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## Out of the financing trap? Financing post-conflict countries and LICUSs

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## Introduction

Post-conflict and fragile countries are emerging as a specific group. Donors recognize that more adaptable frameworks need to be established to support state transitions and consolidations. Hence, along with HIPC countries that face a specific problem of debt sustainability, the Low-Income Countries Under Stress - LICUS - category has been developed by the World Bank since 2002 to strengthen aid responsiveness and impact in states with both poor economic performance and governance, policies and institutions ranking among the lowest (< 3.0) on the Country Policies and Institutional Performance Assessment (CPIA). Some of them have been affected by conflicts. To facilitate a harmonized approach, the term of “fragile states” is now commonly recognised for both LICUS and conflict/post conflict countries<sup>1</sup>. The growing interest for these countries in aid debate was clearly expressed in January 2005 at the London Senior Level Forum on Development Effectiveness in Fragile States.

This group of countries is highly heterogeneous and their situation particularly difficult to address. Some of them are

failing to attract new financing, which usually requires a specific donor taking the lead (see UK for Sierra Leone or France for CAR). Other countries, having endowments in natural resources or a strategic interest, find it easy to borrow from private sources by providing their future commodities sales as collateral, which goes against international recommendations.

Despite this heterogeneity, these countries often face a common set of problems (restoration of peace and security, political transition, lack of capacities, resumption of economic and social development, humanitarian and basic needs, high level and quick results on demand side, etc.) which justify an early, specific and harmonized answer of the donors community.

Among these issues, the international community has to deal specifically with the general difficulty of financing LICUSs, especially when the country involved is in arrears to international financial institutions. The purpose of the present non paper is to suggest some ways forwards on this specific issue.

<sup>1</sup> There is no clear borderline between the conflict and post-conflict contexts, in most cases, the country involved is facing a long intervening period – the “grey area” – while it remains in highly fragile situation.

# 1. The problem

## 1.1 Post-conflict and Low Income Countries Under Stress (LICUSs) face special difficulties

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Most of them have accumulated high stocks of arrears during the crisis, creating a constriction problem because creditors – especially multilateral ones – have to stop immediately disbursements to countries which incurred arrears to them and/or to other financial institutions.

Fragile states still face problems after the issue of arrears has been settled. During a period of disruption, donors tend to reduce country envelopes, creating a kind of trap (low governance and low disbursements resulting in reducing the envelope, resulting in low performance).

Governance is weak (especially in public financial management - PFM). These countries do not meet the standards (CPIA, etc.) for receiving grants or loans from the international financial community. In their case, classical selectivity is counter-productive.

Even if financial commitments of the Donor community are high, public administration of the fragile States is likely to be weak, resulting in very low disbursement rates. Using technical assistance or even NGOs for easing the low efficien-

cy of public administration can be challenging, because of security problems and difficult conditions of living for foreigners<sup>1</sup>.

Fragile States need fast disbursements of external assistance, because the timing and momentum are crucial. Delay in financing availability may result in higher cost, because volatile situation worsen very fast.

As a result, research clearly demonstrated that foreign financial flows to fragile states are usually lower (population and wealth being equal), but also more volatile. Volatility and unpredictability of foreign financing are identified as two major hindrances to aid effectiveness (Levine and Dollar, 2005). Amount of aid to fragile states (with governance difficulties) is even lower than to other low income countries and this gap may widen in the coming years. Among fragile states, post-conflict countries surprisingly attract more aid possibly linked to geopolitical concerns but also in response to urgent investment needs in infrastructure for example.

<sup>2</sup> In this sense, the way the PFM is enhanced in Liberia (GEMAP) seems to be effective in the short run, but may be a problem in the medium run. In this setting, expenditure is allowed by a Liberian official, but with a second signature by a technical assistant.

## 1.2 The design of donors financial tools does not aptly respond to these countries needs

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Hence, in most of the recent cases, the financial community had to implement arrangements on a case by case basis to address financial needs arising in the “grey area” between the conflict and post-conflict situations :

- **The United Nations.** Except the financing of PKOs and humanitarian aids, the UN - and specifically the UNDP, does not currently possess financial resources, or even procedures, to match the scale of the issues at stake.
- **The IMF.** The signalling role of the IMF is often blurred, even if the Fund is capable of showing flexibility in implementing post-conflict programmes (EPCA, see below).
- **The World Bank.** The Bank cannot intervene if the country concerned is in arrears and uses a performance measurement tool (“Country Policy and Institutional Assessment”) which, by construction, penalize LICUSs, even if a different tool has been stepped up under IDA 14 in order to provide additional resources despite poor performance in terms of the standard fund allocation system. Actually the IDA allocation system is different for post-conflict countries. Their allocation is topped-up because of their weak governance that hampers their resources. The premium can last from three to five years and is phased out gradually so as to make sure that allocations are not downsized quickly. Besides, the grant rebate is only 11 % for post-conflict instead of 20 % for normal IDA beneficiaries. Where DDR is concerned, preparation and appraisal phases of World Bank programmes remain a lengthy process and the types of expenditure funded cover only part of the need, combatant disarmament and cantonment operations being ruled out.
- **The African Development Bank.** The AfDB faces the same difficulties as the World Bank.

- **The European Union.** The EU has recently broadened the scope of its action to include the political and security spheres (peace facility, DDR funding, etc.). Still, financial resources remain limited and the procedures for their implementation are complex insofar as such intervention comes under more than one instrument (ECHO, budget lines, EDF Envelope B, etc.), managed by different departments and governed by a variety of procedures and conditionalities.
- In addition, **the Paris Club** sticks to the doctrine that an Upper Credit Tranche IMF agreement should be met before being granted debt rescheduling or debt reduction.
- Last, the mobilisation of **bilateral donors** is very uneven, depending on their interest in the country involved and the media coverage that the crisis may have attracted. It rarely permits to release flexible financial contributions of “budget support” type.

Over and above the difficulty of obtaining swift and sustained mobilisation of all these stakeholders, another major problem in crisis resolution is the lack of coordination between these different actors and the lack of appropriate international mechanism to deal with the problem.

A further complication is the fact that crises are often spreading across national borders (Conakry Guinea, CAR, Ivory Coast, Sudan, etc.), namely because of refugees. Spill-over channels and “bad neighbor” issues have to be managed and a sub-regional approach to conflicts in Africa has to be taken into account. Donors are lacking instruments to tackle the regional dimension of crises and to build effective partnership with neighbouring countries.

### 1.3 It seems that LICUSs have been put aside of the Monterrey Consensus

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The MDGs are not perfectly relevant<sup>2</sup> for Fragile States. Their main problem is to get “the basics right”, namely to have the State functioning in all regions of the country in a peaceful environment. This means that the efforts of the international community should, in the first place, be aimed at providing financing (mostly grants) to have the Government performing its basic tasks in the whole country, with an emphasis on the security forces. In Mauritania, this was made by using debt relief to pay (double) the salary of teachers, nurses, etc. volunteer to work in remote areas (under local control). The recent orientation of the international financial commu-

nity towards selectivity, concentrating the scaling up of aid on good performers, certainly makes the problems of LICUSs harder to resolve.

The successive extensions of debt relief schemes (HIPC then MDRI) also create a confusing situation: how to explain to Fragile States that they are eligible for MDRI – i.e. the cancellation of all their multilateral debts – but that their multilateral arrears prevent them to be back on track under an IMF program and that, because of these arrears, their allocation will be minimum ?

<sup>3</sup> OECD (2005) puts it this way: “Goals for assistance in fragile situations need to focus on peace-building and stabilisation in the short term, in order to lay the basis for long term progress against the MDGs. We need to revise our outcome indicators for these countries to be able to pick up progress against these outcomes”

## 2. How did donors tackle this problem?

Since September 11, 2001, there is a growing interest for the link between Security and Development and a consensus emerged that donors have to act more rapidly and earlier in post conflict countries and prevent the resurgence of conflict during the “grey zone”, when things cool down but financial international community has not come back yet. At the High level meeting in January 2005, donors recognised that there is a lack of resources and coordination among donors in fragile countries.

To address this issue, donors began to ease their procedures/conditionalities and to build a specific – yet unfinished - multilateral framework:

- A special **IMF emergency program**, designed in 1995 in case of natural disasters and conflicts (Emergency Post-Conflict Assistance), is now frequently used (see appendix 1). This program can be put in place more rapidly than a traditional IMF loan (PRGF or SBA). Even if access rights are far lower<sup>4</sup>, this program is adapted to countries in difficulties since only arrears to the Fund have to be repaid before providing an EPCA (arrears to the other multilateral donors or to the Paris Club may remain).

Still, conditions don't appear harmonized and a comprehensive IEO assessment of EPCAs should be useful<sup>5</sup>, taking into account the case of Iraq. Africa is entitled to insist upon adherence to the principle of fair treatment where it is concerned, with a view to defining at the ear-

liest possible date a macro-economic framework supporting crisis resolution and permitting rapid disbursements. Countries with very high stock of arrears to the Fund (Liberia, Sudan, Somalia) or which are not eligible to EPCA have no choice but to follow a successful SMP (Staff Monitored Programme) before clearing their arrears and concluding a PRGF. The process may be very long and complex to finance.

- **The World Bank** has put two funding sources in place in recent years: the “Post-Conflict Fund” and the “LICUS Fund”. These Funds can be used in the “grey period” to grant funds, even when arrears remain. These allocations, in amounts subject to limits, are essentially used to finance analytical work and technical assistance, in particular in social fields. The WB also adopted another way to calculate the post conflict and fragile states performance under CPIA in order to increase access to WB support in such countries.
- In 2004, **the AfDB**, with France's strong support, set up a post-conflict facility for the clearance of arrears owed by countries in post-conflict situations. The AfDB scheme provides for a contribution from the country ranging from 1/4 and 1/3 of the total arrears, to which is added an equal amount from the Facility and donors. The country's contribution can even be lower if necessary. To date, Burundi and Congo Brazzaville have been able to benefit from this mechanism, on the basis of assistance provided by France and the European Union.

<sup>4</sup> Limited to 25% of the quota, 50% in certain circumstances.

<sup>5</sup> Some aspects of the impact of EPCA programs are surveyed in Staines (2004), who underlines the importance of budget support for post-conflict countries.

- **A UN Peacebuilding Commission** has been created with competence in the area of crisis and conflict resolution and prevention. It is attached to the Security Council, and involves Ecosoc, the IFIs and as far as applicable the other actors concerned (regional organisations, main donors and troop contributors). It has been given the specific task of assisting in the transition from conflict to post-conflict peacebuilding, notably by mobilising and coordinating the efforts of the international community over whatever period may be necessary.
- **OECD / DAC** created a working group on post-conflict issues and is about to publish a paper about good practices in fragile states following discussions at the January 2005 Senior Level Forum on Development Effectiveness in Fragile States. These principles mainly emphasize the importance of leadership by people themselves from these countries and shared principles are the best guaranty for aid efficiency.

France, despite budget constraints and even if it has not yet a comprehensive post-conflict strategy<sup>6</sup>, also softened its doctrine to help LICUSs :

- France is now able to give budget support to post-conflict countries as soon as they receive IMF assistance with disbursements<sup>7</sup>. This aid can be used to reimburse the arrears to enable countries to restart aid.
- France also played a key role in arrears clearance schemes. For instance, DRC benefited from an exceptional arrears treatment when obtaining a PRGF. France (with two other countries) accepted to provide a bridge loan in order to repay DRC arrears to IMF and another one to clear the arrears to the WB. France also contributed in finding other partners to gather the amount needed. This action was crucial in the financial normalisation of DRC towards the International Community. A similar scheme was envisaged in 2004 in favour of Haiti.
- France also eased Agence Française de Développement (AFD) procedures in 2004, allowing the Agency to provide grants even to countries in arrears against this institution.
- France acts intensely to attract new donors around LICUSs. Concerning CAR, it hosted donors groups in coordination with the IMF and the World Bank and supported sub-regional efforts. In 2006, France is following, with special vigilance, the situation of Ivory Coast, CAR, DRC, Bissau Guinea, Haiti and Comoros.

<sup>6</sup> For instance, USAID has already a complete post conflict strategy, through its different specialized desks.

<sup>7</sup>The first budget aid to post conflict country was provided to Burundi in 2002.



### 3. Way ahead

To tackle the specific situation of LICUSs and avoid moral hazard, the following orientations could be discussed.

1) **IMF Conditionality:** Restoration of normal relations with the IMF and a positive track record must be a priority insofar as it permits resumption of the commitments of the other donors. But, as proposed by the Managing Director before the Spring Meetings, a new standard should be set for LICUSs.

*The IMF “consider introducing more flexible structural conditionality for programs in postconflict or developmentally-distressed countries. If the Fund is to be successful in the role described in the MD’s Report, it has to be sufficiently flexible in its interactions with LICs. [...] However, even greater flexibility could be considered. [...] First, all Fund arrangements currently use a standard of Upper Credit Tranche (UCT) conditionality. While this is appropriate in most circumstances, in post-conflict countries and other developmentally-distressed countries such a standard may be unreasonable. Although the Fund offers a first-credit tranche facility to post-conflict countries (Emergency Post Conflict Assistance, or EPCA), its flexibility is quite limited and it does not provide the longer term support needed for developmentally-distressed countries that are not in an immediate post-conflict situation. For these countries, the Fund should consider designing a facility with a more flexible conditionality standard. Such programs should also include an appropriate (larger than usual) component of technical assistance, aiming at increasing the country’s capacity (specifically in financial management) as quickly as possible to reach the point where they will be considered as able to commit to a program with full UCT conditionality.”*

Conditionality could be more focused on a smaller set of objectives mostly related to monetary issues, fiscal per-

formance and public financial management (PFM). Other triggers could be progressively introduced and a more flexible approach to benchmarks should be envisaged. In these countries, where a “reference scenario” is very difficult to attain, because of the high volatility of these economies and the lack of capacities, it could also be relevant to consider alternative scenarios.

The question of access (25% and no more than 50% for EPCA), concessional rate (0,5% annually for EPCA) or repurchase period (3<sup>1/4</sup>-5 years for EPCA) of such a Facility should also be discussed. The use of a flexible incentive tranche (like in EU programs) could be considered as a device to develop policy dialogue with the Government and to develop a positive incentive, and as a tool for stabilizing the amount of foreign financing and its predictability.

2) **Financing instruments:** the financial community should recognize that budget support is useful in LICUSs, especially in post-conflict early stages, when very fragile governments should be able to cope with various expenses difficult to plan in advance and to prevent the accumulation of arrears (especially internal arrears).

The World Bank should take stock, analyse best practices and devise guidelines in financing LICUSs. The Bank (and other regional banks) could also be authorized to provide grants to countries in arrears – maybe only on special circumstances with special instruments financed through net income and for very specific expenditures such as DDR or pro-growth programs to prevent moral hazard –. Such a reform could break vicious circles where fragile states stop paying its external debt when its political and economic situations start deteriorating, preferring staying current with its internal creditors and with its civil servants in order to keep civil peace. The Bank should also streamline its procedures and processes in these countries.

The projected Stability Instrument, which should see the light of day in 2007, will give the European Community a unified instrument for the management of political crises. It is important for this instrument to have as broad a scope as possible in order to cover all types of action necessary in the crisis resolution period and to seek to ensure that the procedures for its implementation allow the funds to be applied rapidly.

The immediate need is for the Commission to raise resources to fund countries in a post-conflict situation: DDR, Security Sector Reform, judicial processes, payment of multilateral arrears and, if applicable, salaries and wages.

Besides, in LICUS countries, financing is not the only problem. They also need strengthened policy advice and technical assistance to build the capacity to implement macroeconomic policy and restore basic services.

French bilateral instruments devoted to LICUSs could also be scaled-up and streamlined ("FSP post-conflict", "aide exceptionnelle", "aide budgétaire de stabilisation macroéconomique", assistance technique, etc.).

3) **Debt relief**: We could envisage a more flexible linkage between the Paris Club and IMF programmes for post-conflict countries. Before an agreement with the IMF has even been approved, this intervention could take the form of deferment, either total (covering arrears and payments due) or partial (if financial capacity permits servicing of payments falling due), without any concessional component. The debtor country would in this way resume normal relations with the Paris Club, but with reduced debt service requirements, late payment interest no longer being billed, and with the beginnings of a track record being built up. Creditors would undertake on the basis of this track record to deal with the issue of the accumulated arrears once an agreement had been signed with the IMF, an agreement that would not necessarily be of standard type.

This scheme was the preferred option in the highly unusual case of Iraq, whose creditors granted an initial treatment of the debt on the basis of a post-conflict programme, with the subsequent phases of the agreement being made conditional on satisfactory implementation of a standard programme. Such a scheme might also be envisaged for the post-conflict HIPC most in difficulty (particularly Liberia, Somalia and Sudan) but would nevertheless require a decision from the creditors on a case-by-case basis. For countries that are beneficiaries of a programme of "rights accumulation" type (RAP)<sup>8</sup> at least as concessional as a standard programme, the creditors could allow treatment of the debt without first awaiting a moratorium.

4) **Arrears clearance**: It could be worth considering the possibility of IMF being in charge of pronouncing a moratorium on the debt service during a specific period (say 3 years for instance) in order to avoid the accumulation of arrears and delay interests. The idea of bankruptcy for those States (along the lines of the Krueger proposal) could also be relevant for fragile states, but has been rejected as a general device. It could be considered for fragile states only, after a general agreement of some relevant body and on a case by case basis.

5) **Donors coordination**: A strengthened coordination between all actors – including the IMF - should be set in priority in post conflict countries – whereas the international community tend to do it first in "good performers" –, to limit transaction costs and develop complementarity. The setting up of a UN Peacebuilding Commission would provide a useful focus for political and financial coordination and mobilisation.

The EU, which is often the leading donor in the field, in terms of capacities and funding volume, could be a key actor in this process. In order to increase international leverage, joint strategies should be agreed by all donors involved in the process.

<sup>8</sup> A Rights Accumulation Programme allows a member country far behind in its payments to the IMF to build up a "track record" of good policies and repayments while at the same time accumulating SDRs for future drawing once the arrears have been cleared (subject to a limit equal to the level of arrears existing at the beginning of the programme.)

A pooling of risks, which could take the form of a trust fund whose management would be entrusted to a multilateral agency, could help reassure bilateral donors hesitating to take action.

**6) Regional support:** in coherence with NEPAD principles and to boost regional integration, an African (or at the sub-regional level) post-conflict fund managed by AfDB (or with sub regional bodies), and sponsored by NEPAD/AU, could be envisaged. The objective would not be only to channel money, but also to involve concretely, beyond military contributions, neighbouring countries in the resolution of conflicts.

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## Appendix 1: Post-Conflict Emergency Assistance, 1995 - 2006

Country	Year	Amount (U.S. \$ million)	% of quota
Bosnia and Herzegovina	1995	45.0	25.0
Rwanda	1997	12.2	15.0
Albania	1997	12.0	25.0
Rwanda	1997	8.1	10.0
Tajikistan	1997	10.1	12.5
Tajikistan	1998	10.0	12.5
Republic of Congo	1998	9.6	12.5
Sierra Leone	1998	16.0	15.0
Guinea-Bissau	1999	2.9	15.0
Sierra Leone	1999	21.4	15.0
Guinea-Bissau	2000	1.9	10.0
Sierra Leone	2000	13.3	10.0
Republic of Congo	2000	13.6	12.5
FR of Yugoslavia	2000	151.0	25.0
Burundi	2002	12.7	12.5
Burundi	2003	13.4	12.5
Central African Republic	2004	8.2	10.0
Iraq	2004	435.1	25.0
Haiti	2005	15.5	12.5
Central African Republic	2006	10.2	12.5

Source: *www.imf.org* and authors