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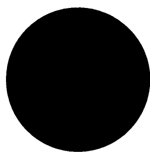

Aid for Peace

Can International Financial Institutions Help Prevent Conflict?

James K. Boyce and Manuel Pastor, Jr.

In October 1996, one year after the Dayton peace negotiations, Carl Bildt, the international community's high representative in Bosnia, faced a crisis. Momcilo Krajisnik, a close associate of indicted war criminal Radovan Karadzic, had just been elected to Bosnia's three-person collective presidency, but in a gesture of continuing Bosnian Serb defiance toward Dayton's goal of a united Bosnia, he now refused to attend the presidential swearing-in ceremony in Sarajevo. His refusal threatened to undermine the fragile new Bosnian state from its inception.

Bildt responded by dispatching his senior deputy for economic reconstruction to the Bosnian Serb headquarters in Pale, accompanied by the resident representatives of the World Bank, the European Bank for Reconstruction and Development, and the European Union, and President Clinton's special envoy for reconstruction. Together they delivered a stern warning: not one penny of reconstruction aid would flow to the Serb Republic if Krajisnik failed to appear. Four days later, Krajisnik was in Sarajevo for the ceremony.

The significance of this episode went beyond the modest victory of persuading a reluctant president to attend his own inauguration. It demonstrated that aid conditionality can furnish political muscle for a peace process, even when dealing with the most recalcitrant of parties. At the World Bank's headquarters in Washington, however, news of the show of resolve in Pale was greeted not with satisfaction, but with dismay. The Bank and its fellow international financial institutions (IFIs)—the International Monetary Fund (IMF) and the regional development banks—are quite accustomed to making their aid conditional on economic reforms. Conditionality on behalf of the political foundations of a peace process is another matter.

A hallowed myth at the IFIs is the apolitical character of their activities. Never mind that throughout the Cold War IFI loans were lavished on the authoritarian Pinochets of the developing world but denied to the Allendes, or that the IFIs have relentlessly pushed policies with profound (and often regressive) effects on the distribution of income: these decisions ostensibly were taken on "purely economic" grounds. In an inversion of the children's fable, the unmentionable truth is that the emperor does indeed wear clothes, tailored to the political fashion of the day. When they decry IFI intrusions on sovereignty, nationalist critics buy into the same diplomatic fiction that IFI loans can be apolitical. Yet injections of large sums of money into a society inevitably affect the balance of power within it. The real issue is not whether political effects will result, but what these will be.

In the traditional division of labor within the international community, the task of the IFIs has been economic development. Conflict prevention and peacebuilding have been left to others, above all to the United Nations. Yet internal peace and economic development do not fit neatly into separate boxes. Peace is a basic prerequisite for investment and growth, and while economic development does not guarantee peace, it can help to lessen the likelihood of

civil war.[1] Recognition of these inescapable links is beginning to dawn at the IFIs. In their rhetoric—and at times in practice—the IFIs in recent years have promoted military expenditure reductions and good governance. In October 1995, incoming World Bank President James Wolfensohn announced that one of his top priorities would be to "anticipate and organize for post-conflict economic development programs, when war is replaced by peace," and last year the Bank established a Post-Conflict Unit to pursue this aim.

These initial moves should be extended in two ways. First, the IFIs should explicitly acknowledge that certain economic policies may exacerbate social tensions and fuel conflict, and then work to ensure that the policies they back do not inadvertently increase the risk of violence. Second, in some settings the IFIs should follow the precedent set in Pale and make access to their resources conditional on specific actions by the borrower to secure peace, in an effort to reduce the risk of violent conflict.

"The Smile on a Child's Face"

The IFIs' core mandate is to promote the economic well-being of their member states. The IMF's main charge is macroeconomic stability; that of the World Bank and the regional development banks—the Asian Development Bank, the Inter-American Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development—is economic growth. Over the years, the IFIs have extended the definition of their mandates to embrace distributional equity and environmental sustainability. World Bank president Wolfensohn has suggested an even broader vision, stating that the real test of development is "the smile on a child's face."[2]

Preventing conflict clearly fits within this generous interpretation of IFI mandates. But even in narrower economic terms, conflict prevention can make good sense. War imposes huge costs—in lost lives and human suffering, in the physical destruction of assets, in foregone economic development, and in the cost of resources devoted to warfare itself. Investments in conflict prevention hence can be justified on economic as well as on humanitarian and political grounds.

Today, one-quarter of the World Bank's concessional lending, excluding that to China and India, goes to countries that have recently undergone or are just emerging from intrastate conflict. Yet even in these postwar transitions, where the costs of conflict are most evident and the risks of renewed violence most acute, the Bank and its fellow IFIs have been slow to accept conflict prevention as an integral part of their economic mandates.

In El Salvador, for example, two key elements of the 1992 peace accords that ended the country's decade-long civil war were the creation of a neutral civilian police force and a land-transfer program for ex-combatants. With the guerrillas demobilized, the government dragged its feet in the implementation of these programs, pleading lack of resources, a smoke screen for its lack of political will. Meanwhile it maintained military expenditure at more than 2 percent of GNP, compared to 0.7 percent before the war. Despite the resulting risks to the peace process—and, by extension, to the country's economic recovery—the World Bank, the IMF, and the Inter-American Development Bank chose not to press the government to shift expenditure to these high-priority peace programs. "This is political conditionality," an official explained, "and we are apolitical organizations."

The Articles of Agreement of the World Bank state that its loans shall be arranged "with due attention to considerations of economy and efficiency and without regard to political or other non-economic influences or considerations." But "economy and efficiency" can seldom be wholly divorced from "political considerations." The attempt to erect an iron wall between the two is par-

ticularly ludicrous when the political considerations at stake include the risk of violent conflict. Given the overlay between economic and political considerations, this exclusionary clause can be read in either of two ways: as ruling out all political considerations, even where these are of great economic importance, or as ruling out only those political considerations that are economically irrelevant. The latter, we believe, is the more sensible reading.

To say that conflict prevention should figure among IFI objectives is not to say that it should be the sole objective, nor that it should override all others when trade-offs arise. In some cases it may not be possible to prevent conflicts at any realistic cost. In others, conflicts can help to launch a society onto a more economically inclusive and politically sustainable path; the struggle against apartheid in South Africa is an example. In many cases, however, investment in conflict prevention can yield handsome returns, in economic terms as well as in the broader dimensions of human well-being.

Social Seismic Zones

Economic inequalities are hardly the only source of violent conflict, but they can be an important one, especially when combined with other sources of social stress. In Central America, for example, deep inequities in the distribution of land and other assets provided the tinder for violent conflict, with macroeconomic crises adding the spark.[3] Similarly, tensions over how to distribute the burden of economic austerity, precipitated by an external debt crisis, were a major source of the conflict that tore apart the former Yugoslavia.[4]

This link underscores the shallowness of the conventional notion of "efficiency" as the sole basis for policymaking. A preoccupation with how to bake a bigger economic pie is misplaced when conflicts over how it will be sliced threaten to wreck it. What is more, a growing body of recent economic research suggests that countries with more equitable distributions of income and power tend to have faster economic growth because they invest more in physical and human capital, and because they avoid destructive political struggles.[5]

In analyzing policies and appraising projects, the IFIs therefore should ask not only whether total benefits exceed total costs but also to whom the benefits and costs will accrue and whether equity will be served. One way to do this is to use distributional weights, in effect recognizing that a dollar is worth more to a poor person than to a rich person. Methodologies for this purpose are well known, but at present they are seldom applied by the IFIs.[6]

Not only class divides, but also the more "horizontal" stresses of ethnic group and regional differences can threaten to become fault lines of violent conflict. To address this risk, the IFIs could undertake conflict-risk impact assessments—akin to environmental impact statements—for proposed loans. These would consider how the project or program might exacerbate social cleavages.[7] In a document endorsed in May 1997 by the World Bank, "social assessments" of this type are identified as an area in which "significant improvement is needed."[8] A World Bank staffer explains, "If you are designing a project for a seismic zone, you need to take account of the risk of earthquakes."

Peace Conditionality

Loans from IFIs invariably come with strings attached. Project loans from the World Bank and the regional development banks include requirements for timely and effective implementation, and frequently specify administrative and policy reforms. IMF standby agreements and program loans from the banks typically require recipient governments to take specific steps toward macroeconomic stabilization and structural adjustment, including budget deficit reduction, trade liberalization, limits on money-supply expansion, and the privatization of state-owned enterprises.

In postconflict transitions, the IFIs could similarly attach conditions relating to the implementation of peace accords and the consolidation of peace. Bosnia is not the only place where such a stance could advance both peace and economic development. In El Salvador, peace conditionality could have speeded implementation of key provisions of the accords, such as the replacement of paramilitary forces by a new civilian police force.[9]

In Guatemala, the peace accords concluded in 1996 mandate an increase in the ratio of taxes to national income, now the lowest in Latin America, by at least 50 percent by the year 2000, and similar increases in public spending for health and education. Firm IFI conditionality will be needed to enforce these targets. A critical related issue is the distribution of the tax burden: will the extra revenue come from Guatemala's upper classes, who have long resisted taxation for social spending, or from the poor? The peace accords call for taxation to be "fair, equitable and, on the whole, progressive," but how fully these aims will be translated into practice remains an open question, the answer to which could be decisively shaped by IFI policies.

A multidonor evaluation of the international response to the conflict in Rwanda concluded that peace conditionality could have helped to deter the 1994 genocide, in which more than 500,000 people were killed. In the months leading up to the slaughter, the donors were stubbornly preoccupied with economic reforms, and many praised the Rwandan government's "absorptive capacity" for aid. A few bilateral donors voiced criticisms of flagrant human rights violations, but they never cut aid on that basis, sending the message that "human rights conditionality was preached but not practiced."[10] Instead, foreign aid to Rwanda rose by 50 percent in 1991–93, from $235 million per year in the late 1980s, to $355 million.[11] The flow of external assistance continued even as government-linked extremist groups openly prepared for the genocide. Whether, and at what stage, conditionality might have altered the course of events in Rwanda will never be known. What is clear is that the final outcome could not have been worse.[12]

Peace conditionality could involve formal performance criteria, informal policy dialogue, or other measures to tie assistance to specific actions by the borrower. Its priorities will vary from one case to the another. In some countries the key issues are taxes and expenditure, in others human rights and the rule of law. But the basic principle is straightforward: IFI conditionalities should reflect fully the interdependence between conflict prevention and economic development.

Buying Peace in the Serb Republic

For the first two years after the signing of the Dayton Peace Agreement in December 1995, reconstruction aid to Bosnia's Serb Republic was held up in an effort to press its hard-line leaders to comply with the agreement. Despite this pressure, Bosnian Serb leader Radovan Karadzic, who is barred from formal public office as an indicted war criminal, and fellow hard-liner Momcilo Krajisnik, the Serb member of Bosnia's collective presidency, showed few signs of relenting. While economic recovery stirred in the Muslim-Croat Federation, the Serb Republic's economy remained in shambles. Unemployment stood at 60 percent, and for the minority with jobs the average wage was less than $35 per month. Humanitarian relief was exempted from political conditions, but some aid officials chafed for reconstruction funds to be released, too. "Conditionality is great when it works," a World Bank staffer mused, "but what about when it doesn't?"

At the December 1996 Peace Implementation Conference in London, one year after the Dayton signing, High Representative Bildt urged donors to rebalance the flow of aid. "Frankly, conditionality hasn't been

working on either side," he explained. "The Federation is convinced money will flow to it no matter what, and Republika Srpska is convinced it won't receive aid under any circumstances."[13] While agreeing that reconstruction aid should be distributed "on an equitable basis," the London conference reaffirmed that it would be "conditional upon support for implementation of the Peace Agreement."

A trickle of reconstruction funds flowed into the Serb Republic in 1997, but of the $1.5 billion in reconstruction aid disbursed in Dayton's first two years, 95 percent was spent in the Muslim-Croat Federation, even though the Serb Republic comprises 49 percent of the country's territory and one-third of its population.

The pressure on the Bosnian Serb leaders began to bear fruit last summer. Bosnian Serb president Biljana Plavsic denounced Karadzic and his cronies for corruption and signaled a willingness to make concessions to Dayton principles in return for aid. She called for new parliamentary elections, which culminated in January in the installation of Milorad Dodik, an outspoken proponent of the peace process, as the entity's new prime minister.

International donors responded swiftly to these developments. The United States and the European Union offered fresh aid, and in December the World Bank announced a $17 million loan for "humanitarian reconstruction" in the Serb Republic. In deference to the continuing political clout of the hard-liners—and Krajisnik's ability to block the loan—about 15 percent of the World Bank funding was slated for those areas of the Serb Republic under their control. After lobbying by human rights groups and objections from U.S. legislators, the Bank excluded from the loan the town of Srbinje (formerly called Foca), where indicted war criminals remain at large under the protection of local officials.[14]

While aid conditionality helped to spur the recent changes in the Serb Republic, more forceful measures—notably the use of NATO-led troops to seize television transmitters and police stations from hard-liner control—were also crucial. In coming months, the efficacy of the carrot-and-stick approach will be put to its most severe test as minorities attempt to return to their former homes on both sides of Bosnia's inter-entity boundary line, in an effort to roll back the results of ethnic cleansing.

Micro-level Conditionality

Peace is not built at the national level alone: regional and local governments and private-sector actors also can fuel violent conflict or help prevent it. In Bosnia, several aid donors have experimented with peace conditionality at these "micro" levels. For example, the commitment of local officials to Dayton principles varies greatly across municipalities. A few such officials protected minorities during the war, even at the risk of antagonizing nationalist politicians on "their" side. Others organized and benefitted personally from ethnic cleansing and now openly oppose the return of minorities to their former homes. Many sit on the fence, neither actively promoting nor actively obstructing returns, and aware that efforts to help minorities could imperil their support in the majority community.

Donors can target aid selectively to reward Dayton compliance, penalize obstruction, and encourage the vacillators to venture off the fence. The United Nations High Commission for Refugees (UNHCR) adopted this strategy in its "Open Cities" program, launched in spring 1997, which targets reconstruction aid to municipalities that publicly declare their willingness to allow minorities to return. Where this commitment is demonstrated with actual minority returns, the UNHCR provides assistance not only to the returnees but also to the majority community.

The World Bank, a major player in Bosnia's postwar reconstruction, has so far shunned such explicit municipal-level peace

conditionalities. Some informal screening is carried out in consultation with the Office of the High Representative, the body charged with oversight of civilian aspects of the Dayton agreement. The director of the World Bank's Resident Mission explains: "There might be a community in Bosnia that does not want to accept refugees, and every time refugees come back, people in that community blow up houses. The High Representative may alert donors to the fact that building a house in that community is unlikely to have a lot of success."[15] Bank officials maintain that, since the Bank's funds are extended in the form of loans rather than as grants, control over site selection is largely ceded to the Bosnian authorities. Yet the recent exclusion of Srbinje from the Serb Republic loan demonstrates that when the Bank wants to act, it can.

One way to incorporate micro-level peace conditionality in IFI loan agreements would be through dated covenants, in which the borrower pledges to undertake specific actions by specific dates. The use of such covenants is already common practice; a transportation loan agreement, for example, may require the borrower to increase railway tariffs by a certain date. Noncompliance can trigger the suspension of loan disbursements. In a similar fashion, dated covenants could be used to enforce timetables for implementing the provisions of peace accords by local authorities.

Of course, the monitoring of local compliance would require time and effort. We believe that in many cases the benefits would justify IFI investment in the necessary monitoring capacity. In some places, however, the IFIs could turn to other agencies that already possess the needed expertise, such as the Office of the High Representative in Bosnia or the United Nations Verification Mission in Guatemala.

There is also scope for peace conditionality with respect to private-sector actors. The U.S. Agency for International Development requires borrowers in its private-sector lending program in Bosnia to sign contracts in which they agree not to discriminate on the basis of ethnicity in hiring decisions. Nondiscrimination clauses could likewise be inserted in contracts with private firms under IFI-financed projects. Even if imperfectly enforced, such provisions would send an important signal to the private sector. A turning point in El Salvador's civil war came when key business sectors concluded that armed conflict was impeding their ability to engage in commercial trade and industrial development. This helped to create the political space for negotiation, allowing a conservative, business-oriented president to lead the Salvadoran government to a successful peace agreement with leftist insurgents. In their training programs for local businesses, the IFIs and other donors could make conflict prevention part of the message, encouraging a pro-peace stance in business sectors.

Reconstructing the IFIs

The eventual repayment of IFI loans—particularly those of the World Bank and the IMF—is, in effect, guaranteed. Whereas commercial banks and bilateral aid agencies have reluctantly written off large sums of developing country debt in recent years, the IFIs have largely avoided debt forgiveness and outright default, even when faced with problematic arrears such as the debt of the former Yugoslavia. When necessary, they finesse this by lending new money to service prior debts.

For example, the IMF lent $45 million to Bosnia in December 1995—the first loan issued under the Fund's newly created emergency credit window for postconflict countries. The IMF heralded this loan as "a new beginning."[16] But its purpose was simply to allow the Bosnian government to repay a bridge loan from the Dutch government, which in turn was used to repay Bosnia's assessed share of the former Yugoslavia's arrears to the IMF. Old Yugoslavian debt was thereby transformed into new Bosnian debt.

Such creative devices not only absorb scarce resources—one can imagine other worthwhile uses for emergency assistance—but also give rise to a moral hazard problem: when insured against a risk, an individual (or institution) has less incentive to take precautions against it. In private bank lending, the fact that repayment is tied to performance gives the creditor an incentive to take account of all relevant information—including the risk that the value of the asset will be impaired or destroyed by violent conflict—before making a loan. This salutary incentive is largely absent at the IFIs.

Instead, IFI loans are repaid or rescheduled, regardless of their effects. Within the IFIs, staff performance is measured more by the quantity of lending than by its results: the route to advancement is to make loans, not to withhold them. Individuals, like the institutions they serve, face no effective penalties for failure to exercise due diligence in conflict prevention.

This is not to suggest that the IFIs should operate no differently from commercial banks, nor that their lending should not receive some subsidy from member governments. The IFIs need incentives to take risks for peace, as well as to reduce the risks of war. But between the extremes of full-risk commercial lending and the current practice of virtually risk-free IFI lending, there is a wide middle ground. It is here, we believe, that an appropriate incentive structure is to be found. For many years, the IFIs have championed the virtues of privatization and market discipline. They could benefit from a judicious dose of their own medicine.

At the IFIs, recognition of the connection between peace and development has all too often been spun into a further rationale for business as usual: the politics of conflict prevention and peacebuilding should not be allowed to interfere with sound economic policy, they claim, since the latter is a prerequisite for peace. Here we have advanced a contrary premise: unless the politics of peace are allowed to reshape economic policy, both will fail. That is, the soundness of policies can be judged only in light of the political economy of peace.

It is time to begin a search for new policies, and new forms of conditionality, that sow the seeds of peace rather than conflict. The broad outlines of a peace-friendly agenda at the IFIs are clear. The costs of violent conflict, and the benefits of its prevention, should be brought into the decision-making calculus. Distributional weights and conflict-risk impact assessments should be incorporated in project appraisal and policy analysis. In program lending, the IFIs should exercise peace conditionality by means of formal performance criteria and informal policy dialogue with borrower governments. In project lending, they should exercise micro-level peace conditionality in the selection of public- and private-sector partners. Last but not least, the incentive structure at the IFIs should be amended to support conflict prevention and peacebuilding. If the IFIs are to invest wisely in peace, they must reconstruct themselves.●

Notes

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1. For a review of the effects of economic development and distributional conflict on peace, see E. Wayne Nafziger and Juha Auvinen, *War, Hunger, and Displacements: An Econometric Investigation into the Sources of Humanitarian Emergencies*, Working paper no. 142 (Helsinki: World Institute for Development Economics Research, September 1997).

2. James Wolfensohn, "New Directions and New Partnerships," Address to the Board of Governors, World Bank Group, Washington, D.C., October 10, 1995.

3. Manuel Pastor and James K. Boyce, *The Political Economy of Complex Humanitarian Emergencies: Lessons from El Salvador*, Working paper no. 131 (Helsinki: World Institute for Development Economics Research, April 1997).

4. Susan Woodward, *Balkan Tragedy: Chaos and Dissolution after the Cold War* (Washington, D.C.: Brookings, 1995).

5. See, for example, T. Persson and G. Tabellini, "Is Inequality Harmful for Growth?" *American Economic Review* 84, no. 3 (1994); and Dani Rodrik, "King Kong Meets Godzilla: The World Bank and the East Asian Miracle," in *Miracle or Design: Lessons from the East Asian Experience*, ed. A. Fishlow (Washington, D.C.: Overseas Development Council, 1994). For a review with specific application to postconflict transitions, see Manuel Pastor and Mike Conroy, "Distributional Implications of Macroeconomic Policy: Theory and Applications to El Salvador," *World Development* 23 (December 1995).

6. Conventional benefit-cost analysis—the standard practice at the IFIs today—ignores distribution by valuing all dollars equally, no matter who receives or loses them. Imagine a society with two classes of people: the rich with annual incomes of $100,000 per head, and the poor with annual incomes of $1,000. A project that would raise the incomes of the rich by $1,000 and reduce the incomes of the same number of poor people by $900 would pass the conventional test: total benefits exceed total costs. Yet for the rich the resulting 1 percent income gain would be negligible, while for the poor the 90 percent loss would be catastrophic. One alternative is to count every 1 percent change in income equally, no matter to whom it accrues. This method would be no more arbitrary—and much more fair—than the current practice.

7. Similary, "ethno-national" impact assessments have been suggested by Wolfgang H. Reinicke, "Can International Financial Institutions Prevent Internal Violence? The Sources of Ethno-National Conflict in Transitional Societies," in *Preventing Conflict in the Post-Communist World*, ed. A. and A. H. Chayes (Washington, D.C.: Brookings Institution, 1996).

8. World Bank, *A Framework for World Bank Involvement in Post-Conflict Reconstruction* (Washington, D.C., April 25, 1997), pp. 5, 19.

9. James K. Boyce, ed., *Economic Policy for Building Peace: The Lessons of El Salvador* (Boulder, Col.: Lynne Rienner, 1996).

10. Joint Evaluation of Emergency Assistance to Rwanda, *The International Response to Conflict and Genocide: Lessons from the Rwanda Experience*, vol. 2 (Copenhagen, March 1996), p. 32.

11. Peter Uvin, *Aid and Violence: The Role of Development Aid in the Rwandan Genocide* (West Hartford, Conn.: Kumarian Press, forthcoming 1998).

12. The Rwandan tragedy suggests that half-hearted intervention can be worse than none at all. Some have argued that international pressure on the Rwandan government to sign the August 1993 Arusha peace agreement provoked Hutu extremists to instigate the genocide in an effort to retain power (see, for example, Bruce D. Jones, "Intervention without Borders: Humanitarian Intervention in Rwanda, 1990–94," *Millennium* 24, no. 2 [1995]). The lesson, in our view, is not that international actors should not have backed peace efforts, but that they should have done so more decisively, not only with aid conditionality in the preceding years but also with military action when the genocide was prepared and unleashed.

13. Quoted in Kurt Schork, "Donors Debate Fine-tuning Bosnian Aid," *Reuter European Business Report*, November 29, 1996.

14. R. Jeffrey Smith, "At U.S.'s Behest, World Bank Won't Finance Water Project," *Washington Post*, January 3, 1998; Mike O'Connor, "Serb Hardliners Grab a Share of Western Aid to Bosnia," *International Herald Tribune*, February 17, 1998.

15. Interview with Rory O'Sullivan, *War Report*, no. 51 (London: Institute for War & Peace Reporting, May 1997).

16. "Bosnia and Herzegovina: A New Beginning," *IMF Survey* (Washington, D.C., January 8, 1996).