

# Have International Financial Institutions Improved?

Written by Franziska Wehinger

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FRANZISKA WEHINGER, AUG 3 2013

## Has the Performance of International Financial Institutions in Dealing with “Post-Conflict” Societies Improved Since the mid-1990s?

### Introduction

As Jonathan Stevenson points out, “International Financial Institutions’ efficacy cannot make a peace process, but International Financial Institutions’ inefficacy can break one.”[1] Indeed, the engagement of International Financial Institutions (IFIs), namely the International Monetary Fund (IMF) and the World Bank, in war-affected economies has been a point of contention. Especially in the early 90s, their performance in post-conflict reconstruction was severely criticized. Authors like Gracianna Del Castillo & Alvaro De Soto and James K. Boyce blame the IFIs for hindering peacebuilding instead of contributing to peace, pointing out that their traditional means of engagement was not necessarily suited to post-conflict societies and, instead, a more peace-sensitive engagement was needed. [2] Using the case study of Bosnia and Herzegovina in the mid-1990s, this essay will test four main criticisms raised by Del Castillo and Boyce in relation to IFIs’ performance in the post-conflict setting in El Salvador. Based upon the criticism the essay argues that with more focus on (1) enforcement of reintegration of refugees and former combatants; (2) strengthening rather than weakening of the governance structures; (3) a gradual rather than a vigorous liberalisation; and (4) better coordination with political institutions, the performance of IFIs in Bosnia and Herzegovina (BiH) has noticeably improved.

### Enforcement of the Reintegration of Refugees and Former Combatants

Firstly, Del Castillo and Boyce argue that the IFIs’ principles of budget discipline and financial constraint were an obstacle to the reintegration of groups most affected by war such as excombatants and refugees and, therefore, to peace.[3] To meet the IFIs’ criteria of a small budget deficit and fiscal discipline, post-war governments were left with only limited financial resources to finance an effective disarmament, demobilization and reintegration (DDR) process and the return and reintegration of refugees and internally displaced people (IDPs).[4] Economic reintegration would require a rapid creation of jobs through fiscal expansion – a no-go for the traditional IMF policy in developing countries.[5]

In El Salvador, for example, the UN-led National Reconstruction Plan of 1991 included a DDR-process that promised credits to young former rebels to start agricultural production. On the other hand, the IMF recommended a very tight fiscal stabilization program. The Salvadoran government complied with the program, cut the budget and kept expenditure low.[6] Consequently, the government did not have enough resources to fund an effective DDR-process of the former combatants of Frente Farabundo Martí para la Liberación Nacional (FMLN). This contradiction in policy posed a threat to the fragile peace, with FMLN suspending demobilization and nearly resorting to arms again in September 1992; the accidental explosion of an FMLN arms cache in Nicaragua 1993 serving as evidence that disarmament was not effective.[7] Additionally, the IMF did not look closely enough at the composition of the budget and failed to ensure that expenditure cuts were implemented evenly. As a result, after the cuts, military expenditure absorbed more than twice its pre-war fraction of national income.[8] A combination of bad policies and lack of financial and technical assistance hindered the effective disarmament of former combatants and reintegration of returnees.[9]



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In BiH, however, the IFIs, especially the World Bank, turned out to be the protagonist in facilitating the DDR-process and the reintegration of refugees. First of all, the IFIs allowed unusually high levels of government expenditure of as much as 63% of GDP in the first two years (compared to 30% of GDP in 2005) enabling the government to engage in rapid job creation in the first phase of DDR.[10] Moreover, the World Bank itself actively engaged in the DDR process. When political institutions failed to initiate a DDR program, the World Bank set up the “Emergency Demobilization and Reintegration Project” conducted from 1996 to 1999 as the first of three World Bank-led DDR-programs. Of the estimated 425,000 former combatants (including the paramilitary and the so called “weekend fighters”), 300,000 left the armies within four months.[11] They were then helped through job-finding services, education or training schemes and post-traumatic stress counseling. Many former combatants were lawfully employed through the 36 contracts the World Bank signed with public and private providers; others received assistance for self-employment in agriculture.[12] A 2003 World Bank study said that 60% of the demobilized soldiers continued in the work they gained through the program.[13] In line with these policies, the World Bank also pushed for a reduction of military expenditure not only in Bosnia, but also in Serbia, the main funding nation of the Serbian force in the Bosnian war.[14]

Apart from DDR, the World Bank also contributed to the return of refugees through technical assistance and special funds. The war in BiH was characterized by an extraordinarily high number of refugees and IDP, all in all around 2,3 million of the 4 million pre-war population.[15] Their return was complicated by the absence of agreed-upon statistical data. The different ethnic groups tried to manipulate the numbers of refugees and returnees. By providing objective statistical data and following the process of returnees, the World Bank greatly contributed to the effort of municipalities and cantons to facilitate the return, particularly of the minorities.[16] Thanks to a micro-credit scheme, the World Bank reintegrated 100,000 IDPs until June 1996 in targeted areas that had suffered particular damage.[17] In contrast to El Salvador, where a huge amount of refugees emigrated to the US, the number of returned refugees in BiH reached 400,000 in 1997 and more than one million in 2004.[18] The unprecedented cooperation between the World Bank and the international military stabilization force (SFOR) ensured security for minority returnees.[19] In contrast to their past performance, in BiH, the IFIs actively supported the reconstruction of human capital by reintegrating former combatants and refugees.

### Strengthening the State and Governance

The second line of criticism states that the IFIs weaken the state and governance by advocating for low tax revenue; neglecting institution building and ignoring rising inequality. Boyce and Susan Woodward emphasize that post-conflict societies need strong state-level institutions and good governance to provide public services.[20] However, the IFIs focused all their attention on the adjustment programs and did not see themselves in a political role or in charge of building government institutions and correcting inequality.[21] After the civil war, tax revenue in El Salvador was less than 9% of GDP – among the lowest in the world – and little to no pressure was put on the government to mobilize domestic resources.[22] Institutions, public services and social safety could not be financed. The arms-for-peace program, which should have led to redistribution of land, suffered from delay and made FMLN suspend demobilization.[23] Given that the roots of the Salvadoran civil war were deeply linked with inequality, a worsening gap between the rich and the poor threatened, rather than preserved peace after 1992.[24]

The role of the IFIs fundamentally changed in the postwar reconstruction of BiH. Especially, the IMF connived at its traditional principle when it comes to government revenue.[25] As suggested by Boyce, the Fund established a tax system with unusually high taxes by international standards.[26] This system also contributed to redistribution, with payroll taxes on gross wages ranging between 45 and 64% in 1996.[27] It protected the poor and the unemployed, and since it continued with the pre-war tax policy, the tax system was instantly accepted. The World Bank contributed further to reducing tensions and promoting equity by distributing funds according to the level of damage and based on different needs by the rural and the urban population.[28] Also, in 1996, the World Bank channeled a major part of the Trust Fund into poor households, approved social programs and allowed one third of all budgetary revenue be spent on health care and poverty programs.[29]

The most successful contribution to peace and state building by the IFIs, however, was the establishment of the Central Bank in 1997.[30] It benefitted peace in three dimensions. First, the IMF achieved the unification of four



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different currencies – the Croatian kuna, the Serbian dinar; the BiH dinar and the Deutsche Mark to one – the convertible mark (KM). This unification prevented monetary competition and a symbolic division among the Muslim, the Croatian and the Serbian communities. Moreover, the IMF obliged the three communities to work together, by including one member of each group on Central Bank's governing board.[31] Although Serbs and Croats resisted in the very beginning, the KM soon achieved circulation throughout the country.[32] Secondly, the Central Bank turned out to be one of the unique functioning institutions on state level. Political interests could not jeopardize the Central Bank, partly because it was headed by the neutral Executive Director of the World Bank, Peter Nicholl, during the first years and partly because its monetary policy is very restricted and the Bank cannot create money.[33] Transparency and good internal decision-making processes have provided a good record for the Central Bank until today.[34]

Lastly, the Bank contributed to peace through stable macroeconomic performance. Pegged to the Deutsche Mark and later to the Euro with a fixed exchange rate, the KM became one of the most stable currencies in Europe.[35] Together with the Central Bank and the Ministry of Finance, the special macro-fiscal IMF-unit created a stable macroeconomic environment through a tight fiscal policy from 1997 on (after having allowed a more flexible macroeconomic policy in the first two years as mentioned in the first part).[36] Although fiscal discipline may have contributed to higher unemployment as Pugh and Del Castillo argue, the essay shows important benefits of fiscal discipline in BiH. The Bosnian people had experienced major financial trauma before the war.[37] While fiscal expansion would have caused instability through a high inflation rate and the devaluation of the KM, the tight fiscal policy stabilized business environment in BiH and provided credibility for both, the Bosnian population as well as foreign investors and remitters.[38] GDP grew steadily from 2 billion US\$ in 1995 to 18.5 billion US\$ in 2008.[39] Stability contributed to an annual increase of GDP of 40% between 2000 and 2008 and a steady growth of foreign remittances.[40] Thus, the IFIs showed a significant improvement in their dealing with the trade-off between political stabilization and economic stabilization by allowing high tax revenue and building effective institutions but nevertheless insisting on fiscal discipline.

### **Emphasis on a Gradual Liberalisation**

Thirdly, Boyce and Pugh argue that the IFIs pushed trade liberalisation too far and too fast in war-torn countries.[41] Vigorous trade liberalisation can threaten the integrity of society; encourage shadow economic activity; and result in high inflation rate. All of this would undermine overall confidence in the state, disaggregate society and threaten peace. They further argue that rapid liberalisation in war-torn countries is also economically counterproductive, since it hits the vulnerable post-war-economy which cannot yet compete with foreign industries.[42] The World Bank itself admitted in 2000 that liberalisation in El Salvador should have been slower. Since the agricultural sector was not protected, liberalisation hit small farmers and hindered reintegration of ex-combatants.[43] People became poorer, industry stagnated and inflation rate accelerated from 11% in 1992 to 19% in 1993 due to rigorous liberalisation.[44]

According to Chandler and Paris, the IFIs applied the same principle in BiH by transforming the war-shattered states into a free-market which destabilized domestic economy and society.[45] Liberalisation triggered informal economy, increased corruption and contributed to unemployment in BiH, they argue further.[46] However, this essay casts doubt on the causal link between liberalisation and informal economy and argues that liberalisation processes in Bosnia occurred much more gradually. The IFIs recognized that the market in BiH was highly segmented, since the Republika Srpska traded more with Serbia than with the Federation of BiH and so did the Croatian-Bosnian community in Herzeg-Bosna with Croatia. The IFIs chose therefore a more gradual approach, knowing that integration in BiH had to come before liberalisation.[47] Based on this account, the IFIs recommended border tariffs for imports in order to protect the local market and to achieve integration of the three ethnic groups.[48] BiH entered into free-trade-agreements with its neighbor states only in 2001.[49] The widespread informal economy[50] was therefore not triggered by liberalisation, but by high administrative barriers to set up a business and by the peace-sensitive trade barriers.[51] Members of the same ethnic communities, but also diaspora and former Yugoslavian business networks bypassed trade barriers. Overall, in contrast with the past, the IFIs in BiH encouraged a slow-paced economic liberalisation conducted in a peace-sensitive manner.

### **Enhancement of their Coordination with Political Institutions**



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The fourth reproach voiced against the involvement of IFIs in post-conflict environments is that they failed to coordinate their actions with non-economic peace institutions, such as the UN, thus hindering the peace process.[52] Although the IMF and the World Bank are part of the UN system, their integration in it is “loose” and their conflicting policies come to the fore, especially in post-conflict reconstruction.[53] As seen above, the trade-off between macroeconomic stability and financial resources to fund peace-related programs can threaten peace. In El Salvador, the UN did not consult the IFIs in peace negotiation in December 1992 and did not even invite them when the socio-economic reconstruction was on the agenda.[54] Instead, the IFIs and the UN followed contradictory programs. For instance, while the IFIs were not able to give concessional lending to El Salvador, since the country was not defined as a low-income country, the UN had already promised huge funds for the creation of National Civil Police and the “arms-for-land” exchange.[55] Del Castillo described this situation as follows: “it was as if a patient lay on the operating table with the left and the right sides of his body separated by a curtain and unrelated surgery being performed on each side.”[56]

After the mid-1990s, however, coordination and communication between the financial and the political institutions improved.[57] BiH is an unprecedented example of peacebuilding led jointly by the IFIs, the European Bank for Reconstruction and Development (EBRD), the European Union (EU) and the UN. Thanks to the constructive role played by the Dutch Executive Director of the World Bank even before the fighting had stopped, the UN Secretary General Boutros Ghali invited the World Bank to participate in the peace negotiations for the Dayton Accord.[58] Before signing the Dayton agreement in December 1995, the World Bank made sure that the agreement included the implementation of monetary and fiscal policy.[59] Thus, economic and political reconstruction policies went hand in hand from the beginning. Evidence of success lies not only in the peace-related macroeconomic policy and the strengthening of the state as outlined above, but also in the conditionality attached to funds provided by the IFIs. For instance, funds for Republika Srpska (RS) were conditioned on the participation of the RS president Momcilo Krakisnik at the inauguration ceremony of the three presidents in September 1996 in Sarajevo.[60]

Through its early involvement, the World Bank also gained a constant coordinator role of all funds and inflows.[61] A “best-practice” case was the Trust Fund of Bosnia and Herzegovina (TFBH) – instead of loans – for reconstruction and emergency projects, established by the World Bank. Unlike the usual instruments, the TFBH did not require membership or any special qualification (such as the status of a low-income country) and transferred unprecedented sums of aid assistance. With an implementation record of the Emergency Projects of four months after the war ended, TFBH counted as an exemplar for the later established Special Post-Conflict Funds by the World Bank.[62] By establishing Project Implementation Units for special sectors the World Bank also put great effort in the improvement of the synchronization of bilateral funds.[63] As the case of BiH shows, the coordination and communication between the IFIs and the UN did not only improve but the World Bank also took over the role of a donor coordinator in emergency reconstruction.

## Conclusion

In conclusion, this essay has shown that the IFIs improved their performance in post-conflict settings from El Salvador to Bosnia and Herzegovina after the mid-1990s. While the IFIs blindly applied the usual economic principles for developing countries in El Salvador, their policies in Bosnia and Herzegovina took the particular demands and vulnerabilities of post-conflict societies into account. The IFIs supported the DDR process and the return of the high number of refugees in BiH through more flexible fiscal policy, major programs and funds for DDR and refugees technical assistance. They strengthened the Bosnian state through an effective and redistributive tax policy allowing high revenues for the government and through the building of the Central Bank, a guarantor of macroeconomic stability. By following a more gradual approach in trade liberalisation and enhancing coordination and communication with UN, the IFIs acted in a much more peace-sensitive way than they did in El Salvador. Overall, we can see that the IFIs have shifted from an approach driven by ideology to one that is more peace-sensitive, promising greater stability in BiH. Nevertheless, this improvement should not lead practitioners to close their eyes to major economic problems in BiH in the longer term, such as the high unemployment and corruption rate, which are problems that need to be tackled with the help of the IFIs.

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*Written by: Franziska Wehinger  
Written at: King's College London  
Written for: Mats Berdal and Domtilla Sagramoso*



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