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## **Transforming War Economies**

**Danielle Lalive d'Epinay and Albrecht Schnabel (Eds.)**

# swisspeace

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Danielle Lalive d'Epinay and Albrecht Schnabel (Eds.)

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# Glossary

BDS	Business Development Services
CSBP	Conflict-Sensitive Business Practice
DAC	Development Assistance Committee (OECD)
DPSL	Development and Peace – Sri Lanka
ECA	Export Credit Agency
EITI	Extractive Industries Transparency Initiative
EU	European Union
FATF	Financial Action Task Force
IA	International Alert
IFC	International Finance Corporation
IFI	International Financial Institution
IISD	International Institute for Sustainable Development
IMF	International Monetary Fund
IRA	Irish Republican Army
KLA	Kosovo Liberation Army
LTTE	Liberation Tigers of Tamil Eelam
MIGA	Multilateral Investment Guarantee Agency
MNE	Multinational Enterprise
NGO	Non-governmental Organization
OECD	Organization for Economic Co-operation and Development
PPP	Public Private Partnership
SDC	Swiss Agency for Development and Cooperation
SIDA	Swedish International Development Cooperation Agency
SME	Small and Medium Enterprise
UN	United Nations
UNEP	United Nations Environment Programme

## Abstract/Zusammenfassung/Résumé

Although economic factors have proven to be crucial factors influencing the conflict proneness of a country, both military cease fires and peace agreements tend to neglect the economic and socio-economic aspects of war, while emphasizing mainly political and military issues. However, peacebuilding and conflict prevention measures applied by the international community cannot limit themselves to ending open violence and cutting conflict profiteers from their power and income. In addition, alternative social, economic and political structures must be fostered to allow the population to meet their basic needs outside the structures of violent conflict. The establishment of relevant economic structures and the creation of an attractive investment climate for foreign investments are crucial for breaking and transforming the destructive structures of economies of violence.

Obwohl wirtschaftliche Faktoren einen bedeutenden Einfluss auf das Konfliktpotential eines Landes haben, kommen in Waffenstillstands- und Friedensabkommen wirtschaftliche und sozio-ökonomische Aspekte von Kriegen gegenüber politischen und militärischen Aspekten oft zu kurz. Massnahmen der internationalen Gemeinschaft sollten sich jedoch nicht nur darauf konzentrieren, offene Gewalt zu beenden und die Macht und Einkünfte von Konfliktprofiten zu beschneiden, sondern darauf achten, dass zusätzlich soziale, wirtschaftliche und politische Strukturen gefördert werden, mit deren Hilfe die Bevölkerung ihre Grundbedürfnisse ausserhalb der vom Gewaltkonflikt geprägten Strukturen befriedigen kann. Der Aufbau entsprechender wirtschaftlicher Strukturen und die Schaffung eines attraktiven Investitionsklimas sind wichtige Voraussetzungen, um die zerstörerischen Strukturen von Gewaltökonomien zu durchbrechen und zu im positiven Sinne zu verändern.

Bien qu'il soit reconnu que les facteurs économiques ont une influence importante sur la probabilité d'un conflit armé, les aspects économiques et socio-économiques des guerres sont souvent négligés lors de l'établissement de trêves militaires et d'accords de paix. L'accent est plus souvent mis sur les aspects militaires et politiques. Cependant, les mesures de la promotion de paix et la prévention de conflit mises en œuvre par la communauté internationale ne doivent pas se limiter à arrêter le conflit armé et à éliminer le pouvoir et les revenus des profiteurs de guerre. La communauté internationale devrait encourager l'aménagement de structures sociales, économiques et politiques, afin de permettre à la population de satisfaire ses besoins élémentaires à l'extérieur des structures marquées par le conflit violent. L'établissement de structures économiques adéquates et la création d'un climat d'investissement attractif sont des conditions importantes afin de changer la dynamique destructrice des économies de guerre en une dynamique positive.



# 1 Preface

## Walter Fust

Sustainable development and durable peace are built on solid economic, socio-cultural and political institutions. International cooperation must strive for long-term peacebuilding, thus recognizing the roots of violent conflict and investing in structures and processes that support the peaceful management of social and resource conflicts.

Once conflicts have escalated and are marked by a fatal dynamic of their own, a vicious circle of violence emerges. Persisting conditions of *de facto* wars with changing sources of volatility are causes of immense human and material costs. Armed violence and loss of political and social stability alter a country's long-term economic survival. For instance, due to extensive use of landmines, large areas can no longer be farmed; the production of goods, services, and trade is severely hampered; and new and illegal activities flourish, such as delivery services for armed groups, arms smuggling, forced prostitution and organized crime.

War does not only affect the economy – the economy by itself is transformed into a war economy, infiltrating effectively and continuously peace economies and related societal and political institutions.

Anchored in local exploitation of lootable natural resources, war economies primarily serve the personal interests of warlords and their protagonists. They do so through global marketing channels. The basis of their power is war and the profit they derive from it. This allows them to establish patronage over their clients. Ultimately they have no interest in peace. At the same time, internationally established and highly efficient criminal networks crop up in their wake. They orchestrate political chaos in order to maintain a lavishly supplied shadow economy. The ensuing privatization of the state's monopoly over the use of force, along with the criminalization of business and illicit trade, represent a complex challenge for those actors who – along with international partners committed to building peace and combating poverty – use nonviolent measures to strengthen rule of law and government legitimacy.

Particularly susceptible to war are societies with widespread poverty, extreme and growing socio-economic disparities, wealth in raw materials, a lack of future opportunities and personal freedom, and a lack of legitimate and credible institutions for conflict transformation. Economic growth – often praised as a key poverty reduction measure – is not capable of slowing down conflict escalation and can even have a destabilizing effect by strengthening existing asymmetries, unless accompanied by equity measures. Often weak states and unstable societies cannot cope with the challenges of rapid economic and social change without outbreaks of violence. Moreover, development and transition processes, both economic and political, can change power relationships, causing crises to emerge within society and leading to an acute loss of cultural identity and social cohesion.

The search for causes alone will be futile if the various actors and their positions, as well as the dynamics, triggering events, and external factors of conflict escalation are not understood properly. Our goal should be less on finding rapid solutions for violent conflicts than on transforming systems of conflict in such a way that rival parties and the affected population find sustainable solutions to their conflicts without resort to violence. Alternative social, economic and political institutions must be established or revived, allowing the society to satisfy its basic needs outside the remnant structures of violent conflicts and the vicious cycle of war economies and criminal violence.

## 2 Introduction

**Danielle Lalive d'Epinay and Albrecht Schnabel**

In the study of protracted violent conflicts, the focus has increasingly shifted away from primarily trying to define the root causes of conflict to determining the factors that sustain violence and are thus partly responsible for the long duration of conflicts and their relapse into violence. In the 1990s, conflict analysis was confronted with conflict dynamics for which traditional approaches did no longer seem to provide useful explanations. The long duration of intrastate conflicts, the variety and frequent change of combatant parties involved and the complex role of international entanglements in conflict dynamics called for new approaches. The analysis of the economic agendas of combatant parties showed that in these protracted violent conflicts, the economic interests of warring parties were crucial to a proper understanding of conflict dynamics, their often long duration and frequent relapses.

Certain economic structures either contribute to the creation of violence and/or emerge through armed conflict. They lead to and feed off violence, are consolidated as the conflict continues and continue to be in place long after open violence has been brought to an end. This is partly due to the fact that the combatant parties often profit directly or indirectly from the conflict. The latter allows them to maintain political power and to consolidate or expand their control over valuable assets or lucrative resources of the country, and to continue their control of black markets and informal market segments and national, regional or even international trading networks. These actors are not interested in preventing or transforming such "War Economies" or "Economies of Violence", as they help them generate income through systematically organized violence.

In war economies, not only conflict profiteers but also large parts of the population unwillingly depend on the economic structures that generate – and are generated by – violence. Even though they do not directly gain financial profit from economies of violence, they depend on them for their daily income and survival, even after the end of a conflict. Peacebuilding and conflict prevention measures applied by the international community cannot limit themselves to merely ending open violence or cutting the conflict profiteers off their power and income. If wider socio-economic impacts of transforming economic structures are not taken into account, transformation towards a peace economy is not sustainable.

Especially during the transition phase from the end of open violence to the consolidation of peace, the establishment of economic structures and the creation of an attractive climate for foreign investments are crucial for breaking and transforming the destructive structures of economies of violence. While economic factors have proven to be crucial factors influencing the conflict proneness of a country, military cease fires and peace agreements tend to neglect the economic and socio-economic aspects of war, while emphasizing mainly political and military issues.

One central characteristic of economies of violence is their dependence on the international economic and financial system. Flows of trade and finance to and from economies of violence are only profitable if they have access to the legal infrastructure of international economic exchange. To tackle the problems of transforming the economic structures in an economy of violence, efforts must therefore not only target local shortcomings but also focus on the role of international players.

In September 2004, swisspeace and the Swiss Agency for Development and Cooperation (SDC) organized a conference on "Transforming War Economies". The conference offered an opportunity to discuss options and strategies for government actors – especially Foreign Ministry and Development Cooperation offices –, civil society organizations and the academic community to contribute to the sustainable transformation of War Economies, through local, national and international activities. Discussions focused on options to cut conflict profiteers off their violence-related income, and on the challenge of establishing alternative economic structures that allow the wider population to meet their needs without depending on activities that support – and are supported by – violence. The proceedings of this conference were published as an internal report. In

addition, we felt that that some of the formal presentations should be shared with a wider audience. We thus asked a selected number of speakers for written contributions based on their September 2004 presentations, whose messages hold true today as they did when they were originally conceived. These essays are featured in this working paper.

In the preface, Walter Fust calls for more efforts to base peacebuilding strategies on a thorough understanding of the root causes of violent conflict. He points to the need for strengthening good governance and non-violent conflict transformation in unstable societies fraught by social and resource conflicts. In his essay entitled "Civil War, War Economies and International Cooperation", Paul Collier argues that there are no mono-causal explanations for civil war, but that a multitude of risk factors determine a country's proneness to hazard. The three most salient factors, however, tend to be economic ones – low level of income, low growth rate of income, and dependence on primary commodities. This combination of factors characterizes many African countries in particular. Besides the difficulty of enforcing settlements, yet another economic factor drives the long duration of civil wars: financial interests and capital develop in and around conflicts and, in turn, sustain them quite effectively. Collier discusses two main sources of such finance: natural resources and diasporas. In addition to facilitated settlements along with military guarantees, he calls for "a financial strategy for squeezing rebel groups of their finances and making governments use their revenues more transparently". Post-conflict societies, about half of which relapse into war partly due to economic interests in the continuation of violence and chaos, should be prioritized in the fight to eradicate war economies. Yet, economic policies do not match the requirements of post-conflict situations: While we "should prioritize social policies first, then structural-, and finally macro policies" – the prevailing approach by the IMF, World Bank and UN, for instance, is the other way around. As well, aid needs to be provided more evenly across the first post-war decade, not massively at the beginning, with little to follow after the first couple of years. In preventing future civil wars, particularly the bottom one billion people must be assisted with a combination of aid, trade, security and improved governance.

Gabi Hesselbein discusses "The Economics of 'Failed States' in Sub-Saharan Africa". War economies are linked to failing/failed states through economic structures that are characterized by an overwhelming agrarian sector, shrinking state resources, weak and fragile state institutions, and powerful business actors. She concludes that "[t]he monopoly of power and taxation must be restored. Political and administrative control must be exercised over the entire state territory. Economic development has to be pushed through a more intensive division of labor, though technical progress and a focus on added value. This all relies on a relatively stable and peaceful environment, which will be facilitated by cooperation among elite-members, power-sharing or income-sharing". This will help in preventing economic problems from turning into war economies.

In her thoughts on "Business and Conflict – Options and Instruments for Government Actors", Jessica Banfield draws on her work for International Alert's Business and Conflict Programme. Northern governments, alone and together via regional or international organizations, have an important part to play in fostering conflict-sensitive business behavior at home and in-country. Particularly the UN, OECD, international financial institutions and the EU are important vehicles for the transfer of best practices into peacebuilding activities. Urs Egger focuses on "The Role of Local Business Actors in Creating New Livelihoods", drawing on the experience of Swisscontact in Eastern Sri Lanka. He argues that development cooperation should support and promote local initiatives without attempting to be the driving force. Moreover, it must avoid creating parallel administrative structures and invest in human resource development alongside rehabilitation efforts and investment. This creates a conducive environment for a stronger and sustainable local economy in former conflict zones.

In their essay "Investing in Stability and Sustainability: How can we Engage the Financial Sector in Conflict Prevention and Peacebuilding?", Jason Switzer and Mareike Hussels take a closer look at the role of finance in conflict escalation and peacebuilding. They identify a number of key

requirements that help reduce the finance sector's destructive role and increase its constructive influence on societies in conflict: On the one hand it is important to reduce financial flows that support violence, and to reduce macroeconomic and local vulnerability to commodity price fluctuations. On the other hand it is important to strengthen conflict sensitivity through innovative products and services, particularly in post-conflict societies. Moreover, it is crucial to integrate conflict sensitivity into project finance, for instance in the case of extractive sector projects. They conclude that, "to be an effective actor in preventing conflict and building peace, the aid community must learn how to nurture local financial institutions and how to make international ones more accountable for their actions".

Investing in the transformation of war economies into peace economies is an important contribution to both conflict prevention and post-conflict reconstruction. As a result of this initial engagement with this subject, swisspeace decided to firmly anchor the analysis of economic activities in violent conflicts and peace processes within its project on Business and Peace (<http://www.swisspeace.ch/typo3/en/peace-conflict-research/business-peace/index.html>).

### 3 Civil War, War Economies and International Cooperation

Paul Collier

We often refer to “causes of conflict.” However, I have given up on using the word “causes.” Despite nearly one hundred years of research, historians still cannot agree on what caused World War One – a fairly simple event compared to most civil wars. Civil wars have a vast array of causes, which can be better expressed by the language of “proneness.” For instance, tracing conflicts back to a misdeed in the 14<sup>th</sup> century is not very helpful. One can probably always trace a conflict back to something that happened in the 14<sup>th</sup> century – simply for the reason that, anywhere in the world, if one looks back to the 14<sup>th</sup> century, one would find that this was a mostly violent and dreadful century. Most of the world has managed to get beyond that. Similarly, there is little if any evidence for the argument that civil wars are based on ethnic hatreds. Of course, in ethnically diverse societies where there are conflicts, communities will inevitably organize and divide – and often fight – along ethnic lines. Such conflicts will be *ethnically patterned*. However, this is different from arguing that they are *ethnically caused* – a step that is unfortunately taken much too fast. Globally, evidence shows that ethnically diverse societies are no more dangerous than ethnically homogenous societies.

#### 3.1 Conflict Proneness Factors

Falling into a civil war is somewhat analogous to falling sick. There are multiple risk factors that make one more or less prone to a hazard. What are some of the main proneness or risk factors? According to my own research, the three most salient factors are all economic ones. That is of course not to say that economics cause civil war, but that they are significant risk factors. Those risk factors are *low level of income*, *low growth rate of income*, and *dependence on primary commodities*, especially natural resources. A community stricken by all three of those risk factors is extremely poor, in economic decline and dependent on natural resources – and thus at high risk of conflict. These characteristics describe the situation in much of Africa: Extreme poverty, economic decline, and natural resource dependence. If one consults statistical data, one will quickly realize why Africa suffers from more conflicts than many other regions, and why the incidence of conflict has risen in Africa, while it has fallen anywhere else. Of course, this is not to suggest that there is a mechanistic and simplistic cause explaining violent conflicts in Africa – but a set of identifiable factors of conflict proneness. If all the proximate factors that cause conflicts – for instance the emergence of a charismatic rebel leader or a government that makes a crucial mistake – happen in an environment with much higher per capita income, rapid growth, and a more diversified economy, that society will probably cope with these events, without escalating to large-scale violence.

#### 3.2 Duration of Violent Conflict

A most striking feature of civil wars is how long they last. On average, they tend to last more than ten times as long as international wars. An extreme case in point is the conflict between Ethiopia and Eritrea, which played out twice, once as a civil war and once as an international war. As a civil war the conflict lasted more than 30 years, while as an international war it lasted less than 30 days.

Why do civil wars last such a long time? Two factors are particularly relevant in this context: First, it is very hard to log into existing frameworks to reach the settlement of a civil war. There has been no system enforcing the terms of a settlement, whereas in the case of international war, we have over the centuries developed ways and means of reaching treaties, as well as of enforcing them. If one cannot *enforce* a settlement in civil wars, there is little utility in arriving at one, as nobody puts much faith into the negotiations. However, in this case the world has begun to learn. Especially during the past few years there has been movement in deploying the techniques of international diplomacy at the level of internal conflict, with a considerable degree of success. The number of civil wars is declining sharply, which bears testimony to the very high pay-offs of increasing efforts of negotiation and increasing efforts to guarantee settlements.

The second reason why civil wars last so long is an economic reason: Over time civil wars become self-sustaining businesses. Interests and capital develop that specialize in conflict – generating huge stocks of armaments and organizations that are basically protection agencies securing access to and control of lucrative resources. This is not to say that civil war is primarily motivated by finance – sometimes it is, sometimes it is not. However, it is – and certainly has to be – sustained by finance. If it is not sustained by finance it stops, as war is very expensive. Thus, one further way to shorten conflicts is to try and squeeze the finances that sustain them.

### 3.3 Sources of Finance

In any given conflict there are always multiple sources of finance. I will highlight two of them: One concerns *natural resources* and the other funding from *diasporas*. Natural resources are an important source of finance to rebel groups. They are also an important source of misgovernance on the part of many governments. Knowing that, the international community is developing a two-pronged effort to try and clean up these natural resource revenues. One such effort is to try and cut the access of rebel groups to natural resource revenues, for instance through the Kimberly Process on diamonds. Similar approaches are developed to cover timber and, possibly, oil, gas, and financial flows. For instance, in Nigeria one billion dollars a year in Nigerian oil is stolen and sold by very powerful and violent large-scale criminal gangs with contacts to the political establishment. If trace materials were put in that oil, it would become counterfeit material, its value would decrease sharply and it would become far less attractive loot for rebel groups. While adding trace substances might be difficult, it is not impossible. For example, China has a very strong interest in a stable Africa, because China sees Africa as a future source of raw materials. Therefore, initiatives like the Kimberly Process and its successors on timber and perhaps oil are a way of cutting rebel groups out of financial resources, thus limiting their capacity to fare war.

On the other hand, one needs to clean up government use of natural resource revenues. The Extractive Industries Transparency Initiative (EITI) is a promising start in the right direction: A great success since its launch by the British government several years ago, it has now been picked up, promoted and implemented by the government of Nigeria. This is a tremendous achievement. In a recent meeting of seven West African oil producers, the Nigerians forged the way, insisting that West Africa clean up its management of oil revenues and make it more transparent, visibly shocking some of the other governments. This serves as an example of an international effort that, had it not existed, the Nigerian reformers could not have picked up. In terms of natural resources we now have international strategies both to cut revenues out of rebel groups and make government access to such revenues more transparent.

The diaspora represents a further significant source of revenues to rebel groups. For example, Tamils in the West, especially in North America, are financing the Tamil Tigers; Albanians in Europe have financed the Kosovo Liberation Army (KLA); and the Irish in North America have been financing the IRA. These problems have gradually and belatedly been realized, leading to increased monitoring of diaspora organizations and the realization that it is our responsibility to curtail organized funding of violence in other societies, which originates in our societies. A devastating bomb attack in Colombo a few years ago – with almost the destructive power of the September 11 disaster – was financed by Tamils in Canada. Yet, no OECD society is eager to go through the trouble of curtailing diaspora organizations, as the violence does not tend to occur in our societies.

In summary, to shorten the duration of conflict we need a combination of facilitating settlements – which is an international diplomatic activity that should include military guarantees for settlements – and a financial strategy for squeezing rebel groups of their finances and making governments use their revenues more transparently.

### 3.4 Post-conflict Societies

Post-conflict societies offer opportunities to improve our performance in preventing war economies. Approximately half of all civil wars are post-conflict relapses, i.e. post-conflict situations that have gone wrong. There is an approximately 50 percent chance – thus, a very high risk – that post-conflict situations relapse into open violence. This fact alone is evidence enough that we could do much better in stabilizing post-conflict societies.

Why are post-conflict societies at such high risk to return to war? Partly this is due to the fact that they represent societies that are inherently at risk – which might have been the reason why violence broke out in the first place. Moreover, the experience of violent conflict generates new divisions, new hatreds, and new potential for future conflict. Of the approximately 50 percent which slide back into conflict, half of them do so over reasons that existed before the original conflict, the other half over reasons generated during that conflict. What are some of the conflictive forces that are generated during a conflict? These are mainly the economic interests mentioned above: During an armed conflict some groups emerge, which can only – and quite well – live by violence. They have no interest in peace and emerge as political spoilers of any peace settlement.

We can oppose these forces with economic, political, and military instruments. Economic instruments take time. As I argued above, the main proneness factors for conflict are indeed economic in nature. If economic problems can be solved, the proneness to violence and risk of conflict would be reduced. However, there are no quick fixes, and it takes at least a decade before economic recovery reaches the point where it effectively reduces the risk of conflict recurrence in post-conflict societies. How then does one survive this first post-conflict decade when the risks of relapse are that high? The answer does not lie in economic recovery but, in the first instance, in political solutions. However, we tend to be over-reliant and over-confident in the power of political solutions for short-term fixes during this first decade. Unfortunately, the standard political design package still tends to be to get to elections as quickly as possible, despite sufficient statistical evidence that elections in post conflict-situations are not actually reducing risks. In fact, the second post-conflict election actually tends to push risks up. Of course, this does not mean that elections should not be held, but it is to say that one should not rely on them as the ultimate solution for bringing peace, at least in the short term. There is also evidence that – if anything – in low-income countries democracy itself raises risks of conflict rather than reduces them. Again, this is not to say that one should not hold elections in low-income countries. Obviously, much good can arise from democratization – and thus also electoral – processes. However, we should not delude ourselves into thinking that by installing a democratic constitutional design into a post-conflict country we will solve the peace process. This is by far not the case. In the short term, even the cleverest, fairest and best political design is new. And because it is new, it is contestable. As there are spoilers in any post-conflict society who do not want peace to succeed, they will contest it. Thus, even political processes will not be able to perform miracles in the short term.

The first post-conflict decade requires a strong military presence, which should evolve according to different levels of risk and, thus, types of security measures. This requires a gradual transition from military to police. Typically, the domestic post-conflict government itself provides much of the military effort, generating a level of military expenditure that often equals that of the war period. In post-conflict situations governments tend to respond to high risk with high military spending, seeing it as a deterrent. Unfortunately, rather than being an effective deterrent, evidence shows that, while outside of post-conflict situations high military spending does not raise the risk of conflict, within this post-conflict decade, high military spending does. While the instinctive response of post-conflict governments is therefore counterproductive to the peace process, there is still a need for military assistance during that decade. This only leaves us with the option of an external military presence. In terms of who should provide such military presence, one could think in terms of subsidiarity, drawing on the lowest level that is competent to do the job. Thus, if a regional organization or a sub-regional organization can supply the required police or military forces, they should do so. If not,

one needs to involve the United Nations or rely on bilateral assistance (such as in the case of UK forces in Sierra Leone). It is important that, whoever puts troops in a post-conflict theater, must be willing to take the risk of casualties. In the case of UN forces, there is a tendency that contributing governments are not willing to see “their” troops engaged in military action. The result is very low credibility peacekeeping. Sierra Leone is again a good example: Before the deployment of British troops, United Nations peacekeeping troops present in the country were not willing or did not have the rules, mandate or incentives to engage in recurring violence. In the end, 500 UN troops were kidnapped by rebel forces that then took their guns, turning UN peacekeepers into a source of armaments for the rebels.

A few further comments are in order about economic instruments in recovery. During the war we experience massive capital flight, as the population tries to move their assets abroad. Getting these assets back in the country is a major and important challenge during the post-conflict period. Two issues are decisive in this context: Property rights and the reduction of risks. Property rights are usually highly contested in post-conflict situations, when opportunism reigns: Property rights are confused and opportunists abuse this confusion to claim property that does not belong to them. It is thus extremely important to address property rights. An instructive example is Uganda: The government set up a commission that adjudicated submitted property claims. If claims were not submitted by a certain date, no future claims were possible. On the other hand, the case of Ethiopia shows how this should not be done – the government of Ethiopia simply went into denial that there was a problem and did not take any measures.

In typical post-conflict situations, economic policies start very badly and typically improve greatly over the first post-conflict decade. This period offers plenty of opportunities to embark on economic policy reform, because vested interests have been broken up and the population expects change. Yet, such reform is usually not a priority in the immediate post-conflict period, for the first two or three years. The government is busy with other, seemingly more urgent, issues, while this would be the right moment to jump-start reforms. However, often there is confusion about which reforms one should tackle first. In a course on post-conflict economics, which I have been offering to staff members of the World Bank, the IMF and the UN, I asked them to prioritize between macro-, structural and social policies. I asked them to imagine that they are going to two extremely poor countries with weak policies – one of them in the post-conflict phase, the other not. Should this distinction affect one’s policy priorities? Staff members from the IMF tended to argue in favor of macro-, those from the World Bank for structural-, and those from the UN for social policies. From that experience I learned that policy priorities largely depend on which international team of experts arrives first. The IMF tends to send in their team immediately, the World Bank arrives after about four weeks, and about six months later the UN team arrives. Unfortunately, econometric evidence tells us that this is not a particularly useful sequence of reform priorities: If we want to generate economic growth in post-conflict situations, we should prioritize social policies first, then structural-, and finally macro policies. Thus, the present and prevalent policy advice is not helpful at all.

### 3.5 Aid

How much aid should be provided and when? Evidence suggests that aid that facilitates growth is much more effective in post-conflict situations than in other situations. Over the first post-conflict decade, aid should be considerably higher than for an equivalent country that is not at the post-conflict stage, particularly for the purpose of generating growth and stimulating poverty reduction. However, historically, that has not been the case. Aid tends to arrive in a flood during the first couple of years after a peace settlement and then tapers off. Unfortunately, econometric evidence shows that aid is contributing most to the growth process in the middle of the decade, not the beginning. In the beginning there are multiple needs, but without absorptive capacity. What would be required is a tapering in during the first half of the decade and then a tapering to normal by the end of the decade. Once understood, this should be a relatively easy problem to fix.



### 3.6 Conflict Prevention

I will conclude with some remarks on economic policy in conflict prevention. One can conceptualize the development problem in a very old fashioned way: Today's world is populated by five billion poor and one billion rich people. In the future, the five billion in developing countries will be divided into a large group that is more or less succeeding on the development path – China and India being the most obvious examples – and a group of one billion people at the bottom, in the most marginalized countries that are not simply in relative but absolute decline. In 10-15 years, we will be addressing the development problem more or less in the context of these one billion at the bottom. To meet this task we require more than just aid, including a wider range of instruments. We require policy coherence between trade policy (where we have made a very slow start) and security policy (where we have to be in a position of rapid provision of external militaries, both in post-conflict situations and pre-emptively). For instance, the international community could offer countries military assistance against coups or other internal threats in return for strict adherence to certain standards of governance. One of the largest threats to human security in Africa is not rebellion or elections, but coups. Anything that guarantees security from a nation's own military, will be welcome in African societies – and by their governments. Thus, addressing the bottom one billion people will require aid, trade, security and, finally, decent governance.

## 4 The Economies of “Failed States” in Sub-Saharan Africa

**Gabi Hesselbein**

War economies are one result of state failure. Transforming war economies requires the re-establishment of the state. In my contribution to this working paper I will focus on similarities between failing or failed states and war economies, particularly with respect to four related aspects: The economic structure; state resources; state institutions; and business actors. I will then offer some basic steps that could be taken to re-establish functioning states.

### 4.1 The Economic Structure

From an economic point of view, failed states and war economies can be characterized as follows: First, there is a huge agrarian sector that basically serves subsistence needs, i.e. people do not farm in the first place to market their products but to sustain their living. The very low level of productivity hardly allows for surplus. Between 70 and 90 percent of Africa’s population rely on this agrarian sector for survival. Secondly, some export earnings come from the cash-crop sector. Although not always the case, productivity in this sector can be higher. However, there is almost no value added, as processing is virtually non-existent. Earnings from this sector have been sharply declining in most African states. And thirdly, a further contribution to export earnings comes from mineral primary goods such as diamonds, coltan or gold. Again, there is little if no processing, just simple extraction from what the land provides.

Industry is almost non-existent, and the service sector is characterized by its low value added. In many, if not all African countries the entire economy is run on extremely low levels of productivity: Only very few companies are involved in the extraction and sale of primary commodities, and their technical base is simple, with little relevant value added. An increase of production is usually not achieved by more intensive production, but by an extension of the area under cultivation. However, given the land scarcity in almost all African countries, the latter can itself develop into a source of conflict.

### 4.2 State Ressources

The economic structure is reflected in the state budget and thus limits government actions. The main source of income for the state is taxes on international trade. Although many efforts have been undertaken to expand the tax base through company taxation, individual taxes or taxes on goods and services, and although these revenues vary greatly across African budgets, the overwhelming revenue relies on the taxation of international trade. Official development aid and grants also play an important role, but African states are more often than not limited in their decisions as to how and for which purposes they are allowed to spend those funds.

With very few exceptions – such as “successful developers” like Botswana – since the 1980s state revenues are declining considerably in most African states. Massive economic and financial shocks affected the budgets, making it increasingly difficult for governments to fulfill even simple responsibilities towards their citizens. Policing, schooling or health-care deteriorated, increasing the suffering of the population, which, in turn, questioned the legitimacy of their government. The erosion of the state’s ability to “deliver” led to an erosion of the state itself.

What remains – and is thriving – are conflicts about the distribution of what little is left. Once these conflicts turn violent, the state budget finally collapses. This tends to be followed by the (violent) usurpation of resources through local or regional groups.

### 4.3 State Institutions

In African states, state institutions in general are weak and fragile, although some pomp and display of strength sometimes seems to indicate the opposite. In failed or failing states, as well as in war economies, we find that "modern" rules and regulations co-exist with older settings of law, written or unwritten. This is particularly true in the realm of land ownership, which is generally based on inherited collective law, and it is also true when the legitimacy to rule is questioned. A modern constitution or a modern parliament does not necessarily mean that chiefs, emirs, local, regional or religious leaders cease to be in power.

In war economies, violence against "others" goes hand in hand with rules that have to be observed within the "own" group. The elites are relatively small groups and consist of only few people who serve – according to status – as minister, head of state, university professor, chief, rebel leader or warlord.

### 4.4 Business Actors

Private business actors (or even managers of parastatal structures), of which there are only few, generally wield considerable power within society. They enjoy access to both state and military power. This power tends to be used in two ways: On the one hand, earnings from the mineral or cash-crop sector are used to extend or stabilize the military power and level of violence in favor of one's own group. In this case resources are fuelling conflict. On the other hand, resources are used to expand one's economic position without resort to force, as the societal status allows for that. This might fuel economic growth.

In both cases the resources base in a given country is the same. Diamonds in Botswana serve economic development, diamonds in Sierra Leone finance war. The main difference is whether they are formally extracted and appropriated, or if this is done through the use of force for the benefit of a particular violent group.

### 4.5 Basic Steps

The difficulties inherent in ending violence and pursuing disarmament should by no means be belittled or underestimated. These are huge tasks by themselves. However, given the striking similarities between failing or failed states and war economies as far as economic and power structures are concerned, a number of steps, among others, must be taken to overcome these outrageous obstacles for human development: The monopoly of power and taxation must be restored; political and administrative control must be exercised over the entire state territory; and economic development has to be pushed with a more intensive division of labor, technical progress and a focus on value added. All of these steps rely on a relatively stable and peaceful environment, which will be facilitated by cooperation among the elite, power-sharing, or income-sharing. Although this is easier said than done, it needs to be done. When war economies become an answer to economic problems, all actors involved need to work for better solutions that generate more surplus, more benefits and better options for millions of people.

## 5 Business and Conflict – Options and Instruments for Government Actors

**Jessica Banfield**

While the issue of war economies is vast, the following comments will focus on the role of multinational companies investing in conflict-affected countries, based on the peacebuilding NGO International Alert's (IA) broader programme of work on business and conflict.

During the most recent years, the issue of business in conflict zones has focused on both corporate social responsibility and humanitarian agendas, generating several international policy initiatives, numerous publications by NGOs and research institutions, and both private and public sector conferences and events. International Alert's "Business and Conflict Programme" targets a diverse group of actors: business leaders in conflict countries; companies that invest in conflict-prone countries; donor governments and multilaterals; and peacebuilding practitioners. The programme aims to contribute to conflict prevention and transformation through engagement with economic actors and issues.

After two years of research and development, the report *Conflict-Sensitive Business Practice: Guidance for Extractive Industries* was published in early 2005 by International Alert (<http://www.international-alert.org/publications/234.php>). The work was funded by Foreign Affairs Canada, UK Department for International Development, Swedish SIDA and the human rights division of the Swiss Federal Department of Foreign Affairs. It includes a foreword from former UN Secretary-General Kofi Annan. CSBP was developed with input from some of the world's leading extractive industry companies and conflict experts. It is meant to provide corporate managers with a better understanding of the impact of their own operations on violent conflict, and it offers a number of tools that can be used to mitigate such impact.

The incentives for companies to think more carefully about their conduct in conflict zones can be based on the company's own appreciation of the various costs imposed on business by conflict (increases in security, insurance, and capital costs; opportunity costs; and legal and reputational risk). Globalized networks of civil society and the media play their role in keeping the spotlight on multinationals operating abroad, and on the impact of their operations on the livelihoods and security of local people.

The OECD Development Assistance Committee (DAC) offers a definition of 'fragile states' as those that 'cannot or will not manage the resources at their disposal for the benefit of the majority of its populations'. Such states are often conflict-prone – and in these environments, the overall benefits of foreign investment can be complex. The conduct and operating practice of multinational companies – decisions relating to distribution of employment opportunities, security arrangements, environmental impact, and relationships with political elites for example – can all exacerbate or act as a trigger to underlying tensions in society. In such contexts it becomes all the more important for 'home' governments and international organizations to clarify appropriate standards of behavior and to hold companies that flout these to account. Thus, governments clearly have an important role to play.

### 5.1 National Policy Priorities

Northern governments play an important role in this process, as they can help to:

- strengthen legal accountability;
- ensure implementation of key standards (such as the Extractive Industries Transparency Initiative (EITI), the Voluntary Principles on Security and Human Rights, or OECD Guidelines for MNEs);

- ensure that state-backed investment (such as Export Credit Agencies, Public Private Partnerships, funds) are 'conflict-sensitive';
- promote best practices (at home and in-country);
- support the capacity of developing country governments to manage natural resource exploitation effectively and for the benefit of local people.

Northern governments can take a much more active role than is currently the case to promote best practices both at home and in-country. This would enhance conflict-sensitive business behavior through dialogue, awareness-raising and the promotion of such simple steps as mandatory registration for companies that operate in conflict-prone zones. Where their home companies are accused of complicity in war crimes or other abuses – as has been the case through the Alien Torts Claims Act or through complaints brought to the attention of OECD 'National Contact Points' – governments should take all possible steps to investigate and address such concerns. Doing so would send a strong signal to business that investing in conflict zones must be managed with care and integrity. Greater synergy between development and trade/investment ministries is required to ensure that promotion of national business interests does not undermine development goals.

## 5.2 International Policy Priorities

At present no overarching internationally agreed convention or standard exists regarding companies' roles in conflict zones. The absence of clear guidance and rules becomes apparent time and again as companies and civil society actors alike face uncertainty as to the appropriate responses to challenging interactions between companies and conflict actors and dynamics.

The UN has played an important role in promoting certification and sanction regimes on certain conflict commodities and, through the UN Global Compact and work of the High Commission on Human Rights, in developing the UN Draft Norms on Responsibilities of Business, in contributing to the emergence of a new normative framework for doing business in conflict affected countries. The UN Special Representative on Business and Human Rights could become a focal point for much-needed coordinated international action on this issue.

The OECD Guidelines for MNEs have featured in civil society-led debates about company conduct in conflict zones, particularly the Democratic Republic of Congo. It is an important source of guidance given the widespread application of the OECD Guidelines. Unfortunately, the text of the Guidelines itself has little to say about the intersection between business and human rights or conflict, and clarification in this regard is urgently needed.

International Financial Institutions have an important role to play in promoting better governance of natural resource exploitation at the domestic level and, through development banks, in promoting higher standards of conflict-sensitivity among companies and project financiers.

While the EU has shown a commitment to addressing trade in specific conflict commodities (e.g. diamonds and timber), it has done little on the issue of company conduct in conflict zones, despite a clear statement in its 2001 Communication on Conflict Prevention of the importance of European companies contributing to conflict prevention and peace. Greater coordination is required between relevant EU institutions and actors in order to develop EU-wide standards and guidance for companies.

## 6 The Role of Local Business Actors in Creating New Livelihoods

Urs Egger

### 6.1 When Can We Really Talk of a “Post-Conflict Situation”?

A civil war does not simply end when a ceasefire or a peace agreement is signed at Track I level. It is never completely clear if an agreement was signed with a genuine commitment to peace in the first place. Often, low-scale warfare or covert interventions continue. Different armed groups might become more active in a perceived power vacuum, mistrust and hatred among the communities still persist, the situation is still tense and even a vague rumor might spark and spiral into violence.

### 6.2 What Do We Mean When We Talk of a Post-Conflict Situation?

The observations below are based on examples from Sri Lanka, where Swisscontact has been working since 1981. At the time of writing (2004/05), a formal cease-fire agreement had been in force since the beginning of 2002. However, at Track I level, the negotiations had been stalled. Political stalemates made it difficult for the present minority government to move forward with the peace process while a split within the LTTE had led to an armed standoff between the two factions. These factors influenced the peace process on the national level as well as the local level. In Eastern Sri Lanka, the situation was tense and overall the country had again moved away from a sustainable peace. When we face a post-conflict situation in places like Congo, Kosovo, Sri Lanka, or even Iraq, we have to keep in mind that these are very fragile and largely unpredictable situations where violence has not stopped entirely and conflict can easily and suddenly resume.

In the following, I will outline some of the constraints and opportunities local businesses face in such a context and how the local private sector can be supported to contribute to local reconstruction, development and the strengthening of the peace process at Track II and III levels.

### 6.3 Challenges and Opportunities of Local Business Actors in Post-Conflict Rehabilitation and Peace Promotion

In the context of Eastern Sri Lanka in 2004/5, the following challenges for local business actors can be identified (among others):

- Since no elections on the provincial level or below have been held in the North and East since the war officially ended in December 2001, all government representatives (provincial, district, divisional and communal) are appointees. The local authorities are mostly inefficient. They lack democratic legitimacy, budgets that go beyond recurrent expenses, and human resources. On the other hand, the quasi-parallel “LTTE administrative system” is very authoritarian. (However, due to a recent split within the LTTE, their grip on the East had decreased and many of their offices seemed to be closed for the moment). Businesses have to face taxation by the LTTE and sometimes claim double taxation (by both LTTE and the government).
- Soft and hard infrastructure, including water, electricity supply, roads, the education and vocational training system or medical services, has been badly damaged and/or neglected during the war.
- The conflict has also caused price distortion (but not as strong as for instance in Kosovo), as humanitarian and development agencies are paying high salaries and high prices for other services. Similarly, people became used to free services, for instance for training. However, development agencies are slowly realizing this. Obviously this has created a mentality of receiving/expecting rather than delivering/performing among the beneficiaries, whom Swisscontact therefore prefers to call “clients”.

- A sustainable peace has not yet been reached. Investors are reluctant to place money because of the risk of a renewed outbreak of war and because they do not know who will be in control in a future administrative system in the North and East. Large-scale investment plans exist, but no outsider will invest in the present climate because the risks are perceived as being far too high.
- There are people at all levels who have an interest in keeping the war going – either for economic or for political reasons.

Despite these constraints on the business environment, there are a number of opportunities:

- If people stand to benefit economically, they are more willing to cooperate with members of other communities. Some economic ties have existed throughout and after the armed conflict. While these economic ties across different communities potentially strengthen peace, they should not be over-estimated as to their effect on the cooperation of communities as a whole, since they might only be limited to business interests. These economic links can even be a source of conflict when they are perceived as exploitative. For instance, it is often claimed that Muslim traders cheat Singhalese or Tamil farmers or fishermen, or that Singhalese fishermen (from outside the area) encroach on beaches and fishing grounds in Tamil or Muslim areas and destroy their livelihoods.
- The post-conflict regions represent potentially large new markets for (outside) SMEs and the corporate sector. Since many families have at least one member working abroad, there are remittance flows to those areas, which should not be underestimated. In Sri Lanka, foreign remittances are the single most important foreign exchange earner. A large amount of these resources already flow to the conflict-affected areas and is expected to increase if there is a sustainable peace. For example, in the absence of investment possibilities in Jaffna, it is estimated that every day US\$ 500,000 flow to Colombo – mainly into the booming real estate market.
- Linked to the above are the “untapped or under-utilized resources” of the post-conflict areas. If put to use again and developed further, they can contribute to employment and income generation. For instance, in 2003, Ampara District, heavily affected by the war, was the largest paddy producer on the island. There are opportunities in other sectors such as tourism or (re-)construction. If local resources are put to use and local as well as outside public and private investment takes place, this will lead to further job and income opportunities and contribute to the diversification of the economy.
- The flow of relief and development money also represents an opportunity for local businesses to participate in the reconstruction of the region. In order to strengthen the *local* economy and create *local* job-opportunities, private, public and NGOs-initiated reconstruction projects use *local* resources and manpower to the largest extent possible.

## 6.4 Promotion of the Local Private Sector in Post-Conflict Situations

In the context outlined above, what is the role of the local private sector and how and by whom can it be strengthened?

- The *business sector* (particularly the organized middle-sized firms and the corporate sector including multinationals) is the driving force of any economic development. Their primary motive is of course to generate profits. By investing in the development of hard and soft infrastructure (see below, through PPP with the government), the private sector can contribute to offering jobs and income to the local population.

- The *public sector*, on the other hand, should support the business environment by taking care of vital infrastructure development such as roads, water and electricity supply, in close collaboration with the local private sector. In order to boost economic development, the public sector can also provide incentives such as tax exemptions or allocation of government land on long-term lease to “early market entrants” and investors in post-conflict areas. Promoting PPP is another option, for instance by privatizing former government services (such as utilities).
- The *local society* provides the labor force and invests in and develops micro- and small businesses on the village level. Services provided by local entrepreneurs, for example in the crafts and construction sector, can be used to support local rehabilitation and infrastructure development. Eventually, they can become service providers and subcontractors for bigger enterprises.
- A *well-trained labor force* is a key element in local economic development. In a post-conflict situation it is especially important that young people are offered a new perspective in life and the chance to a decent way to earn their living. This is a field in which the private sector, the state, as well as the development community should work closely together. However, both coordination and timing of training efforts should coincide with the reconstruction and investment drive. If the trained labor force cannot apply their newly acquired skills, it is likely that they engage in unlawful activities and forget what they have learned.
- *Development cooperation* can contribute to support both private and public sectors in infrastructure development, access to resources, access to information and technology, as well as in the development of a strong, employable labor force. Nevertheless, the driving forces should be the various local actors and their initiatives.

All these efforts together will contribute to a more conducive environment in which local businesses can prosper.

## 6.5 The Current Situation in Eastern Sri Lanka

The following section examines a project that aims to contribute to peacebuilding by promoting the private sector in Eastern Sri Lanka.

The current situation in this region – the context in which this project was launched – could be described as follows:

- A cease-fire agreement holds, but the situation of “negative peace” is slipping back to a low-scale warfare, possibly with government and intelligence involvement. The population is caught between two factions of the LTTE who combat each other. Mutual suspicion among the communities is high, and political and internecine killings occur almost on a daily basis.
- Hard and soft infrastructure is badly damaged after more than two decades of war. Numerous qualified individuals have left the country.
- The main livelihood resource is agriculture and fisheries. These sectors are recovering, yet profits go to middle men (traders). There is a very low degree of industrialization and diversification.
- The many unresolved land disputes are a source of conflict and leave potentially cultivatable land resources unused.
- Unemployment is high, especially among the youth (unemployment stands at around 25 percent, with underemployment higher than 50 percent). Many are waiting for a chance in the



public sector, where job placements are controlled by politicians. A large part of the working populations cannot earn a decent living, as their activities do not generate enough income. There is a mismatch between the current trainings on offer and the labor force requirements of the private sector. Un- and underemployed (male) youth are especially prone to get involved in troublesome activities, often linked to armed gangs, alcohol, drugs and crime. If in post-conflict situations, these people cannot be absorbed into the labor market, they are bound to become spoilers of the local peace process and generate violence.

## 6.6 Swisscontact Project in Eastern Sri Lanka

How does Swisscontact contribute to local economic development in the former conflict zone?

Swisscontact has two projects in Sri Lanka: The "Development and Peace – Sri Lanka" project (DPSL), a mandate by SDC, and the "Swisscontact Development Programme," which is partially funded by SDC. Designed to complement each other, these two projects in the post-conflict Eastern District consist of three interventions:

- *Private Sector Promotion* aims at improving access to BDS (Business Development Services) for local SMEs; creating market linkages for local producers; improving access to business information and adequate credit products for SMEs; and working on related issues that support a conducive business environment.
- *Unemployed Youth Support* (Tamils, Muslims and Singhalese) aims at the improvement of sustainable livelihoods through imparting technical (vocational) skills and social skills (such as life skills, conflict sensitivity skills, or community and project work with all three ethnicities).
- *Skills Development Provider Strengthening* addresses the supply side of training and development, i.e., the gap between supply and demand of a trained labor force. It also assumes that, once a peaceful settlement is achieved and investment is increasing, a trained labor force in potential sectors such as construction, tourism, agriculture/food processing and other services will be in demand.

By combining the efforts of these projects and by linking them with other stakeholders and initiatives, Swisscontact hopes to have a quality impact on strengthening the local economy, thereby giving fresh opportunities to the people and contributing to peacebuilding at the levels of Track II and III.

## 6.7 Some Conclusions

In summary, the following issues can be identified as key elements in development cooperation initiatives: It is important to work towards a conducive environment and the abolishment of parallel administrative structures. Investment in human resource development is critical, but should coincide with (Timing) and respond (Competencies) to rehabilitation efforts and investment drive. Additional incentives by the government could have a positive influence on an early investment drive. Transparent information channels about the situation, plans and investment opportunities complement such efforts.

Development cooperation can support and promote local initiatives, but should and cannot be the driving force. Building local capacity is thus a quintessential aspect of development cooperation.

## 7 Investing in Stability and Sustainability

**Jason Switzer and Mareike Hussels**

The economic drivers behind many contemporary conflicts have received increasing scrutiny in recent years. As a consequence, attention has turned to the role of the private sector in conflict zones, and to examples of its role in conflict prevention and peacebuilding. Most research and advocacy efforts have focused on the extractive sectors – oil, gas, mining and forestry. Yet comparatively little effort has been invested in unpacking the positive and negative relationships between the financial sector and conflict prevention, with the exception of efforts to rein in finance for terrorist groups and criminal elements.

In fall 2003, the United Nations Environment Programme (UNEP) and the International Institute for Sustainable Development (IISD) brought together leading financial professionals, researchers and conflict management and transformation practitioners for an experts' meeting to discuss these issues, identify gaps in understanding, and determine whether further effort was warranted. The following points represent the highlights of this discussion and related research.<sup>1</sup>

The finance sector can become entangled in conflict scenarios as a consequence of long-standing investments or operations in formerly peaceful countries, or through investment in projects whose impacts may generate local grievances. Armed groups and conflict entrepreneurs can misuse financial services, and the financial sector can be associated with contributing to or failing to prevent macroeconomic shocks that weaken the state.

On the other hand, the financial sector can help to secure peace and manage or prevent conflict through its core business, by insuring or mobilizing finance for key infrastructure, energy and water services, through ensuring that projects are implemented in a conflict sensitive manner, and through spreading the financial impacts of conflict and terrorism over time and space. It can further have a positive impact through social investments in communities and protection of natural resources critical to their lives and livelihoods; through participation in policy dialogue to promote reconciliation, more-accountable governance and protection of human rights; and through knowledge sharing with the public sector. The financial sector can create win-win opportunities for itself and host societies by mobilizing and managing funds from diaspora communities for post-conflict reconstruction; by providing innovative services to companies and governments that help to predict and prevent conflict and terrorism; and by identifying investment opportunities that have the potential to outperform competitors by managing or avoiding conflict-related risks.

### 7.1 Reducing Financial Flows that Support Violence

Financial services are an important element in facilitating corrupt practices and in exchanging natural resources, drugs and people for arms. Efforts to reduce these linkages have grown substantially since 11 September 2001, through the activities of the Financial Action Task Force (FATF), through the adoption of the Wolfsberg Principles by leading institutions, and through national legislation such as the US Patriot Act. Because implementing these initiatives poses considerable costs to the financial sector – as much as 20 percent of annual profits for Patriot Act compliance according to one source – proactive efforts to understand and prevent the misuse of financial services for conflict purposes by firms will head off more costly and punitive regulation in the future.

<sup>1</sup> See also: <http://www.iisd.org/publications/publication.asp?pno=636>

## 7.2 Reducing Macroeconomic and Local Vulnerability to Shocks

Countries with a high degree of dependence on commodity exports are vulnerable to international commodity price swings with sometimes calamitous results, as illustrated by the link between conflict in Rwanda in 1994 and the collapse of international coffee prices. Similarly, communities are vulnerable to these price swings and to local-level shocks (e.g. drought, blight, pestilence, refugee influx, etc.) The financial sector can contribute to reducing macroeconomic vulnerability through assistance in the implementation of national and international revenue stabilization mechanisms (e.g. Norway's petroleum fund and Chile's copper fund); and to reducing local-level vulnerability and strengthening economic diversification through extension of micro insurance and other basic financial services, such as bank accounts. In South Africa and Canada, access to financial services has recently been endorsed as a basic right for all citizens, yet implementing this for the very poor will require considerable innovation.

## 7.3 Innovative Products and Services

Conflict sensitivity can be a new opportunity for competitive advantage, as evidenced by the "peace premium" consumers are prepared to pay for Canadian diamonds untainted by allegations of conflict complicity. Similarly, it may be possible to target the nearly US\$1 billion in annual expatriate remittances to conflict zones, with high-risk/reward managed funds that invest productively in these regions.

## 7.4 Strengthening Post-Conflict Reconstruction

Private sector investment is most needed during the second half of the decade that follows the cessation of hostilities. When international donor funds and attention decline, this will ensure the transition from humanitarian assistance to long-term reconstruction. While there is no framework for engagement between the financial sector and the donor community (and little mutual understanding), such a framework is critically needed. A recent study by MIGA of post-conflict Bosnia has revealed that the financial sector is more responsive to political risk insurance from the World Bank and other agencies than other sectors, and that such firms are vital to the re-launching of local small business development. These small ventures are essential for the regeneration of both the economy and society. International support for the restoration of the financial sector may be a better value than many other forms of aid, but little is known about effective donor assistance in this area. As a first step, it would be worthwhile reviewing the impact of relevant donor projects in this sector, while convening a group of international and local financial professionals around the question of what it would take on the part of the donor community and the international financial institutions to strengthen investment in specific countries in post-conflict settings.

## 7.5 Bringing Conflict Sensitivity into Project Finance

Readily accessible natural resource stocks in Europe and North America are running out and, as a result, extractive sector projects are increasingly being developed in regions mired in poverty or emerging from decades of protracted violence. Such projects are therefore at increasing risk of contributing to tension or turmoil, undermining international security. In one example, a coup attempt in Equatorial Guinea has been linked to the discovery of oil. Extractive sector projects in impoverished regions are rarely undertaken without direct finance or political risk insurance from international financial institutions (IFI) and national export credit agencies (ECA). While important initiatives are underway to define benchmarks for conflict sensitive business practices, there is no linkage between access to public sources of finance and conflict sensitive project implementation, unlike World Bank safeguards and guidelines for resettlement, indigenous communities and environmental assessment. One way forward would be to convene the ECAs, IFC and MIGA around the definition of a guideline for conflict sensitive project implementation, drawing on available codes

and guidelines. This would readily spill over to the private project finance community through the Equator Principles, endorsed by banks representing 70 percent of this market, and modeled on the World Bank safeguards.

## **7.6 Conclusion**

A strong and resilient financial sector is the backbone of a functioning market economy. To be an effective actor in preventing conflict and building peace, the aid community must learn how to nurture local financial institutions and make international ones more accountable for their actions.

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