ERF Policy Brief

When Commitment Matters for Macroeconomic Reforms in Post-Conflict Countries

Adeel Malik and Chahir Zaki

About the authors

Adeel Malik is an Associate Professor at University of Oxford and ERF Senior Associate.

Chahir Zaki is a Professor, Faculty of Economics and Political Science, Cairo University and ERF Research Fellow.

In a nutshell

- *The objective of this policy brief is twofold. First, it provides the basic elements of a possible analytical framework for post-conflict reform in Arab societies. Second, it presents the main characteristics of macroeconomic policies that have to be adopted in both the short (stabilization policies) and the long (structural reforms) term in order to avoid the time inconsistency problem.*
- *The latter refers to the fact that some policies that were optimal in the short term are no longer perceived to be optimal in the long run and might not be implemented.*
- *We argue that macroeconomic reforms must be analyzed through a more comprehensive approach (with its political-economic factors and its time horizons) not just specific measures that help stabilize the economies in the short term.*

Why does commitment matter for macro reforms?

While the Middle East seems perpetually embroiled in conflict, how can policy makers envision reform in the post-conflict stage and what is the political economy of such reform? In a new ERF paper, we offer some basic analytical insights on the political economy of post-conflict reform in the Arab world. We argue that a crucial challenge for post-conflict reform (including reconstruction) is the challenge of eliciting credible commitment from relevant actors. This challenge is particularly binding in the Arab context.

Post-conflict reform requires governments, donors, and private actors to commit large resources on a sustained basis over several years. It requires them to commit to reforms that could generate benefits and losses that are unevenly distributed across actors. In conflict settings where uncertainty is rife, time horizons are short, and investments are long-term in nature, this could raise an important challenge: How to secure credible commitments from different stakeholders involved in post-conflict reform whose promises today may run counter to their incentives to fulfil them tomorrow. Such temporal disconnect between incentives and choices is a classic political economy challenge. An understanding of commitment problems is particularly relevant for initiating and implementing reform in conflict-torn Arab societies. Given the multiplicity of local, regional and international actors involved in conflict, it is especially hard to coordinate their interests and incentives around post-conflict reform. The private incentives of some of these agents can run counter to the aims of reforms with a long horizon. In any civil war like situation, new contenders of power emerge who profit from conflict. They thrive on new rent streams—be it revenues from fuel smuggling or premiums earned from differences in the official and black market exchange rates—that are derived from the war economy.

Besides the commitment challenge, we emphasize the importance of temporality, process, and the interaction between domestic and external factors. Post-conflict reform needs to be situated within an evolving political economy milieu where what happens before, during and after the conflict will be crucial to the analysis. Emphasizing a "moving picture" view of political economy (Pierson 2004), we emphasize that policy interventions need to be situated in an institutional continuum. Such interventions should be informed by the pre-conflict distribution of power in time, the institutional possibilities that could be achieved in the future, and the credible commitment and coordination problems faced by policymakers in the current period. Thus, on the one hand, policy reforms are crucially influenced by the prior institutional structure and power distribution in a society. On the other, policy interventions in time, t, can reinforce or create new inequalities in time, t+1. Such interventions can be a step towards creating a cooperative equilibrium in the future or unintendedly generate perverse institutional incentives and outcomes.

Macro policies: between stabilizing and transformative programs

Concretely, it is important to analyze the different macroeconomic policies that can be implemented in post-conflict economies in both the short-term (to stabilize the economy) and the long-run (to change its structure and reduce the risk of conflict eruption).

At the exchange rate policy level, post-conflict counties must adopt a managed regime that might boost economic performance as it might keep the currency undervalued, which might increase the effectiveness of aid on output. Indeed, while foreign aid is necessary to address short-term challenges (and thus can be perceived as a stabilization policy), it can create other problems such as exchange rate appreciation, growth volatility, the deterioration of the tradable sector if aid is allocated to non-tradables only.

At the fiscal level, Stewart et al. (2007) show that this policy must address mainly horizontal inequalities among ethnic, racial, linguistic, regional, and religious groups as the latter can be the main source of conflict relapse. In addition, it is important to avoid higher levels of fiscal deficits to avoid higher levels of inflation that erode the purchasing parity of individuals and lead to another conflict. Reducing budget deficits may be achieved by some combination of tax rises and/or expenditure reductions. Yet, at the structural level, it is important to balance between the immediate benefits of non-productive spending that is essential to stabilize demand in the short term on the one hand, and on the other, the gradual benefits of productive one that will be pronounced in the long-run. Chu et al. (2020) show that productive government spending increases the productivity of the economy thanks to a higher investment in physical and human capital and hence has a direct impact on growth. In contrast, non-productive or current expenditure affects citizens' welfare through subsidies, wages, and compensation of employees and government purchases. Yet, it is not likely to affect economic growth since it is immediately spent and consumed in the short term. Moreover, in the short term, post-conflict countries must avoid austerity policies that might depress demand and increase economic marginalization and political tensions, leading to conflict relapse. Third, from a longer-term perspective, both countries (oil poor or oil rich) need to develop a fiscal rule (revenue, expenditure, debt, or deficit rule) to guarantee that improve debt sustainability and increase the credibility of fiscal policy.

At the monetary level, in the short term, it is important to move money from the realm of the old elites and powers to the reals of the common good (Starr, 2004). In addition, Hailu and Weeks (2011) argue that a fundamental aspect of the monetary policy should be to mobilize private resources for investment, mainly through remittances that have to be channeled to the formal banking system. In fact, post-conflict countries predominantly have a large diaspora due to the substantial outflow of migrants caused by the conflict. As per the long term, guaranteeing the Central Bank independence and accountability vis-à-vis the parliament is crucial to increase its credibility and hence commitment to implement the relevant policies. This was clear in the Croatian case that established an independent currency with a strong independent and accountable central bank that managed to have a very low inflation between 2 to 7%. Thus, it introduced the dinar in 1991 as a transitional currency and, in 1994, it was replaced by the kuna.

The way forward

Several points are worthy to be highlighted for post-conflict countries from a political economy perspective. First, commitment challenges are a fundamental feature of post-conflict settings. Reform that recognizes and addresses these challenges are more likely to succeed. Second, it is important to analyze the political economy of reforms from a more dynamic lens. This requires that we understand how power was distributed before conflict, how the configuration of power shifts during conflict, and who are the actors and their incentives. A more temporal approach is essential for designing effective interventions. Third, post-conflict institution building needs to take into account the complexity and contradictions of the reform space. This requires a greater nuance, and a shift of focus away from outcomes (e.g. elections, transparency, control of corruption, etc.) to processes (what will set actors onto a more productive institutional path with second-best outcomes). Inclusive political transitions with decentralized input from are more important than elections per se. Yet, inclusion is not synonymous to sectarian power sharing. It also necessitates a focus on sequencing. And, the need for compensation to actors who stand to lose out from reform. These different points confirm the findings of Acemoglu and Robinson (2013) who argue that, while implementing economic reforms, it is indispensable to evaluate different policy proposals and take into consideration the potential backlash created by the conflict between various economic and political factors.

From a policy perspective, it is important to approach macroeconomic reforms (at the monetary, fiscal and exchange rate levels) from both a stabilization (short term oriented) and a structural (long term) lens. This will guarantee that macroeconomic policies do not suffer from a time inconsistency problem. Moreover, policies adopted must be tailored to the structural characteristics of the countries (such as their fractionalization and the abundance of natural resources) that were initially the reason behind the conflicts eruption. In addition, ownership of such reforms is crucial for successful execution of policies. This is especially related to the role of donors and international actors who can provide the required financial support. Yet, if reforms are imposed (with no sense of ownership), such reforms can exacerbate horizontal inequalities and lead once again to conflict relapse.

Thus, macroeconomic reforms must be analyzed through a more comprehensive approach (with its political-economic factors and its time horizons) not just specific measures that help stabilize the economies in the short term.

Selected References

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Contact Information

ERF Office
Address: 21 Al-Sad Al-Aaly St. Dokki, Giza, Egypt
PO Box 12311
Tel: +202 333 18 600 - 603
Fax: +202 333 18 604
Email: erf@erf.org.eg
Website: http://www.erf.org.eg

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