

**USAID ECONOMIC GROWTH OFFICERS CONFERENCE
OCTOBER 15-19, 2007
WASHINGTON, D.C.**

Session Title: Guide to Economic Growth in Post-Conflict Countries

Date and Time: October 15, 2007, 12:15 p.m.

Type of Session: Plenary (lunch)

Speaker(s): Steve Hadley, Jay Smith, Steve Lewarne

Moderator: Bob Aten

Overview of Session:



Steve Lewarne addresses workshop attendees. Photo by Paul Goodman.

- Jay Smith presented a summary of EGAT's recent work to develop an economic growth strategy for post-conflict countries and Steve Lewarne presented the experience of implementing an economic growth strategy in Kosovo.
- According to Jay, the first step is to expand physical security. "Capital is a coward!" The second step is to provide jobs. Third step: undertake policy reforms, and liberalize as fast as you can. Finally, build institutional capacity; start right away, and continue

building it over time.

- Steve advocated for studying the Marshall Plan experience to understand our current experience in Iraq and other post-conflict settings. President Truman admitted to mistakes made early in the Plan, and adjusted accordingly. He argued that critical mistakes were made in Iraq because we did not employ the knowledge we have fast enough: secure the monetary system, focus on transitional currency, identify and take full advantage of available human capital. "Focus on economics, and early!"

Speaker's Remarks:

Jay Smith:

Post-conflict situations have not been dealt with well. 40% return to conflict within 10 years. You then have a 10-year period to deal with.

There has been a focus on relief, building democracy, elections, etc and the idea that those institutions will channel causes of conflict into peaceful resolution. But the data does not bear this out. Just doing these things returns you to conflict in 10 years.



Paul Davis poses a question to the panel. Photo by Paul Goodman.

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Paul Collier's work shows that if you do economic growth programs early on (e.g. right after conflict has ended), you can improve the odds of success: you can reduce odds of returning to conflict to 25%, instead of 40%.

Post-conflict context is characterized by: physical destruction, loss of lives, IDPs, refugees, and unemployment. Your best people have left, there are demobilized ex-combatants, a weak and fragile government, high expectations, and a sense of urgency.

What are your goals in the post-conflict context?

- 1) Re-establish economic governance: manage payments, collect revenues. Fiscal and monetary policy
- 2) Restore legitimacy of government
- 3) Get people working, by almost any means: change calculus of unemployed folks
- 4) Address root economic causes: key point – ensure programs don't disproportionately benefit one party to another...benefits should be shared broadly.
- 5) Stabilize the economy; bring down inflation (this does tend to come down within the first 2-3 years)
- 6) Position economy to grow rapidly - make sure the private sector has a voice.

What is required for success?

- Clear goals and sensitivity to the political and social context
 - A pragmatic approach: work on simple issues first and make sure the basics are in place.
 - Host country ownership
 - "Do EG early!" and "Do EG differently!"
- 1) First thing: expand physical security. Capital is a coward, it will not go where the risk is too high. Without security, you are not going to have business transactions or investments. Paul Collier says you need international peacekeepers there for a decade!
 - 2) Second: provide jobs. Jay's experience: get grants out to all kinds of private sector actors. Over time, you'll stop providing jobs.
 - 3) Undertake policy reforms: liberalize as fast as you can. Get out of the way of the private economy: encourage informal activity to flourish. Get policy reforms started right away.
 - 4) Reconstruct infrastructure and provide public services.
 - 5) Build institutional capacity over time, but start right away. There is tug of war between building capacity and the absorptive capacity of government. Mozambique instituted a tax reform to introduce a VAT. At the same time, US Treasury wanted to implement an income tax reform. USAID told the Ministry if you are going to do both, do it one at a time. The US Treasury's approach was not the right one.

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How should it be done? Focus on the basics. Many people like to just push out microfinance. If your central bank does not work well, and you do not have much bank supervision, you better first prioritize that before spreading microcredit around the country. Get that basic financial system working first. Establish priorities. In Mozambique, the IMF gave them 150 conditions—this is overwhelming. Understand recurring trade-offs. Pay attention to sequencing. Anticipate transition to the long-term. Ultimately, you will get back to doing things that will work in stable contexts.

Key trade-offs:

Effectiveness v. Efficiency:

- Just get people employed, don't worry about sustainability of jobs.
- Be effective right away and work towards efficiency (don't tackle it right away)

Urgency v. Legitimacy

- Company law in Afghanistan: it was felt they needed one and it turns out it was not necessary. It undermined the legitimacy of the government because people did not think it was necessary.
- Banking law: all businesses agreed a law was necessary – urgent and seen as legit at least by a small percent of the population.
 - o If you pay attention to the legitimacy issue, you can still do urgent things, but you can do them better.

Short-term v. long-term:

- Yes, only collecting excise and border taxes is a bad tax structure. Well, it works. And they need some revenue in government. You can push towards a better, fairer system, but do not worry about that right away. First, get the less desirable taxes collected well.
- One pet response of many investors: my buddies from US corporations should come in. Do NOT waste your time on foreign investment. Rely on local investors or south-south investors.

Window of opportunity v. absorptive capacity:

- You need to be sensitive to what the government is capable of absorbing (and the people are capable of absorbing)

Steve Lewarne:

Key points of his presentation:

- 1) Need to focus on economics, and early!
- 2) Wants to talk about some major mistakes in Iraq. We knew so much going into Iraq that we just did not use. That loss of time and the resulting cost led Lewarne to write a book.
- 3) Kosovo: importance of early decisions..
- 4) Afghanistan: some good economics.
- 5) Europe 1946: admitting mistakes – what Truman did— and what correctable steps he took. (Lewarne is a strong advocate of looking at to the Marshall Plan for lessons.)

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Economics really does matter. One classic statement he finds: things are different in country x. However, in every country, economics matters. Key early questions:

- 1 – Who is running things? What is the state of the monetary and fiscal authority?
- 2 – What are they being paid? Who is available? If you don't know the available human capital stock, you are not going to be doing your job.
- 3 – What is the state of the MOF and the fiscal authority? How many staff? What systems in place? What can they absorb? Get to know as much as possible right away.

Monetary problems will not leave you alone just because you are in a post-conflict country. In Iraq, they did not focus on transitional currency until several months into the transition. They needed to manage the outgoing currency the way they had done in Afghanistan. Unfortunately, it took an awfully long time to make that call.

In Kosovo, two people on the EU team looked at the central bank and immediately decided they were incapable of handling a currency and immediately adopted the Deutschmark. This made things go more smoothly.

The difference: In Kosovo, they paid attention to the monetary problem at hand. The Kosovo issue: when they moved to the D-mark, there was not enough liquidity. So they ordered \$20 million D-marks to come in via plane. Notes came in on a big plane. They flew it back into Central Bank in Kosovo, deposited it; and that slowly started improving liquidity.

Iraq: major mistakes

The tragedy for Iraq: Iraq had certain advantages – it had established relationships in international organizations. It had a nationwide civil service administration that had administered an economy on par with others in the region. Human capital was of relatively high quality. Humanitarian crises in Iraq had largely been avoided.

Despite these advantages, they had in place a system of distribution called *Oil for Food*. This served to distort incentives and crush the agricultural sector.

DeBaathification – ignored the human capital rule. That may go down as the single largest mistake in the reconstruction. “Do NOT get rid of your human capital!” If it is punishment you seek, leave that to war crimes tribunal. The *Oil for Food* program had 16 people from US Treasury trying to serve 12 million families – insanity!

In Kosovo, they had co-heads as Ministers, but these were to be passed off over time.

In Iraq, we had available all plans from Afghanistan, Kosovo, East Timor, etc., but these were refused for between a year and 18 months. They treated us as an IQC. Same with DFID.

Many good things have been done in Iraq since, but because of the time lost, it was a much steeper hill to climb.

Kosovo: importance of early decisions.

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There was an umbrella program that focused on economics. Key lessons: watch the budget process (once you have taken care of the monetary issues). Do not let procurement get out of control. Then get implementing regulations in place. (This can be crushingly boring, but it is important.)

Make sure the current and capital budgets are linked. We told the Japanese to cool down their aid efforts since there was no way the economy could absorb it. In Kosovo, we made sure the Department of Reconstruction had a sunset clause where it was absorbed into the Ministry of Finance within some amount of time.

Remember to go back to things: pension reform. Do not distort payroll taxes.

On Afghanistan: some good economic policy. It had the advantage of being planned better than Iraq, and even better than Kosovo in the beginning. Bonn and Tokyo conferences decided on a framework. All donor monies were to be accounted for in the budget.

1946: Admitting mistakes:

Truman thought the Marshall Plan in 1948 was a complete failure (18 months after its inception). He had a feuding State and Defense Dept. He was convinced that so long as American assistance was used in piecemeal efforts, aid would be ineffective. The feuding was very similar to feuding in Iraq between Defense and State today. Truman swallowed his pride and hired Hoover to go to Europe. He wrote a scathing report. Truman revamped the Plan and made it more sympathetic to the Germans' priorities. Perhaps admitting mistakes is more helpful?

Economics matters no matter what the situation: water does not run uphill anywhere. What you have available is probably more than you think. Good governance can overcome old habits. Human capital matters more than any other capital.

Umbrella economic programs do best.

Key Points Discussed During Question & Answer Segment:

Q: Challenged Steve's claim that there were real costs to currency transition in Iraq: he sees that as a core success – and this view is shared by all agencies. Also, in Afghanistan, did the banking law happen subsequently to the company law?

A: Yes, currency was done well in Iraq – when it was done. There was a period of time (18 months) when the old dinar was still in operation. His point: it harms poor households that do not have the time to convert to dollars. Purchasing power of miserable households went down very fast.

On oil-for-food, eventually they just got fed up with waiting for food basket subsidies. This affected 90% of families in Iraq. Even today, there are some outside that are still done by the Ministry of Trade. This program of social safety net goes hand in hand with the monetization of money for food. You still have a distortion problem in the economy of Iraq – this doesn't help.

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Company law: people were investing without it, despite that it was “critical”. Domestic demand for banking law was much stronger. External demand drove the company law. It was not needed immediately and took three years.

Q: Food subsidies: it would have been great to eliminate the food basket. But, it was really tough to get the fuel subsidies eliminated.

Q: Challenged the sequencing of Jay’s chart: she would push forward infrastructure – because it is linked to job creation.

Also, she thinks that there are certain decisions where the international community has a disproportionate amount of influence. On the other hand, they give the government some level of deniability. She would have suggested that the UN be bolder. She suggests making bold decisions about intergovernmental cooperation, etc. That is controversial, because it is not our country.

A: On the diagram: you can generate a lot more jobs with unproductive employment quickly. To organize and have the capacity to do infrastructure projects takes time. But the amount you can do early is not so great, and you need to expand over time. International firms can sweep in quickly and do it, but that will not necessarily generate much in the way of jobs. You need to find ways to do a lot of small infrastructure projects – but you may not have capacity to do that. Need to balance capacity with need.

Moderator: Creating deniability for government – this is an important issue, and we had not thought of it – good point.

A: This is meant to be a template for everyone, not a final output. On boldness of decisions: if you want reforms to work, you need to be supporting reform champions.

Q: Champions of reform: In Nigeria, after a 20-year hiatus and drop-out of the external world, they were following outdated systems. One thing Obasanjo did: reversed brain drain. He formed a group of people around him, and people came back to Nigeria. He put the best people in Ministries. They single-handedly are responsible for any reforms that were passed.

Q: In my region, microfinance institutions are not authorized to accept deposits, so they are not regulated by the central bank.

A: Right. The point is that in Afghanistan, the Central Bank Governor was aware that if he did not do anything about the currency, poorer people’s purchasing power would be very affected.

Q: Coordination between donors, yes, but we also need to coordinate between USG agencies. What is the voice that prevails?

There is also an issue of how governments communicate with citizens, and manage expectations.

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Infrastructure: there are some models for how infrastructure can employ low-skilled labor.

There is another issue as to the in-house capacity of AID to manage these infrastructure problems. Where within USAID are we going to get the technical support to manage these types of projects?

A: Point about coordination is critical, and is highlighted in the document. We also agree on communication with citizens.