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Macroeconomic Policies for Post-Conflict Countries

The central challenge for a government of a post-conflict country is achieving a social consensus for peace. While macroeconomic policies are not the primary mechanism to achieve social peace, their fundamental goal should be to contribute to that end, not to make it more difficult.

First, and most fundamental, is that macroeconomic policy should avoid adding the pain of austerity measures to the legacy of conflict. The struggle over limited resources is a common cause of or contributing element to conflict. *Ex-ante* or *ex-post* fiscal austerity, aggravated by a tight monetary stance, can exacerbate social tensions that cause or rekindle conflict and violence. For instance, investments in social services explain the relatively peaceful legacy of Ghana. In the mid-1990s, conflict broke out in the northern region, in a dispute between the Konkomba and Nanumba communities. However, substantial government spending on infrastructure and social welfare schemes—such as the Program of Action and Measures to Address the Social Costs of Adjustment (PAMSCAD)—contributed to the containment of violence and the restoration of peace (Snyder & Bhavnani, 2005).[1]

Second, discrimination in the distribution of expenditures should be avoided. This may seem obvious. However, one common form of allocating expenditures (through targeting) is often socially discriminatory in practice or perceived as such (see critique in Cramer & Weeks, 2002)[2]. An obvious example is a post-conflict policy that provides benefits to ex-combatants. While apparently conflict-reducing, this policy can flounder on the often intractable problem of identifying who was a combatant. Identification becomes an extremely delicate political exercise when the conflict was between a formal army and irregular insurgents, with the task being easy for the former and ambiguous for the latter (Özerdem 2008)[3]. If a country has pronounced ethnic regional inequalities, means testing of benefits can appear as politically motivated discrimination. There can also be problems in community-targeting methods. Community leaders can use access to benefits as a way of rewarding friends and punishing adversaries, which could have harmful impacts on social cohesion.

According to the World Bank (2011, p. 4)[4]: "For every three years a country is affected by major violence (battle deaths or excess deaths from homicides equivalent to a major war), poverty reduction lags behind by 2.7 percentage points." Hence, the most important economic objectives in a post-conflict country are poverty reduction and maintaining economic growth near potential, while doing both in a manner perceived as equitable and fair across social groups.

In the short term, a major objective of public expenditure would be to fill the aggregate demand gap created by the collapse of private sector investment and exports. This implies employment creation, for instance through non-discriminatory public works and other social assistance programs. As economic collapse reduces revenue collecting capacity, support for public expenditure from external sources is essential for recovery. In providing this support, conditionalities that are demand-depressing as well as unduly austere deficit and inflation targets need to be avoided. In general, fostering recipient ownership is good development cooperation (Weeks, *et al.* 2005; Cramer, *et al.,* 2006)[5 6].

The collapse of revenue capacity implies that governments need to exhaust all feasible sources. The major revenue source for many low-income post-conflict countries is trade taxes. While maintaining some of these may have negative effects on exports in normal circumstances, this is unlikely to be the case in a post-conflict context. Compared to the major barriers to export growth, disruption of marketing channels and productive capacity, the tax regime will be a minor element. The fiscal expansion can be accommodated by monetary policy through bond sales and/or by monetization.

Given the large trade deficits that characterize a post-conflict country, active exchange rate management cannot be avoided. Real depreciation through adjustment of nominal rates can be used to restore competitiveness. This management is all the more essential because of the typically large flows of development assistance that are frequently unstable and unpredictable (Weeks 2009)[7].

The focus for medium-term macroeconomic policy is essentially *public sector-led growth in anticipation of private sector recovery*. Besides the temporary employment creation, public expenditure can lower private sector costs through the repair, reconstruction and expansion of infrastructure. On the revenue side, deepening political stability should allow broadening the tax base (especially by reducing evasion). Growth fostered by short-term policy might allow for the diversification of the revenue regime into direct taxes.

Monetary strategy should strengthen financial institutions to mobilize private resources for investment. Two important sources would be remittances from people who fled during conflict and asset hoards accumulated during the period of political instability. The former is frequently cited as an untapped source to fund investment. Realizing the developmental potential of remittances requires carefully designed mechanisms that channel funds into the formal banking system, yet do not provoke fears of unjustified taxation (Toporowski, *et al.* 2009)[8]. Reviving the financial sector would tap into asset hoards. Essential to strengthening financial institutions as well as central bank capacity to implement policy will be the progressive reduction of the use of foreign currencies in domestic commerce.

An almost universal characteristic of post-conflict countries is a large trade gap that implies reliance on official development assistance to an unsustainable extent. Therefore, it is essential that post-conflict recovery be export-driven to create a sustained growth process. Export-driven growth requires, among other policies,

conscious management of the exchange rate to foster external competitiveness.

The summary of policy options discussed above is found in the Table of the Appendix.

Country-Specifics and Limitations in Implementation

The feasibility and success of macroeconomic policy will depend on specific policy designs adapted to each country's unique characteristics. This caveat applies to countries that may have many features in common. For example, Liberia and Sierra Leone are both post-conflict, least-developed countries exporting similar products. However, a fiscal expansion of the type that was successful in Sierra Leone is unlikely to be feasible in Liberia because of the high degree of dollarization of the Liberian economy (Weeks, 2011)[9].

The practical result of such currency arrangements is that the major monetary and exchange rate tools are not available. All that remains of monetary policy is a limited scope to issue bonds and conduct financial sector oversight. Fiscal policy is also limited, restricted to allocation of expenditure and adjustment of tax coverage and rates. Even without a formal deficit rule, financing expenditures is difficult with a common currency because of restrictions on issuing bonds. The macroeconomic guidelines developed in this paper, therefore, do not fully apply to the countries constrained by currency agreements.

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Table: Macroeconomic Policy Options for Post-Conflict Countries

		Objectives and Actions	Comment
Short-Term	Fiscal Policy	*Expenditure*: Compensate for temporary lack of private investment and exports; focus on employment creation with public works programs. *Revenue*: Maintain taxes on imports and levies on price inelastic exports.	Public expenditure will be dependent on external funding, creating the likelihood of policy constraints. Narrow revenue base is a common characteristic of post-conflict countries; hence, every revenue source need to be exploited.
	Monetary Policy	Bond sales to accommodate fiscal expansion, or by monetization (which also supports exchange rate competitiveness).	Bond markets may not exist or the market is too narrow to be effective.
	Exchange Rate Policy	Slow real depreciation or devaluation through adjustment of nominal rate compared to export competitors.	The immediate task may be to prevent excessive depreciation due to trade deficits while achieving short-term price competitiveness.
Medium-Term	Fiscal Policy	*Expenditure*: Public investment to repair infrastructure and "crowd in" private investment. *Revenue*: Broaden and diversify tax base; tax remittances	Major medium-term problem may be low private investment. Increase tax collection to reduce reliance on external assistance.
	Monetary Policy	Reduce use of foreign currencies; support development of financial intermediaries; create secure stores of financial wealth.	The challenge may be reducing the use of foreign currencies, requiring a balance between a stable national currency and export competitiveness.
	Exchange Rate Policy	Consider "crawling peg" to get a slowly depreciating real exchange rate.	The central problem is shifting resources to tradeables and export diversification.