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### Enhancing the Private Sector Contribution to Post-War Recovery in Poor Countries

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*This paper analyses the duration and nature of post-war reconstruction in aid-dependent developing countries. Part I presents a comparative analysis, Part II discusses the post-war reconstruction in Nicaragua, and Part III analyses the case of Mozambique.*

*The main findings are that post-war reconstruction, defined as obtaining external and internal balance and high per capita growth, is surprisingly difficult to obtain even under favourable political and economic conditions. The legacy of war is a key constraint on post-war growth, especially through the damaged commercial network, the loss of trust, and the weakening of market institutions. In addition, political uncertainty in the post-war period inhibits private sector investment and significantly reduces the peace dividend. This is worsened by inappropriate stabilisation policies.*

*Aid policies should be modified for war and post-war economies to accelerate the reduction in foreign debt and to support small scale private producers, including those in the countryside. Military spending does not fall and social spending does not rise as quickly as is generally expected thus delaying a noticeable reduction in poverty. The clear sequencing but gradual implementation of government reforms, especially in the social sectors, is important in maintaining entitlements. Key victims of war, and especially of internal war, are civil and economic institutions. Their importance in post-war reconstruction has been underestimated and they should receive priority funding by donors and governments to accelerate post-war growth and poverty reduction.*

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## EXECUTIVE SUMMARY

1. Violent conflict has become more frequent in developing countries in the last two decades, and international support for peace-making has become more important. However, the problems of post-war reconstruction have received less attention - despite the fact that over half the least-developed countries have undergone civil wars in the recent past.
2. This study addresses the issue of why post-war reconstruction in developing countries is so difficult and prolonged, despite high levels of foreign aid. Part II and III contain case studies of Nicaragua and Mozambique, while Part I contains the comparative analysis and draws policy conclusions. The central policy research hypothesis was that key characteristics of private sector behaviour determine the speed and sustainability of recovery, and thus the effectiveness of international co-operation efforts.
3. The inheritance of the wartime economy itself was important in both cases. This was not merely a question of the destruction of productive capacity or the displacement of the population. Rather it was the disarticulation of commercial networks, the loss of trust and the weakening of market institutions which were the key economic costs. External, fiscal and private sector solvency, once lost proved very difficult to recover.
4. A substantial 'peace dividend' was expected in both cases when the war ended: due to reduced defence expenditures, demobilisation of soldiers, and recovered production capacity. However, this appears to be the first attempt to measure this dividend; and to examine the role of the private sector in the reconstruction process. The extent of the dividend turned out to be much less than expected in both cases, and can clearly be dissipated if uncertainty about political consensus depresses private investment.
5. Existing policy dialogue focuses on fiscal adjustment, market reforms and poverty alleviation in the post-war period. While aid has been considerable and monetary stabilisation effective, achieving external solvency and sustainable growth has proved almost impossible in both Mozambique and Nicaragua. Structural adjustment policy did not provide sufficient support to the recovery of agricultural production for food and exports. The multilateral agencies, while promoting privatisation, paid little direct attention to the needs of the private sector - particularly small farmers.
6. Both countries had considerable success in achieving fiscal equilibrium quite quickly after peace was established; which had positive consequences for inflation. However, reduced military expenditure could not be translated into increased health and education expenditure, due in part to continued burden of external debt servicing. The dismantling of the state sector in order to reduce expenditure also had serious implications for unemployment and rural support in Nicaragua; while the more gradual approach in Mozambique appears to have been better for both production and social stability.
7. Private investment recovered very slowly in both cases, although the greater institutional stability in Mozambique appears to have helped, and the lack of consensus in Nicaragua - and thus uncertainty about future policy - was a negative factor. Private savings did not recover to the same extent as investment; possibly as a consequence of the easy availability of aid funds. In both cases, the continued debt overhang was both a drain on fiscal and foreign exchange resources, and a major cause of uncertainty among investors.

8. In an agrarian economy, both economic progress and social welfare depend upon food and export production. The two cases studies provide contrasting evidence on this problem. In Mozambique there was more rapid recovery of food production, which probably helped to reduce unemployment and poverty; but exports did not recover to the same degree. In contrast, exports recovered in Nicaragua but food production did not; helping to improve external solvency but not reducing poverty.
9. The failure to provide for immediate debt relief in the post-war period - particularly from multilateral agencies - caused continued uncertainty in the private sector in both cases. The potential benefits in terms of policy 'leverage' were not realised; and the protracted delays in the 'HIPC initiative', in combination with the unrealistic performance criteria, meant that debt relief made little contribution to post-war reconstruction or poverty alleviation.
10. Poverty alleviation has been problematic in both cases. Health and education expenditure did not rise as much as had been hoped. In the case of Nicaragua, the reform process itself and the neglect of small farmers (particularly the withdrawal of rural credit) led to increasing poverty levels, which further undermined political consensus. In the case of Mozambique, a more gradual pace of reform and more rapid revival of small-scale agriculture probably helped to increase food security and thus contain absolute poverty.
11. The construction of economic institutions with a broad supporting consensus seems essential to the recovery of the private sector after a war. The rather slower pace of reform in Mozambique, based on an implicit alliance between the previously contending parties; appears to have been more effective than the rapid reforms in Nicaragua, which were supported by only part of the society.
12. Finally, the evaluation of post-war reconstruction policy based on large-scale donor support must be based on the extent to which, once the immediate emergency period is over, a sustainable growth process has been established. This requires the attainment of solvency in three dimensions: the external sector in terms of significant export expansion and a manageable debt level; the fiscal sector in terms of sufficient tax income to fund infrastructure and social provision without reliance on aid; and the private sector in terms of high levels of domestic investment and saving, among both large and small producers.
13. On these criteria neither Mozambique nor Nicaragua had completed post-war reconstruction ten years after peace had been attained, despite considerable international support and the pursuit of orthodox economic policies. This experience implies serious reconsideration of the issue by all concerned - particularly the need for international donors to shift their emphasis from finance towards production.

## **P R E F A C E**

This study addresses the issue of post-war economic reconstruction in developing countries. Unfortunately, this issue is of increasing importance because armed conflict in poor societies have become more - rather than less - frequent after the end of the Cold War brought super-power confrontation to an end. Funding was awarded by the Department for International Development (ESCOR Grant R7216) in order to investigate this problem in more depth, using Mozambique and Nicaragua as case studies and paying particular attention to the role of the private sector in the post-war reconstruction process.

The choice of these two countries was guided by a number of criteria. First, they had both undergone severe civil wars of an 'ideological' (not ethnic) nature during the 1980s, so that there was a sufficiently long reconstruction period in order to evaluate progress. Second, they are both agricultural economies, where the role of small farmers is crucial to economic development. Third, both countries have received large volumes of aid from DAC members, which provides an opportunity to evaluate the effectiveness of international co-operation in supporting the reconstruction effort.

The project team was led by Valpy FitzGerald, who drafted Part I of the study, which contains a systematic comparison of the two cases and draws general conclusions. Arturo Grigsby was responsible for the case study of Nicaragua in Part II; while Tilman Brück prepared the case study of Mozambique in Part III. The two case studies were carried out in close collaboration with counterpart institutions: the Nitlapan Research Institute at the Universidad Centro Americano in Managua, Nicaragua; and the Food Security Project at the Ministry of Agriculture in Maputo, Mozambique. Particular attention was paid to constructing a consistent data base for the two countries so that valid comparative analysis could be carried out.

Research for the two case studies finished in mid-1999. In consequence, the effects of the disasters in Nicaragua (October 1999) and Mozambique (February 2000) are not taken into account. The impact of these natural disasters does not alter - indeed it reinforces - the lessons of post-war reconstruction drawn in this report.

This draft of the study findings will now be disseminated in order to promote discussion among scholars, policy makers and practitioners. The two case studies will be translated into Spanish and Portuguese, respectively, so that they are accessible by a wider readership in Nicaragua and Mozambique. A summary will be published in both languages. The whole study will also be available on our website (<http://www.qeh.ox.ac.uk>) for access and comment by the international community. It is planned to hold a workshop at Oxford in order to discuss this study at the end of 2000.

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**Part I:**

**The Private Sector in Post-War Reconstruction:  
A Comparative Analysis**

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“An adequate housing programme ... involving purchases of materials and acquisition of land on a large scale ... a considerable transfer of agricultural lands to public authorities for the purpose of small holdings, soldiers’ settlements, afforestation and reclamation ... the reconstruction of roads and the repair of railways and their equipment ... the financing for a time in whole or in part by the State of certain essential industries ... an extension of unemployment insurance to meet the dislocation of industry that is to be expected during the transition period ... a strengthened health service both at the centre and locally.... (As opposed to) the view that everything should be subordinated to the paying off of debt ... (Britain should be) prepared to incur expenditure essential for establishing at the earliest possible moment, the fullest measure of productivity.”

British Minister of Reconstruction Christopher Addison in 1918, cited by Ferguson (1998, p. 421).

## 1.1 INTRODUCTION

### *The Cost of Conflict*

War in general, and civil war in particular, is one of the main causes of human suffering and economic underdevelopment. The uneasy calm of the global confrontation between capitalism and communism during the Cold War may have prevented global nuclear destruction, but in any one of these forty years a number of countries of what was then known as the “Third World” were at war. Between 1950 and 1990, some fifteen million deaths were caused directly or indirectly by wars of all types in developing countries - including international conflicts, civil war and government violence against citizens.(Stewart and FitzGerald, 2000). Yet despite the high incidence of armed conflict in poor countries, economic analysis of developing countries at war is relatively rare.

That war is very costly in terms of not only the sacrifice of innocent lives, but also of human and economic development, would be a truism were this fact not so often overlooked by development theorists and international policy makers. Modern development economists tend to treat countries at war as subject to exogenous developments which take them outside the normal realms of analysis. The greater part of the human costs of war does not result directly from battle deaths and injuries, but rather ‘indirectly’ from the loss of livelihoods caused by the dislocation of economy and society resulting from conflict. If we are to understand the process of post-war economic reconstruction, in the hope of reducing these human costs as soon as possible, it is essential that we attempt to understand the processes that have occurred during the wartime economy.

At best, the Bretton Woods institutions appear to see armed conflicts in or between developing countries as temporary interruptions to an established economic development path. Post-war reconstruction is seen as a matter of short term costs (demobilising the military, reconstructing

damaged infrastructure and resettling refugees) - which can be reasonably covered by an exceptional aid effort of limited duration - followed by a return to 'sound' economic policy rules. These include orthodox stabilisation policy, a structural adjustment programme (including trade liberalisation and extensive privatisation) and full integration into world markets.

Post-war reconstruction in practice seems to have taken much longer than expected (at least a decade in the two cases discussed here) despite large infusions of international development assistance and repeated attempts to apply the policy framework proposed by the Bretton Woods institutions. The key constraints appear to be the failure of the private sector - small and medium farmers in particular - to invest on a sustainable basis; the failure of the government to provide the security and infrastructure required for this to happen; and the failure of the international community to design and support reconstruction policies specific to the post-war situation.

### *The Approach in this Report*

The costs of war do not end when peace is established and armed forces demobilised. This Report builds on two comprehensive case studies of reconstruction after prolonged civil war in two developing countries - Mozambique and Nicaragua. These two cases are representative of the very long and difficult process of post-war reconstruction, which many policy-makers (particularly international agencies) have assumed to be a relatively speedy and unproblematic process as long as sufficient aid resources are provided. However, the process turns out to be far more complex, perhaps as much so as the peace-making process itself - while the inflow of aid can turn out to be highly problematic in itself.

We address three central themes:

First, the effectiveness of economic policies in supporting post-war recovery, particularly macroeconomic stabilization, recuperation of agricultural production levels and the reduction of poverty levels.

Second, the way in which post-war recovery has contributed to the building of sustainable long-term development, with particular reference to working markets, institutional capacity and the investment of the 'peace dividend'

Third, the role of the donor community in effectively supporting the two previous aims, in terms of the level and nature of funding, policy conditionality and coherence.

From this analysis, some general considerations as to the design of post-war reconstruction policy in developing countries are derived, which go beyond economic analysis towards the political economy of the post-war state and its relationship with donor governments.

In fact, despite their differences of region, culture and previous development level, Mozambique and Nicaragua do share considerable common features, particularly the nature of their civil war (peasant resistance to a socialist state-led project, both sides being supported by external powers), the reliance on small farmers for economic recovery, the emergence of aid dependence, and the influence of fiscal disequilibrium on the private sector.

### *The Contents of Part I*

In Part I of this study, we draw on the extensive case study material in Parts II and III in order to draw wider lessons from the comparison of these archetypal two cases. We open with the economic inheritance of conflict (Section 1.2) and the policies designed to support post-war economic policy

(Section 1.3). We then turn to the difficulties of achieving a sustainable development path, once the initial stabilisation of the macro-economy has been achieved (Section 1.4).

The role of donors is critical to this process, and we view this critically (Section 1.5) but also suggest that this must be seen in the context of the political economy of reconstruction (Section 1.6) rather than as a purely administrative matter. Finally, Part I concludes with some policy lessons.

## 1.2 THE INHERITANCE OF WAR

### *The General Principles*

The economic inheritance of conflict goes far beyond the immediate destruction and human losses. Profound changes take place in the economy, which are not reversed to the pre-war situation by the cessation of conflict. Patterns of economic behaviour that have emerged in war in response to new incentives, greater constraints and heightened uncertainty will remain.

On the basis of a detailed comparison of conflict economies in some twenty developing countries, Stewart and FitzGerald (2000) suggest that there are seven main economic consequences of war.

### *Six Economic Legacies of War*

First, *economic growth* is almost always negatively affected, sometimes dramatically so, as in the cases of Mozambique and Nicaragua. However, aggregate output is least affected where the conflict is confined to one geographic region and export decline can be contained, as in the case of Sri Lanka or in the recent conflicts in Uganda. The *agricultural sector* is usually particularly badly hit in civil wars in developing countries, as people are forced to move in the course of the conflict, as a result of fighting, land mines, or to camps to secure food.

Second, *exports* are also invariably negatively affected. This partly stems from the general fall in production; partly from a shift towards domestic markets in order to sustain domestic consumption in the face of falling production; and partly from disruptions in international markets. Contrary to what might be expected at first sight, *import capacity* usually holds up - often growing even though exports often fall. This is due to the availability of aid and foreign debt spiralled in every country at war studied, leaving a huge post-conflict debt burden. In some cases - notably Nicaragua - this import compression was one of the main causes of a collapse in production.

Third, there is a *sectoral shift* from tradable to non-tradable sectors, as a consequence of market disruptions, including undermining of formal organisations, such as banks, reduced trust and failures of the transport system. One aspect of this - a major consequence of conflict - is a switch to subsistence and informal activities, including simple production (even arms) and trading (particularly smuggling). Mozambique illustrates the development of the urban informal sector most graphically; while the ability to retreat to subsistence agriculture also helps protect nutritional standards - it did so, for example, during the Amin era in Uganda but not sufficiently in Nicaragua.

Fourth, *consumption* per head inevitably falls with per capita GDP, even though domestic savings decline due both to attempts to maintain consumption levels and to uncertainty as to asset values. Attempts by households to maintain consumption and by the government to protect current expenditure lead to foreign borrowing and increased aid dependence - in other words 'foreign savings' replace 'domestic savings'. As expected, government capital formation and large-scale foreign and private *investment* generally fell quite sharply, due to budgetary restrictions and

increased uncertainty respectively. None the less, aggregate investment did not seem to fall as much as domestic savings, possibly due to small-scale investment as the informal sector expands and aid-funded projects - as was the case in Mozambique and Nicaragua.

Fifth, contrary to a priori expectations the government *revenue* share of GDP did not invariably fall among countries in conflict. In many cases, such as Nicaragua and Mozambique, it rose quite sharply; while in a few cases, government revenue-raising ability was totally undermined - for example in Uganda and in Sierra Leone. This difference was important in determining whether the government could, in practice or in principle, sustain public entitlements. In all cases government *expenditure* rose more than revenue and budget deficit widened, financed by a combination of foreign and domestic borrowing and increased money supply. But despite the rising budget deficit, *inflation* was quite moderate in the majority of cases, and hyperinflation occurred rarely. The share of government *expenditure* allocated to military items invariably increased, making it difficult to sustain social and economic expenditure, and in almost all cases the share of social expenditure fell, sometimes severely.

Sixth, as a result of falling *entitlements*, heavy human costs were experienced in most countries leading, in addition to the deaths and injuries from the war itself, to worse infant mortality rates than would have occurred in the absence of war, and deteriorating nutrition and health standards. However, Nicaragua gave increased priority to social expenditure compared with the pre-war situation and thereby succeeded in increasing public entitlements, but this was exceptional. Public entitlements fell in most cases, although some governments did attempt to sustain health services and food rations throughout the country, even in rebel held areas. Civic entitlements compensated to some extent for lost public entitlements through NGO efforts to deliver food and other services in Mozambique.

### *The Vulnerability of the Economy at War*

The economic effects of war are the result of an interaction between a particular type of war and the economy in which takes place, and these define its 'vulnerability'. Those characteristics which seem to be most important are: the average income level; the degree of self-subsistence of the poor; reliance on essential imports; and the flexibility of the production system.

The average level of income of an economy determines what proportion of the population is near or below the poverty line - whether they are already near the edge of survival so that a substantial reduction can have devastating consequences in terms of survival. Dependence of the poor on product or labour markets, or on public services also matters if these are destroyed or disarticulated by war. In contrast, where there is an extensive rural food sector and so long as this is not directly destroyed by war, then poor households maybe able to survive by retreating into subsistence. Similarly, if people have not had access to public entitlements, they will not suffer so much from their loss; so that urban populations may suffer more than rural ones and periods of war may be characterized by a reversal of secular migration flows.

Finally, the length and nature of the war is another important determinant of the costs of conflict. Obviously a long war will have different effects from a short-one: in a long war reserves will be exhausted, so vulnerability is greater. However, given time people will have time to adapt their lifestyles in order to enhance their productivity and well-being in the context of the war. The geographic spread of the war is also important. When confined to one part of the country, the war may have only small direct effects on the economy as a whole and thus reduce the overall war vulnerability of the economy. However, where this direct cost is large in relation to the resources of the state, the indirect social costs may become very large, increasing vulnerability.

Analytically, it is helpful to distinguish between the consequences of the direct impact of the conflict on the one hand, and of the compensating behaviour of economic agents in their attempt to moderate or offset the negative impacts of war, on the other. There are certain direct effects arising from conflict, which cause other effects as they work their way through the economy. These effects include:

- (i) an output loss as people move from their place of work because they join the fighting, are killed or flee;
- (ii) the destruction of capital (such as large energy plants) through bombing or arson, and the consequent loss of output;
- (iii) the disruption of transport due to physical destruction;
- (iv) the loss of trust between economic agents, reducing market transactions;
- (v) the disruption of international markets due to frontier closure or embargoes;
- (vi) and the diversion of scarce foreign exchange from economic and social needs to military uses.

These effects will tend to reduce aggregate levels of output, including exports. Reduced agricultural output, and disrupted internal and international markets are particularly likely to affect exports adversely. Labour markets will be disarticulated as unskilled men of prime working age are particularly hit by violent deaths and military recruitment; while skilled labour is most likely to leave the country. Hence an important indirect effect will be reduced foreign exchange availability for productive inputs leading to a shortage of imported inputs and, consequently, to a further fall in output and exports.

Aggregate indicators of human well-being - for example, mortality rates, nutrition standards and school enrolment - would be expected to worsen compared with what they would have been in the absence of the war. This does not mean they necessarily fall in absolute terms, but that improvement is less than in normal times. In addition, distributional changes will occur, and some groups (those favoured by the government or foreign forces, and those with military strength) may gain more than their peace-time prospects while others will lose much more than proportionately to national performance. Indeed some individuals can make spectacular fortunes, which in the context of falling average incomes implies that many more households must have suffered disproportionately.

Due to shortages of consumer goods, fuels and foreign exchange, groups with access to these commodities (including not only traders and smugglers but also military leaders, civil servants and even those working with aid agencies) are likely to make large profits. In contrast, those trying to gain access to these commodities such as small farmers, formal sector wage earners, women and children are likely to suffer from the redistribution implicit in shortages and inflation which undermine their entitlements as discussed above.

### *The Development Costs of War*

War clearly reduces the potential for future economic growth and social improvements in developing countries, by destroying installed capital and reductions in new investment. By 'capital' in this context (and others) we understand:

- (i) productive capacity (eg plant, equipment and natural resources including land free of mines);
- (ii) economic infrastructure (eg roads, bridges and railway tracks);

- (iii) social infrastructure (eg schools and hospitals);
- (iv) human capital (eg health and skills);
- (v) collective assets such as organisational capital (eg government capacity);
- (vi) and social capital (eg trust and culture).

The development costs of war are far greater than the destruction associated with natural disasters, for two reasons. First, natural disasters such as floods, hurricanes and earthquakes tend to destroy housing and transport infrastructure, but have less effect on productive capacity and leave human capital (other than those killed of course) intact. Second, as organisational and social capital remains intact and natural disasters tend to be of relatively short duration, investment quickly recovers and may even have a positive multiplier effect on the economy as a whole (Alaba-Bertrand, 1993). In marked contrast, war destroys all forms of capital and the uncertainty it causes reduces investment radically. In particular, the destruction of entitlements which occurs during conflict constitutes an important development cost, as worsening levels of human education and nutrition reduce the human resources of an economy. The output losses discussed above will also lead to development costs as they reduce the capacity of the economy to invest, even with an unchanged investment ratio.

The range of capital destruction in wartime is not only broad but also of those capacities which are recognised as being critical for sustainable development in poor countries. Organisational capital can be severely weakened, as a result of the enfeebling of governments often associated with civil war, the worsening infrastructure and the out-migration of skilled people and foreigners, so that the government administrative machinery becomes less effective, banks may cease to work, etc. But again this depends on the nature of war. In some contexts (normally international wars), government machinery is strengthened by war. Social capital tends to be destroyed, with trust being weakened, community ties destroyed by fighting or the mass movement of people, and so on.

Undoubtedly, there tends to be a disintegration of existing forms. But new forms can develop, with, for example, new forms of authority and governance among rebel movements; informal financing mechanisms developing to substitute for the collapsed formal sector; NGOs, local and foreign, substituting for government, and so on. How far this occurs is likely to depend on the society, the development of the war and the actions of outside actors. Moreover, these new forms of organisational and social capital may not be so appropriate to peacetime conditions. But they should not be entirely discounted as a new development resource emerging, to a varying extent, in some conflict-ridden societies.

**Table 1.1: Development Costs of War**

Category of capital	Destruction of existing stock	Impact on new investment
Productive capital – plant, equipment and buildings	Land mined; agribusiness plant abandoned; transport stolen.	Fall in private productive investment; some investment in informal activities.
Economic infrastructure	Transport and communications system, power, irrigation disrupted	Decline in government expenditure on infrastructure
Social infrastructure	Schools, hospitals, clinics damaged	
Human capital	Death, migration (specially of skills); worsened nutrition and health of workforce	Decline in public entitlements, especially health and education.
Organisational capital	Government institutions, banks, agricultural extension, science and technology organisation weakened	No resources in formal sector; new informal organisations develop; NGOs take on new activities.
Social capital	Destruction of trust; work ethic; respect for property; community links	New forms of social capital, through groups that develop links in war; NGO activity.

### 1.3 ECONOMIC RECOVERY POLICY AND THE PEACE DIVIDEND

#### *Post-War Recovery and the Peace Dividend*

The widespread expectation - not least among the civilian population that have suffered from conflict - is that the ending of open warfare in a peace settlement and subsequent demobilisation of the armed forces, would lead rapidly to a recovery of the economy. This perception is encapsulated by the notion of the 'peace dividend'. In its original sense, the peace dividend refers to the reduction of military expenditure and the redirection of resources towards civilian production. In developed countries (eg the US after WWII), this would mean that the army would return to the agricultural and industrial labour force, and that output (and imports) would shift from supporting the military towards consumption and productive investment. In the case of developed countries which had suffered widespread destruction (eg Germany after WWII) there would also be widespread destruction of plant and infrastructure, plus a loss of much of the labour force; but precisely for that reason and investment and demographic boom is to be expected in post-war years. Historically this has not always occurred automatically; particularly where the sharp reduction of demand as government expenditure is scaled back (as in the case of the UK after both World Wars) leads to recession or where a large debt has to be serviced (eg Germany after WWI); which is the reason why extensive reconstruction assistance (eg the Marshall Plan) may be justified.

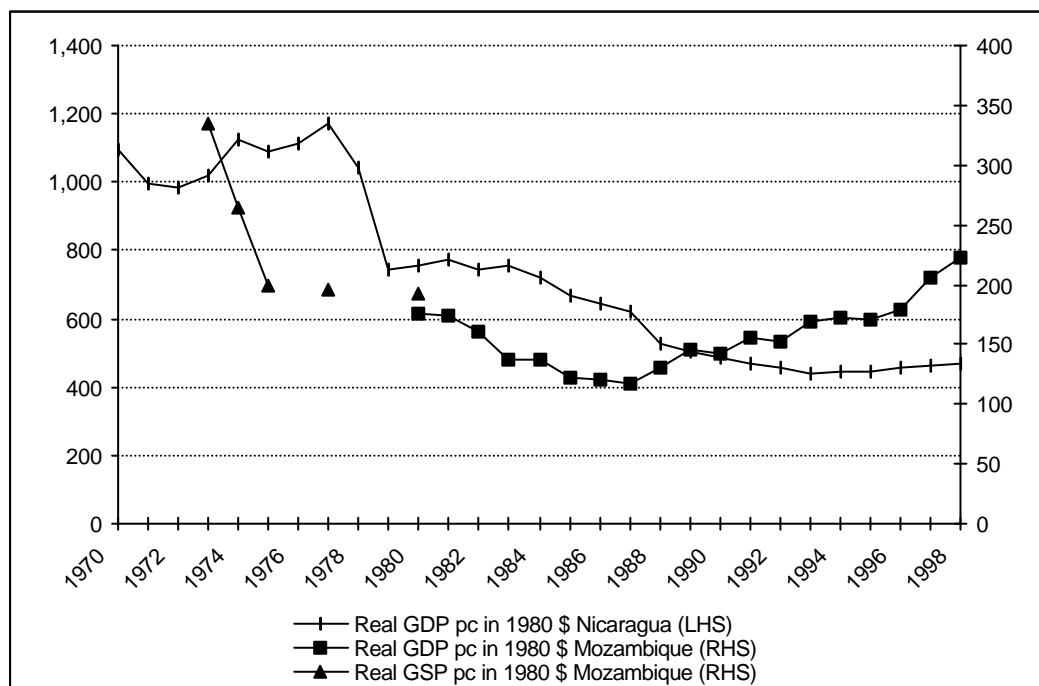
In developing countries the situation is rather different. On the one hand, the productive capacity is not simply switched from peace to war and back again. The productive system has been destroyed or distorted by the conflict, while the military labour force may be unwilling or unable to simply return to farming like some latter-day Cincinnatus. Widespread insecurity can persist, personal security still not be restored, and property rights remain uncertain. On the other hand, the problems of underdevelopment - widespread poverty, human capital, low investment, external constraints and so on - have been exacerbated by the years of conflict. The social pressure to address these problems

is all the greater at just the point when the attention of the international community is reduced by the official cessation of conflict and thus the apparent end to the 'humanitarian emergency'.

The cases of Mozambique and Nicaragua illustrate this problematic very clearly.

As Figure 1.1 shows, per capita income fell drastically during the war: allowing for measurement differences, the decline was of the order of one half in both cases. In Nicaragua per capita income, which had been rising in the late 1970s, fell by nearly one-third in 1979-80 as a result of the Sandinista insurrection against Somoza. It stabilised in the early 1980s, but renewed its decline as conflict was renewed with outside support, reaching one half of the mid-1970s level by 1990 when conflict was nominally resolved in 1990. Again, in the case of Mozambique, allowing for differences in measurement between 'gross social product' (GSP) and 'gross domestic product' (GDP) the post-independence conflict period from 1975 to 1987 is marked by a decline of per capita incomes by nearly two-thirds made up of a sharp decline immediately after independence, a certain degree of stabilisation in the late 1970s, and then a sharp decline as externally-supported civil war broke out.

**Figure 1.1: GDP per Capita in Mozambique and Nicaragua (1980 US \$)**



The striking result, therefore is the similarity between wartime experience of the two countries. Indeed, the pattern of wartime per capital income decline (allowing for the four-fold absolute income differential) is almost identical but with a time differential of some five years. Although both countries were far from recovering pre-war levels of income a full decade after the conflict had been nominally settled, Figure 1.1 clearly indicates that Mozambique recovered much more rapidly than Nicaragua. None the less, both countries could lay claim to be solvent 'middle income' countries before the war, with average incomes similar to that of their respective regions, albeit with severe distributional inequalities and thus serious poverty problems (see Table 1.2). Both are now countries with incomes far below the regional average and serious debt problems despite over a decade of post-war reconstruction. It is one of the central concerns of this study to establish why this should be so.

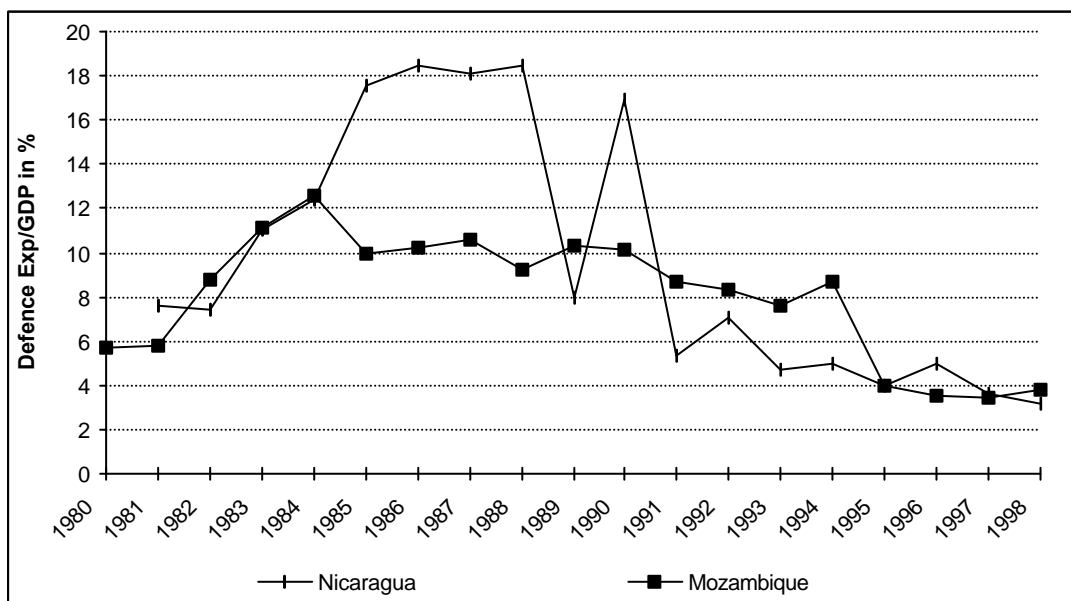
**Table 1.2: Regional Income Comparison for Mozambique and Nicaragua**

(GNP per capita in 1995 US \$)

	1972	1977	1982	1987	1992	1997
Mozambique	..	..	124	93	96	131
Sub-Saharan Africa	556	582	573	528	491	503
Ratio (percent)	..	..	21.6	17.6	19.5	26.0
Nicaragua	782	906	540	458	325	408
Latin America & Caribbean	2840	3334	3273	3407	3359	3706
Ratio (percent)	27.5	27.2	16.5	13.4	9.7	11.0

A major difference between peace and war should be the ‘peace dividend’. We would expect to see this demonstrated most clearly in levels of military expenditure. Figure 1.2 shows the level of defence expenditure in Mozambique and Nicaragua as a proportion of GDP. In the case of Mozambique, defence expenditure rose from less than 6 percent of GDP in 1980 to 12 percent at its height in 1984. From this year onwards it declined very slowly indeed for the next ten years, remaining around the 10 percent level. It was only in the mid-1990s that defence expenditure finally fell back towards pre-war levels of 4 percent of GDP.

**Figure 1.2: Defence Expenditure in Nicaragua and Mozambique (percent of GDP)**



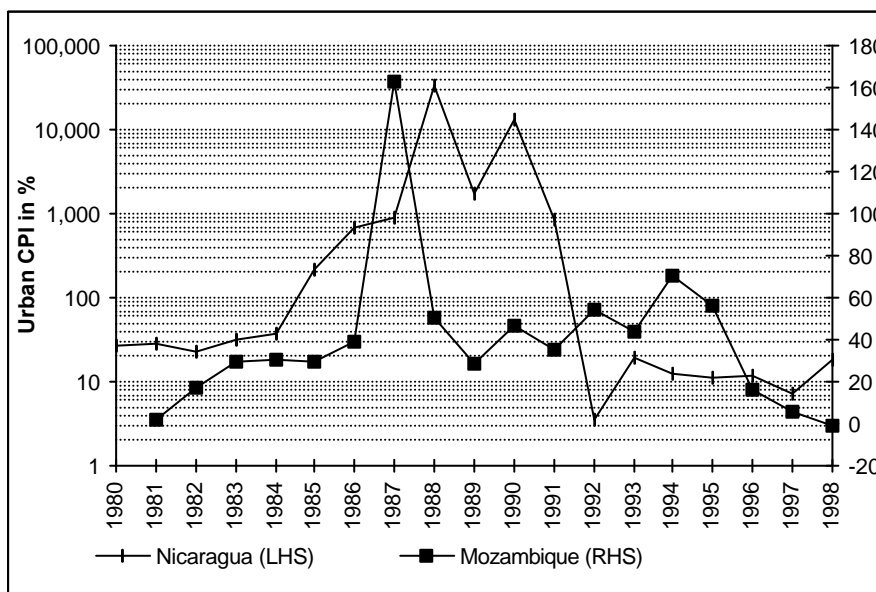
Interestingly, Nicaragua has similar starting and finishing points, although the intervening trajectory is very different. Military expenditure rose from 8 percent of GDP in 1981 to a very high level of 16-18 percent in 1985-1990. However, unlike in the case of Mozambique, expenditure fell sharply as soon as peace was declared, staying at 5-6 percent of GDP throughout the 1990s. The reasons why this was so are obvious: the radical military government remained in power in Mozambique but lost the elections in Nicaragua. None the less, we might expect that economic recovery would have been more rapid in Nicaragua than in Mozambique because a ‘peace dividend’ of the order of over 10 percent of GDP had been gained by the reduction in defence expenditure. The resources released were, of course, young men who still had to be clothed and fed and could only be a productive resource if adsorbed back into a growing agricultural sector - a factor that was to prove to turn out to be a central obstacle to recovery.

*Post-War Economic Performance*

As we have seen, both economies recovered relatively slowly after armed conflict ceased, although Mozambique did perform rather better. Both countries applied fairly conventional stabilisation programmes in the post-war period in order to reduce the level of inflation, which was felt to be not only distorting relative prices but also causing uncertainty and thus depressing investment. In the case of Nicaragua, this was achieved in just two years as the result of sudden fiscal contraction in not only military but also civilian expenditure and the dismantling of state enterprises. As Figure 1.3 shows, the result was the elimination of the hyperinflation of the late 1980s (itself the result of attempts at monetary correction without fiscal retrenchment) and the achievement of an annual inflation level of the order of 10 percent per annum during the reconstruction period.

In contrast, although Mozambique had suffered from rising inflation rates during the war, only one year (1987) could be described as hyper-inflationary. The fiscal and monetary restraints were far less severe than in Nicaragua: military expenditure stayed relatively higher and state restructuring was much slower. In fact inflation continued at 40-60 percent per annum between 1988 and 1995, only declining to acceptable levels in the late 1990s when the economy was finally liberalised. As in the case of the 'peace dividend' from military expenditure cuts, it might be expected that this would have led to recovery being quicker - but as we have seen, this was not the case.

**Figure 1.3: Inflation in Mozambique and Nicaragua (percent per annum)**



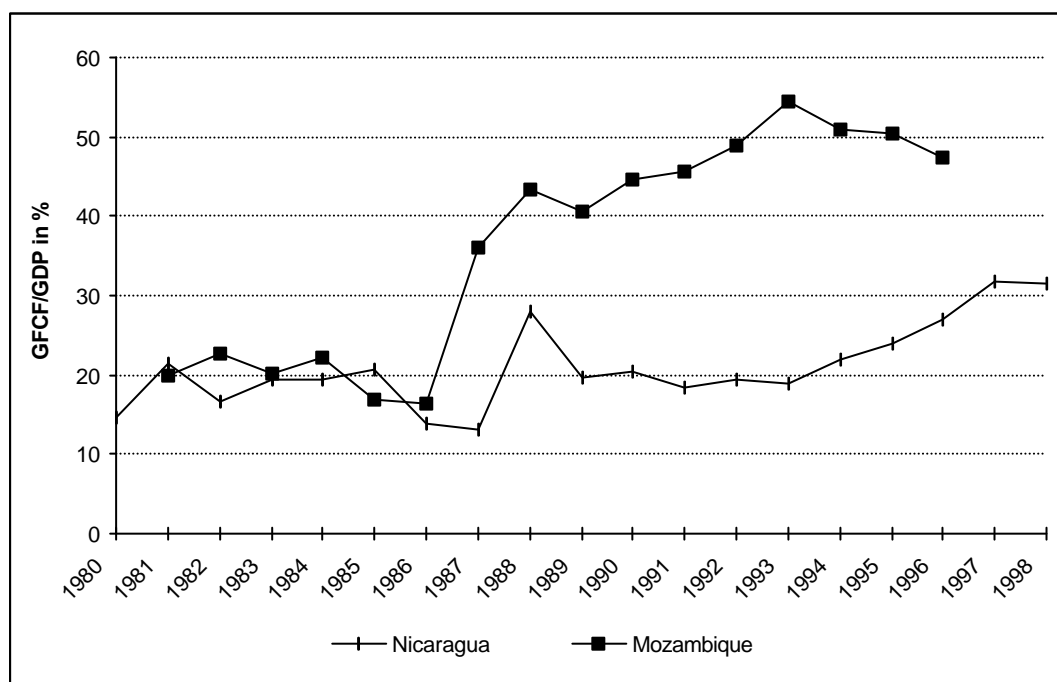
In fact, as the case studies in Parts II and III demonstrate, much of the difference was in agricultural performance; itself the product of post-war pacification (or lack thereof) and macro-economic policy. In Nicaragua, rural markets recovered quite quickly after the war ended, although depressed world prices remained a problem for exporters. However, the combination of a lack of credit (due to monetary policy and financial liberalisation) and the over-valuation of the exchange rate (due to the tight monetary policy and the level of aid) meant that incentives to invest were minimal and the land area under cultivation expanded very slowly.

In Mozambique, rural markets recovered much more slowly, but producers were less dependent on credit and were helped by favourable weather conditions and the ability to return to abandoned farmland. Again, the level of investment in infrastructure in Nicaragua remained low due to the fiscal restraints; while in Mozambique it rose as aid shifted from emergency relief (particularly from food

aid, which probably depressed domestic production) towards the reconstruction of roads, hospitals and schools.

The result can be seen in Figure 1.4. Even allowing for some over-estimation of investment rates in the case of Mozambique, the contrast with Nicaragua is striking. In the latter case, the relatively low wartime investment levels were maintained through the first half of the 1990s, and although private investment began to recover in the late 1990s, this was mainly related to a construction boom in Managua and not to capacity formation in agriculture. In Mozambique, however, post-war investment levels least double as a share of GDP; and even though much of this is aid projects, it helps explain the relatively rapid recovery in comparison with Nicaragua.

**Figure 1.4: Investment Levels in Mozambique and Nicaragua (percent of GDP)**



In sum, it would appear that while monetary stability can be restored relatively quickly, and that this is clearly a necessary condition for post-war reconstruction, far more is needed in order to restore investment levels and farm production. Indeed, the case of Nicaragua seems to indicate that the *form* of stabilisation and structural adjustment policy can actually delay recovery even if it eliminates inflation and restores fiscal balance.

### *Post-War Social Performance*

The widespread notion that social conditions are very bad during war and necessarily improve in peacetime is not necessarily correct. Indeed, in the UK during WWII for instance health and nutrition standards actually improved, only to deteriorate again in the immediate post-war years. Both Nicaragua and Mozambique had progressive regimes during their war periods, regimes which were committed to reducing poverty and extending health access. These policies tended to be undermined in peacetime by the effects of economic liberalisation and fiscal retrenchment; which in turn affected both income inequality and health provision.

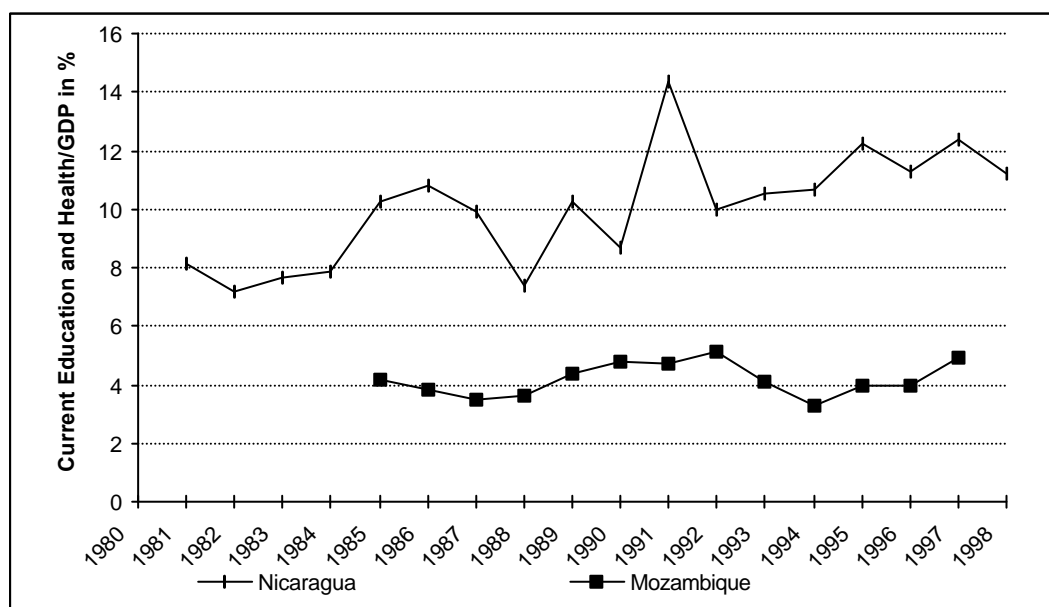
One reflection of the 'peace dividend' is that the decline of military expenditure frees fiscal resources for health and education. Figure 1.5 shows the long-term trends in current expenditure on health and education as a proportion of GDP. In the case of Nicaragua, the increase in the early 1980s is

reversed in the latter half of the decade as social expenditure is 'crowded out' by rising defence commitments (see Figure 1.2). Social expenditure rises again in the early 1990s, and might be thought to reflect the 'peace dividend'; but most of this was financed by renewed aid inflows (see Figure 1.17 below) and expenditure stabilised again by the mid-1990s at a level similar to that a decade earlier. In other words, economic reconstruction did not involve a major improvement in social expenditure, although it did continue a long term upward trend.

In Mozambique, the relative level of health and expenditure was much lower than in Nicaragua. In absolute terms they were very different indeed: in the mid-1990s expenditure per capita in Nicaragua was about US \$ 50 per capita (at 1980 prices) compared to US \$ 10 in Mozambique. Expenditure rose in the late 1980s, again as part of the 'peace dividend' but only from 3 to 4 percent of GDP. However, it fell in the early 1990s under fiscal retrenchment (see Figure 1.13 below) and although it subsequently recovered somewhat, health and education expenditure still only accounted for 10 percent of fiscal expenditure by the end of the decade.

**Figure 1.5: Health and Education Expenditure in Mozambique and Nicaragua**

(percent of GDP)

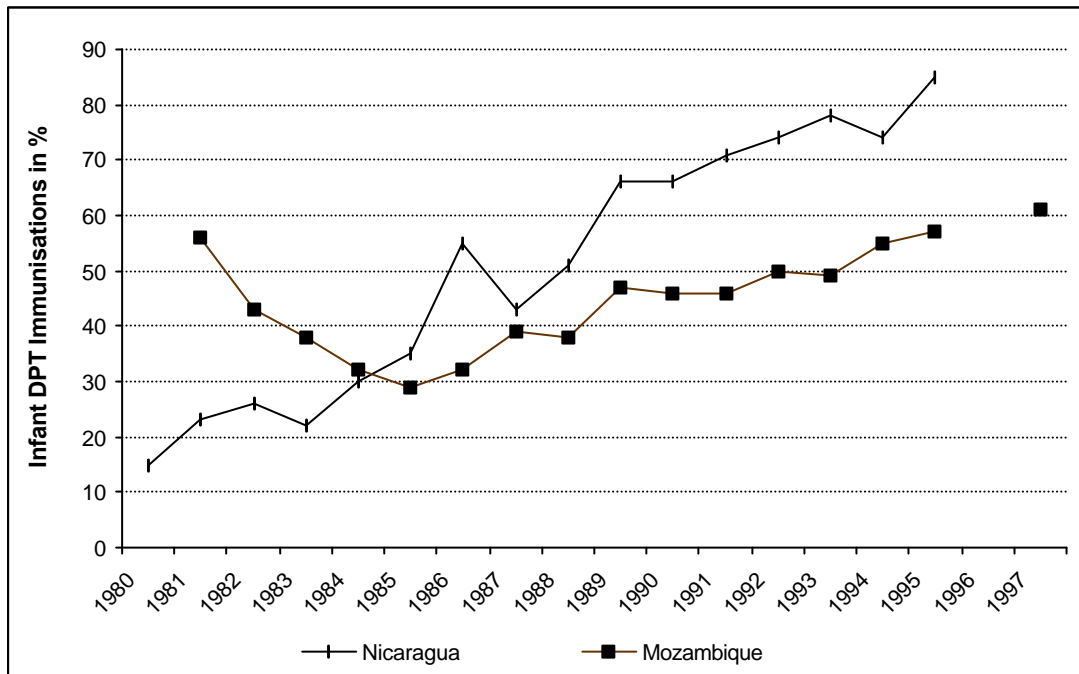


This relatively poor performance in terms of social expenditure does permit a reallocation of resources towards post-war priorities, of course. In fact, both Nicaragua and Mozambique did target shift towards provision of primary health and education, and a focus on children in particular - possible under the influence of aid donors (NGOs in particular) as much as from the domestic electorate. As Figure 1.6 indicates, Nicaragua managed to increase the coverage of infant DPT immunisation from 15 to 70 percent during the conflict-torn 1980s; and this progress was sustained during post-war reconstruction, when the coverage reached over 80 percent. In the case of Mozambique, the coverage declined seriously during the war, and although it has recovered in the reconstruction period, it had only reached 60 percent by the end of the 1990s.

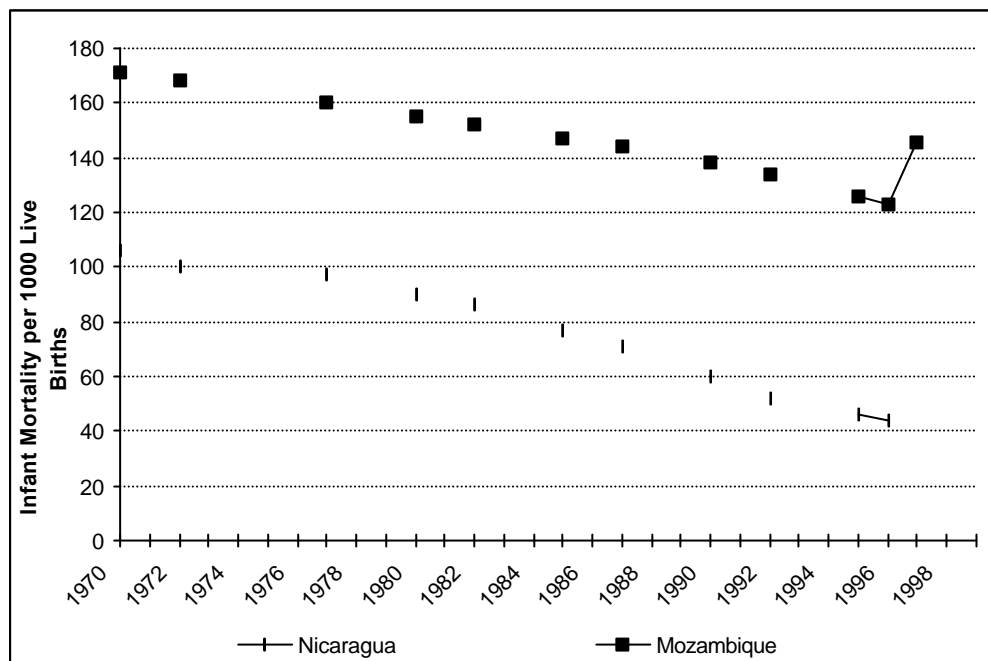
In the case of Nicaragua (see Part II) World Bank surveys clearly indicate both a worsening of income distribution and rising poverty in the 1990s. The decline in income per capita in the 1980s had not led to increased poverty because the income distribution had improved, in part due to wealth losses by the rich, but also measures designed to help the poor - such as land redistribution, inflation adjustments to wages and subsidised foodstuffs. These ceased after 1990, so the growing dispersion

of income is not surprising. When combined with slow average income growth, the rise in poverty was only to be expected. Although the data on income distribution in Mozambique is poor (see Part III), the more rapid recovery in per capita GDP has helped to avoid an increase in absolute poverty numbers - which in this case would imply starvation.

**Figure 1.6: Infant Immunisation Coverage (percent of age group)**



Surprisingly perhaps, the net effect of these two forces - private incomes and public health - seems to have been positive in both our cases when measured in terms of the key human welfare indicator, infant mortality. As Figure 1.7 indicates, infant mortality in Mozambique declined steadily throughout the war (as public health standards rose) and continued to decline in peacetime. None the less, the level remains high by international standards, and more progress might have been made - the apparent increase in 1998 is worrying. In the case of Nicaragua, the trend shows considerable progress in reducing infant mortality (from 100 to 60 infant deaths per 1000 live births) during the 1980s wartime conditions, and rather slower improvement in peacetime.

**Figure 1.7: Infant Mortality in Mozambique and Nicaragua (per thousand live births)**

In sum, economic recovery alone is clearly not sufficient to reduce poverty, unless it is very rapid and does not involve a deterioration of the income distribution. If either economic liberalisation worsens distribution (as it usually does) or GDP does not grow much faster than the population - or a combination of the two - than post-war poverty is very likely to increase. This does not only mean continued human suffering by the vulnerable: it also implies that social tensions will continue and make sustainable economic recovery all the more difficult.

#### 1.4 REACHING A SUSTAINABLE DEVELOPMENT PATH

##### *The Process of Economic Reconstruction*

The reconstruction of the economy after a war involves the establishment of ‘solvency’ in the wide sense. There are three basic elements:

first, the recovery and expansion of the export base in order to generate the foreign exchange income necessary to provide current imports, undertake debt service and eventually finance the investment required for growth;

second, the reorganisation of the fiscal sector so that there are sufficient tax revenues, an efficient expenditure system, and a manageable debt level; and

third, the rebuilding of the institutions necessary to allow the private sector to revive and contribute to sustainable growth, employment creation and rising income levels.

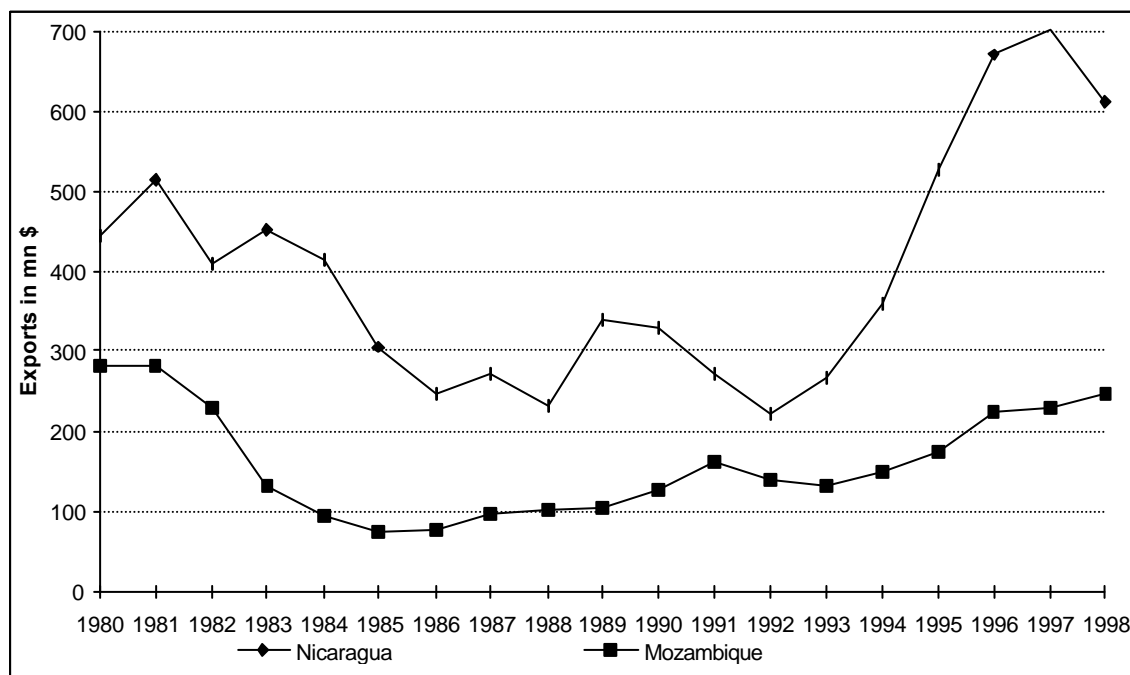
In the short run these three functions can be temporarily replaced by an international aid effort, but the measure of the effectiveness of this effort is not the immediate welfare gains but whether solvency is in fact re-established and a sustainable development path reached.

*Export Reconstruction*

Post-war export recovery is a double task. On the one hand, the existing export capacity must be restored. In an agrarian economy, this means the recovery of land (which may be mined), the return and possibly re-training of the labour force, the recuperation of traditional volumes and quality of production, the repair of processing facilities and transport infrastructure (roads and ports) and the re-establishment of trading and financial linkages with traditional markets. On the other hand, the changes in the regional and world economy during the war period must be adapted to. This may mean the development of new product lines, penetrating new export markets, competing with other exporters and discovering new sources of trade credit. These are tasks which a weakened private sector finds very difficult and costly to carry out. In consequence, it is not surprising to find that exports recover slowly after a war. This problem may be exacerbated by the aid programme in a 'Dutch Disease' effect : first, the influx of 'free' foreign exchange can lead to an over-valuation of the currency and consequently reduce exporters' profitability; second, the availability of imports increases the profitability of non-traded sectors such as commerce and construction, which are much easier for the private sector to expand into than export recovery.

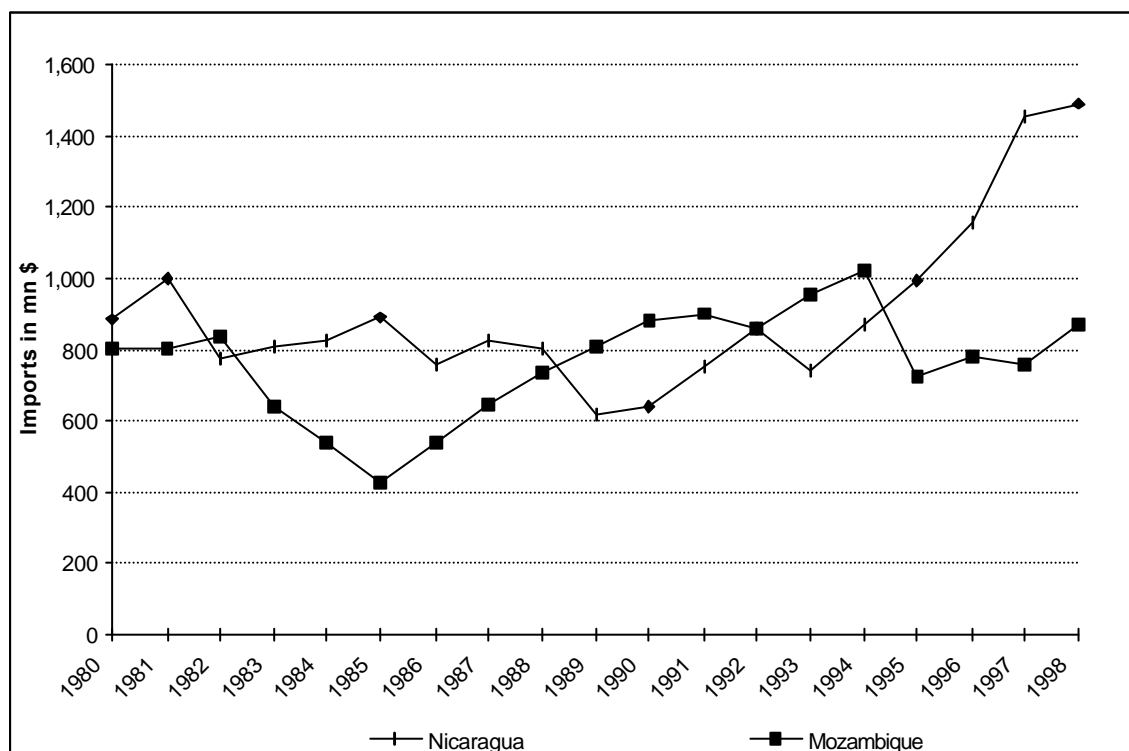
As Figure 1.8 indicates, both Mozambique and Nicaragua experienced considerable export declines during the conflict period - losing over half their foreign exchange revenue in the process. In the case of Nicaragua, this decline continued into the first half of the 1990s, as the initial reconstruction programme led to currency overvaluation as hyperinflation was eliminated, while rural unrest prevented export farms from returning to full production. The latter half of the 1990s saw strong export growth, however - although this was largely based on tax-free export zones exporting light manufactures from Managua rather than a true rural revival. Mozambique also managed a considerable export revival based on the agricultural output recovery. Recovery was much steadier but also slower than in Nicaragua, taking over a decade to recover pre-war levels. In both cases, however, export levels in real dollar terms (let alone per capita) remained at well below pre-war levels. This failure of the agro-export sector to recover in both cases also had serious consequences for rural employment.

**Figure 1.8: Exports from Mozambique and Nicaragua (US \$ millions)**



Imports, however, did not follow the export trend, as Figure 1.9 demonstrates. Nicaraguan import levels were maintained throughout the war period, and recovered sharply after peace was attained in 1990. In the second half of the 1990s imports expand rapidly due to a combination of trade liberalisation and export growth. In marked contrast, imports to Mozambique decline seriously during the war period, reaching half their pre-war level by 1985 as the modern sector of the economy ground to a halt. The peace process and structural adjustment (particularly import liberalisation) led to a rapid import recovery in the late 1980s: in the 1990s the pre-war import level was more or less maintained. In both cases, as we shall see, this import recovery was mainly made possible by aid inflows and foreign borrowing.

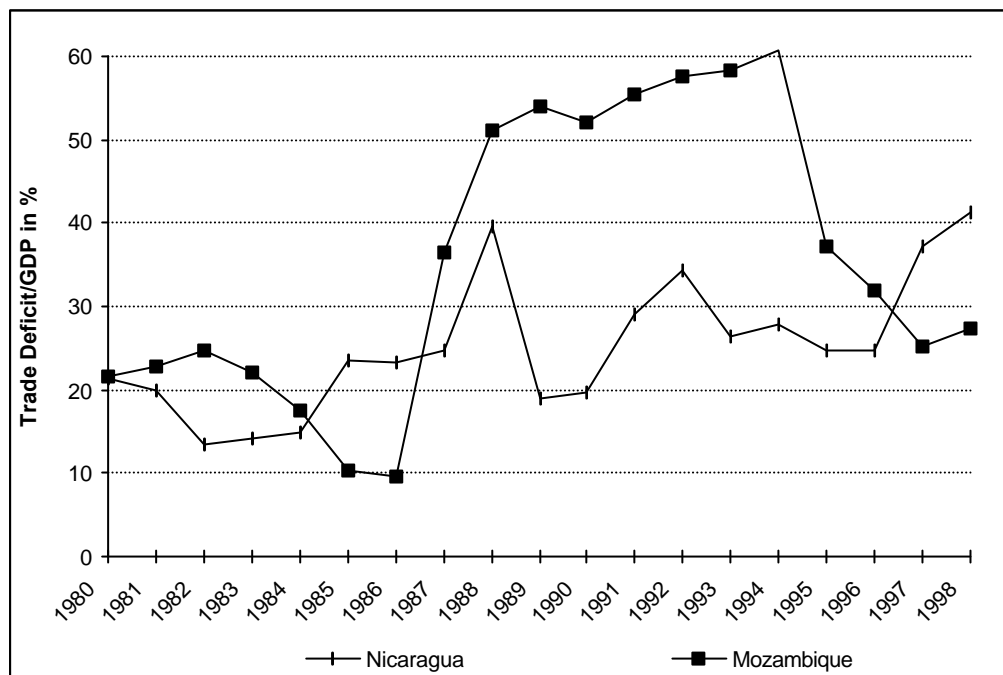
**Figure 1.9: Imports to Mozambique and Nicaragua (US \$ millions)**



The consequent imbalance between exports and imports in the two economies has led to very large and persistent post-war trade deficits in both Mozambique and Nicaragua - as Figure 1.10 shows. In the case of Mozambique the trade deficit as a proportion of GDP was actually declining during the war - albeit due to the slowdown of the formal sector. However, during the 1990s this trade gap actually increased, fluctuating around an average of 50 percent of GDP between 1988 and 1994. This was clearly unsustainable, and in fact the structural adjustment efforts of the late 1990s, in combination with the decline of aid and the slow export recovery, reduced the trade deficit towards 30 percent of GDP - still unsustainable in the long run.

In Nicaragua, in contrast, the trade deficit rose as a proportion of GDP during the war; and initially fell when this ended. However, it then steadily rose again due to a combination of trade liberalisation and access to foreign finance - fluctuating around 30 percent of GDP which was - as in the case of Mozambique - unsustainable in the long run. We will return to this problem in the next Section of Part I.

In sum, in neither Mozambique nor Nicaragua did post-war reconstruction lead to a sustainable external trade position.

**Figure 1.10: Trade Deficit in Mozambique and Nicaragua (percent of GDP)**

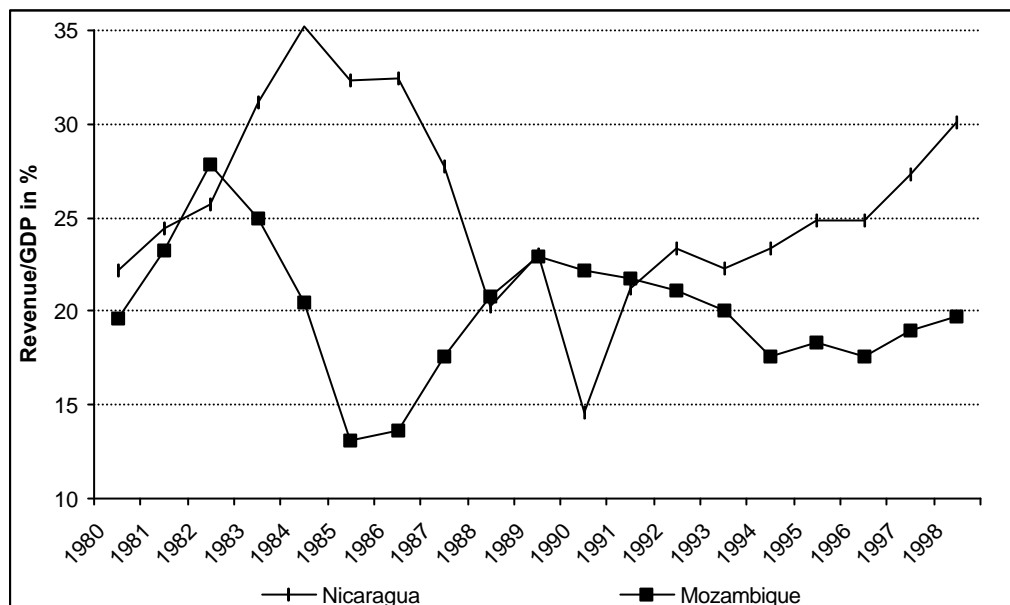
### *Fiscal Reorganisation*

The first step towards fiscal solvency is the recovery of tax revenue. As Figure 1.11 indicates, current government revenue in Mozambique declined seriously in the war years, falling by over a half as a proportion of GDP. This is easily explained in terms of the declining tax base, and the immediate post-war years saw a strong recovery as would be expected as economic activity picked up again and the government regained control of the national territory. However, the subsequent decade has seen a gradual decline in tax pressure - which did not exceed 20 percent of GDP, compared to 28 percent in 1982. This made debt service and adequate provision of social services very difficult, despite the decline in military expenditure.

In the case of Nicaragua fiscal revenue rose rapidly in the early 1980s as a consequence of more effective collection, from 22 percent of GDP in 1980 to 35 percent in 1984. However, the hyperinflationary process undermined the tax base and revenue had declined to 15 percent of GDP by 1990. Post-war efforts at stabilisation have involved a sustained attempt to recover the wartime effectiveness of tax collection, and despite widespread corruption revenue reached 30 percent of GDP in 1998 - which seemed a reasonable maximum in practice for a country of this level of development.

**Figure 1.11: Current Government Revenue in Mozambique and Nicaragua**

(percent of GDP)

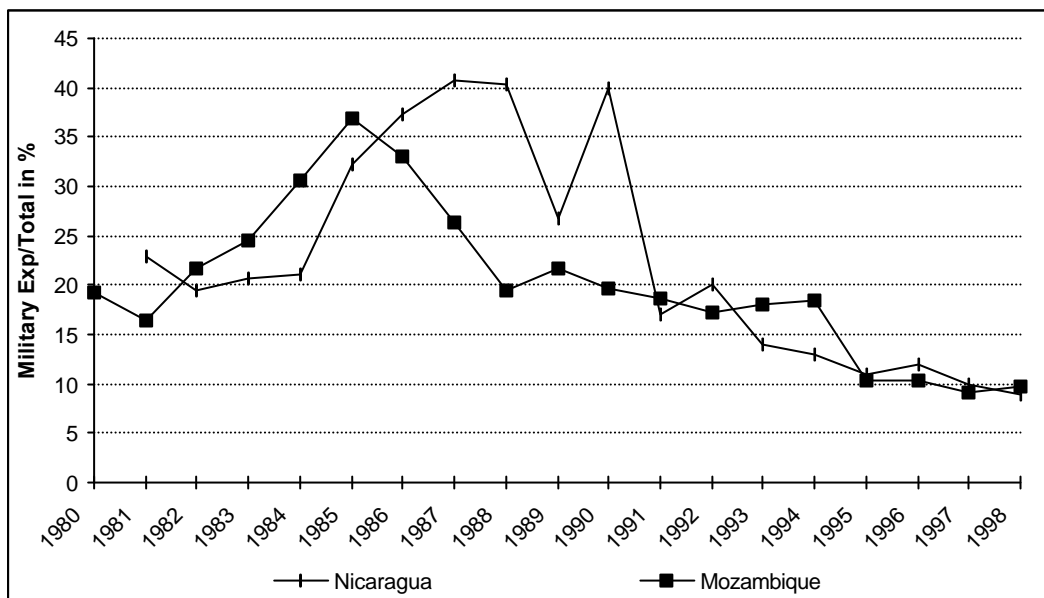


As discussed above, the rise of military expenditure in wartime and its subsequent peacetime decline is a central feature of reconstruction in both economies. As Figure 1.12 indicates, both economies have followed strikingly similar fiscal paths in this respect. In the case of Mozambique, the military share in the budget rose from 20 to 35 percent between 1980 and 1985; declining steadily thereafter to less than 10 percent of the total in 1998. Similarly, the military share of the Nicaraguan budget rose from 20 to 40 percent between 1982 and 1987, declining to below 10 percent in 1998. The only real difference is the more gradual and steady adjustment in Mozambique compared to the sudden shift in Nicaragua: it may well be that subsequent unrest in Nicaragua, compared to the higher level of social cohesion in Mozambique, is related to this shift. However, in principle at least, both countries should have benefited from a ‘peace dividend’ of the order of 20 percent of the budget - which could be assigned to social expenditure or deficit reduction.

As we have seen social expenditure was maintained and even grew in both countries after the war, although not as much as might have been expected. As Figure 1.13 indicates, in Nicaragua the share of the budget allocated to health and education actually rose from around 20 percent in the 1980s to around 30 percent in the 1990s. In Mozambique, in contrast, the corresponding budget share was fairly stable at around 10 percent level throughout the post-war period. This latter figure seems very low in relation to the needs of the population and the relatively ample resources available from taxation and aid grants. It may reflect, however, the fact that many social services are directly provided by non-governmental organisations rather than by the central government.

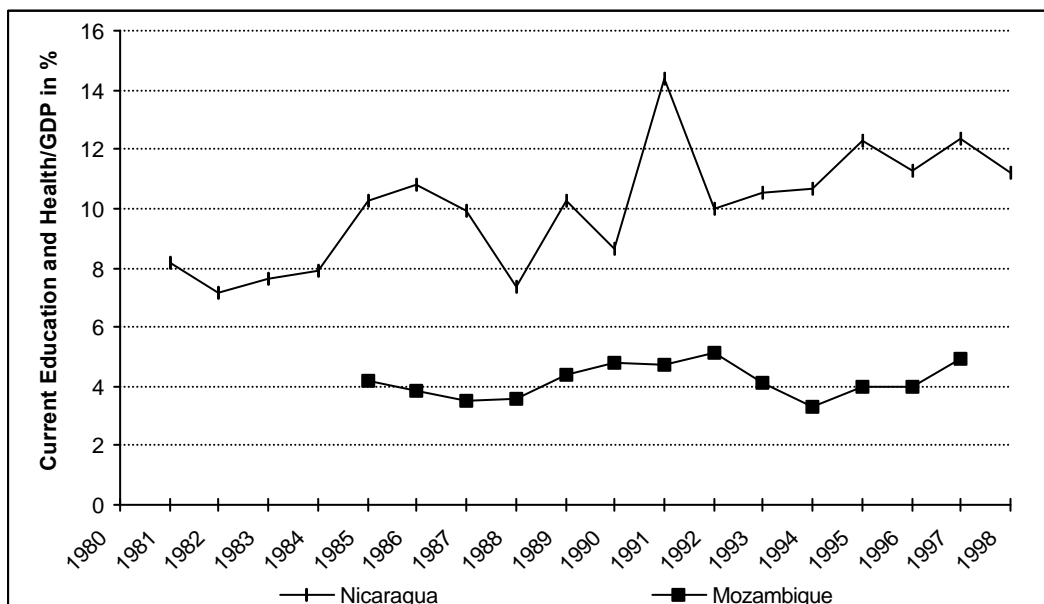
**Figure 1.12: Military Budgets in Mozambique and Nicaragua**

(percent of total government expenditure)



One of the major problems of post-war fiscal management in both countries has been the level of outstanding foreign debt, and the consequent service costs. We shall return to this point later in Part I , but here it is worth noting that interest costs have risen to occupy a significant share of the budget - indeed to some extent they have balanced the decline in military expenditure and thus used up much of the ‘peace dividend’.

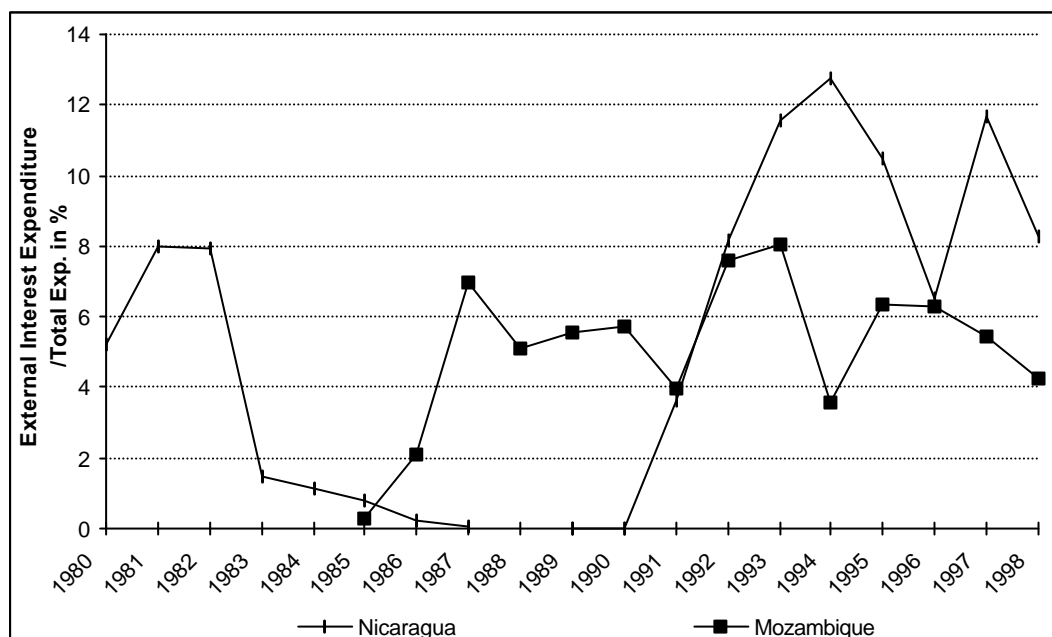
**Figure 1.13: Health and Education Budgets** (percent of total government expenditure)



As Figure 1.14 indicates, Mozambique began to service its debt with the onset of structural adjustment in the mid-1980s, since when it has fluctuated around 6 percent of the budget. In the case of Nicaragua, interest payments fell during the war as debt was not serviced, but immediately afterwards interest payments resumed varying widely in subsequent years dependent on the status of debt renegotiations, but averaging some 10 percent of the budget.

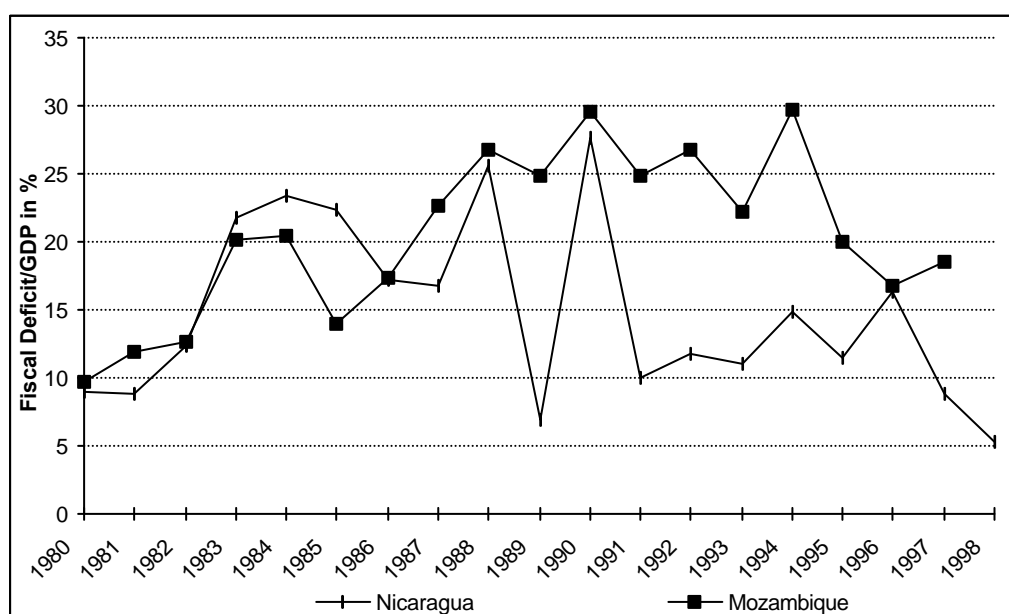
**Figure 1.14: External Interest Burden in Mozambique and Nicaragua**

(percent of total government expenditure)



The outcome of these income and expenditure trends was continued fiscal disequilibrium. In both countries the fiscal deficit followed a remarkably similar - albeit predictable - path during the war: the deficit rose from 10 percent to over 25 percent of GDP; which in neither case was sustainable. However, Mozambique maintained this extraordinarily high deficit into the mid-1990s, and only began to reduce this towards pre-war levels by the end of the decade. Even then, this level of deficit would clearly be unsustainable if it had to be financed domestically rather than through aid. In contrast, Nicaragua cut the fiscal deficit back to 10 percent of GDP as soon as the war ended, but this rose again subsequently and was only cut back to a sustainable level of 5 percent of GDP at the end of the decade.

**Figure 1.15: Fiscal Deficits in Mozambique and Nicaragua (percent of GDP)**



*Rebuilding Institutions*

It is very difficult indeed to make meaningful comparisons between the institutions of two very different societies. None the less, such a comparison is necessary if we are to understand the differences in economic behaviour and, perhaps more importantly, design appropriate reconstruction policies.

In the case of Nicaragua, markets were apparently working very soon after the end of the war and the dismantling of state controls over the economy. However, private activity in productive (especially exports and small farming) sectors only responded slowly to this liberalisation. In retrospect it is clear that the problem of property rights in general - and law and order in rural areas in particular - was more important in explaining slow private response than the form of economic policy. What is more, the sudden shifts in economic policy further increased uncertainty among private investors.

In contrast, the return to markets (which had not been highly functional before the war in any case) was much slower in the case of Mozambique. Indeed, unlike in Nicaragua, property rights were not the central issue in rural recovery - rather it was the infrastructure of markets themselves that was missing - ranging from transport infrastructure to enforceable commercial contracts. In part this difference was due to the improvement in the law and order situation (while in Nicaragua it had been *better* in those localised areas where fighting was taking place) after the war. It was possibly also the case that traditional collective property forms were stronger in Mozambique (as opposed to modern 'capitalist' or 'socialist' forms in Nicaragua) and thus that property rights were considered stable independently of official institutions. In other words - contrary to expectations - the less developed economy of the two was better positioned for recovery. However, this may be too simple an explanation - as we shall see in the discussion of the political economy of reconstruction below.

In sum, the reconstruction period did not really establish the basis for sustainable growth in either Mozambique or Nicaragua ten years after peace. In order to do so exports would have to be at least their level at that point, and if tax pressure had reached a natural limit then debt service would have had to be reduced to zero in order to permit adequate levels of social and infrastructure expenditure. Mozambique made much more progress in rebuilding institutions, despite the higher level of development in Nicaragua. This appears to have had much to do with fact that the post-war political regime in Mozambique appears to have enjoyed more social support than in Nicaragua, a point to which we shall return later on in Part I. However, there is still in both countries a real danger of 'economic regress' (Sen, 1994) and thus fiscal strains that could bring about a return to conflict. During the reconstruction period these tensions were 'resolved' by recourse to aid, a topic which we address next.

## 1.5 ROLE OF THE DONORS

*The Scale and Scope of Aid*

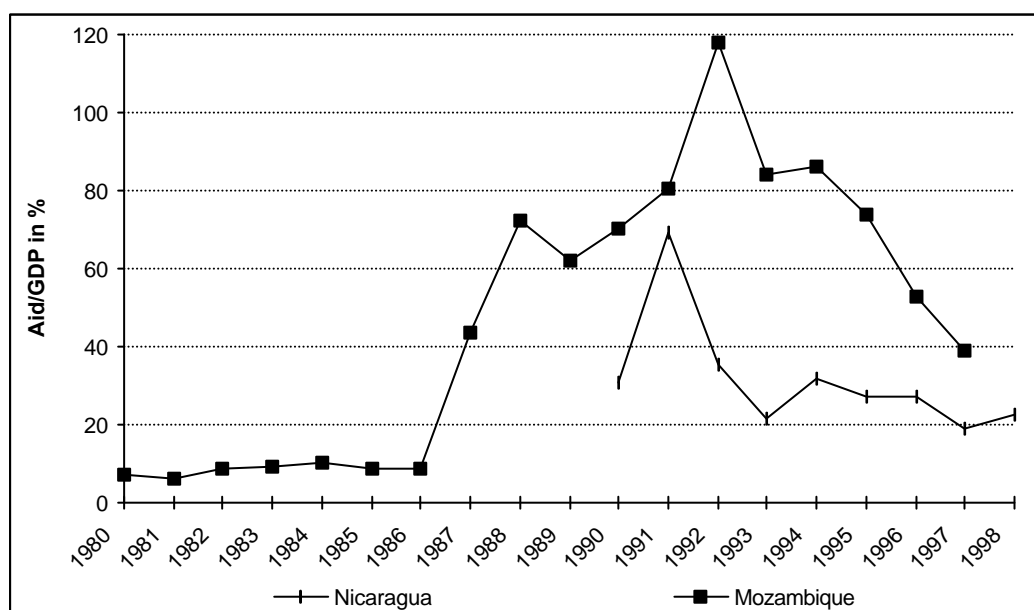
A key characteristic of the post-war reconstruction period in both Mozambique and Nicaragua is the very large amount of external assistance (in relation the size of these economies) that was supplied by donors. While the intention of this aid was clearly to support the reconstruction process, it is not obvious whether - in the event - this was the long-term consequence. In particular, while it is clear that aid maintained consumption levels above what they might otherwise have been - and to that extent reduced the incidence of poverty - it is far less clear that aid contributed to a sustainable

development path.

Mozambique received about US \$ 500 millions a year on average throughout the 1990s, which was equivalent to about two-thirds of imports and 60 percent of the government budget. Figure 1.16 shows the very low level of aid until the start of structural adjustment in the mid-1980s, when it rose rapidly towards 70 percent and then reached an extraordinary peak of 120 percent of GDP in 1992, the year of a drought and the peace agreement. After this, aid declined in relative terms towards a still large level of 40 percent of GDP. None the less, aid was still more important than exports as a source of foreign exchange after six years of reconstruction.

Aid to Nicaragua too rose rapidly after peace was established in 1990. Some US \$ 600 millions a year was received between 1990 and 1995, declining somewhat to US \$ 400 million a year between 1996 and 1999: equivalent to 30 and 25 percent of GDP respectively. These flows financed about one third of imports and half the government budget during the reconstruction period.

**Figure 1.16: Aid to Mozambique and Nicaragua (percent of GDP)**



However, these aggregate figures do not give a very clear indication of the economic impact of this enormous (in relation to the size of these economies) inflow of resources. This is for three reasons:

First, much of the gross flows are related to the refinancing of debt or the accumulation of central bank reserves; and thus are accounting entries and do not enter the economy as such - unless it is assumed that these transactions would otherwise have adsorbed domestic resources.

Second, aid can involve a transfer of resources to the public or private sector; the transfer to the public sector should be evident in the fiscal accounts, although these may not reflect all state activities; transfer to the private sector involves direct distribution to households (e.g. food aid) and support of local NGOs.

Third; within both the public and private sector, aid may logically result in investment or consumption (with a consequent effect on saving); ideally the support of consumption will only happen during emergencies, and shift to investment support during reconstruction will take place.

As Tables 1.4 and 1.5 in the next Section indicate, the impact of this aid on the balance of investment and savings in the economy - and thus private sector behaviour - was very large in both our two economies during the reconstruction period. Table 1.3 summarises this data for a late war/early post-war year and a late post-war year from each economy. From this it is evident that the level of 'fiscal aid dependency' was much higher in Mozambique than in Nicaragua, as might be expected, and that this dependency did not decline during reconstruction in either case. However, despite this reliance on aid resources, the public sector did shift from dis-saving to positive saving in both countries, so that the aid was used for investment and - as domestic borrowing became negative in both cases - towards financing the private sector.

The considerable scale of net external finance to the private sector is also evident in both cases: while in the case of Mozambique this reliance declines, in Nicaragua it becomes larger, as reconstruction proceeds. In the case of Mozambique, this is mainly aid-financed, but clearly private savings recover, so that while aid was supporting private consumption at the outset, it is subsequently financing about half of private investment. In the case of Nicaragua, the picture is quite different because private capital inflows are renewed by the end of the period: aid basically supports the fiscal sector. The public sector is a net domestic *lender*, which has the effect of supporting the private sector. The private sector has a corresponding and increasingly negative savings rate, thus indicating financial unsustainability.

**Table 1.3: Aid and Investment in Mozambique and Nicaragua** (percent of GDP)

	Mozambique		Nicaragua	
	1988	1996	1991	1998
Public Sector Investment	22.1	18.7	4.7	8.6
Saving	-4.7	2.0	-3.5	6.4
Balance	-26.8	-16.7	-7.9	-2.2
External Finance	22.9	18.5	12.4	11.0
Internal Finance	3.9	-1.8	-4.5	-8.8
Private Sector				
Investment	21.2	28.6	13.9	22.9
Saving	-6.1	13.5	-2.2	-13.0
Balance	-27.3	-15.1	-16.1	-35.9
External Finance	31.2	13.3	11.6	27.1
Internal Finance	-3.9	1.8	4.5	8.8
Totals				
Investment	43.3	47.3	18.3	31.5
Saving	-10.8	15.5	-5.7	-6.6
Balance = CAB	-54.1	-31.8	-24.0	-38.1
memo: 'aid'	70	50	65	15

The organisation of external assistance was very similar in our two cases. The World Bank and the IMF made a standard structural adjustment and stabilisation programme a condition for their support. A common pattern of monetary and fiscal retrenchment was established as policy aims, although as we have seen it proved difficult to implement in both cases - inflation reduction being easier to achieve than fiscal solvency. The liberalisation of trade and finance were also conditions for multilateral aid, as was privatisation; but progress was much more rapid in the case of Nicaragua than in Mozambique.

At the micro-economic level, aid in both cases was largely administered by bilateral donors and above all by non-governmental organisations. In Mozambique, a very high degree of policy dependency accepted by government at the sectoral as well as the macro-economic level. Donor coordination by sector and even province was relatively effective, due in part to a high degree of consensus as to what to be done, even though there was often a lack of human resources to achieve it.

In contrast, while there was a high degree of consensus between the Nicaraguan government and donors on policy objectives in the first post-war administration (1990-94) this was not the case after 1995. There was a tendency for macroeconomic policy (agreed between the IMF and the central bank) to be inconsistent with bilateral aid efforts coordinated with sectoral agencies and NGOs. What is more, there was increasing conflict after 1995 between the government and bilateral donors on social objectives, with the latter becoming increasingly concerned by rising poverty and corruption.

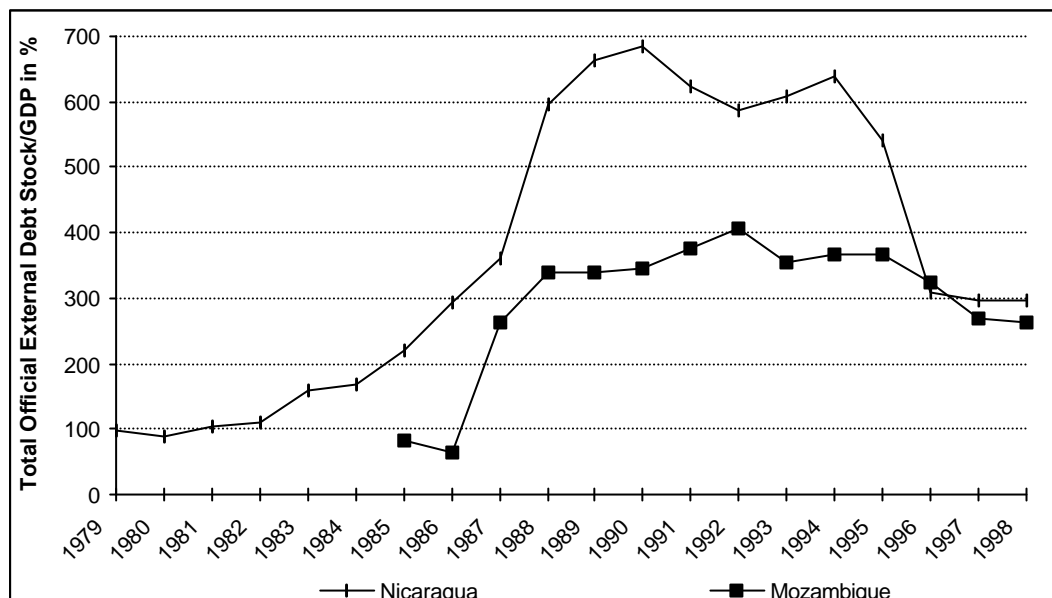
### *The Debt Problem*

Both Mozambique and Nicaragua were heavily burdened by debt at the outset of their reconstruction efforts. In both cases these contained a considerable proportion of debts to the former socialist members of COMECON, but there was little prospect of these being repaid in hard currencies and the transitional arrangements in the donor countries themselves led to a substantial reduction of this debt. Commercial debt was of little consequence for Mozambique, and in the Nicaraguan case had been re-negotiated during the war. In consequence, the peacetime debt was fundamentally with DAC member governments and multilateral agencies. Further, the process of negotiation for the restructuring and cancellation of debt was relatively successful with bilateral donors during the 1990s in both cases, so that outstanding debt became increasingly 'multilateralised', so to speak. The issue of the implementation of the HIPC Initiative to Mozambique and Nicaragua was still unresolved by the end of the period under consideration (mid 1999). In fact, natural disasters so affected both our economies in 1999 and 2000 that the case for debt cancellation came to be based on inability to pay rather than the implementation of 'sound' economic policies as had been intended by the donors.

Figure 1.17 below shows both the very high levels of indebtedness and a common pattern of relief over time. However, it is noticeable that Nicaragua and Mozambique both started off the reconstruction period with debt to GDP levels of over 300 percent, and both were still at this level by the end of the 1990s - a level which is clearly unsustainable and was not in fact serviced, as we shall see. In both cases, the ratio rose as new reconstruction loans were extended, and fell as the *wartime* debt was restructured or cancelled.

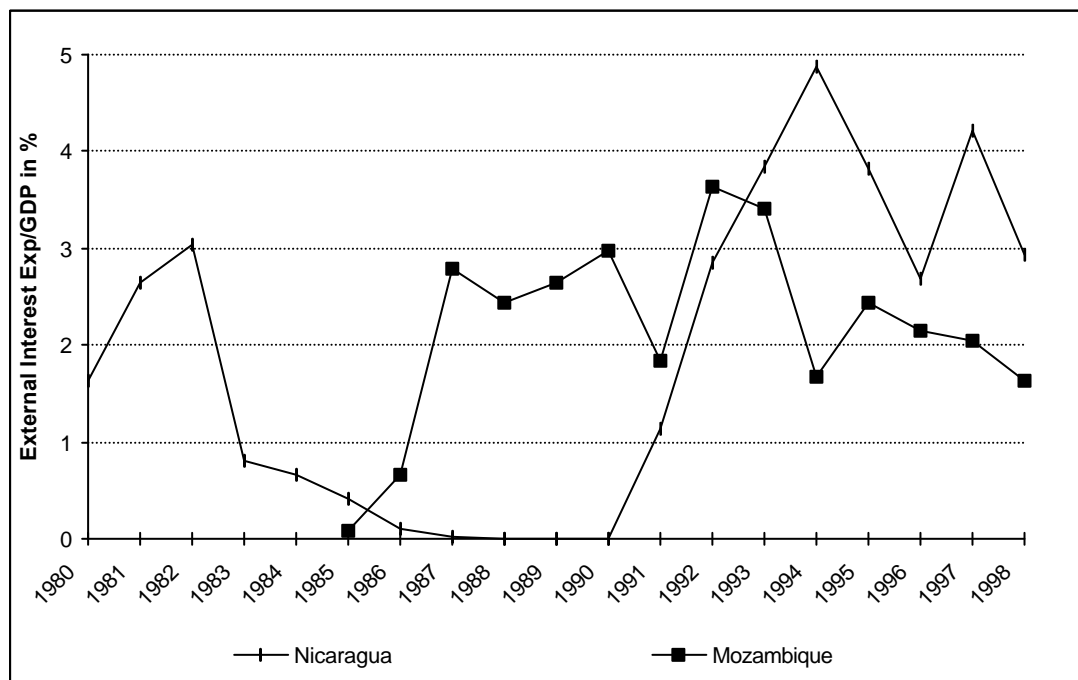
Although the debt overhang was an enormous contingent burden on export income and tax revenue in both cases - interest payments oscillated annually depending on the state of debt negotiations. Overall, they averaged some 3 percent of GDP in both cases. When this average level is applied to an average debt level of 300 percent of GDP; this can be seen as equivalent to 1 percent interest on the total debt, or (say) 3 percent on one third of the debt. In other words, only a small proportion of the debt was serviced in either case.

Figure 1.17: External Debt in Mozambique and Nicaragua (percent of GDP)



None the less, contingent liabilities of such a size in proportion to the economy inevitably created a high degree of uncertainty in the private sector and thus explain the problems with raising both investment and savings levels.

Figure 1.18: External Interest Costs in Mozambique and Nicaragua (percent of GDP)

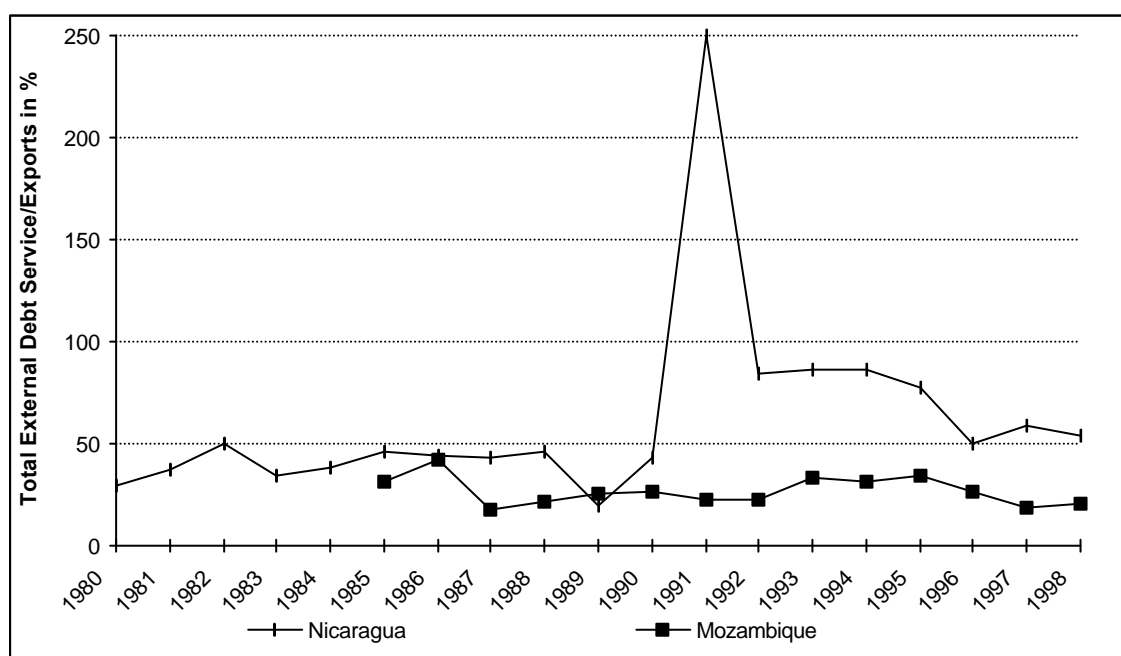


Given the low levels of exports in both Mozambique and Nicaragua (see above) even these minimal debt servicing rates represented a very high burden on both economies, as Figure 1.19 below indicates. In the case of Mozambique this oscillated between 20 and 40 percent of exports, with some slight tendency to decline. In the case of Nicaragua, a similar pattern was observed during the war period, but as soon as peace was attained in 1990, the debt service ratio to exports *rose*, and even after re-negotiation in the late 1990s, it remained at over 50 percent. In both cases, and

particularly that of Nicaragua, it is difficult to avoid the conclusion that this debt burden made reconstruction far more difficult.

The argument used by donors to maintain these high levels of debt and debt service in both cases was that this was an effective form of policy conditionality. There is little evidence that this was the case: on the one hand, after the end of the Cold War neither country was in a position to continue with a socialist model in any case; on the other hand, such conditionality as was required could equally well have been achieved through grant aid. There is of course another (less explicit) argument: that if apparently 'deserving' cases such as Nicaragua and Mozambique enjoy debt cancellation, then it will be impossible to deny this facility to middle-income countries (eg Brazil) or badly administered ones (such as Nigeria). It is far from clear why such a ('moral hazard') argument would be effective in these latter countries' debt negotiations; but even if this were to be the case, it seems quite unjust that the people of Nicaragua and Mozambique - who have already suffered quite enough - should service debt in order to ensure that larger debtors do not default.

**Figure 1.19: Debt Service Burden in Mozambique and Nicaragua (percent of exports)**



## 1.6 POLITICAL ECONOMY OF THE PRIVATE SECTOR UNDER RECONSTRUCTION

### *The Nature of the Peace Dividend*

From the point of view of the private sector - on whom post-war economic reconstruction depends, rather than government or donors - it is the reduction of uncertainty as much as the potential for profit which determines the willingness to invest, raise production and create employment.

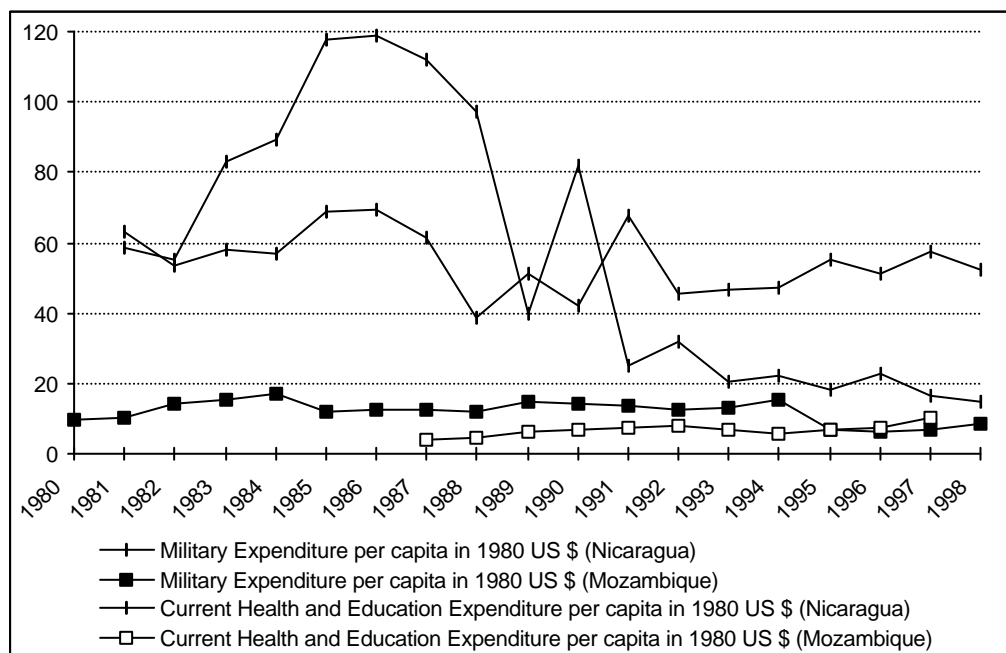
In Nicaragua peace came when the US ceased to support the insurgents and the Sandinistas not only allowed democratic elections but abided by the result when they lost. The new government accelerated the return to a market economy, but armed unrest and rural banditry continued for several years led by the demobilised soldiers from both sides. Not only did demobilisation release labour into urban unemployment rather than rural production, but it was difficult to recover lost capacity in the war zones.

In Mozambique peace came when both sides were exhausted and the settlement was guaranteed by UN presence. In effect an implicit alliance of two warring parties was united in power, permitting a considerable degree of political continuity. The return to civilian society and market reforms were more gradual. Demobilisation was funded by donors and the return of the population to the land was comparatively rapid.

In other words, the value of peace dividend depends on security situation (that is, the nature of the peace settlement itself) as much as upon the reallocation of budgetary resources; in an agricultural economy it is expressed by a return to land and the return of investor confidence. Both these changes depend on the nature of the post-war political alliance between 'victors' and 'vanquished'; and the effectiveness of donor support depends upon the degree in which they are consistent with this new 'social contract'.

Reducing uncertainty is not just a matter of the immediate settlement: it also requires clarity as to political stability in the longer term. In Mozambique this longer-term perspective was clear: the colonial power would not return and there was an implicit alliance of the factions (especially at the local and provincial level) about a common economic development project based on market reforms and nation building. In contrast, not only did a conflictive balance of power continued between the Sandinistas and the traditional political parties, but these latter were sharply divided between conservative and liberal groups. In consequence, the private sector - small farmers, domestic businessmen and foreign firms - did not feel secure as to their long term future.

**Figure 1.20: The Peace Dividend (1980 US \$)**



The economic dimension of the peace dividend in absolute terms is set out in Figure 1.20 below. The rapid decline in military expenditure in Nicaragua is notable, reducing expenditure by some US \$100 per capita a year. However, these resources were not immediately available for peacetime reconstruction, for two reasons: first, they were largely supplied by foreign powers, and were cut off once war ended; and second, the domestic resources required to feed and cloth the troops was still needed in peacetime once they returned to the civilian workforce. In contrast, military expenditure in Mozambique never exceeded US \$ 20 per capita a year (indeed both sides appear to have largely 'lived off the land') and the 'saving' in peacetime was less than US \$ 10 per capita a year in peacetime.

Moreover, in both cases, health and education expenditure did not increase dramatically in peacetime, so that the population did not perceive a significant social dividend. Indeed, while military expenditure in Nicaragua was reduced to below the level of social expenditure by 1992, two years after the settlement; this inversion was only achieved in Mozambique in 1995, some three years after the end of the war. At first sight, this might seem to imply that economic and social recovery would be more rapid in Nicaragua than in Mozambique. However, as we have seen, the reverse was in fact the case.

### *Private Sector Response*

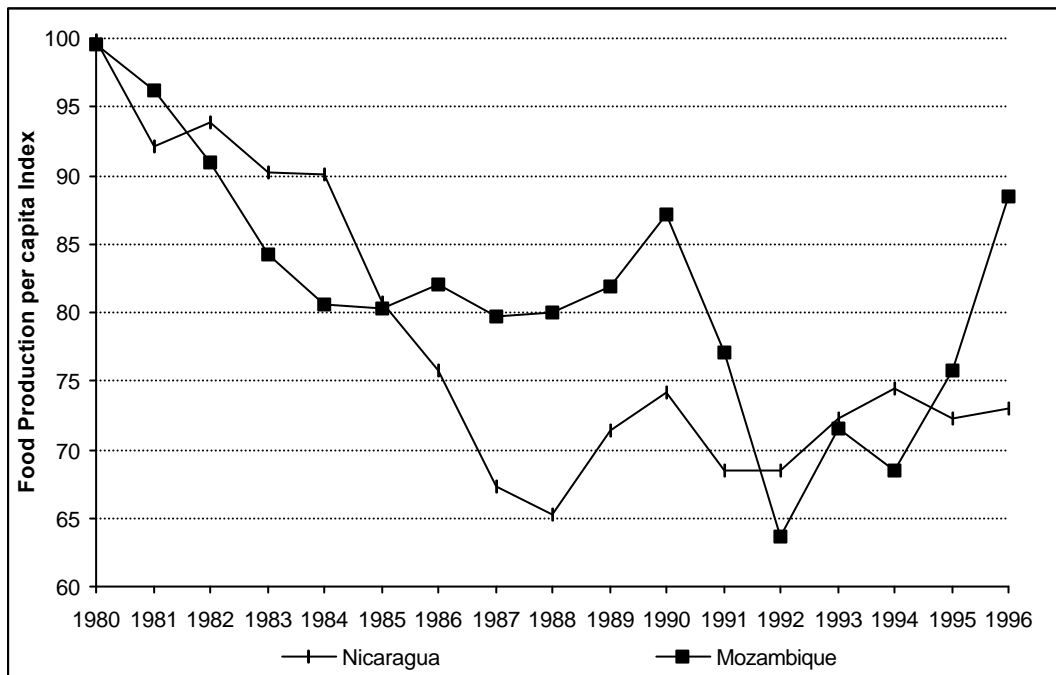
The response of the private sector to the challenge of post-war reconstruction is detailed in Parts II and III below. This is difficult to sum up in a way which permits the two cases to be compared. One way of addressing the issue is to examine trends in private investment and saving. Estimates of the trends in these variables are set out in Tables 1.4 and 1.5 below.

In the case of Mozambique (Table 1.4) the investment estimates for the private sector are probably too high, but it should be remembered that they include the activities of NGOs. There is a clear increase in the private investment rate after 1990, which sustained a steady rate of economic recovery. What is more, the level of private saving moves from negative in 1988 to strongly positive by 1996. Both of these trends can be said to reflect the return of private sector confidence; supported by a reduction of public sector domestic financing (effectively seignorage). These positive trends permit a steadily declining reliance on external finance for the private sector.

In marked contrast, the case of Nicaragua reflects a very different pattern of private sector behaviour. On the one hand, private investment does not revive immediately after peace is established - in fact it is only seven years later that the private investment rate rises to 20 percent of GDP from the 10 percent it had been previously. On the other hand, the private savings rate remains very weak, so that private investment is financed by public sector transfers into the financial system (debt reduction) and external finance. Initially this external finance is associated with donor support, but subsequently it is associated with an inflow of private foreign investment - much of it speculative in nature. In sum, this does not appear that private accumulation recovered on a sustainable basis.

The recovery of small farmer production was central to post-war reconstruction in both Mozambique and Nicaragua. The best comparable indicator in this context is domestic food production per capita, which is illustrated in Figure 1.21. The downward trend in food output during the conflict period is clear and explicable in terms of the focus of armed conflict in rural areas and the dislocation of agricultural markets in both cases. None the less, it is noticeable that food production stabilised in Mozambique during the war, and although it fell sharply in 1991-92 due to adverse weather conditions, it did recover quite quickly thereafter - and had reached 90 percent of its 1980 level by 1996. This was largely due to the return of labour to the land, favourable weather conditions and the re-establishment of some marketing channels.

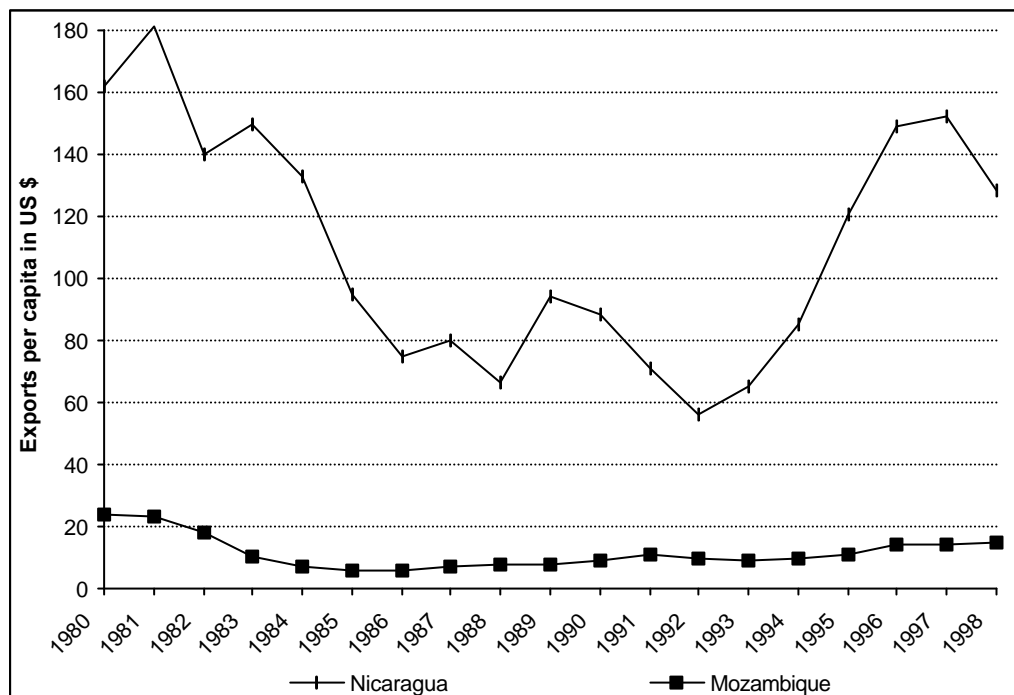
In Nicaragua, in contrast, output also began to recover before the war concluded - due to liberalisation of rural markets as in the case of Mozambique; but after 1990 production did not continue to rise - remaining at little more than 70 percent of its 1980 level in 1996. This is not just a question of food supply as such: it is also an indicator of the incomes of small farmers - and by extension of the extent of rural poverty. The reason for the lack of recovery in this sector was partly the continued unrest in the countryside; and partly the effect of closing the state-owned rural banking system, which led to a collapse of rural credit, and thus the ability of small farmers to obtain essential inputs.

**Figure 1.21: Food Production Per Capita** (Index, 1980 = 100)

The export response is an indicator of how the private business sector has recovered. Exports per capita, as illustrated in Figure 1.22, give some indication of traded sector productivity and, insofar as these are dominated by larger firms, of the activity of the business sector in production. Exports per capita in Mozambique remained more or less static throughout the reconstruction period, and at barely US \$ 15 per capita per annum were clearly insufficient to finance the reconstruction process. In sharp contrast, after an initial post-war decline, exports recovered relatively rapidly in Nicaragua during the mid-1990s; reflecting the ability of larger farmers to obtain credit and re-start production.

In sum, the private sector recovery in Mozambique appears to have been led by small producers; while in Nicaragua it was larger businesses that benefited. This difference has two important implications. First, that post-war reconstruction based on small farmers can be more rapid as they are able to respond rapidly to access to land and labour, and in any case do not have alternative asset choices. Second, that a recovery programme based on small rather than large business is likely to have more positive redistributive effects and thus reduce poverty more rapidly.

**Figure 1.22: Export Productivity (US \$ per capita)**



*The Role of Donors in Supporting the Private Sector*

A central donor objective in both Mozambique and Nicaragua was the revival of the private sector: in part due to the perceived need to lead societies away from socialist models of development; and in part because the private sector accounts for the bulk of employment and output. None the less, the main emphasis was on actions affecting the state sector, and relatively little attention was paid to the private sector as such.

**Table 1.4: Investment, Saving and External Finance in Mozambique (percent of GDP)**

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
<b>Public Sector</b>													
Investment	6.0	7.6	17.3	22.1	21.6	24.2	22.6	22.2	20.1	24.5	21.3	18.7	20.0
Savings	-7.9	-9.7	-5.4	-4.7	-3.2	-5.3	-2.3	-4.6	-2.1	-5.2	1.3	2.0	1.4
Balance	-13.9	-17.3	-22.7	-26.8	-24.8	-29.5	-24.9	-26.8	-22.2	-29.7	-20.0	-16.7	-18.6
External Finance	7.3	8.0	18.0	22.9	24.4	29.4	25.5	25.8	20.8	30.6	21.7	18.5	21.1
Domestic Finance	6.6	9.3	4.7	3.9	0.4	0.1	-0.6	1.0	1.4	-0.9	-1.7	-1.8	-2.5
<b>Private Sector</b>													
Investment	30.3	29.7	21.0	17.1	18.7	17.1	19.7	21.1	24.2	20.8	24.9	28.6	..
Savings	34.0	37.4	7.1	-7.1	-10.6	-5.6	-10.8	-9.7	-12.0	-10.1	7.8	13.4	..
Balance	3.7	7.7	-13.9	-24.2	-29.3	-22.7	-30.5	-30.8	-36.2	-31.0	-17.2	-15.1	..
External Finance	2.9	1.6	18.5	28.1	29.7	22.7	29.8	31.8	37.6	30.1	15.5	13.3	..
Domestic Finance	-6.6	-9.3	-4.7	-3.9	-0.4	-0.1	0.6	-1.0	-1.4	0.9	1.7	1.8	..
<b>Total</b>													
Investment	36.3	37.3	38.3	39.3	40.3	41.3	42.3	43.3	44.3	45.3	46.3	47.3	..
Savings	26.1	27.7	1.7	-11.7	-13.8	-10.9	-13.1	-14.3	-14.1	-15.4	9.1	15.4	..
Current Account	-10.2	-9.6	-36.6	-51.0	-54.1	-52.2	-55.4	-57.6	-58.4	-60.7	-37.2	-31.8	-25.3

In the case of Mozambique, donors did help bring an end to the war and the re-establishment of trade and investment links with the ‘West’. None the less, donor strategy appeared to be the

outcome of repeated emergency programmes rather than a development strategy as such. In the case of Nicaragua, the donors obtained the 'transition from socialism' they desired, and were able to support a fairly coherent reconstruction strategy for the first five years (1990-94); but after that date the incoherence of government policy itself left donors without a strategy, and reduced to sectoral interventions. In consequence, even though the Nicaraguan government was the more overtly supportive to private enterprise, the Mozambican strategy appears to have been more successful.

This contrast is underscored by the macroeconomic effects of the large aid inflow on the private sector in the two cases. In Nicaragua the aid flow clearly led to overvaluation of the currency and 'Dutch disease' in the sense that profit margins on traded production (and particularly exports) were reduced; while non-traded activities such as urban services and construction became highly profitable. In Mozambique, this was not so much of a problem because aid was vital in lifting supply constraints in roads, transport and storage.

**Table 1.5: Investment, Saving and External Finance in Nicaragua** (percent of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998
<b>Public Sector</b>								
Investment	4.4	8.5	8	11.6	11.8	15.4	10	8.6
Savings	-3.5	0.1	-0.6	-0.9	0.6	1.2	2.9	6.4
Balance	-7.9	-8.4	-8.6	-12.5	-11.2	-14.2	-7.1	-2.2
External Finance	12.4	15.2	9.8	14.8	11.9	17.8	9.4	11.0
Domestic Finance	-4.5	-6.8	-1.2	-2.3	-0.7	-3.6	-2.3	-8.8
<b>Private Sector</b>								
Investment	13.9	11	10.9	10.4	12.1	11.7	21.7	22.9
Savings	-2.2	-10.3	-2.8	-0.3	3.7	6.6	-4.2	-13.0
Balance	16.1	21.3	13.7	10.7	8.4	5.1	25.9	35.9
External Finance	11.6	14.5	12.5	8.4	7.7	1.5	23.6	27.1
Domestic Finance	4.5	6.8	1.2	2.3	0.7	3.6	2.3	8.8
<b>Total</b>								
Investment	18.3	19.5	18.9	22	23.9	27.1	31.7	31.5
Savings	-5.7	-10.2	-3.4	-1.2	4.3	7.8	-1.3	-6.6
Current Account	24.0	29.7	22.3	23.2	19.6	19.3	33.0	38.1

In sum, aid did help: it ensured post-war survival; and also supported liberalisation and demilitarisation. But aid did not support longer-term fiscal solvency or export strength, or markedly reduce poverty. Although aid was rather more effective in Mozambique than in Nicaragua, due to greater coherence between government and donor aims; in neither case did it lead to a sustainable private accumulation path in the decade of post-war reconstruction.

## 1.7 CONCLUSIONS AND POLICY RECOMMENDATIONS

### *Donors and Post-War Reconstruction*

Multilateral lenders (that is, the Bretton Woods institutions and the regional development banks) should suspend principle payments on their debt for countries in post-conflict reconstruction, so as to avoid bilateral aid being diverted to maintaining multilateral debt service rather than alleviating the economic burden of conflict on vulnerable groups.

In particular, the 'highly indebted poor countries' (HIPC) initiative should be related to post-conflict reconstruction and the protection of vulnerable groups rather than long periods of macroeconomic probity that war-torn economies cannot fulfil. This might be achieved by the suspension of debt payments against commitments to maintain health and education without discrimination; or possibly payment of debt service into accounts for aid agencies.

The use of official bilateral credits, longer-term development loans and multilateral investment funds to place pressure on the governments in post-conflict economies should be applied with great care. If the development finance being cancelled was properly designed in the first place - in other words that it followed DAC criteria and is clearly targeted at poverty reduction - then aid sanctions affect vulnerable groups disproportionately.

Conventional conditionality packages are not appropriate during reconstruction, veering between the judgement that the usual adjustment package should be introduced and the view that adjustment should be postponed until the war is ended. Where the price system functions poorly and post-war disequilibria have devastating consequences on entitlements; administrative allocation of foreign exchange, intervention in food markets, and rising tax pressure should be accepted by donors.

Structural adjustment assistance should focus on the strengthening export capacity before import liberalisation; and the securing of long-term credit to investment before reforming the financial sector. This should stabilise incomes and jobs for vulnerable groups in the short term, while reassuring the population as a whole as to benefits of integration to the world economy in the longer term; both of which should reduce the potential for conflict. Establishment of external solvency by cancelling all outstanding official debt would support this integration, with the condition that the fiscal resources released from debt service used only for the reduction of monetised deficits and net additions to the provision of public health and education.

The design of humanitarian aid in response not only to conflict-related emergencies but also to post-conflict reconstruction should take into account the explicit reorientation of development assistance towards reducing inter-group and inter-regional inequality, and towards strengthening the capacity of the state to deliver the public goods of health, education and security to all citizens.

### *Domestic Actors and Post-War Reconstruction*

The governments of war-affected areas should consider the individual and regionally varying impact of conflict on the economy and prioritise their actions accordingly. Policies suitable for equitable post-war reconstruction include the return of trust, stability and peaceful politics; the equitable and politically sustainable distribution of a peace dividend; the stabilisation of the macro-economy in accordance with international donors as discussed above; and the establishment of humanitarian, economic and institutional investment programmes which combine the need to build government

capacity, support the social needs of the population, and enhance the supply response to the emergence of peace.

In particular, such investment programmes should address health, water, education, transport, communication, agriculture and the civil and institutional sectors, depending on the legacy of the war and the structure of the economy. Donors, the government and civil society (including representatives from the opposing, war-time factions) should be involved in the design, planning and implementation of these programmes. Despite the apparent humanitarian short-term needs of the immediate post-war period, the distinction between short-term emergency planning followed by long-term development work should be avoided. Instead, all programmes should lay early foundations for long-term growth, eg by combining demobilisation or refugee return programmes with asset rebuilding, transport improvement and private sector development programmes.

Above all, donors and domestic actors should strongly consider implementing a civil institutional investment programme for the war-affected economy. Such programme should prioritise the establishment of independent police and judicial authorities, improve the quality of the law making process, strengthen conflict resolution capacities, support an independent press, and improve other civil and market institutions which may have been damaged by war and which are pre-requisites for balanced post-war growth.

#### *International Actions to Prevent Recurrence of Conflict*

There are two separate tasks here for the international community: on the one hand, to reduce the economic vulnerability of poor; and on the other, to ensure that those countries remaining in the vulnerable group do not slide back into conflict. The first task might seem to be merely that of development policy in the conventionally accepted sense of market orientation, macroeconomic stability, investment in human capital and so on. While these may well make up a sufficient strategy for the middle-income countries, it is far from clear that this is the best course for the low-income economies without sufficient assets or institutions to enter the international market directly.

Possible *international* policy measures include schemes to stabilise the incomes of primary commodity exporting poor countries so as to reduce uncertainty about foreign exchange income; and preferential access to regional and multilateral trade arrangements to increase export capacity. The international regulation of international trade and investment in 'sensitive' commodities (such as arms, oil, gems, and timber) with a view to minimising the destabilising effects of these activities in vulnerable countries could be achieved within existing multilateral trade agreements and the multilateral investment arrangements currently under negotiation; by creating specific transitory conditions for poor countries.

The explicit reorientation of co-ordinated international development assistance towards reducing inter-group and inter-regional inequality, and towards strengthening the capacity of the state to deliver the public goods of health, education and security to all citizens, would imply the adoption of the reduction of conflict potential (and by extension, the reduction of vulnerability) as the key priority in development co-operation with poor countries, rather than broader notions of economic growth which can disguise redistribution of income and assets between social or regional groups which increase conflict potential.

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