bank Berhard has been weakened by Malaysia's own financial crisis). Mozambique's domestic debt was in decline prior to the banks' failure, but is now expected to rise from MT 15 billion to MT 196 billion (EIU 2001). As a country still reconstructing from war, and one in which 69 per cent of the population is poor, Mozambique can ill afford the fiscal burden of bank crisis (see IMF 2001 for poverty data).

## 5 Conclusions

This paper has discussed some of the principal issues relating to the reconstruction of the financial sector in conflict-affected countries, focusing on currency reform, the rebuilding (or creation) of central banks, the revitalization of the banking system, and its prudential supervision and regulation. Our discussion has focused on their banking sectors, since equity and corporate debt markets remain underdeveloped or non-existent in most conflict-affected countries. Public finance issues are discussed separately in Addison and Murshed (2000).

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<sup>11</sup> Diwan (1999: 19) finds that the labour share usually falls sharply following a financial crisis, recovering only partially in subsequent years:

Perhaps because labour is less mobile than capital, it ends up forced to bear a large share of these asset losses (in the sense of transferring parts of its income to another group). There is strong evidence of this happening. Crises are resolved when workers end up bearing large costs that resemble bailouts of (financial) capital. We estimate that the total losses to labor, from the beginning to the end of a crisis, amounts on average to 20 percentage points of GDP.

Of course conflict is not a homogenous phenomenon. Different types of conflict have different effects on the financial system, and country reconstruction-programmes will reflect this. These effects include: guerrilla insurrections that disrupt the rural financial system but not the system as a whole (e.g. Guatemala); cronyism in bank lending linked to autocratic rule (e.g. the Yugoslav Federation and Zimbabwe); temporary shutdowns of the financial system due to military revolts (e.g. Côte d'Ivoire and Guinea-Bissau) and secessions (East Timor and Kosovo); looting of banks to finance and profit from genocide (e.g. Rwanda); civil wars that leave central banks intact but otherwise damage financial infrastructure (Angola and Mozambique); civil wars that destroy central banks and most formal financial institutions (e.g. Somalia 1992-94); and inter-state conflicts in which formal financial institutions are stressed but continue to function (e.g. the 1998-2000 Eritrea/Ethiopia war). Country priorities for financial reconstruction therefore vary accordingly.

Nevertheless, the following problems repeatedly occur in reconstruction. 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 Basle Core Principles. Second, regulatory forbearance is common, reflecting both the technical weakness of central banks, but also the pressure of powerful interests—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 destabilize economies in recovery from war, and the fiscal burden of bank crises limits development and poverty spending—thereby threatening 'post-conflict' reconstruction itself.

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