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'Global Factors Influencing the Risk of Conflict and Fragility'

Building a "fragile consensus": Liberalisation and state fragility

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Note to the reader

This paper is one of eight thematic papers supporting the OECD DAC INCAF project on Global Factors Influencing the Risk of Conflict and Fragility. Each paper explores a specific global factor. The synthesis report, *Think Global, Act Global: Confronting global factors influencing conflict and fragility* (OECD, 2012), can be found at:

www.oecd.org/dac/conflictandfragility/globalfactors.htm

While the thematic papers have been subjected to a robust peer review process, they remain working papers rather than for publication in peer-reviewed journals.

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Abstract

This research paper seeks to answer three central questions: (i) how can different forms of liberalisation be classified; (ii) how have liberalisation policies and measures affected conflict-affected and fragile states; and (iii) what are the essential institutional governance pre-conditions to manage the liberalisation-fragility interface?

This research suggests that no single country conforms entirely to classical liberalism. Fragile states – many of which have long communist, socialist and patrimonial histories – exhibit a cocktail of economic personalities. They may best be referred to as "liberal-hybrids". Research shows that while such states are highly exposed to global transmission channels for liberal market policies, many of these liberal hybrids fared better through the global financial crisis because of their adaptive mechanisms. There is, therefore, a great need to deepen understanding of the drivers of fragility and resilience in fragile states, and redefine proscriptive ideological approaches that drive economic and development policies in different directions. This paper focuses on four key pillars of liberal order policies: financial liberalisation, trade liberalisation, foreign direction investment and exchange rate management. These aspects are fundamental to growth, but "test" fragile institutions and societies too severely in many cases – aggravating fragility and creating inequitable growth patterns. Policy responses to mitigate risks and maximise benefits from adoption of these liberal order policies in fragile contexts have been stronger in theory (as the Post-Washington consensus era draws to a close) than in practice; fragile states are still subject to blueprint prescriptions and competitive political pressures.

Drawing on country examples, this paper proposes future avenues for international research and action: (i) grouping fragile states according to a new set of vulnerability criteria on which to base support; (ii) developing a set of leading or proxy indicators to close the action-research time gap for fragile states; (iii) modelling fragile state responses to global risks towards early warning; (iv) integrating economic and development policies at national level; (v) staggering liberalisation policies to keep pace with institutional capacities; and (vi) prioritising internal economic cohesion. To create the analytical base, three fragile state case studies could be produced exploring liberalisation adoption from ideology and prescription to uptake pattern over time. Results could be synthesised by a newly established Global & Fragile Systems Contact Group, empowered to create the new metrics required to turn the New Deal into the "real deal" for fragile and conflict-affected states.

Acronyms and abbreviations

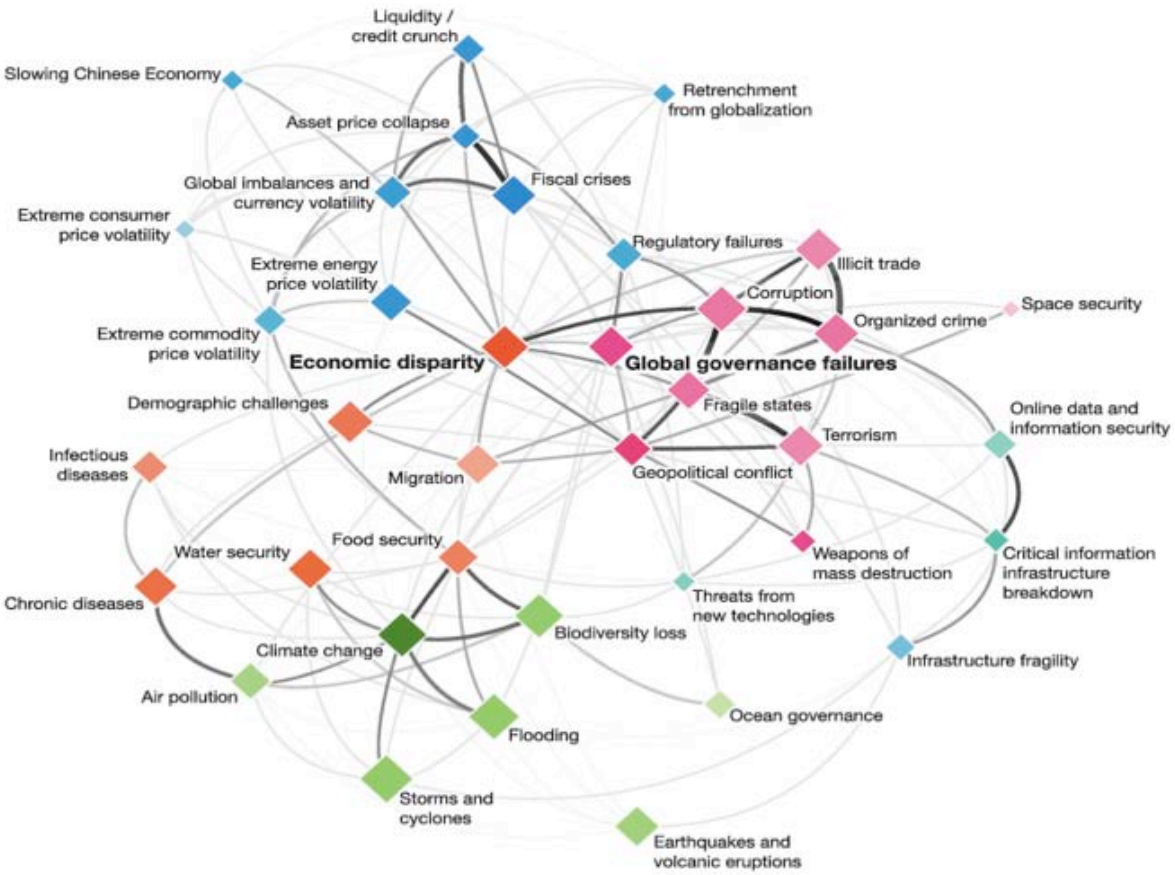
ADB	African Development Bank
DAC	Development Assistance Committee
EU	European Union
FCAS	Fragile and conflict-affected states
FDI	Foreign direct investment
GFC	Global financial crisis
IFIs	International financial institutions
IMF	International Monetary Fund
INCAF	International Network on Conflict and Fragility
LDC	least developed countries
LTTE	Liberation Tigers of Tamil Eelam
MDG	Millennium Development Goals
MENA	Middle East and North Africa
ODA	Official development assistance
OECD	Organisation for Economic Cooperation and Development
PBF	Peacebuilding Fund
PRSP	Poverty reduction strategy paper
PSC	Private Security Company
SOE	State-owned enterprises
TOC	Transnational organised crime
UNCTAD	United Nations Conference on Trade and Development
UNDP/BCPR	United Nations Development Program's Bureau for Crisis Prevention and Recovery
UNODC	United Nations Office on Drugs and Crime
WTO	World Trade Organization

1. Introduction

"Revenue is the chief preoccupation of the State. Nay more it is the state."
- Edmund Burke (1729-1797)

There has arguably never been a more urgent need to explore how global liberalisation factors affect patterns of fragility in states. The seismic financial shocks of the past five years continue to ricochet around the globe, empirically deepening our understanding of the reach of "fragility" and drawing a line under the three-decade reign of prescriptive growth and stability models. As highlighted in Figure 1.1, the interconnections between global risk factors have never been more complex.

Figure 1.1 Global Risks Interconnection Map



Source: World Economic Forum (2011), *Global Risks*, Sixth Edition, World Economic Forum. Geneva

The task, however, is made complex by definitions – or the lack of them. To date, there is no internationally-agreed definition of "liberalisation". We have, of course, *de facto* examples of the application of more-or-less neo-liberalist [1] policies in most of the world's major economies. However, despite the Washington consensus and its successor – known as the post-Washington consensus (see Box 1.1 and Section 2) – we still lack a broadly-accepted set of measures to describe liberalisation as a system for economic intervention. This means we have little *systematic* evidence for how liberal economic choices, or contact with a liberalised global market, can affect the trajectories of fragile states.

Definitions of fragility are also open to interpretation. The OECD defines fragile and conflict-affected states as “those that have weak capacity to carry out basic functions of governing their population and territory, and lack the ability to develop mutually constructive and reinforcing relations with society.” (OECD, 2011:11). [2] However, in such a deeply economically-integrated climate, this definition appears rather narrow. The 2008 global financial crisis (GFC) indicated very clearly that fragility (both economic and social) can be contagious even in climates of stable governance where certain underlying market conditions exist: *e.g.* single commodity dominance, high sovereign debt, over-reliance on foreign direct investment (FDI) or a single export market *etc*. In addition, fragility and conflict can have distinct causes: such as contested external boundaries (Afghanistan, Somalia); invasion by external forces (Iraq); internal conflict (Rwanda); capture by self-serving elite groups who impede social progress in the interests of stability (Afghanistan, Libya, Syria); and the imposition of international sanctions (Iraq, Iran, South Africa). They can also be driven by various geopolitical factors (such as the contraction of the former Soviet Union) and as seen in the so-called Arab Spring (Geopolicity, 2011a).

Box 1.1. What is the post-Washington consensus?

The term “Washington consensus” was originally coined in 1989 by economist John Williamson to describe a set of ten relatively specific economic policy prescriptions that broadly constituted the "standard" reform package promoted for crisis-wracked developing countries by Washington-based institutions, such as the International Monetary Fund, World Bank and Department of Treasury (Williamson, 2002). For many supporters, the post-Washington consensus differs fundamentally from the original. While the Washington consensus made economic growth the main goal of development, the new consensus moves away from the neo-liberal, market-friendly approach and places sustainable, egalitarian and democratic development at the heart of the agenda. It includes a more poverty-focused approach that protects and supports the poor and prioritises social spending on education and health. Others argue that the original neo-liberal agenda still underpins the post-Washington consensus, saying that the social safety net aspects of the new policies are put in place as an add-on to deal with market failure (WHO, 2012).

The post-Washington consensus has attempted, valiantly, to address some of the definition problems surrounding liberalisation. It expands on earlier neo-liberal prescriptions, but with greater emphasis on the “neo”, *i.e.* free market economics with a stronger policy environment and national equity rather than national wealth as the end goal of economic activity. Therefore, it contains new policy elements such as “crisis-proofing”, second-generation reforms and stronger social strategies to relieve political and social inequality. The consensus better reflects the complex linkages among the economic, social and cultural aspects of fragility across different countries.

And yet, complex challenges remain in both its theoretical construction and practical application. Architects of the post-Washington consensus (such as Joseph Stiglitz) acknowledge that fragile and conflict-affected states are rarely open to one globally-generated and proscriptive policy solution. Nevertheless, certain factors may be consistently important across various different contexts: cogent economic policy throughout government, strong state regulation to prevent capital instabilities, fostering capital accumulation, ensuring asymmetric free trade and competition, disciplining labour forces and minimising political and social exclusion. However, we currently lack adequate political economy measures to evaluate the risk of exposure of fragile states to external stresses, including the impact of a particular transmission mechanism (policy induced changes to the economy characterised by long, variable and uncertain time lags) and the risks and impacts of globalisation in a given country or market context.

This report seeks to address three central questions:

i) How can different forms of liberalisation be classified?
ii) How have liberalisation policies affected fragile and conflict-affected states?
iii) What are the essential institutional governance pre-conditions for managing the liberalisation-fragility interface?

These questions are explored first, in Section 2, by deconstructing the term "economic liberalisation" and reviewing some of the key dimensions of the concept and its evolution in the context of the recent global financial crisis. Section 3 classifies the main "global transmission mechanisms" through which liberalisation influences fragile states, and focuses in particular on four mechanisms: (i) financial liberalisation; (ii) trade liberalisation, (iii) FDI; and (iv) exchange rate management. Section 4 presents the international response to date and Section 5 outlines some detailed entry points for a more nuanced approach to liberalisation.

I argue that the adoption and implementation of policies aimed at overcoming fragility must be conceived within the country's particular political-economy context. Each fragile state must develop its own alternative sets and sequence of liberalisation measures calibrated to their own particular hybrid requirements and informed by the structural context, institutional and agency considerations. Such an approach (in part advocated by the New Deal for Engagement in Fragile States; IDPS, 2011)[3] is essential if the benefits of a more open economy are to be balanced carefully with the potential risks to instability or exclusion (state capture). I argue that there is no "fragile consensus" or "tool kit" with which to calibrate liberalisation policy. The following chapters examine how such a consensus might be created.

NOTES

[1] Classical liberalism (based on Adam Smith's theories and developed by John Locke, David Ricardo, Thomas Malthus and Jean-Baptiste Say) advocates limited government, constitutionalism, rule of law, due process, liberty and free markets. Neo-liberalism (coined by Alexander Rüstow at the Colloque Walter Lippmann in 1938 and sharing similarities with the Freiberg School of Economics) argues for temperance of classical "non-interference" doctrines with regulative policies to meet the challenges of modern governance.

[2] While the number of fragile states can change, in 2010 the OECD provided the following list of fragile states: (1) 26 low-income countries: Afghanistan, Burundi, Central African Republic, Chad, Democratic Republic of Congo, Comoros, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kenya, North Korea, Liberia, Myanmar, Nepal, Niger, Rwanda, Somalia, Sierra Leone, Tajikistan, Togo, Uganda, Republic of Yemen, Zimbabwe (2) 16 middle-income countries: Angola, Cameroon, Republic of Congo, Côte d'Ivoire, Djibouti, Iraq, Kiribati, Nigeria, São Tomé and Principe, Solomon Islands, Sudan, Timor-Leste, Tonga, Pakistan, Papua New Guinea, West Bank and Gaza; and (3) one high-income country: Equatorial Guinea. See OECD (2012).

[3] Western development actors, Northern and Southern civil society and the g7+ (a group of around 15 fragile states) signed the *New Deal for Engagement in Fragile States* in November 2011 in Korea.

2. What are the key dimensions and developments?

2.1. From ideology to reality

Understanding liberalisation involves deconstructing the term as (i) an ideology; (ii) a prescription; and (iii) a pattern. Liberalised economic *ideology* implicitly assumes a set of known and constant policy outcomes irrespective of context. Liberalised economic *prescriptions* are a specific set of policy measures that can be taken to meet ideological goals dependent on context. Liberalised economic *patterns* highlight the changing demographic of policy uptake over time. Distinguishing among these different layers reveals the following insights:

- ***Ideological push and pull factors***: Neo-liberal *ideologies* are not instinctive, and the incentives for adopting them are convoluted in most fragile and conflict contexts. With rare exceptions, developing country governments in or emerging from crisis are likely to adopt liberalisation reforms for one of four reasons: (i) aid conditions (including structural adjustment) or dependency; (ii) the need to broaden the revenue base; (iii) to benefit the political elite; or (iv) to align country leadership with a major external power. [1]
- ***Policy transmission time lags***: Following the adoption of new economic ideologies in fragile and conflict-affected states, a significant gap almost inevitably emerges between policy *prescriptions* and uptake patterns. Even if the break-up of the Washington consensus led to a more nuanced and adaptive set of policy measures for developing countries, there is still an unfortunate tendency to over-estimate their uptake capacity. It takes many years for new policies to penetrate down through global and national institutions and become reality on the ground. Most policy and regulatory reforms require major functional restructuring of state entities, and/or privatisation or remodelling of parastatal structures. Adjustment can, therefore, take anywhere from 5-20 years to achieve, a timescale similar to that for country accession to the WTO. As a result, many countries are likely still to be operating within the rules of increasingly outdated games, still attempting to implement decade-old policy models in a highly fluid economic climate (both domestic and global). The vulnerability of fragile and conflict-affected states becomes paradoxically more acute as they gain much sought-after regional and global integration – the fiscal equivalent of sailing a small boat under repair out of harbour into the Pacific Ocean.
- ***An inevitable period of maximum uncertainty, fuelled by inequity***: Where uptake *patterns* become linked to global factors, outcomes depend on the effectiveness of national transmission mechanisms and on how global, regional and domestic factors play out in a fragile, ideologically-shifting context. The liberalised growth model could be seen to dictate a period of maximum uncertainty – where weak state structures and domestic transmission mechanisms achieve integration with both positive and negative aspects of regional/global economies. Where fragile states have long porous borders, where infrastructure connecting the national economy within the region and globally is under-developed, and where the state is surrounded by less than liberal trade regimes, the effects of global factors through domestic transmission mechanisms would be uncertain. How a state responds to such circumstances depends on factors beyond the macro-economic; *i.e.* the national equity gap, the depth of public trust and investment in rule of law and perceptions of socio-political inclusiveness.

2.2. All states as liberal hybrids

A key conclusion of this thinking is that no single country can be characterised as entirely liberal. Fragile states, many of which have emerged out of long histories of communist (*e.g.* North Korea, Ethiopia, Tajikistan), socialist (*e.g.* Iraq and Syria) and patrimonial (*e.g.* Somalia, Afghanistan) systems, exhibit a cocktail of economic personalities that do not

conform to normative liberal traditions and practices in any pure sense – neither ideologically, nor in their policy prescriptions and uptake patterns. Moreover, many high-growth economies, such as the United Arab Emirates (UAE), Qatar, Brazil, Russia, India, China and Turkey, have adopted their own economic models – many of which are decidedly non-liberal in character. They have taken this step at a time when the West is viewed as entering a phase of decline and the stigma once attached to refusing to adopt Western policies has all but evaporated.

The world's major economies have been forced, in recent times, to adapt to new realities. The 2008 global financial crisis (GFC) and 2011 sovereign debt crisis have not so far led to the outright rejection of broad neo-liberalism ideology. However, they have stretched this ideology to perhaps its furthest possible extent, integrating strategies such as trade protectionism, taxpayer bailout of private banks, exchange rate controls and import substitution. Bastions of free market thinking are moving towards tighter regulation, new austerity pacts, new debt instruments and calls for global taxes on financial transactions. It could be said that many countries in the OECD and outside it have moved well beyond neo-liberalism and are now also sailing in uncharted ideological waters.

2.3. An ideology adrift

If leaders of the world's largest economies have been profoundly shaken by the historic changes taking place in today's economy, then imagine the view from the world's most fragile contexts hoping to strengthen attachment to the primary global markets. In less than 20 years, the once proud Washington consensus has been reduced to what might best be described as a Post Washington Confusion. The resulting impact on world stock markets, on effective demand for primary and secondary commodities, on trade flows and on exchange rates between a basket of the major currencies and the rest, has been substantial. The current situation is not "business as usual" so much as "business unusual".

Some interesting new dynamics are emerging as a result – affecting the economic ideology, prescription and uptake pattern in fragile states seeking regenerative solutions. As the economic climate has shifted, so have geopolitical power balances and the relative influence of global powerbrokers. Traditional neoliberal giants are being overshadowed by proponents of other economic models, notably China. Currently, the BRICs (Brazil, Russia, India and China) and other G20 countries are pioneering their own successful national economic policy consensuses, borrowing from both liberal and non-liberal doctrines. The rise of sovereign wealth funds are, in part, paving the way for increasing Middle Eastern and Chinese influence in Africa and, indeed, Europe and the US. This is a significant departure from Western neo-liberalism practices in the OECD, in the sense that publicly-owned funds are buying stakes in private equity markets globally. In the emerging new-school economic mainframe, anything goes as long as it drives growth and creates employment. Observable policy responses include controlling public ownership stakes in private banks, something unimaginable even five years ago (making once commercial banks, such as Lloyds and the Royal Bank of Scotland, in effect increasingly state-owned enterprises).

It *is* clear, however, that the relevance of many widely-accepted liberal order policies is currently being aggressively re-visited. All multilateral entities, from the World Bank to the OECD, from the G8 to the G20, from the IMF to UNCTAD, from WTO to ISO and from the United Nations to NATO have initiated research to better understand the risks that different liberalisation transmission mechanisms have on fragility. This is best reflected by the World Bank's recent publication, *New Structural Economics: A Framework for Rethinking Development and Policy* (World Bank, 2012).

If economic events have spurred a revisionist approach to neo-liberal doctrines, recent political events have redefined concepts of fragility. The Arab Spring, for example,

dramatically revealed that countries such as Egypt and Syria must now be considered fragile, and open to conflict –albeit largely asymmetric in nature. In the Arab world, pursuit of the Washington Consensus' liberal model has been tagged as a key underlying driver of social unrest – fuelling resentment against controlling elites whilst also enabling demand for governance accountability to build and strengthen through modern media technologies:

> Although Arab petro states have relied on their oil revenues to avoid economic reform, changes in the world economy and the liberalising requirements of foreign aid donors have, over the past two decades, forced non-oil-producing states to modernize their economies. A number of Arab regimes, including in Egypt, Jordan, Morocco, and Tunisia, have privatized state enterprises, encouraged foreign investment, created incentives to kick-start the private sector, and cut subsidies and state expenditures that previously consumed government budgets. Such Washington consensus-style economic reforms exacerbated inequalities and made life more difficult for the poor, but they also opened up new opportunities for local entrepreneurs and allowed the upper classes to enjoy greater consumer choice through liberalised trade regimes (Gausse, 2011).

The unusual feature of relatively wealthy or middle-income states entering conflict and fragility has challenged the Washington consensus model and its successors still further. No-one has suggested, for example, that growth alone could be the solution for a Libya or an Egypt – instead fairness, transparency, employment generation and revenue redistribution with a heavy youth and poverty focus are the key ingredients proposed. Similar challenges have been found in Kosovo (UNDP, 2010 and 2011). There, a very straightforward chase towards economic liberalisation has resulted, more than a decade after conflict, in 43% unemployment, poverty rates of 48% and deep socio-political fractures set incredibly against steadily rising GDP. It seems almost irrelevant to argue whether the policies themselves or the implementation is to blame; clearly the demands of liberalisation have proved too great a test for Kosovo's post-conflict institutions. With global growth forecasts reversed ever downwards, including in Sub-Saharan Africa and the Middle East and North Africa, more and more countries are likely to edge over the brink of fragility towards civil conflict.

These developments have given momentum to the model for human progress (the "capability approach") first proposed in 1990 by Amartya K. Sen, which states that economic growth is a necessary but insufficient pre-condition for poverty reduction unless growth is managed so as to be inclusive (Sen, 1990). Stiglitz reached a similar conclusion in 2002:

> Behind the free market ideology there is a model, often attributed to Adam Smith, which argues that market forces - the profit motive - drive the economy to efficient outcomes as if by an invisible hand. One of the great achievements of modern economics is to show the sense in which, and the conditions under which, Smith's conclusion is correct. It turns out that these conditions are highly restrictive. Indeed, more recent advances in economic theory - ironically occurring precisely during the period of the most relentless pursuit of the Washington consensus policies - have shown that whenever information is imperfect and markets incomplete, which is to say always, and especially in developing countries, then the invisible hand works most imperfectly. Significantly, there are desirable government interventions, which, in principle, can improve upon the efficiency of the market. These restrictions on the conditions under which markets result in efficiency are important - many of the key activities of government can be understood as responses to the resulting market failures (Stiglitz, 2003).

In a closed discussion with the then World Bank Chief Economist, François Bourguignon in New Delhi in 2006, I presented views on the risks of adopting certain liberalisation policies in Afghanistan, given the large number of market and information imperfections, information asymmetry and the dominance of the illegal economy. Bourguignon, whilst acknowledging the challenge of policy adaptation faced by the World Bank, also recognised that such imperfections meant the "invisible hand" works imperfectly in such contexts. He also outlined that the adaptation of liberal policies in such fragile and conflict-affected contexts remains an uncharted challenge for the international financial institutions (IFIs).

Against this backdrop it is interesting that the 2011 *World Development Report* (World Bank, 2011) on conflict, security and development omitted to mention the terms "liberal", "neoliberal" or "liberalisation" in the entire document; a significant departure perhaps. A decade earlier, Cramer (1999), in his paper entitled "Privatisation and the Post-Washington Consensus: Between the Lab and the Real World?" had outlined the shortcomings of the post-Washington consensus, many of which are currently being reflected in new policy circles. So there appear to be multiple time lags, one between global policy and practice and the other between global policy and subaltern views even in the West.

If global political and economic developments have challenged some of the certainties of neo-liberal policies, and called for a much more "people-facing" system, then there are also lessons to be learned from fragile states themselves. One of the most counter-intuitive aspects of recent financial shocks is the remarkable resilience shown by some fragile contexts compared to their wealthier and nominally more stable peers (see Naudé, 2010). Fragile states have, in effect, been dealing with the consequences of global economic turbulence and have in many instances already embarked on their own set of adaptive (crisis-proofing) policies, aimed at minimising the risk of global contagion through different transmission channels listed in the previous section. For example, Sampawende Tapsoba, an IMF economist with the Africa Department, noted in his paper *Reforms to Rival Fragility* that "despite facing the difficulties of a fragile state, the Central African Republic is showing resilience in the face of the global economic downturn", although he points to a spike in consumer price inflation in 2008 as a result of high food and fuel prices (Tapsoba, 2012). Even though recent growth in the Central African Republic (forecast by the IMF at 4.1% in 2012) is partially as a result of the low base from which it began, the analysis supports the idea that no individual fragile state responds to identical policy measures or global factors in the same way, and as such no "one-size-fits-all" policy or risk management strategy applies.

Economic liberalism, as with all economic models, presents risks as well as benefits to societies. Fragile and conflict-affected states are assumed to be in desperate need of the benefits of a liberalised, integrated, free-market economy, while being at the same time more exposed to the risks. The post-Washington consensus for economic intervention seeks to "firewall" these states against the worst economic and social risks of neo-liberal economic policies by balancing wealth creation with social investments and regulatory protections. However, it has yet to explain *why* certain aspects of liberalisation have a particularly strong effect on states struggling with governance and integration and *how* this effect manifests itself. These will be explored further in the next section.

NOTES

[1] Even where countries (such as the central Asian republics) are already part of the World Trade Organization (WTO) accession protocol process, the rush towards liberalisation was as a consequence of the contraction of the Soviet Union in 1991 and not necessarily an ideological leaning in favour of a largely Western liberal order. The same might be said of former Eastern Europe's accession to the European Union (EU), initially driven by the expansion of NATO's security footprint as well as the prospect of significant pre-accession funding and (at the time) visa liberalisation – rather than fundamental commitment to the socio-economic requirements of European law.

3. Impacts of liberalisation on conflict and fragility

Liberalisation and globalisation have become, in some senses, synonymous. There are few nations today that totally eschew free market trade in the global arena. Developing economies, which include the world's most fragile nations, are particularly eager to participate in economic exchanges with bilateral trading partners, multilateral trading blocks and wider global markets – spurring both legal and illegal trade (imports, exports, capital, labour, diplomacy). Liberalisation offers solutions to the biggest day-to-day challenge facing most fragile states: a lack of state revenues to establish the core capacities required to grow, secure and regulate the state, and therefore the economy. It represents a vital recovery tool for countries emerging from conflict and seeking to shed enormous burdens of systems that – generally – maintained state dominance over private interests (see Box 3.1). Liberalising the economy and downsizing government can offer immediate revenue gains via new growth and fiscal savings (Box 3.2).

Box 3.1. Iraq: Ripe for liberalisation?

Iraq is an excellent example of how liberal order policies and functional restructuring could one day relieve the burdens of over-large public sectors. With its quasi-socialist administrative legacy and deeply fractured legislative set up, Iraq sought to maintain high state dominance in a climate of political uncertainty. It suffered a major fiscal crisis in 2008 and 2009, attributable to low oil prices, and in response sought to increase public sector staffing, that now stands just short of 4 million civil servants. This makes Iraq the largest public sector (per capita) in the world. While increasing public employment arguably encouraged consensus and stability, it has meant that until 2012, the majority of government revenue was spent on the massive and growing public wage bill, rather than on growth-inducing capital investment. This system limits Iraq's ability to truly capitalise on higher oil revenues (exceeding USD 100 billion in 2012). State-owned enterprises (SOEs) continue to dominate large parts of the economy and the government is paying SOE staff wages and financing operations. In 2011, the Ministry of Agriculture, for example, provided USD 250 million to the state-owned agricultural banks, at 0% interest. So far repayment rates have been around 80%, implying a USD 50 million loss. It is impossible for private banks to compete with state-owned banks under such conditions, further eroding internal economic cohesion.

However, opening up an economy to global factors such as trade, financial markets, FDI and natural resource extraction is by no means a development panacea. Liberalisation has a paradoxical impact on fragile systems, which are defined by higher levels of informality, weaker government, lower levels of global market integration, weak revenue to GDP ratios, often large combat and coping economies, natural resource and other struggles, and poorly administered borderlands and market frontiers. It encourages weak institutions to shift towards modernisation, global integration and democratisation (almost by default). However, it also tests these institutions and the societies that depend on them, sometimes to breaking point. This "test" operates through two mechanisms (i) exposure to global factors that affect fragility and conflict; and (ii) pressure on weak state capacities to manage the uncertainties of political, security and socio-economic change in a "free market" context.

Fragile and conflict-affected states often lack the capacity necessary to positively shape the flow of benefits resulting from connection to global economic transmission channels. They also struggle to develop domestic economic liberalisation capacities that tackle poverty, strengthen social contracts and minimise the risks of elite capture of newly "liberalised" national assets. Where a breakdown in the social contract between government and wider society already exists (*e.g.* Afghanistan, Iraq and Somalia), global factors do not merely

aggravate existing grievances – they can also open up new ones (*e.g.* the UN brokered succession of South Sudan has led to conflict with the north over territorial rights and ownership of revenues in relation to oil extraction). The pressure on governments to move towards liberal economic and political models concurrently has also been counterproductive in some cases. While it may be relatively easy to identify the primary drivers of instability, the measures required to address structural fiscal instability, import dependency, declining productivity, youth unemployment (pockets of up to 60%) and social demands for greater representation cannot be achieved within a normal electoral period. [1]

Box 3.2. Liberalistion in post-conflict Sierra Leone: a country on a better path

Measurements of the success of liberalisation policies can be critically linked to uptake patterns that manifest over time. In Sierra Leone (like Liberia) liberalisation in the context of post-conflict stabilisation has opened the door to mineral concessions, which could transform the public sector and basic and essential services while generating significant direct, indirect, catalytic and spin-off employment. Real GDP growth increased to 5% in 2010 and 6% in 2011. The commencement of an iron ore megaproject in 2012 is expected to boost GDP and exports substantially, in particular through concessions, which will precipitate substantial revenues some years down the line. FDI and portfolio investment increased from USD 79.4 million in 2009 to USD 1 billion in 2011 (projected). These revenues may or may not reduce poverty – this depends on future monetary policies. Inflation remains in double digits (at 17% in the 12 months to September 2011).

Source: IMF (2012), *Sierra Leone: Fourth Review*, IMF Country Report No. 12/285, IMF, Washington, DC.

Even before the GFC struck, there was no clear consensus as to (i) whether the adoption of liberal order policies by fragile states has been beneficial overall or not; and (ii) which global factors are most likely to affect conflict and fragility. In 2009 the World Bank noted that "fragile states are vulnerable to financial shocks because of their dependency on remittances, very concessional financing, primary commodity export and overseas aid, levels of which have been affected by the financial crises" (World Bank, 2009).

Key steps in answering how liberalisation affects fragile contexts are to (i) define what economic liberalisation means in generically measurable terms, with implications for core state governance capacities; and (ii) identify which different liberalisation measures and global transmission mechanisms are most likely to affect conflict and fragility – both positively and negatively. In this section I outline a classification of the main liberalisation transmission factors affecting fragile states, and then go on to analyse the impact, in detail, of four of the most influential factors.

3.1. Measuring impact: a new classification

This analysis is complex since (i) many of the core drivers of change resulting from the global liberal order and financial and sovereign debt crisis apply equally to non-fragile states, yet there is no easy control group around which verifiable impact (positive and negative) can be assessed; (ii) the differences between countries and their various stages and drivers of economic transition make it difficult to determine long-term impact; and (iii) the outcome of liberalisation policies is shaped by the political economy, informal and non-state actors and international interests – not just government and the marketplace.

Another source of difficulty is that liberalisation is itself a fragile and dynamic process that (i) creates both winners and losers, changing and sometimes breaking time-honoured social contracts; (ii) has different impacts resulting from different natural advantages (oil and mineral wealth export and import dependencies, landlocked or coastal positions etc.); (iii)

opens up the national economy to global risk factors; and (iv) requires strong state capacities, which are – by definition – lacking in fragile states.

There is no agreement on how to model the exact operation of economic liberalisation within fragile contexts. There seem to be different solutions in different contexts. Velde *et al*. (2009), in a study of countries including Benin, Uganda and Zambia, indicates a very complex formula for a country's risk exposure, determined by different levels of openness, aid and remittance dependency, financial integration, economic and trading structures and institutions.

In this section I ask if we can come up with a useful definition of economic liberalisation including a set of characterising metrics that hold true for the majority of fragile contexts? Table 3.1 proposes a set of key ideological building blocks that many fragile states are progressively gravitating towards, either as a result of their strategic alignment with trading partners, such as the WTO and/or regional trading bodies, or as a result of other factors explored above. The general objective of each building block, its potential benefits and risks are outlined in aggregate terms.

Table 3.1. Classification of Core Liberal Economic Policy Objectives & Benefits and Risks for Fragile States

Policy Area	Objective	Potential Benefits	Potential Risks
A. Monetary, Fiscal and Expenditure Management Reforms			
Fiscal discipline	To improve and sustain economic performance, maintain macroeconomic stability and reduce vulnerabilities through prudent, countercyclical macroeconomic policies.	Management of economic shocks, sustained delivery of services.	Sophisticated fiscal operations difficult, few tax levers, risks of persistent deficits and pro-cyclical policies, rising debt levels, and, over time, a loss in policy credibility.
Exchange rate management	To determine an optimal exchange rate (floating/fluctuating, fixed, pegged (hard, soft, adjustable, crawling, target zone etc)) to maintain macro-economic stability while encouraging sustained growth.	Exchange rate stability, improved competitiveness, macro-economic stability, control over inflation.	Depends on exchange rate regime, but large fluctuations in exchange rates, due to changes in capital flows or other factors can create large disruptions in economic activity and lead to balance of payment problems.
Tax reform	To establish a tax system that achieves simplicity, equity, broadening of the tax base, growth, competitiveness and compliance.	Broadening the tax base, improving tax administration, lowering import tariffs, simplification and harmonization.	Tax systems hard to administer due to weak institutional capacities, poor compliance and large informal economy.
Public expenditure prioritization	To maximise investment returns to economic growth, employment creation, revenue mobilization and poverty reduction through improved allocative efficiency.	Higher quality growth, allocative efficiency through improved resource re-allocation focused on removing the binding constraints to growth, right sizing, subsidy removal and contracting out.	Difficult for fragile states to cover much more than recurrent costs/essential services. Growth financing undermines basic and essential service delivery, aid dependency.
B. Enabling Environment Reforms			
Financial	To deregulate domestic	Growth, welfare and	Bust and boom cycles,

liberalisation	financial markets and liberalise the capital account to allow for proper allocation of savings to investment.	consumption smoothing (through international risk sharing), benefits outweigh the costs associated with more frequent financial crisis.	increased exchange rate volatility pressure, and inflation in fixed exchange rate regimes. Little justification for fragile states.
Trade liberalisation	To promote free trade through lower tariffs, removal of quotas and restrictions on capital flows, customs harmonization/simplification.	Drives dynamic productivity gains, enhances allocative efficiency gains, export expansion and lower transaction costs which increase market penetration.	De-industrialization, with infant industries out-competed. Economy-wide and household vulnerability to shocks, higher unemployment.
Foreign direct investment	Removing barriers to market entry by foreign investors.	Growth, technology transfer, diversification, tax revenues, employment.	FDI can out-compete domestic producers, assuming the political and security situation allows investment.
Privatisation	Privatisation of state-owned enterprises, restructuring or corporatization.	Greater fiscal space, improved value and efficiency and an expanded role for the private sector.	Large risk of corruption and political nepotism, and privatisation of land often not part of the privatisation process.
Deregulation	Lowering the costs and ease of doing business to encourage investment.	Improved growth, productivity and economic efficiency and competitiveness.	Weak regulatory oversight and enforcement capacities and corruption.
Property rights	Securing private and informal property rights.	Legal respect for possessory claims and credit mobilization.	Claims of possession and abandonment linked to ethno-political conflict history.

The secondary challenge in answering the question of how liberalisation affects fragile contexts is to define *which mechanisms* are primarily responsible for transmitting global trends into the mix of fragile economic policies. Poorly sequenced and prioritised liberal reforms that are not calibrated around the development of core state market regulation capacities increase the likelihood of one or more of the following global transmission factors affecting state fragility:

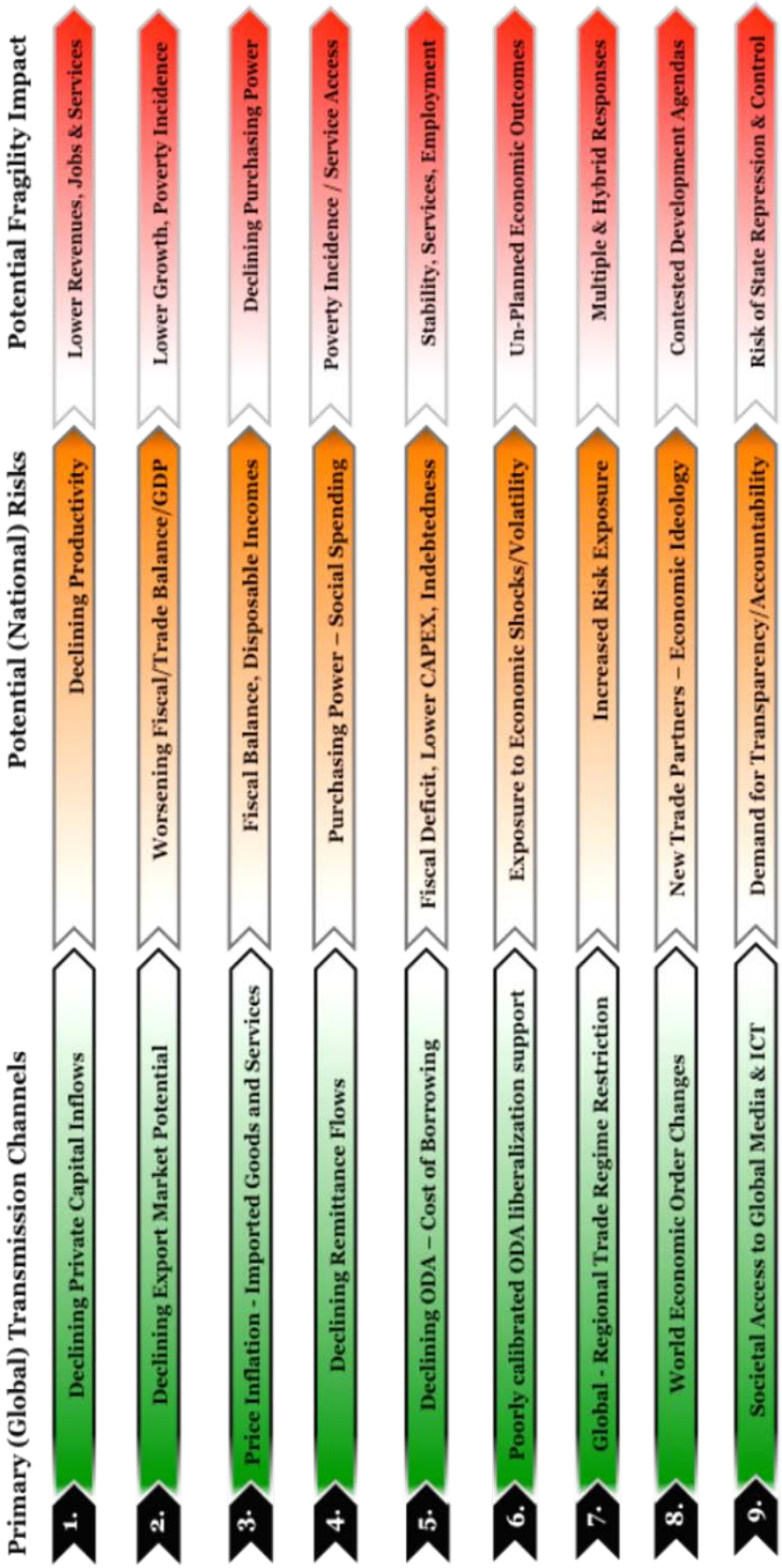
- Declining private capital flows including FDI;
- Declining export market potential;
- Inflation of imported goods and services;
- Declining remittance flows;
- Declining overseas development assistance in nominal and real terms;
- Global and regional trade regimes which can restrict national policy responses;
- Changing patterns of global economic opportunities and markets; and,
- Increased societal access to global media and information and communications technology (ICT) with implications for transparency.

Figure 3.1 illustrates the effect of these transmission mechanisms on outcomes. These primary transmission channels are all global factors with national implications. In one way or another they affect macro-economic stability, poverty incidence, employment rates and household incomes – all critical drivers of conflict (Collier & Hoeffler, 2002; 2004). The exposure of one country over another will vary according to factors such as openness and levels of integration, as well as dependency on primary exports or external assistance.

Given the substantial impact on fragile and conflict-affected states of recent financial and stock market volatility, declining private capital flows, changing terms of trade and alternations to global and national monetary and fiscal regimes, the following concentrates on the implications of four transmission channels that present the most fraught economic choices to fragile states: (i) financial liberalisation; (ii) trade liberalisation, (iii) FDI; and (iv) exchange rate management. Other issues such as declining value of ODA, the impact on unemployment, fiscal management and privatisation are addressed within this framework.

Why are these four elements the most critical for consideration when embarking on economic reforms in fragile contexts? Together, they determine the philosophy, direction and management capacity of economic governance in its interaction with world markets. They create the main channels of domestic growth and underpin the dynamics of economic linkages with other countries. In essence, they are the main pillars on which liberal market structures are built and connected to the wider world. After a period of instability and change – in which economic constriction has been a factor – fragile states will need to make decisions about how and whether to liberalise financial systems, open the door to trade, encourage FDI and adjust exchange rates. From these primary decisions, others will then flow – including public sector institutional and functional restructuring, adjustments in social welfare and redistribution systems and other critical governance areas linked to equitable growth.

Figure 3.1 Global Factor Transmission Channels and Possible Effect on Fragile and Conflict States



All such choices are necessarily complex, not just because turbulent systems are hard to predict but because of the "chicken and egg" factor: successful reform processes depend upon the very institutional strength and political will that the reform itself is designed to create. In addition, because political, governance and economic reforms affect each other so closely, unpredictability is increased when they occur concurrently – as is often the case in fragile contexts.

3.2. Financial liberalisation

Financial liberalisation is a process of "freeing" finance flows – particularly via credit systems – from the tight regulatory controls that characterise socialist economies. Liberalised financial systems in developing countries are characterised by a move towards more independent banking systems. This independence extends to interest rate levels; reduce repression of lending and borrowing mechanisms; and greater capital flows, including external capital flows. The challenge of financial liberalisation has always been to ensure an adequate balance between market freedom and regulatory controls – to ensure that the former is effectively controlled but not constricted by the latter.

Which global financial liberalisation factors most affect fragile states?

Key financial liberalisation factors affecting state fragility include:[2]

- volatility exposure through fully integrating with international finance systems. Those African countries which have resisted the complete liberalisation of their banking systems appear to have been less affected by the GFC as a result (see Bakrania and Lucas, 2009);
- high dependency on lending through foreign banks, exacerbated by escalating costs of borrowing, with knock-on implications for economic and financial rates of return; and
- increased capital account legal regulatory controls, as a result of the current crisis.

Volatility

The GFC exposed how interconnected and interdependent the world has become, including between international banking and fragile states. In 2010 the OECD assessed the impact of the GFC on fragile states from the perspective of official development assistance, remittances, trade and FDI (OECD, 2010d). Key findings showed: (i) a widening gap between aid commitments and delivery; (ii) a 6% retraction in remittances in the last quarter of 2008, although countries had varying exposures;[3] (iii) both winners and losers in fragile states in terms of trade; and (iv) a fall in global net private capital flows for the first time since 2003.

Another assessment of the GFC and its impact on conflict and state fragility in sub-Saharan explores how global economic transmission channels affected a range of states that are differently exposed (Bakrania and Lucas, 2009). The report highlighted that emerging markets such as South Africa, Nigeria, Ghana and Kenya were first affected through their stock exchanges, but that the wider impact of the crisis included other, low-income countries through secondary channels:

> Sub-Saharan Africa was largely insulated from the initial stages of the financial crisis as the majority of the countries in the region are de-linked from the international financial markets. However, with the worsening of the global

> financial and economic crisis, the region as a whole has now been exposed to the downturn, and growth estimates have been continually lowered from 5% in 2008 to 1.7% in April 2009 (Bakrania and Lucas, 2009).

Within a region already struggling to meet the Millennium Development Goals (MDGs), and with food and fuel prices at near record highs, this "triple jeopardy" has already thrown millions of households into poverty and will hinder progress (World Bank, 2009).[4]

These impacts, plus falling world commodity prices and increased costs of borrowing, led the IMF *World Economic Outlook* to lower global and regional growth forecasts between 2008 and 2011 (IMF, 2012b). The impact of economic contraction on revenues, expenditures, employment and poverty are obvious (see Boyce and O'Donnel, 2007). The OECD report stated that "the financial crisis in developing countries is projected to put US$ 11.6 billion (or 1.1% of GDP) of core spending at risk, threatening cuts in education, health, operations and maintenance of critical public expenditure and social protection…. Fragile states are estimated to account for 58% of this total. This equates to US$ 6.7 billion, some 20% of 2008 aid flows (net of debt relief), and may have significant consequences for social indicators, poverty and wider security in the absence of additional assistance" (OECD, 2010d).

Lending dependency and borrowing costs

According to the African Development Bank (ADB), the GFC is making it harder for banks to secure external credit to operate in fragile states, and the costs of borrowing have also increased in Arab Spring countries, many of which need now to be classified as fragile (Egypt and Syria).[5] An ADB report on the global financial crisis and fragile states in Africa states that:

> Lines of credit have shrunk; the cost of credit is rising as risk premiums widen; and fund-raising for new initiatives is in jeopardy. The high degree of foreign ownership of banks in fragile states poses potential additional risks of capital withdrawals to finance dwindling portfolios in home countries, or meet capital adequacy requirements. Foreign ownership of total banking assets is close to 100% in Djibouti and Guinea. It is about 80% in the Gambia and Togo, over 60% in Côte d'Ivoire, and between 40% and 60% in Angola, the Republic of Congo and Zimbabwe (ADB, 2009).

To this list provided by ADB can be added Kenya, Nigeria and Uganda. As borrowing costs escalate, growth is constrained, creating disincentives to make long-term capital investments that are non-essential and do not generate immediate return.

Increased capital account regulation

In theory, capital account liberalisation should allow for more efficient global allocation of capital, from capital-rich industrial countries to capital-poor developing economies. This should have widespread benefits – by providing a higher rate of return on people's savings in industrial countries and by increasing growth, employment opportunities, and living standards in developing countries. However, as Ethiopia demonstrates, liberalisation (which has been heavily shaped by party politics and national security interests) does not always provide the quick solution to growth and prosperity that theory too often implies. Here the (painfully slow) pace and depth of liberalisation of financial markets have been carefully measured to maintain stability, and Ethiopia's commitment to strong micro-finance institutions shows an understanding of the needs and limits of the formal banking system in providing viable solutions for the largely rainfed farming-based economy.

IMF research into who benefits from capital account liberalisation found that over the past 30 years governments have progressively imposed fewer legal restrictions on capital account transactions, although no country has eliminated all capital controls (IMF, 2009). However, "several countries imposed new legal restrictions on capital account transactions or tightened existing ones" (Schindler, 2009), demonstrating that capital account restrictions remain an active policy instrument in shaping their economies' integration with world financial markets.

Poorly capitalised groups

Where domestic credit markets have been liberalised, but where no financial services authority has been established and the regulatory environment remains weak, liberalisation of the domestic banking sector in fragile states has often favoured government employees (for home construction loans), party employees and those with collateral who are able to obtain credit. I have observed this first hand in Ethiopia, Iraq and Afghanistan. Poor people, by default, rely heavily on informal markets or, where they exist, micro-finance institutions. Although these provide short-term credit for farmers, small businesses, consumption smoothing and other uses, they have often been less effective in really bringing people out of poverty, as evidenced by the wide array of such services in India and Bangladesh for example. However, even here, "the current drive to establish the central role of microfinance in development policy cannot be divorced from its supreme serviceability to the neoliberal/globalisation agenda" (Bateman and Chang, 2009). While microenterprises provide a key poverty alleviation service in fragile states, they are not the key to a stable and inclusive growth cycle with a balanced sectoral portfolio enabling consistent revenue redistribution.

Does it always make sense to insist on a liberalised financial system?

William Byrd, ex-World Bank country economist for Afghanistan, Pakistan and India, stated in personal communication with the author that, "there is often little justification for drastic financial deregulation in many fragile states, unless the financial sector is heavily depressed (*e.g.* due to interest rate controls, mandatory purchases of government bonds, *etc*.) in which case those forms of repression can be removed". Many country examples can be found to support this. In Afghanistan the liberalisation of financial markets, and the emergence of commercial banking following the introduction of liberal policies in 2003/04, contributed to the theft of USD 1 billion in capital from the Kabul Bank, largely due to weak checks and balances. As the story of the massive fraud emerged in 2010, amidst rumours that key political figures such as President Karzai's brother Mahmoud Karzai received USD 22 million in loans, the IMF cut its credit line to the country.

The failure of due diligence across the banking sector in Afghanistan shows how vulnerable liberal reforms can be to nepotism, corruption and state capture, with officials able to escape justice often with impunity. According to the *Washington Post*: "The top two officials of Kabul Bank used fake names, forged documents, fictitious companies and secret records as part of an elaborate ruse to funnel hundreds of millions of dollars to shareholders and top Afghan officials, according to newly obtained documents and interviews" (Partlow, 2011).

It seems logical, therefore, to stop pushing purely for financial liberalisation in fragile states and instead initially support the creation and consolidation of national banking systems. In many fragile contexts, informal money transfer systems such as the *Hawala*, *Hundi* and *Fei ch'ien* systems either rival (Bangladesh) or dominate (Somalia and Afghanistan) financial services provision – compensating for the instability of modern financial systems. While these informal systems are central to the transfer of remittances, they have been targeted by

the United Nations Office on Drugs and Crime (UNODC) since 2001 with the aim of minimising the risks of money laundering and other criminal activity.

Ghosh states that "there is a strong case for developing countries to ensure that their own financial systems are adequately regulated with respect to their own specific requirements" (Ghosh, 2005). In the light of the global financial crisis the risks of weak regulation in OECD countries must also be a reminder that establishing a rigorous, enforceable and transparent regulatory framework in fragile states presents a particular challenge.

3.3. Trade liberalisation

Trade liberalisation means removing obstacles to the exchange of goods between states. Such obstacles include customs duties, surcharges, licensing regulations, subsidies, quotas and embargos. A more open and dynamic trade context has many potential benefits for fragile and conflict-affected states, while challenging them to assure economic stability, safeguard domestic markets and enforce a minimum standard of trade controls.

Which global trade liberalisation factors most affect fragile states?

Much has already been written about the impact of trade liberalisation on fragile states; in this short paper I do not wish to duplicate extensive analysis provided by the OECD, World Bank, UNCTAD, IMF and others (*e.g.* World Bank, 2005). Here I summarise the main risks for fragile states from trade liberalisation before discussing them in more detail below:

- Inadequate or hurried deregulation, dismantling one system before another effective system can fill the gap;
- Export-dependent states at risk from high levels of global market volatility combined with poor fiscal stabilisation;
- Appreciation of fragile state currencies against other major currencies, reducing demand for exports;
- Import-dependent economies in the absence of major balancing exports such as oil or minerals, leading to substantial fiscal deficits and the temptation to generate revenue through anti-growth policies such as import taxation;
- Two-track regions such as the Middle East and North Africa, composed of winners (energy exporters gaining from buoyant oil prices) and losers (energy importers being crippled by higher energy prices), substantially increasing fragility;
- The development of informal economies as a hedge against volatility, relying on income from illegal exports, informal exports, international aid and illegal activities; and
- Tough environmental choices where growth appears to depend on allowing accelerated resource depletion and increased levels of pollution.

Inadequate deregulation

In many fragile states the word deregulation implies simply reducing the oversight of government over a given productive process to allow industry greater operating freedoms. When deregulation is required as part of WTO accession and privatisation, following ISO (International Organization for Standardization) and other regulatory standards, it takes many years to build the institutional capacities required to have independent oversight. When a government repeals statutes and regulations, new regulations and functional mandates are required to oversee services that are no longer provided by government. This

means recruiting and training staff and building regulatory enforcement capacities. In many cases, however, as occurred in Afghanistan and Somalia, enforcement standards and officers were not put in place until after deregulation. Without sufficient training and financial incentives, the risks of corruption/facilitation payments were high. These risks stemmed mainly from weak capacities to review company turnover (for tax purposes) by either independent auditors or state tax offices and inadequate imposition of fines for irregularities, opening up the door for corruption. In Afghanistan, for instance, customs authorities were unwilling to relocate thousands of customs enforcement officers to the border due to their limited oversight capacities and the potential for fraudulent activities. The situation is similar in Liberia and Sierra Leone.

There are several lessons from deregulation in fragile states:

1) Revenues generated from licences and concessions often lead to wage hikes and greater staffing, not more effective oversight.
2) In the absence of a strong market economy, monopolies are often created, driving up prices and creating private structures that are in many ways more powerful than government.
3) Where stock exchanges have been established (*e.g.* in Egypt, Cameroon, Nigeria, Kenya, Mozambique, Rwanda and Sudan for example), weak financial service authority structures and regulatory procedures heighten the risk of malpractice.
4) While over-regulation badly distorts markets, too little regulation often does the same – even in non-fragile contexts (witness the sub-prime disaster). Indeed, in many fragile states, despite years of deregulation efforts, the number of procedures required by private operators remains inhibitive. For example, in Sudan in 2011 there were 53 procedures required to enforce a contract. In Afghanistan after a decade of deregulation activities the state still ranked bottom in the number of documents required to export (requiring 12 documents).

Table 3.2 Fragile State WTO Membership Status

Countries	Member status
Kenya, Myanmar, Uganda, Cote d'Ivoire, Nigeria, Pakistan, Zimbabwe, Central African Republic, Guinea Bissau, Togo, Djibouti, Burundi, Sierra Leone, Guinea and Cameroon	1995
Haiti, Rwanda, Papua New Guinea, Solomon Islands, Chad, Gambia, Angola, Niger	1996
Democratic Republic of Congo and Republic of Congo	1997
Nepal	2004
Tonga	2007
Afghanistan, Comoros, Ethiopia, Liberia, Tajikistan, Republic of, Yemen, Iraq, São Tomé and, Principe, Sudan, Equatorial Guinea	Observer countries
Eritrea, North Korea, Somalia, Kiribati, Timor-Leste, West Bank and Gaza	Not members

Export or import dependency

Many fragile states are heavily dependent on a small number of primary export products – *e.g.* Iraq, Nigeria (oil); Angola (diamonds, gold, oil and copper); Sierra Leone (mining and diamonds); Liberia (rubber and timber); Ethiopia (coffee) and Somalia (livestock). Changes in the price of that commodity on world markets (for example as a result of falling demand due to global recession) have implications for other core economic governance factors,

including foreign currency holdings and fiscal reserves. These then affect expenditure programmes, trade balance and indeed the wages of workers and profits of business owners.

The recent downturn in global trade volume and value has left no economy untouched. The export-dependent fragile states have had their growth targets slashed in certain cases, and significantly lowered in others. Lower trade volumes affect growth, revenues and services. Under a free trade policy, prices are shaped by supply and demand, and therefore determine resource allocation between trading parties. While no country can be fully classified as complying with a truly "free" trade regime, because of behind-the-border issues (such as hidden import barriers), many fragile states have long been members of the WTO (Table 3.2), which demands the strict compliance of trade regime standards, customs harmonisation and standardisation, and regulatory standards and enforcement procedures.

Where fragile states are part of a regional free-trade grouping (Figure 3.2) such as the African Free Trade Zone (AFTZ – only established in 2008), monetary, fiscal, trade and capital account policies are dictated by the perceived benefits of that trading body and aim for the harmonisation of tariffs and customs automation. The aim of the AFTZ has been to ease access to markets by benefiting all member countries and to strive towards becoming a full economic union.[6] Within such trading blocks, the liberalisation of trading policies is heavily dictated, meaning there are perhaps fewer monetary and fiscal levers in certain country contexts.

In 2010 the African Development Bank assessed the impact of global economic stress on trade in fragile states. It stated that:

> The economies of many fragile states rely strongly on exports of primary commodities which account for well over 95% of total exports in most fragile states. Oil exporters like Angola, Chad, the Republic of Congo, and Sudan have been hard hit by the collapse of commodity prices from the global economic slowdown. The result has been the severe decline in foreign exchange earning, government revenues and households incomes. In Chad, and Equatorial Guinea, for instance, oil export revenues fell by 59% and 43%, respectively, between July 2007 and July 2008. In the Sudan, oil revenues are expected to be 43% lower in 2009 compared to 2008 (ADB, 2010).

This analysis stresses the volatility that fragile states can face as a result of global commodity price shifts. If the report had been written in 2012 – when oil prices were between USD 120-130 per barrel of Brent crude (March 2012), up from USD 40 a barrel in 2008 – that analysis would have showed the gains of being heavily dependent on such commodities. Therefore the main policy for these states is fiscal stabilisation. This requires setting up a fiscal stabilisation fund and other monetary policies to stabilise the currency, balance trade and smooth consumption. The ADB has launched a USD 1 billion Trade Finance Initiative (TFI) to counter the kind of export revenue shortfalls shown in Table 3.3.[7]

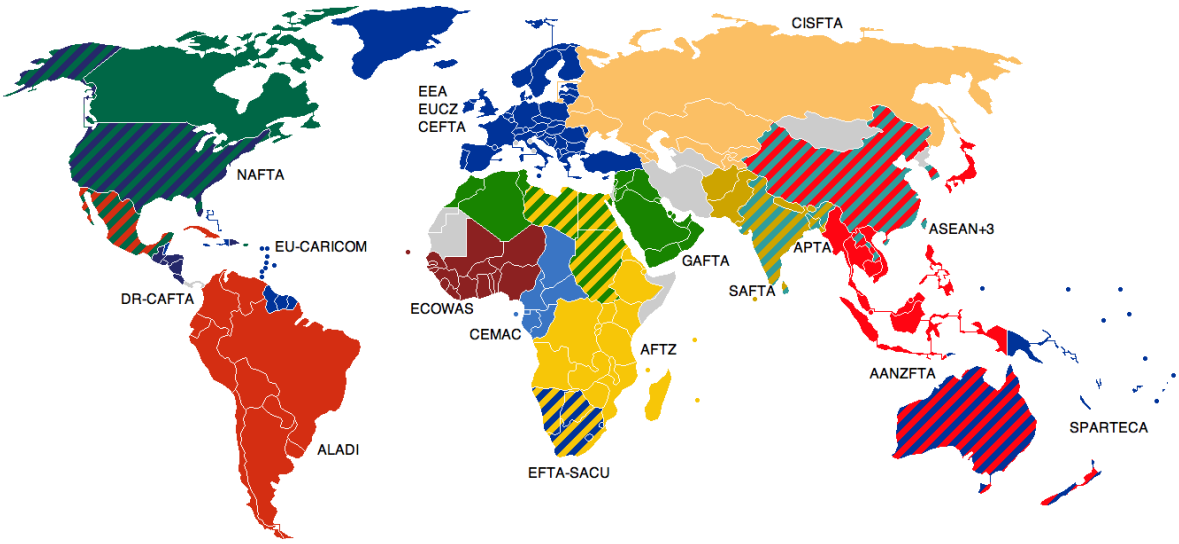
Table 3.3 Export Revenue Shortfalls in Selected Fragile States (Billion USD)

Country	2009	2010
Angola	38.2	45
Chad	2.5	2.1
Congo, Democratic Rep.	2.9	4.5
Congo, Republic	7.3	8.6
Côte d'Ivoire	3.6	3.8
Sudan	5.5	6.4

Source: ADB (African Development Bank) (2009), *The Global Financial Crisis and Fragile States in Africa*, ADB, Abidjan.

In addition, maintaining effective growth policies and stable (pro-export) exchange rates are not always mutually-compatible goals. As an IMF paper has noted, "as capital inflows increase, tension will likely develop between the authorities' desire, on the one hand, to contain inflation and, on the other, to maintain a stable (and competitive) exchange rate. As signs of overheating appear, and investors become increasingly aware of the tension between the two policy goals, a turnaround in market sentiment may occur, triggering a sudden reversal in capital flows" (Caramazza and Aziz, 1998).

Figure 3.2 Current Free Trade Areas



Source: *Wikipedia*, at *www.thefullwiki.org/Free_Trade_Agreement*

Import-dependent economies have been even harder pressed to match recent swings in food and other commodity prices. States without significant exports and without major industries, such as Kosovo, can be forced to generate government revenue from imports. An estimated 80% of Kosovo's administrative revenue stems from customs taxation (UNKT, 2010), perpetuating a significant trade imbalance and weakening incentives to invest in domestic production. Import-dominated economies struggle to create jobs, particularly where they are most needed – in the poorest sector of society. Regions where different countries demonstrate large trade imbalances in imports and exports are particularly fragile.

While there is general agreement that free trade creates both winners and losers, little recent work has been done on the potential of alternative approaches in fragile states. These might include so-called balanced trade, fair trade, protectionism and the application of the Tobin Tax (a tax on financial transactions named after Nobel Laureate James Tobin). Balanced trade, for example, suggests that a "country should import only as much as it exports so that trade and money flows are balanced" (Mckeever, 1996).

Hedging against system fluctuations

The uncertainties of trade liberalisation are themselves drivers of fragility. Where regulatory models, reliable enforcement systems and price swings act against formal economic activity, there are greater incentives to engage in informal or illicit activities because these provide some degree of economic shelter. Opiates in Afghanistan, livestock trade in Somalia, global piracy and other informal, illicit or illegal forms of trade are logical responses, from a certain perspective, to the dangerous waters of trade liberalisation policies. So is aid dependency, if it does not create the conditions for sustainable growth and protect against the slings and arrows of a free market global system. It is up to the government to pace trade policies in such a way that this hedging becomes less necessary and less profitable from economic and personal perspectives; otherwise it will always have a place in domestic and global economic models.

Tough environmental choices

Environmentalists give three primary reasons why liberal trade policies negatively affect the environment: (i) they lead to a "race to the bottom" in environmental standards a result of the drive for competitiveness; (ii) they conflict with morally-conscious environmental policies; and (iii) they encourage trade in products that create global pollution ("pollution havens") as firms seek to produce in poorly regulated governance environments where the costs of environmental sustainability are over-looked (Carbaugh, 2005). Fragile states can become havens for wealthier nations seeking to defer or compensate for their environmental compliance burdens. They are also understandably resentful that the polluting and depleting behaviour that allowed major global powers to emerge is now being tagged as immoral and unsustainable by those same powers, denying them similar opportunities for growth untrammelled by costly environmental considerations. On the other hand, trade liberalisation can actually promote environmental protection (through eco-tourism, for example). However, ensuring a positive balance between trade incentives and environmental concerns, hard to do even in non-fragile states, can become virtually impossible when fragility enters the picture and complicates monitoring and evaluation.

3.4. Foreign direct investment

FDI "is a type of investment that involves the injection of foreign funds into an enterprise that operates in a different country of origin from the investor".[8] FDI can be private-to-private, public-to-private or through public-to-public/private partnership. FDI can contribute significantly to growth, employment and revenues, as has been shown in Egypt. However, it requires a positive, well-regulated and stable investment climate, which is often lacking in emerging or frontier markets.[9] Insecurity can lead to significant capital flight and reduction in private capital flows, loss of jobs and much needed foreign currency. In fragile states such as Liberia or Sierra Leone, where foreign investment in key sectors can form a large share of GDP, risks of corrupt external influences can be substantial.

Which global FDI factors most affect fragile states?

FDI remains an economic lifeline for low-income capital recipients, many of which can be categorised as fragile. From a cursory review of levels of FDI in fragile states and ease of doing business rankings (see below), it appears that the main drivers of FDI are economic opportunity rather than the costs of doing business. However, the interplay of FDI drivers in fragile economies generates as many potential costs as benefits. The influence of FDI on fragility and conflict include:

- Encouraging a rush towards privatisation, trade liberalisation and financial deregulation to encourage FDI. The drive to attract FDI can spur quick advances in liberalised economic policies, sometimes too quick for state capacities to manage. Often these are the very states most exposed to the market fluctuations driving up prices, lowering remittance values and decreasing overseas development assistance ODA.
- Extending free market exploitation of economic opportunity into fragile contexts, tempered but not eliminated by the higher cost of doing business.
- The application of risk management policies determined in wealthier markets, leaving fragile markets more vulnerable to the impact of global fiscal austerity and food and fuel crises.

Rushing to privatise

Following the contraction of the Soviet system after 1989, privatisation has proceeded at a variable pace, including in many fragile states (*e.g.* Ethiopia, Kenya, Rwanda, Zimbabwe), with often widely different results. Clearly, privatisation makes most sense when the market is reasonably mature and competition can be effective. In fragile states these conditions are seldom met. Although removing state-owned enterprises from the state's payroll increases fiscal space for other investments while generating revenues, the costs and benefits of privatisation are often based on skewed cost factors that appear to favour privatisation, and in many cases the gains of privatisation can be negative due to market failures related to externalities, and can accrue to elite interest groups where state regulatory controls and checks and balances are weak.

This is because fragile states provide generally unpromising ground for privatisation given their weak governments, poor regulatory oversight environments, lack of competition, weak rule of law and risks of corruption and nepotism. Monopolies can easily emerge, undermining the benefits of market-based transactions. The absence of a clearly established set of privatisation impact assessment measures, including assessment of social costs and benefits, means we lack understanding of success rates for countries and economic sub-sectors. Further, political capture of procurement processes through corruption, cronyism or nepotism is a logical risk that can lead to mal-procurement, opaque processes, poor delivery and excessive profit taking. However, in countries such as Afghanistan, where telecommunication services have been privatised, ineffective land-line systems have been replaced by cheap national mobile services that connect even the most remote rural villages while generating significant revenues for government.

There are major social consequences of privatisation in fragile contexts, particularly when private enterprise ends up in the hands of foreign stakeholders. For the poorest consumers, privatisation can very easily drive prices up and quality down, aggravating inequities unless there is enough competition to mitigate risks. But local producers can suffer if external private enterprise, able to bring economies of scale from international business to a fragile context, can out-price and out-deliver the local competition. Privatisation in the absence of an enforceable business climate and labour regulations is a primary cause of labour injustices and can aggravate patterns of exclusion across gender, class, religious and ethnic divides. Privatisation is therefore a risky business if not well managed.

Exploiting economic opportunity

Economists tend to favour the free flow of capital across national borders because it allows capital (and its investors) to seek out the highest rate of return. Research by the IMF shows that "One striking feature of FDI flows is that their share in total inflows is higher in riskier countries, with risk measured either by countries' credit ratings for sovereign (government) debt or by other indicators of country risk" (Loungani and Razin, 2001). During the GFC, levels of FDI into fragile states – many of which, such as Lebanon, could be classified as "frontier markets" – show wide variation.[10] While average global FDI flows were equivalent to only 20% of gross fixed capital formation at the start of the decade, they reached 28% in 2008 before starting to decline again (UNCTAD, 2011). In countries where oil and minerals are being extracted through FDI (*e.g.* Liberia and Iraq), increasing levels of FDI can contribute to huge resource booms. Where countries lack the value chain infrastructure for supplying their minerals to world markets, and where political instability and security concerns exist (*e.g.* Afghanistan), FDI investment remains low. Furthermore, as noted by OECD INCAF, there is a need to harness the potential contribution of FDI and other flows such as remittances in the fragile context, whilst recognising that a reduction in both during times of global volatility affects domestic revenues with knock-on implications for basic and essential services.

The OECD's INCAF states that:

> In fragile states, we need to go beyond aid and harness the full range of resource flows to take advantage of their potential contributions to development results. Domestic revenues, FDI and remittances dominate the resource equation, even in fragile states that are highly aid-dependent. While FDI and remittances have continued to grow throughout the crisis, in both fuel-exporting and other fragile states, there has been a dramatic contraction of domestic revenues, threatening cuts in education, health and social protection programmes. Trade has also dropped, with 40 fragile states facing a trade gap (OECD (2011) notes on "Data from Ensuring Fragile States are Not Left Behind", OECD, Paris).[11]

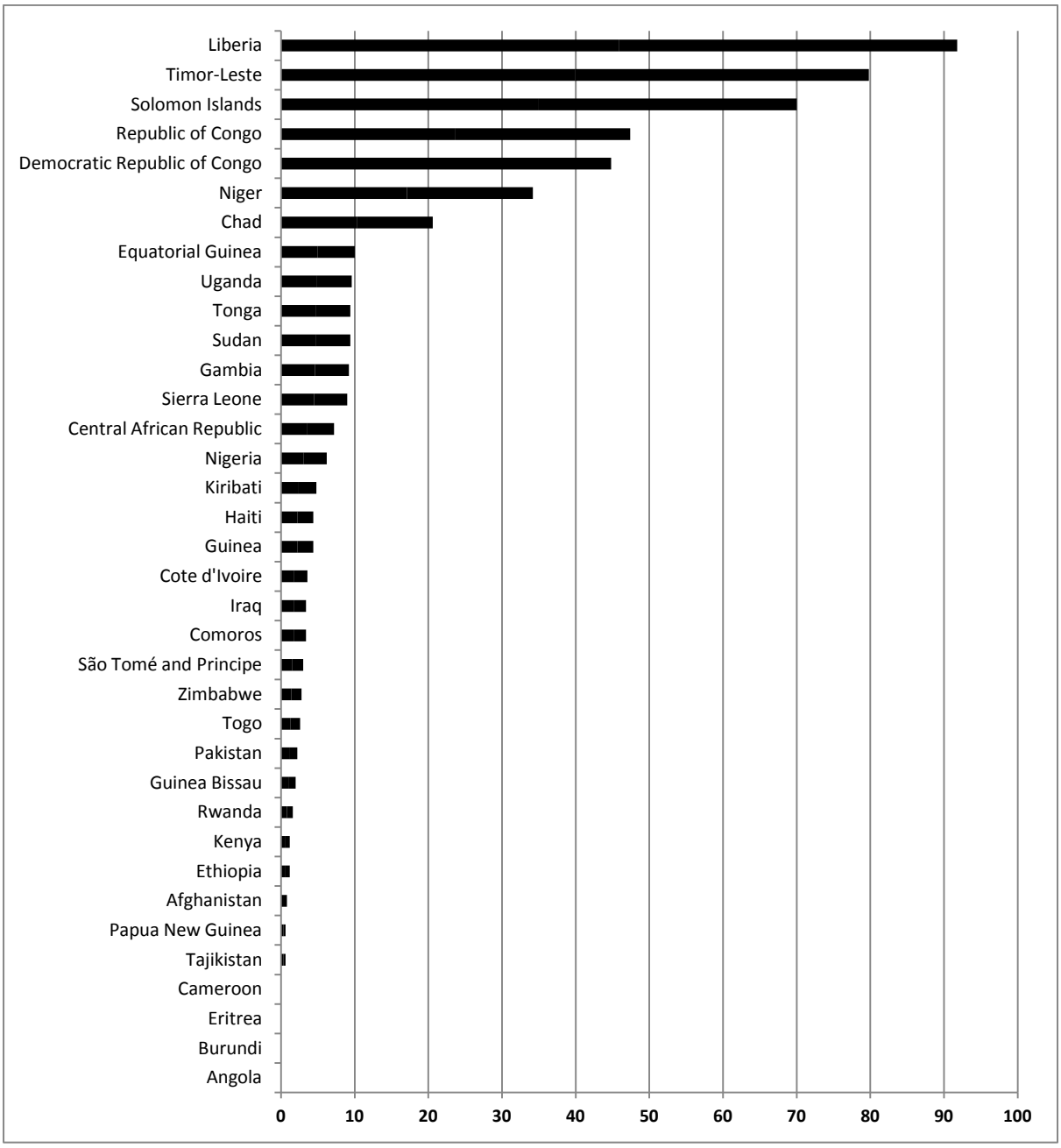
FDI has critical implications for the least developed countries (LDCs) that are also fragile. For them, achieving a 7% economic growth target depends increasingly on FDI as a key driver of enabling environment reforms and as a formal, taxable source of income and growth. Levels of FDI are increasingly as important as official development assistance in LDCs (Figure 3.3). An UNCTAD report on foreign direct investment states that FDI is important because, "In the past decade (2001-2010) FDI inflows have been the most important external private capital flows for LDCs, exceeding foreign portfolio and other investments combined. While they still remain below the level of total official development assistance (ODA) flows, they have been larger than bilateral ODA (that is, ODA excluding ODA from multilateral organizations) from 2006. In the period 1990-2009, in 13 LDCs FDI increased while bilateral ODA decreased" (UNCTAD, 2011). FDI inflows to LDCs were valued at USD 24 billion in 2010, providing a major contribution to fixed capital formation rates. However chasing FDI to the exclusion of other balancing fiscal policies is dangerous. Revenue redistribution strategies, environmental protection and fair labour and welfare models depend on a balanced portfolio of domestic production, responsible FDI and sound fiscal/monetary policy.

This is true in the context of declining FDI, which is even affecting middle-income countries. In the Arab world, falling FDI is affecting growth and revenues.[12] Egypt saw FDI fall from USD 6.4 billion in 2010 to just USD 500 million in 2011, leading to the loss of tens of thousands of jobs. In 2009 the ADB showed that "some fragile states with high levels of foreign direct investment are already feeling the pinch. These include the Gambia and Guinea Bissau where net foreign direct investment was 16% and 14% of GDP respectively

in 2006. However, this channel is weak in other fragile states with relatively low levels of foreign direct investment (e.g. 0% of GDP in Burundi in 2006)".

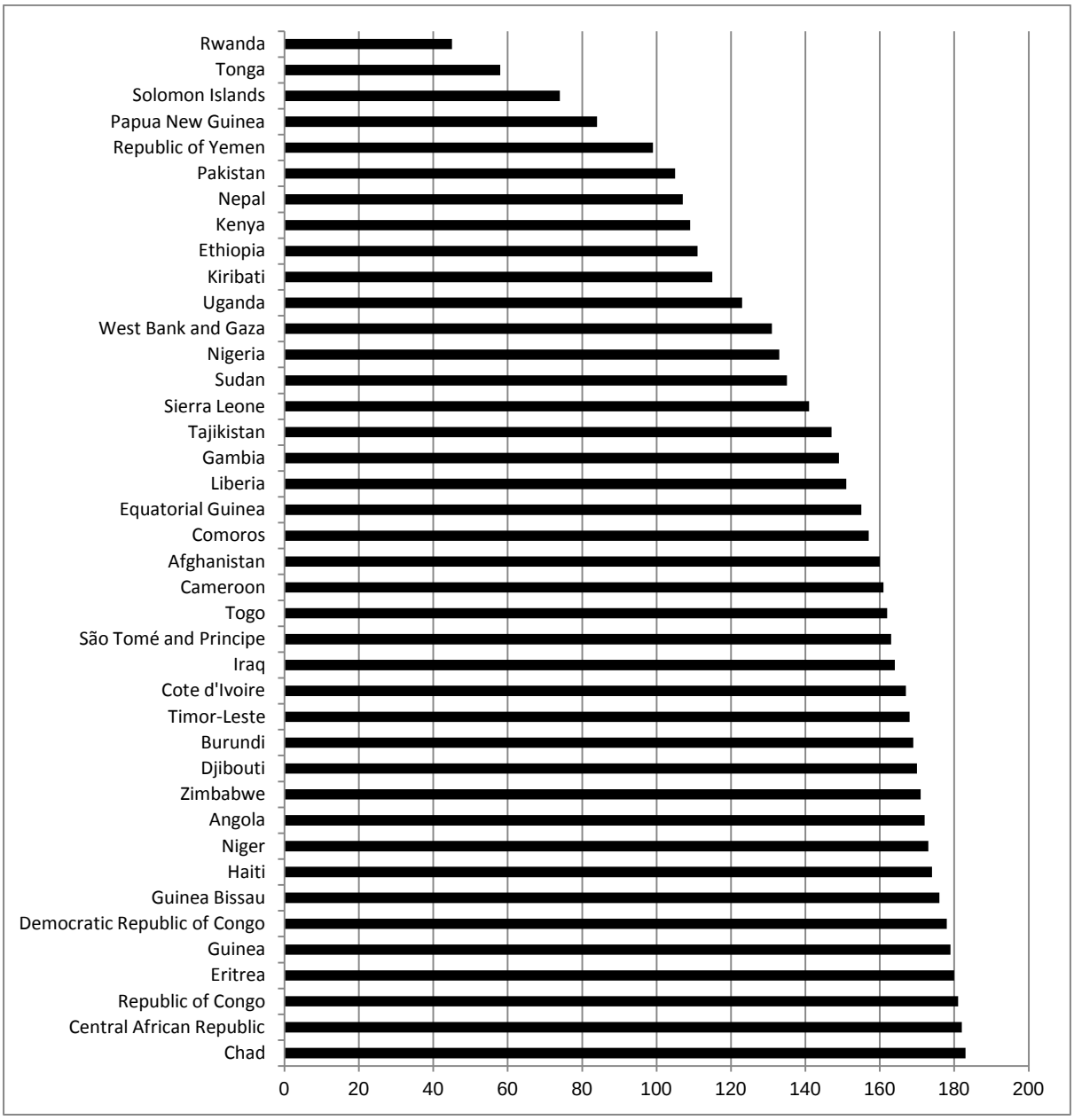
Figure 3.3 shows the startling contraction in FDI for both the Gambia and Guinea Bissau, when compared to 2006 figures provided by the ADB above. But what it really shows is that most fragile states are not hugely dependent on FDI (Liberia, Timor Leste and Congo and Niger being notable exceptions). The World Bank and International Finance Corporation (IFC) Doing Business Rankings order countries by the ease of doing business (measured against numerous business-related variables such as regulations and costs). Comparing Figure 3.3 with the ease-of-doing-business ranking in Figure 3.4 suggests that the costs of doing business do not seem closely correlated to levels of FDI given that countries such as Liberia and Timor Leste, which depend heavily on FDI, rank poorly in these rankings. Other factors – such as economic opportunity, rates of return on a given investment, start-up costs, the size of the economy, diplomatic relations and stability – would therefore appear to be more important drivers of FDI than the ease of doing business *per se*.

Figure 3.3 FDI as a Percentage of GDP in Fragile States 2010



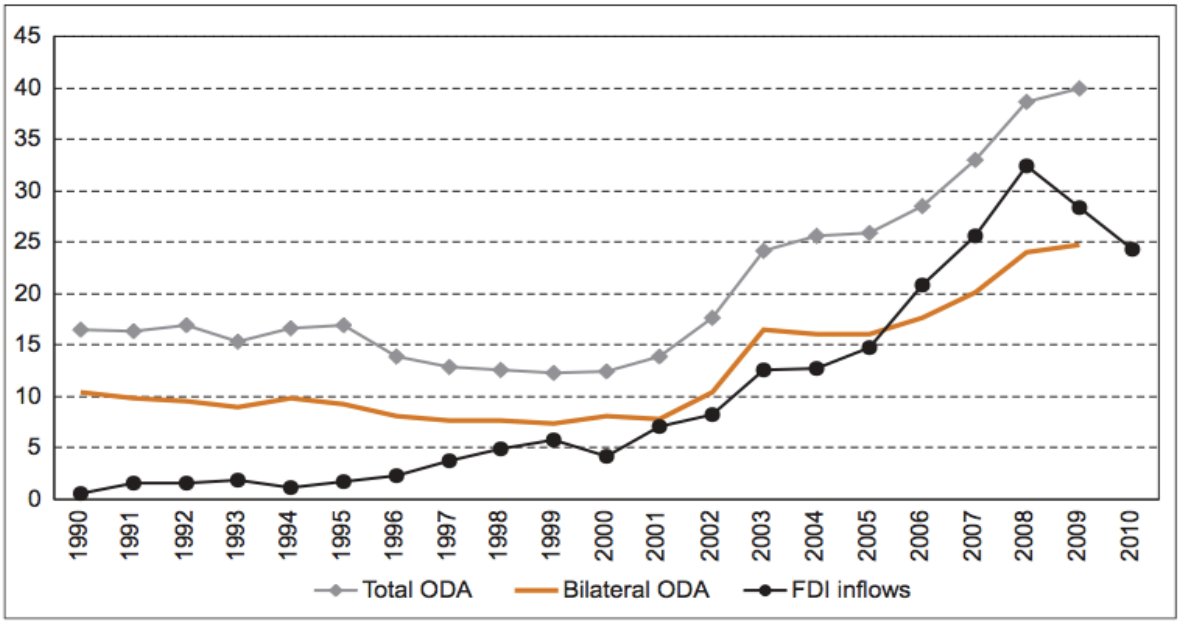
Source: Based on World Bank (2010), *World Development Indicators (WDI) 2010*, World Bank, Washington, DC.

Figure 3.4 Ease of Doing Business in Fragile States, 2010[13]



Source: World Bank (2010), *World Development Indicators (WDI) 2010*, World Bank, Washington, DC.

Figure 3.5 FDI Inflows and ODA Flows to LDCs, 1990-2010 (USD Billions)



Source: UNCTAD, FDI/TNC Database *(www.unctad.org/fdistatistics*)

Applying inappropriate FDI risk management

When FDI contracts (as shown in Figure 3.5 above for the years following 2008), ODA becomes much more essential to economic wellbeing in fragile contexts. The higher the degree of fragility and the more uncertain economic outcomes seem, the greater the degree of risk investors must bear. Risk management algorithms designed for global markets, therefore, determine FDI flows into fragile states. A weaker global economic climate is more risk-averse and less likely to take on the challenges of the most fragile contexts unless they offer enormous gains for the taking. The relations between these factors have been explored by the OECD in *The Impact of the Financial Crisis on Fragile States and the Response* (OECD, 2010e). It explores how declining ODA receipts are affecting the fiscal balance of fragile contexts. These declining receipts are a result of a number of factors: (i) euro and US dollar exchange rate movements lowering aid value; (ii) constricted national aid budgets; and (iii) realigned foreign policy objectives. Other OECD research on *Making Sure that Fragile States are Not Left Behind* states that, "The indirect effect of exchange rates movements against the dollar could further depress current values of aid by as much as US$ 8 billion (US$ 2.2 billion for fragile states, assuming constant proportions), although technical co-operation and humanitarian assistance – less sensitive to currency movements – will be less affected" (OECD, 2010a). With the sovereign debt crisis likely to hurt Europe for some time to come, and with the EUR to USD rate falling from 1.48 in May 2011 to 1.27 in January 2012, the costs to fragile states receiving European aid are likely to have increased further.

Concurrently, weakened Europe and US economies are lowering the value of remittances being sent to fragile states by emigrants, while falling global commodity prices are affecting export volume and pricing and costs of food and fuel continue to rise. Borrowing costs and debt servicing in the context of stringent IMF fiscal policy are also contracting public spending, stretching the capacity of fragile states to ensure employment growth, meet welfare requirements, continue subsidies and generally ensure a minimum social contract. A cocktail of falling FDI and contracting ODA is likely to edge vulnerable states towards fragility, and push fragile states towards conflict.

3.5. Exchange rate management

Finding the right balance between a currency value that empowers trade while protecting people – particularly in contexts where basic goods and services are being imported or where GDP depends largely on exports – is a critical challenge facing fragile states. Exchange rate management refers to setting the relative value of domestic currencies, notably against major global currencies such as the US dollar and euro. Managing the national currency exchange value has a major knock-on effect on the ability of countries to capitalise on financial liberalisation, trade liberalisation and FDI. It affects public as well as private balance sheets, influencing the spending reach of government in global markets, the capacity of domestic firms to engage in trade and the ability of national citizens to make essential purchases overseas. Exchange rate rigidity is equally problematic, as the recent Eurozone crisis has highlighted.

Which global exchange rate factors affect fragile states?

Clearly international exchange rate fluctuations affect fragile state economies in numerous ways. The impact depends on:

- the exchange rate regime: for example, pegging a country's exchange rate to a major currency can result in real exchange rate depreciation, with inflationary and debt service burden consequences;
- export and import dependencies of products: currency appreciation against major world economies results in lower exports, with implications for foreign exchange earnings and undermining the balance of payments position; and
- the degree of dependence on remittances.

The impact of exchange rate fluctuations on trade and aid has already been outlined.[14] While the fragile states under research here have adopted different exchange rate regimes (see Annex 1), with regular regime switching as a result of global and regional trade and financial market factors, the conventional wisdom is that fragile states would benefit most from flexible exchange rates. This is because fixed exchange rates can easily lead to balance of payments problems and speculation against the currency. Annex 3 analyses fragile state exchange rates against the US dollar between 2000 and 2011. This reveals a currency appreciation of 1,568% for Angola over the reporting period, 399% for Guinea, a depreciation of 40% for the Comoros and no change for Syria, whose currency is pegged to the USD.

In 2010, Charalambos Tsangarides explored how emerging market economies fared in the recent global financial crisis, particularly in terms of output losses and growth resilience. The paper grouped variables as proxies of trade and financial transmission channels of shocks in the global economy. The proxy trade channel was established through (i) trade-weighted growth rates of partner countries; and (ii) the growth in commodity terms of trade. The proxy financial channel was established through (i) comparing short-term external debt to GDP; (ii) comparing the current account deficit to GDP; and (iii) net portfolio investment. The paper finds that:

> After controlling for regime switches during the crisis, using alternative definitions for pegs (such as crawling or conventional pegs), and taking account of other likely determinants, we find that the growth performance for pegs was not different from that of floats during the crisis. For the recovery period 2010–11, pegs appear to be faring worse, with growth recovering more slowly than

> floats. In addition to the rebound effect from the crisis, trading partner growth is the only contributor to recovery, as adjustment tools like fiscal policy may have not had enough time to take effect. Taken together, these results suggest an asymmetric effect of the exchange rate regime on growth performance during the crisis compared to the recovery from the crisis, and a symmetric effect of the trade channel (Tsangarides, 2010).

In short, there are times when it works to be pegged, and times when it works to float. The Central African Republic, Chad, Comoros, Côte d'Ivoire, Guinea-Bissau, Republic of Congo, and Togo (all of which had currencies pegged to the euro in 2008), were negatively affected by the depreciation of the euro against the dollar, which induced real exchange rate depreciation. Moreover, exchange rate depreciation has inflationary consequences, as import prices are mainly dollar-denominated and the debt service burden can increase in domestic currency terms, raising the prospect of additional fiscal difficulties.

The most extreme example of exchange rate (and economic) mismanagement comes from Zimbabwe. Inflation went from 7.5% in 1980 to 500 billion % in 2008, after which the government abandoned the currency (Makochekanwa and Kwaramba, 2009). By 2011, government action brought inflation back to below 4%, largely due to gains made by the power-sharing government. Growth is forecast at 8-9% in 2012 (Reserve Bank of Zimbabwe, 2012).

A growth agenda for Latin America in the 1980s (often referred to as the "lost decade", as many countries' foreign debt exceeded their earning capacity) "advocated competitive exchange rates to provide an incentive for export growth, import liberalisation, the generation of adequate domestic savings to finance investment (primarily by tightening fiscal policy) and cutting back the bloated role of government to allow it to concentrate on the provision of core public services and a framework for economic activity" (Balassa *et al*., 1986, cited in Williamson, 2002). It is clear from this statement how critical getting the right exchange rate is, given the wider implications for the economy. Countries like Brazil, with intermediate exchange rate regimes (somewhere between fixed pegs and free floats) appear to have weathered the financial storm better than others (Kaltenbrunner and Nissanke, 2009).

Summary

Of all the global variables affecting fragile states (positively and negatively), the liberalisation of financial markets, trade and aid policy appear to have the most determinant impact on either building, or creating fragility. The greater the level of dependency on these external factors, the bigger the potential risk of exposure. Fragile states heavily dependent on exporting one or two primary commodities to a limited number of market destinations are most likely to be highly affected.

In essence, the neo-liberal ideology assumes that market forces are best placed to meet supply and demand needs, while the state needs to focus on creating an appropriate climate for growth through removing binding constraints. So-called "enabling environment" reforms are central to the process of liberalisation. They require the state to enable growth and the private sector to drive it; not *vice versa*.

However, the above analysis of how global factors can drive economic choices in key liberalised policy areas suggests a different approach is necessary. Markets cannot automatically provide the kind of "hothouse" protection that fragile states require, economically or socially. The transmission of global economic trends and fluctuations into fragile contexts has the capacity to either stifle growth or misdirect it – creating uneven and

often resentful societies. And yet, without global integration, the capacity for growth itself is extremely limited.

In the fragile state context, it might be more appropriate to focus on creating an enabling environment for stability and inclusivity as part of a modified liberalisation process. This would necessarily lead to the adoption of a different set of policy measures than currently proposed as part of the classic “liberalisation” package. The potential for a more nuanced approach – an expanded version of the post-Washington consensus – is discussed in the following sections.

NOTES

[1] As highlighted by reports on the cost of the Arab Spring (Geopolicity, 2011a) and design of the Arab Stabilization Plan White Paper (Geopolicity, 2012).

[2] It is important to note the predominance of a large number of poorly capitalised groups who are unlikely to benefit from the potential gains of financial liberalisation in largely informal economies.

[3] The ADB states that "remittances are an important source of financing for consumption and investment in fragile states. In 2007, remittances as a share of GDP were as high as 10% in Sierra Leone, 8% in Guinea-Bissau, and 7% in the Gambia. Remittances by Africans living in Europe and North America – where the bulk of remittances to Africa originate – are projected to decline, with adverse implications for poverty reduction in fragile states" (ADB, 2009).

[4] This data presented above has been further expanded and was confirmed by both Naude (2009) and Devarajan (2009).

[5] The MENA region has also been hit by the impact of the Arab Spring which, again, has spawned winners (UAE, Saudi Arabia, Qatar and Kuwait - oil exporters) and losers (Egypt, Syria, Libya, Tunisia, Bahrain).

[6] Members include Angola, Botswana, Burundi, Comoros, Djibouti, Democratic Republic of Congo, Egypt, Eritrea, Ethiopia, Kenya, Lesotho, Libya, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Seychelles, Swaziland, South Africa, Sudan, Tanzania, Uganda, Zambia, and Zimbabwe.

[7] See www.afdb.org/en/news-and-events/article/asian-development-bank-and-african-development-bank-to-cooperate-to-set-up-trade-finance-program-for-africa-8209/

[8] See *www.economywatch.com/foreign-direct-investment/definition.html*

[9] Frontier markets generally describe the smallest, less developed, less liquid countries that make up emerging markets.

[10] See *http://en.wikipedia.org/wiki/Frontier_markets*

[11] See *www.oecd.org/dac/conflictandfragility/datafromensuringfragilestatesarenotleftbehind201138.htm*

[12] The OECD report on the *Impact of the Global Financial Crisis on Fragile States and their Response* states that "investment in African fragile states has grown by almost 44% since 2007, whereas FDI to non-African fragile states, which have shown markedly slower growth since the beginning of the decade, has declined by 8.6%" (OECD, 2010e).

[13] For the World Bank's Ease of Doing Business' rankings, economies are ranked on their ease of doing business from 1 to 185. A high ranking on the index means the regulatory environment is more conducive to the starting and operation of a local firm. This index averages the country's percentile rankings for 10 topics, made up of a variety of indicators, giving equal weight to each topic.

[14] In the 1990s the official doctrine of the Washington-based finance institutions was the so-called "corner solution" idea. This states that developing countries either absolutely fix [i.e. PEG] their exchange rate against an international anchor currency or allow them to float freely. However, after the Asian and global financial crises the international community has favoured the return to floating rates.

4. What has the policy response been to date?

There is little doubt that since the events of September 11, 2001 there has been increased global attention to the plight and wider impact of fragile states on the global economy, and more recently, of the impact of the global economy on fragile states. This work has been led by OECD (INCAF), the World Bank, the IMF and regional international finance institutions and a number of institutes and academics. However, given the extreme range of variables at play and their complex interaction, the task of developing an empirically-sound approach to assessing the impact of economic liberalisation on fragility remains challenging at best.

There has been a degree of policy evolution at the global level to guide fragility support strategies. As early as 1999, the G8 acknowledged that globalisation could have a less than desirable effect on the citizens of fragile states, and that traditional ODA models might require rethinking. ODA policies have increasingly reflected awareness of inequality within states, and have shifted to the use of metrics that assess poverty incidence by income quintiles, and even social and gender-based exclusion. A clear indication of this is the *Paris Declaration on Aid Effectiveness* (OECD, 2005), which aimed to moderate unhelpful ideological proscriptions by donors and put developing country governments in the front seat. The use of these metrics reflects a greater willingness to make wealth creation solutions (the ultimate neo-liberal agenda) subsidiary to the broader goal of human wellbeing across social spectra. Such an approach, if backed by global lenders (including the World Bank and IMF), would enable fragile states to take a more contextually-modulated and inclusive approach to economic reform.

While these developments show promise, they have been hampered by a lack of institutional support. The capacities of the World Bank and IMF Analytical and Advisory Assistance (AAA) are determined by the size of country programmes and, as a result, many fragile states have been under-served by these institutions.

Political and internal economic pressures driving many processes need to be modulated to avoid rapid, project-driven approaches to growth. For example, as the cost of borrowing from external sources can be exorbitant, fragile states have traditionally relied on concessional loans from the World Bank or fiscal stabilisation support from the IMF, such as the Poverty Reduction Growth Facility, to meet critical revenue needs. These loans must be repaid at a minimum rate of return; thus by default they encourage the removal of the binding constraints to growth, with policy, legislative and institutional reforms being pursued through national reform programmes. Under such circumstances, liberalisation reforms have therefore essentially been implemented through individual projects, scattered across government, and they have focused on identifying the benefits of such reform measures, while making the assumption that potential costs can be mitigated. The problem is that mitigation cannot be done by project. Often, it cannot even be done by the government itself, which in many cases lacks the core capacities to manage risks.

Furthermore, even though the 2011 *World Development Report* focused on conflict and fragility (World Bank, 2011), there are no central global institutions specialising in understanding the impact of economic liberalisation on fragility. As a result, the policy response is sporadic. There are few cross-national comparative research initiatives that provide information to governments, even though it is they who legally manage macro-economic, monetary, fiscal, financial and trade-based policy arenas, not the aid community.

Academic advances in the economic development arena have spectacularly failed to be translated into action at the national implementation level. Social development and economic strategies are general developed separately, without reference to each other and often led

by entirely different actors with contrasting agendas and ideologies. This is the case even though it is clear that:

- economic liberalisation can present grave socio-economic risks to fragile contexts, that can themselves become a driver of fragility if poorly-managed;
- social and economic concerns cannot be divorced from one another; and
- new thinking is needed to modulate the application of wealth creation strategies in the context of weak institutions and fractured societies.

Routine reporting simply does not exist as an open source on issues such as state revenue-to-GDP ratios, changing composition of trade as a result of global factors, the impact of "behind the border" issues on denied market opportunities and other key issues relevant to financial and trade liberalisation and their socio-economic impact. Small wonder that the leaders of fragile states struggle to balance the positives and negatives of economic reform, and often rush to implement policies without truly understanding their potential impact on those without the power to make such choices.

It should be embarrassing to the aid community that much of the detailed work on economic factors in fragile states has been pioneered around "emerging" and "frontier market" investments; frontier markets being a sub-set of emerging market classification. While both of these terms relate to markets directly and to capital liquidity within market systems, rather than to government, analysis provided under these banners reflects a desire for higher rates of return on investments than available within high-income countries. Standard & Poor's launched the first investible index for frontier equity markets in 2007. It includes the following countries, many of which are classified as fragile:

> Constituents for the S&P/IFCG Extended Frontier 150 are drawn from countries including Bahrain, Bangladesh, Botswana, Bulgaria, Cambodia, Colombia, Côte D'Ivoire, Croatia, Ecuador, Estonia, Georgia, Ghana, Jordan, Kazakhstan, Kenya, Kuwait, Lebanon, Lithuania, Nigeria, Oman, Pakistan, Panama, Qatar, Romania, Slovenia, Sri Lanka, Tunisia, Ukraine, United Arab Emirates (UAE), Vietnam and Zimbabwe (Standard & Poor's, 2011).

Standard & Poor's believes that these markets have adequate listings and turnover, and have attracted sufficient foreign investor interest to warrant the infrastructure necessary to sustain regular index calculations. So, to some extent the corporate world currently collects more information on many fragile state markets, including on investment returns and political and security risk, than public sector bodies. Clearly, there is a private-sector consensus that such emerging and frontier markets are profitable for business and investment, and this consensus has been around for some time. However, public sector consensus on fragile states has been slower to emerge - except for the broad agreement that fragile states are an important global policy priority.

The emerging question – challenging to ask as well as to answer – is not just whether the process of liberalisation is inherently good or bad, but rather *why* the process has favoured certain regions such as Asia, and not Africa; and *whether* global factors (including multinational companies) actually benefit from the maintenance of fragile states and conflict. This has arguably occurred in Somalia through illegal international fishing and dumping of toxic waste. In 1998, the UN Special Envoy for Somalia, Ahmedou Ould Abdallah, stated that "because there is no (effective) government, there is so much irregular fishing from European and Asian countries" (AFP, 2008). He continued by stating that "the phenomenon helps fuel the endless civil war in Somalia as the illegal fishermen are paying corrupt Somali ministers or warlords for protection or to secure fake licenses. I am convinced there is dumping of solid waste, chemicals and probably nuclear (waste).... There is no government control." In this case, it is not liberalisation *per se* that fuels conflict, but rather the absence of

an effective government; an absence which international private businesses can easily exploit. In other words, organised criminal networks can exploit fragile state governments with impunity, due to weak institutional capacities, undermining effective rule of law and regulatory compliance (see also Miraglia *et al.,* 2012 in this series).

The much-heralded Paris Declaration was undermined by the determination of donors to continue to drive their own foreign policy objectives (as opposed to achieving the MDGs) through aid channels. The 2008 Accra Agenda for Action (OECD, 2008) sought to overcome the same criticism and the 2011 New Deal for fragile state engagement (IDPS, 2011) is yet to be tested. However, it opens – indeed, demands – promising entry points to fill these gaps. All five of its peacebuilding and statebuilding goals (legitimate politics, security, justice, economic institutions, and revenues and services) are affected by economic policy decisions. The entry points for filling these gaps are the subject of the next section.

5. The entry points for international action

As we have seen in the previous section, policy responses to date have failed not because of lack of goodwill, but because of the lack of agreement about the right "basket" of liberal order policies, a lack of metrics to measure risk and shock exposure, and a lack of systematic approaches to fragile contexts. Solutions to such complex conundrums are not easy, and it would be facile to suggest a simple formula. However, there are several interesting entry points for a more constructive and nuanced approach. In this section I examine these possible entry points for moving forward in these three key areas.

5.1. Getting the metrics right: economic liberalisation indicators for fragile states

Understanding the economic policy variables influencing fragility and their complex interaction requires (i) an agreed definition of economic liberalisation; and (ii) a global impetus for identifying, collecting and reporting economic liberalisation indicators for fragile states that can influence national policy and institutional dialogue, and assess the impact of global liberalisation in a more timely and transparent way.[1] Based on the classification developed in Section 3 and impact analysis presented in Section 4, there would appear to be compelling arguments for identifying, collecting and reporting a defined group of economic liberalisation indicators for fragile states to influence national policy and institutional dialogue. This could involve the following steps:

- *Create a central global institution* charged with the collection of "new" sets of fragile state data to support the New Deal and provide a baseline for monitoring change and progress, and impacts (positive and negative) of implementation. Current reporting by the IMF, World Bank, OECD CRS, UN Statistics, UNCTAD, regional development banks and other institutions is often *ad hoc* and not always relevant to fragile states. In all these institutions, external assistance and FDI must focus (within the framework of the New Deal) on how they can contribute to inclusive economic growth through revenue mobilisation, strong linkages to the rule of law, social expenditures and broad-based employment gains.

- *Gather faster and more responsive data:* There are many unanswered questions that forestall a smarter and more appropriately-paced approach to fragile dynamics. They are unanswered because adequate data have not yet been gathered. This is not because such data do not exist, but because international actors have yet to decide what datasets are most important and how to gather them. For example, we have no way to track whether and when fragile states that are less integrated into the global economy are more or less vulnerable to global shocks than non-fragile states. This will require a more responsive set of vulnerability criteria – not merely income-based – to group states more effectively for models of economic support (Box 5.1) and for developing a set of "early warning" indicators for shock exposure (discussed below). These might help governments manage their policy prescriptions and uptake patterns. There are real opportunities here, particularly if development institutions and the private sector are able to collaborate more closely. Data from fragile state financial markets are available on a daily basis. There is considerable literature on fragile states, and increasing time series data available on many aspects of fragility. The most up-to-date data come from frontier market operations and the World Bank Global Economic Monitor and World Integrated Trade Solutions (WITS), for example. All other data – as used by the World Development Report and OECD INCAF - tend to be more macro and are often reported two to three years later. The impact of the 2011 sovereign debt crisis on fragile states may not be reported until 2013 or 2014.

This can lead to false policy prescriptions, given that policies do not reflect current realities and take years to translate into implementation.

Box 5.1 How data can help tailor support to specific conditions

Fragile states with significant natural resources to export (Angola, Sierra Leone, Liberia, Iraq etc.) can gain considerable revenues through concessions, but the national currency will likely appreciate, making exports more expensive while cheapening imports. For these states, exports are critical drivers of growth and fragility, and macro-economic stability is best achieved through prudent fiscal and monetary policy operations focused on stabilisation. However, fragile states with limited export potential (*e.g.* Afghanistan and Somalia) are often forced to rely heavily on illegal economic activities, the changing value of remittances, aid and limited FDI, making such states the most vulnerable and arguably in the most need of risk mitigation measures.

It is therefore recommended that rather than grouping fragile states by low, medium and high income groups, instead they are better grouped around a different set of vulnerability measures such as export, aid or FDI dependence, risks of exchange rate fluctuations, geo-strategic positions (*e.g.* land locked), etc. A set of criteria could easily be defined (not just based on state income) and rankings developed.

- *Take evidence-based approaches to monetary and fiscal policy, growth diagnostic and investment climate assessments*: A critical part of getting liberalisation right is underpinning reforms with economic and market-based evidence. Understanding growth diagnostics (drivers of growth); investment climates (binding constraints to entrepreneurial activity); labour market, trade value and volume; and value chain development is critical to making sure that public investments match reality, minimise the risk of social exclusion and provide adequate safety nets. Many fragile state governments lack fiscal or monetary policy units, and the core human capacities to provide routine analysis and monitoring around which corrective economic policy measures can be identified and agreed. The IMF and World Bank can support their development, but with associated dependency risks once programmatic loans are being negotiated due to fiscal space constraints.

- *Create capacity to undertake independent economic risk assessments:* Poorly-designed national economic liberalisation "investments" can leave countries exposed to various global factors, as a result of elite capture processes, weak economic governance and regulatory oversight and enforcement capacities. Within the fragile state context, it is therefore desirable to create the capacity to conduct independent economic risks assessments to provide a truly independent view on the costs and benefits of policy adoption. Within the context of the New Deal for Engagement in Fragile States, such a review would support policies aimed at laying an economic foundation for a viable state with linkages to revenue mobilisation and support for service expansion.

- *Create a "global systems approach" to model global risks for early warning:* A combination of national and global indicators accommodating financial, social and political information (structural as well as dynamic indicators) could be used to model input and output changes (conditional and causal factors) to the economy as a result of different scenarios, identify risks, and point to the best policy response to mitigate these risks. Such an approach would increase understanding of the interaction of different variables in specific contexts, and would pave the way for a new approach to understanding fragility. This "global systems approach" could alert policy makers to potential risks and provide much needed early warning of state crisis. Lessons

could also be drawn from the US Government's Political Instability Task Force (PITF), formerly known as the State Failure Task Force.[2] A matrix of early warning indicators (including peacebuilding capacity indicators) could be established in discussion with the OECD, the World Bank, IMF and other global institutions.

5.2. Agreeing the right "basket" of liberal order policies

Even though fragile states generally conform to a fairly normative set of problems (weak political cohesion, weak revenue base undermining services etc.), the idiosyncratic nature of each context must be better understood to carefully calibrate policy reforms to a particular country's needs. Agreeing the right basket of liberal order policies with the state, based on evidence and within a risk-awareness framework, has never been more vital. The New Deal provides options for such an approach to be piloted, perhaps leading to new adaptive and innovative approaches. Options include:

- *Implement innovative approaches for stabilisation and crisis-proofing strategies in fragile export and import-dominated states:* There have already been notable instances of donors introducing new ways to support stable economic transition in countries where GDP depends on exports. In Ethiopia, the European Union has a Stabilization of Export (STABEX) earnings initiative to protect Ethiopia from volatile international coffee markets. All African Caribbean and Pacific (ACP) states benefit from this as part of the Lomé Convention. Research suggests that this model could be critical for protecting against the consequences of trade imbalances (Aiello, 1999). There is no reason why such an approach could not support import-dependent countries too.

- *Use creative public-private collaboration in fragile contexts:* Engagement of private actors in public goods is at an all-time high, bringing private sector innovation and leverage to areas traditionally the province of states. Private engagement in stabilisation is not limited to foundations (such as the Gates' Ashoka Foundation), but increasingly involves corporations interacting directly with fragile states on agendas encompassing far more than profit alone. Given the significance and delicate balance of aid and FDI for fragile states, it is essential for private institutions – such as the World Economic Forum's Global Agenda Council and its other research bodies – as well as financial market research institutions, to co-operate with states and indeed with global development institutions. Key areas of potential collaboration include data and analytical modelling to predict the impact of global factors on priority states – including technological innovations to collect local, real-time data at a micro and macro level, coherent policy and advocacy approaches to fragile states and the strengthening of global institutional responses to fragility in the long term. Specific elements of how such institutions could collaborate are set out in the conclusion and recommendations below.

- *Integrate economic and development planning towards equity and stability outcomes:* It is not useful to acknowledge the relevance of Gini coefficients and human development indicators at the global level if economic policy and development strategies (where they exist) remain separate within fragile states and driven by different agendas. Liberalisation is – or should be – a strategy to promote the widest possible human wellbeing in fragile contexts and remove the worst forms of socio-economic imbalances that perpetuate fragility. Where economic and social policies are divorced, and economic liberalisation results in elite capture of assets, instability follows. The Arab uprisings, triggered by many factors, including increasing youth unemployment (pockets up to 60% in Egypt and Tunisia), demonstrate how quickly new fragile states can emerge. Lessons from recent examples might cast a different light on the drivers of fragility in certain political economy contexts, countering or re-

enforcing widely-held beliefs about civil war, for example. The formal process of liberalisation tends to benefit those connected to the formal economy (elite and capital-rich groups), not those dependent on informal markets and non-state systems. Where this is the case, the risks of increasing inequality are considerable and can lead to renewed conflict, particularly when the centrifugal and centripetal forces of state building are diametrically opposed (*e.g.* Afghanistan, Iraq, Liberia). In such contexts, donors need to place far greater emphasis on strengthening socio-economic factors such as employment, representation, essential services and internal cohesion rather than on pushing fragile state economies too quickly towards the turbulence of global markets.

- *Stagger fragile financial and trade liberalisation strategies to keep pace with institutional strengthening,* focusing on consolidating national systems (*e.g.,* banking, enforcement etc.). The GFC has provided many examples of how fragile states that had resisted wholesale financial liberalisation reforms were better able to ride the storm. Prudence, therefore, must not just apply to monetary and fiscal policy, but equally to the pace and depth of all market liberalisation measures. This might include not just pushing purely for financial liberalisation in fragile states, but instead (and initially) supporting the creation and consolidation of national banking systems. Many fragile states already have limited government due to fiscal constraints, not design. These states often lack the minimum set of institutional capacities necessary to readily promote or monitor transition towards a full market economy. While the CPIA provides a significant contribution to our understanding of core state capacities,[3] there is often a disconnect between the promotion of national liberal policies and state capacities. Afghanistan provides the perfect example. Over a course of 10 years new enabling legislation has been passed to foster a market economy, but state capacities to regulate and shape economic activity and incentives remain virtually non-existent. In such situations, and where the state fails to provide legal purview over its periphery, constitutional rule of law, due legal process, liberty and free market ideals will not be achieved.

- *Build public accountability and transparency:* Strengthening a weak institutional framework means establishing autonomous and independent commissions, ombudsmen, authorities and watchdogs alongside an informed media and parliament, so that wider society is provided fair access to information to build public trust, encourage compliance and maintain a level playing field in wealth creation and its re-distribution.

- *Create consensus:* When pushing through complex legislative reforms, all of which need to be agreed to by parliament, internal political groupings must be able to build and consolidate national consensus around the national economic vision. In the absence of political consensus and political stability, reforms can be hijacked and political parties can divert the rule of law and legal jurisprudence in the interests of party (not market) objectives. The first essential pre-condition for successful liberalisation reforms is for the political leadership to own and share its vision through meaningful public-private dialogue. Moreover, for political leaders to get buy-in across society requires a clear understanding of the comparative advantages of the economy, and quantifiable evidence of the advantages and disadvantages of greater market integration; given the reality of upside benefits and downside risks.

- *Focus on implementation/absorption capacity for major functional restructuring and human resource reforms:* In many cases, the biggest failure of government is underestimating the challenges of transforming often moribund government structures into modern institutions capable of setting regulatory standards, having oversight and building strong enforcement capabilities, whilst also contracting out.

National investment commissions, civil service commissions, one-stop-shops, financial services authorities and independent agencies may need to be established, necessitating major changes to the way government does business. Adequate market-based mechanisms can take years to establish. Liberalising the capital account and embracing a commercial banking sector is, therefore, very much the "thin end" of a much larger governance wedge. National standards must also be realigned to either regional or international standards. Governments also need to be able to change the composition of spending through the budget process to implement policy, adjust institutional capacities and to re-tool, re-skill and modernise human resources. Linking administrative and civil service reforms around such an approach is critical if form, function and finance linkages are to be established – requiring significant fiscal space.

5.3. A systematic international approach to fragile contexts

The key areas of focus for systematic international support are to:

- *Review the composition of aid in fragile states:* A useful debate is emerging on the type of aid that is most appropriate for fragile environments. International donors are seeking to balance their basket of support between concessional loans, conditionality, and earmarked and non-earmarked grants so as to reduce debt burdens and create the greatest possible growth stimulus. This has the potential, if driven by the right type of evidence (see point above), to enhance fragile state resilience rather than inadvertently increase risk exposure. It is critical that the institutional process to rethink aid composition and the quantitative process to model fragile dynamics work hand in hand; they are mutually-reinforcing processes that can yield much for both donor countries and fragile states seeking to identify their own optimal growth and stabilisation trajectory. This is particularly true in a rapidly-constricting aid environment, where every dollar counts more than ever.

- *Consider the value of trust fund arrangements:* The last 10 years have added greatly to global experience with multi-donor funding mechanisms in fragile settings – their complexities, potential and drawbacks. Examples include those in South Sudan, Afghanistan, Zimbabwe, Khyber Pakhtunkhwa, Federally Administered Tribal Areas and Balochistan. The Paris Declaration itself presumes in many ways that trust fund arrangements are an ideal resource for fragile settings, fostering a clear set of mutual accountabilities and obliging international donors and recipient states to unite around defined goals. However, there are also salutary lessons to be taken on board, particularly in the slow and onerous management of trust funds, the reduced impact on donor preferences and visibility, and the lack of buy-in at country level. Addressing these challenges may be extremely useful to better defragment donor support should a new global fund be considered for economic resilience in fragile settings.[4]

- A fund-type arrangement could potentially offset high levels of aid volatility, minimise national transaction costs and define outcomes around a clear set of indicators. However, a "fragility" trust fund should not be attempted without the critical data and modelling work to obtain a better picture of what investments should aim to achieve. However, this is a powerful engagement model open to the international community, with many best practices and hard lessons now available (for example see the recent systematic review of the track record of multi-donor trust funds in improving aid effectiveness; Barakat *et al*., 2011) to guide its construction and management. It might be possible, for example, to explore a dual model involving: (i) an international Economic Stabilisation Support fund linked to "early warning indicators", aimed

purely at correcting and mitigating global destabilising effects of economic liberalisation in individual fragile states; and (ii) individual trust fund arrangements for priority states allowing a paced and resourced economic liberalisation programme that concurrently builds the capacity of the state to model its own dynamics and adjust for global market factors.

- *View liberalisation within a long-term statebuilding context*: Liberalisation involves a great deal of heavy lifting. Where ideological commitment by fragile states is weak or conditional, the outcome of liberalisation risks being uneven (as in Iraq, Ethiopia, Kenya, Cameroon *etc*.). Commitment must also be long-term and patience will be needed. Building the core policy, regulatory and institutional foundations of a market economy is likely to take 20-30 years or more to complete. Therefore, liberalisation must be integrated into a broader statebuilding agenda. Many fragile states, unable to meet their citizens' basic needs, must focus on minimising the risks of economic transition within the context of a managed and mitigated process, particularly with regard to social exclusion. Moreover, as fragile states can also be characterised as post-conflict (Rwanda, Sierra Leone), those without a peace agreement (Iraq and Afghanistan), those suffering a crisis in political transition (Syria, Lebanon), those exhibiting a deteriorating governance environment (Syria) and those showing signs of greater resilience (Somalia), the pace and sequence of market based reforms must be tailored to context.

NOTES

[1] For example, INCAF's latest *Ensuring Fragile States Are Not Left Behind* factsheet (OECD, 2011b) is based on data from 2009, despite the fact we are in 2012. This will potentially lead to antiquated policy prescriptions given the onset of sovereign debt crisis which has likely decimated official development assistance in 2011.

[2] See *http://globalpolicy.gmu.edu/political-instability-task-force-home/*

[3] The World Bank's Country Policy and Institutional Assessment (CPIA) rates the quality of a country's policies and institutional arrangements against a set of criteria grouped in four clusters: (1) economic management; (2) structural policies; (3) policies for social inclusion and equity; and (4) public sector management and institutions.

[4] According to the OECD INCAF, "there are too many donors in a handful of fragile states, and there are too few in others. Despite limited capacity, 14 fragile states have partnerships with 30 donors or more, half of which are considered non-significant*. By contrast, four fragile states are each dependent on only one donor for at least 50% of their aid. These are Iraq (89%), Solomon Islands (81%), Papua New Guinea (68%) and Afghanistan (53%). Whilst donor concentration should generally be encouraged, changes in donor priorities could have a significant impact on countries dependent on exceptionally few donors". (*A donor is "non-significant" when the donor does not contribute a higher share of the recipient's CPA than its global share of CPA, and/or is not among the top 90% of aid in the recipient country; OECD, 2011b).

6. Conclusion and further research

No country – liberal or otherwise – is immune to the volatility of global financial and commodity markets. Given that the global economy is largely founded on a liberal economic order, the question for fragile states is no longer whether to embrace liberalism or not, but rather what kind and pacing of a hybrid model best serves their particular socio-economic interests. Once this has been decided, the next step is to identify the core capacities required to maximise potential benefits while minimising risks, before carefully sequencing liberal reforms in line with policy, institutional and fiscal capacities.

Fragile states cannot bear the test of liberalisation if it comes too hard and too fast. Their institutions and social contract are simply too fragile, and the threat that comes from imbalance and inequity is real and damaging, often costing lives. On the other hand, carefully calibrated liberalisation reforms, sequenced in line with the development of greater institution and market regulatory capacities can work in favour of greater resilience, assuming the state has commodities to trade and fiscal stabilisation arrangements during periods of volatility.

Based on the classification and analysis presented in this paper, a number of tentative recommendations have emerged, alongside a number of global and national avenues to be explored for research and response.

This research has tried to demonstrate that all states are liberal hybrids, of one degree or another, and all have different economic growth futures, different binding constraints, different geo-strategic positions (land-locked, coastal, island), different colonial histories and widely different market-based infrastructures. As a result, the interaction of each state within the wider global economy needs to be carefully studied, with a more careful analysis of benefits and risks. The extent to which liberalisation should be pursued depends on such an analysis - which is rarely done. Moreover, with liberal order policies more likely to lead to bust and boom cycles, the focus of investment efforts should be on fragility analysis at the national not international level, where national input-output models can be developed and sets of measures established to meet the need for long-term stable growth. Development assistance and policy advice to fragile states needs to put much more emphasis on the promotion of internal economic integration. Current strategies, which place more attention on promoting liberal economic models aimed at integrating poor economies with global markets, need rethinking.

It is important not to become too alarmist about the negatives of economic liberalism in fragile contexts. This economic model has only come to prominence within the last three decades. The drivers of fragility and conflict most definitely precede the liberal economic order and are, therefore, a structural component of all economic systems. Many of the changes wrought by liberalisation may have been inevitable; merely catalysed more rapidly, and perhaps even beneficial in the long-term. Nevertheless, according to the *2011 World Development Report*, “no low-income fragile or conflict-affected state has yet to achieve a single Millennium Development Goal, and…90% of the last decade’s civil wars occurred in countries that had experienced a civil war in the last 30 years” (World Bank, 2011). It is certainly time for a New Deal for these states and there is no reason why the New Deal cannot result in an entirely new fragile consensus, relegating the entire Washington debate to history. However, without answering these questions it is likely to do no better than its predecessors. In addition to strengthening economic engagement, leaders of the New Deal will also need to resolve a core problem with the ‘Old Deal’: lack of country-leadership and

true country ownership. And that will require the seemingly impossible – a united front and similar ideological approach between international actors engaging in fragile and transitioning contexts. This last, the holy grail of international peace, security and development efforts, may yet prove to be the ultimate challenge; however, if met, it will yield powerful and lasting results (IDPS, 2011).

6.1. A way forward for the New Deal

The need for a fragile consensus is clear and urgent. Key global actors are agreed on the "what" of such a consensus, and this thinking is reflected in the New Deal. This paper is perhaps a key step in outlining the "how" of such a consensus. Remodelling data, metrics and engagement models for a more systematic approach to fragility within global liberalisation seems like a mammoth task. However, it can be completed with leadership, and a patient and cogent approach to the different global and national aspects suggested above.

The range of literature documenting the impact on global factors has recently mounted up, but there have been no systematic country studies which the New Deal could use to develop the ingredients of state resilience. I therefore suggest that a first step would be to develop three case studies on fragile states and liberalisation, looking back over the past decade to tell the liberalisation story from a political economy perspective. The studies could be conducted with national research institutions, include consultation with political leadership groups, and describe the winners and losers of reform. These case studies could be co-ordinated with the New Deal's country-based fragility assessment framework which is already being piloted in countries such as Afghanistan and Sierra Leone. The "fragility spectrum" being used for this analysis would do well to reflect and address the issues identified in this paper.[1] Logical case studies emerging from this study might include Angola, Sierra Leone, Guinea Bissau and perhaps the Comoros, given their varied openness as economies to various global factors. Outcomes could be put to a Global & Fragile Systems Contact Group harnessing the major players in markets, as well as economic and human development. Such a group would be asked to create the metrics and models necessary to finally answer the questions posed by our turbulent new world.

NOTES

[1] The fragility spectrum is a diagnostic tool to assist fragile and conflict affected states to identify the nature of their own fragility and plan a pathway of transition towards stability and development.

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Annex 1 Statistical Annex

Fragile State/Selected Economic Statistics										
Countries/economies	GDP (Billion USD)	Revenue (GDP %)	Populatio n (Million)	Exchange Rate policy	FDI % of GDP	Gini Coefficient (latest)	HDI Ranking	WTO Membership	Doing Business Ranking	CPI Ranking
Low Income Countries										
Afghanistan	19.138	24.704	32.017	Managed floating with no pre-determined path for the exchange rate	0.4	27.8	172	Observer	160	180
Burundi	1.908	39.021	8.605	Managed floating with no pre-determined path for the exchange rate	0	n/a	185	23-Jul-95	169	172
Central African Republic	2.482	16.982	4.862	Other conventional fixed peg arrangement	3.6	56.3	179	31-May-95	182	154
Chad	9.723	27.533	10.74	Other conventional fixed peg arrangement	10.3	n/a	183	19-Oct-96	183	168
Democratic Republic of Congo	16.491	28.375	74.749	Independently floating	22.4	n/a	187	1-Jan-97	178	168
Comoros	0.641	20.716	0.694	Other conventional fixed peg arrangement	1.7	n/a	163	Observer	157	143
Eritrea	3.061	17.229	5.659	Other conventional fixed peg arrangement	0	n/a	177	No	180	134
Ethiopia	36.883	17.14	88.918	Crawling peg	0.6	n/a	174	Observer	111	120
Gambia	1.141	18.13	1.852	Managed floating with no pre-determined path for the exchange rate	4.6	n/a	168	23-Oct-96	149	77
Guinea	4.976	19.433	10.854	Managed floating with no pre-determined path for the exchange rate	2.2	39.4	178	25-Oct-95	179	164
Guinea Bissau	1.05	19.754	1.72	Other conventional fixed peg arrangement	1	n/a	176	31-May-95	176	154
Haiti	8.325	28.012	10.163	Managed floating with no pre-determined path for the exchange rate	2.2	n/a	158	30-Jan-96	174	175

Fragile State/Selected Economic Statistics										
Countries/economies	GDP (Billion USD)	Revenue (GDP %)	Populatio n (Million)	Exchange Rate policy	FDI % of GDP	Gini Coefficient (latest)	HDI Ranking	WTO Membership	Doing Business Ranking	CPI Ranking
Kenya	40.638	27.971	42.104	Managed floating with no pre-determined path for the exchange rate	0.6	n/a	143	1-Jan-95	109	154
North Korea*	28	11.4	2.458	n/a	n/a	n/a	n/a	No	n/a	182
Liberia	1.353	27.91	4.613	Managed floating with no pre-determined path for the exchange rate	45.9	38.2	182	Observer	151	91
Myanmar	52.195	7.182	63.672	Managed floating with no pre-determined path for the exchange rate	n/a	n/a	149	1-Jan-95	n/a	180
Nepal	20.37	18.75	28.737	Other conventional fixed peg arrangement	n/a	32.8	157	23-Apr-04	107	154
Niger	7.408	21.991	15.553	Other conventional fixed peg arrangement	17.1	34.6		13-Dec-96	173	134
Rwanda	6.476	22.577	10.422	Other conventional fixed peg arrangement	0.8	50.8	166	22-May-96	45	49
Somalia**	2.372	n/a	10.085	Independently floating	n/a	n/a	n/a	No	n/a	182
Sierra Leone	3.422	16.443	6.156	Other conventional fixed peg arrangement	4.5	n/a	180	23-Jul-95	141	134
Tajikistan	7.486	22.496	8.014	Other conventional fixed peg arrangement	0.3	30.8		Observer	147	152
Togo	3.907	22.7	7.319	Other conventional fixed peg arrangement	1.3	n/a	162	31-May-95	162	143
Uganda	16.959	16.74	36.468	Managed floating with no pre-determined path for the exchange rate	4.8	44.3	161	1-Jan-95	123	143
Republic of Yemen	39.275	24.018	25.884	Other conventional fixed peg arrangement	n/a	n/a	154	Observer	99	164
Zimbabwe	10.042	28.856	12.575	Other conventional fixed peg arrangement	1.4	n/a	173	5-Mar-95	171	154
Middle Income Countries										

Fragile State/Selected Economic Statistics										
Countries/economies	GDP (Billion USD)	Revenue (GDP %)	Populatio n (Million)	Exchange Rate policy	FDI % of GDP	Gini Coefficient (latest)	HDI Ranking	WTO Membership	Doing Business Ranking	CPI Ranking
Angola	108.96	43.431	20.213	Other conventional fixed peg arrangement	-3.8	n/a	148	23-Nov-96	172	168
Cameroon	27.618	18.517	21.458	Other conventional fixed peg arrangement	0	38.9	150	13-Dec-95	161	134
Republic of Congo	15.87	44.665	4.092	Other conventional fixed peg arrangement	23.7	n/a	137	27-Mar-97	181	154
Cote d'Ivoire	26.659	18.892	23.368	Other conventional fixed peg arrangement	1.8	41.5	170	1-Jan-95	167	154
Djibouti	1.357	35.361	0.866	Currency board arrangement	n/a	n/a	165	31-May-95	170	100
Iraq	118.661	73.001	33.635	Crawling peg	1.7	30.9	132	Observer	164	175
Kiribati	0.207	79.85	0.107	Exchange arrangement with no separate legal tender	2.4	n/a	122	No	115	95
Nigeria	263.225	28.46	164.752	Managed floating with no pre-determined path for the exchange rate	3.1	48.8	156	1-Jan-95	133	143
São Tomé and Principe	0.249	39.076	0.172	Managed floating with no pre-determined path for the exchange rate	1.5	n/a	144	Observer	163	100
Solomon Islands	0.867	53.947	0.553	Other conventional fixed peg arrangement	35	n/a	142	26-Jul-96	74	120
Sudan	59.286	12.374	33.51	Managed floating with no pre-determined path for the exchange rate	4.7	35.3		Observer	135	177
Timor-Leste	0.807	310.889	1.119	Exchange arrangement with no separate legal tender	39.9	31.9		No	168	143
Tonga	0.39	20.829	0.104	Pegged exchange rate within horizontal bands	4.7	n/a	90	27-Jul-07	58	95
Pakistan	233.76	12.62	178.912	Managed floating with no pre-determined path for the exchange rate	1.1	30	145	1-Jan-95	105	134

Fragile State/Selected Economic Statistics										
Countries/economies	GDP (Billion USD)	Revenue (GDP %)	Populatio n (Million)	Exchange Rate policy	FDI % of GDP	Gini Coefficient (latest)	HDI Ranking	WTO Membership	Doing Business Ranking	CPI Ranking
Papua New Guinea	12.329	31.395	6.826	Managed floating with no pre-determined path for the exchange rate	0.3	n/a	153	9-Jun-96	84	154
West Bank and Gaza***	6.641	32.4	4.332	n/a	n/a	35.5		No	131	n/a
High Income Countries										
Equatorial Guinea	20.271	27.912	1.39	Other conventional fixed peg arrangement	5	n/a	136	Observer	155	172
Data Sources										
	International Monetary Fund, World Economic Outlook Database, September 2011			IMF (2008) De Facto Classification of Exchange Rate Regimes and Monetary Policy Frameworks	World Developm ent Indicators (2010)	World Development Indicators - Gini Indicators (2007-2011)	*HDI (2011)*	*WTO Website*	*WB Ease of Doing Business (2012)*	*Transparenc y International CPI (2011)*
	* The Government of North Korea does not publish official data, the numbers are CIA estimates: GDP (2009), Revenue (2007)									
	** CIA estimates: GDP (2010), Population (2012)									
	*** CIA estimates: GDP (2011), Revenue (2011), Population (2012)									

Annex 2: sample evolution in world commodity prices

Evolution in Sample World Commodity Prices							
Years	Aluminium, $/Mt, nominal$	Coffee, Arabica, cents/kg, nominal US$	Copper, US$/Mt, nominal US$	Crude oil, Brent, US$/bbl, nominal US$	Metals and minerals, 2005=100, nominal US$	Natural gas, Europe, US$/ mmbtu, real 2005$	Wheat, Canada, US$/Mt, nominal$
1980	1774.913	346.6283	2182.092	37.89167	68.13397	5.537004	190.825
1981	1262.73	286.855	1741.95	36.67583	55.20472	6.028712	196.37
1982	991.5667	308.7558	1480.442	33.41833	48.32203	6.011164	166.495
1983	1438.433	291.1258	1591.925	29.82917	54.54398	5.619865	169.4642
1984	1251.325	318.8658	1377.317	28.80167	49.17091	5.334862	165.365
1985	1040.725	323.0792	1417.383	27.32917	46.1279	5.233363	173.2733
1986	1149.935	429.2583	1373.782	14.77083	44.97638	4.550092	160.6442
1987	1565.361	250.4983	1782.503	18.34167	55.97375	2.946318	133.52
1988	2550.456	303.3708	2601.672	14.97083	84.48057	2.521044	179.5125
1989	1951.257	238.7308	2848.41	18.21667	81.08742	2.246077	201.22
1990	1639.445	197.22	2661.483	23.68333	72.80474	2.916327	156.1817
1991	1302.188	187.3392	2338.783	20.06667	63.1886	3.230181	142.9458
1992	1254.283	141.1917	2281.157	19.3125	61.2764	2.620263	176.9992
1993	1139.049	156.02	1913.077	17.02083	52.37975	2.710791	192.6583
1994	1476.783	330.7642	2307.418	15.83	61.50916	2.476582	198.5583
1995	1805.658	333.2325	2935.606	17.06583	74.74484	2.531187	207.1392
1996	1505.661	269.4208	2294.857	20.65	64.13984	2.72385	230.815
1997	1599.33	416.7942	2276.767	19.09021	65.43188	2.79718	181.3758
1998	1357.469	298.1317	1654.058	12.71654	53.4519	2.595167	162.915
1999	1361.09	229.0583	1572.861	17.80833	52.48693	2.339901	151.2633
2000	1549.141	191.9667	1813.469	28.27292	59.50015	4.318985	147.1325
2001	1443.634	137.3117	1578.288	24.42157	53.50351	4.782982	151.4483
2002	1349.915	135.6608	1559.478	24.96948	51.75393	3.619684	175.7708
2003	1431.294	141.5385	1779.145	28.85139	58.01729	4.3316	177.4366
2004	1715.541	177.3984	2865.885	38.30068	79.74476	4.404057	186.5105

2005	1898.308	253.2171	3678.876	54.43413	100	6.326667	197.5666
2006	2569.899	252.2104	6722.135	65.39138	154.2465	8.291747	216.8139
2007	2638.179	272.3698	7118.226	72.69617	185.9203	7.880118	300.3672
2008	2572.789	308.1599	6955.88	97.63648	180.2647	11.45368	454.5853
2009	1664.83	317.1143	5149.739	61.86221	120.3152	7.967892	300.5232
2010	2173.117	432.01	7534.78	79.63563	179.6256	7.338942	312.3912
2011	2401.387	597.6137	8828.188	110.9399	205.4667	8.553489	439.6392
2012	2176.06	508.5693	8240.98	115.4293	184.7278	9.613227	380.7795

Annex 3 Fluctuations in exchange rates in selected fragile states (2000-2011)

Fluctuations in exchange rates in selected fragile states (2000-2011)
Rate against US dollar

Year	Angola	Burundi	CAR	Côte d'Ivoire	Comoros	Eritrea	Ethio.	Guinea	Gambia	Guyana	Kenya	Liberia	Rwanda	Sudan	Sierra L.	Syria
2000	5.57	627.75	647.25	647.86	647.86	9.60	8.02	1452.82	11.69	181.00	70.85	41.00	339.70	2.56	1965.11	11.23
2001	17.61	781.99	699.21	699.74	699.73	10.20	8.12	1857.39	15.52	185.64	78.56	45.12	359.02	2.59	1981.66	11.23
2002	32.10	864.42	742.79	742.69	742.68	13.81	8.43	1969.35	17.52	189.59	78.60	52.12	454.67	2.59	2242.05	11.23
2003	60.18	1070.00	617.68	617.94	617.93	14.25	8.30	1981.52	23.69	191.75	77.67	65.65	505.30	2.59	2009.61	11.23
2004	79.50	1060.00	520.10	519.80	430.94	13.79	8.56	2005.00	29.67	196.00	76.29	53.50	557.23	2.60	2450.00	11.23
2005	86.66	1060.88	495.24	500.37	375.28	15.29	8.60	2802.66	29.30	199.75	77.83	57.38	555.44	2.51	2457.14	11.23
2006	80.55	972.55	542.02	541.77	406.33	15.38	8.73	4303.07	28.49	200.25	72.15	56.78	540.42	2.30	2930.99	11.23
2007	80.28	1012.69	504.66	504.69	378.52	15.38	8.85	5690.87	27.97	200.86	69.90	61.11	549.23	2.01	2974.14	11.23
2008	75.03	1141.75	445.71	445.83	334.37	15.38	9.25	4278.92	22.49	202.94	68.52	63.48	543.83	2.05	2977.49	11.23
2009	75.13	1231.59	495.44	494.77	371.08	15.38	10.72	4966.63	26.42	204.29	79.05	64.44	563.14	2.22	3046.88	11.23
2010	89.74	1230.07	459.68	459.62	344.72	15.38	12.71	5018.67	26.49	203.70	75.77	71.33	572.08	2.36	3914.39	11.23
2011	92.95	1233.27	490.99	490.85	368.14	15.38	16.66	7262.26	28.17	203.63	80.99	72.27	596.62	2.36	4226.65	11.23
Change	1568.8%	96.5%	-24.1%	-24.2%	-43.2%	60.2%	107.8%	399.9%	140.9%	12.5%	14.3%	76.3%	75.6%	-7.8%	115.1%	0.0%

Sources: Various, IMF World Economic Outlooks, World Bank World Development Indicators.