

## **Fragile States: Institution Building and the Private Sector**

Scott Brown, Policy Development and Review Dept, IMF

Notes for Presentation at Breakout Session of the Conference

*Improving Governance and Fighting Corruption:*

*New Frontiers in Public-Private Partnerships*

Brussels, March 15, 2007

For the international community, assistance to fragile states is both a moral responsibility and a matter of self-interest. Left to their own devices, these nations may be unable to lift themselves out of a vicious circle of poverty, corruption, and violence. At the same time, global integration ensures that their problems will be felt well beyond national borders, becoming a source of regional and possibly even global instability.

### **International Financial Institution Involvement in Fragile States**

This year's issue of the Global Monitoring Report—the annual document of the World Bank and IMF on progress toward the Millennium Development Goals—will contain a good discussion of the work of international financial institutions in fragile states. Assistance to fragile states fits naturally within the respective mandates of the IFI's, with their concentration on sound economic policies, stability, growth, and poverty reduction. For the IMF, work in fragile states is focused on macroeconomic and financial issues, our core area of responsibility. In virtually all fragile states, we have an active dialogue on fiscal, monetary, and exchange rate policies; we are helping countries to identify gaps in the economic institutions and legal frameworks; and we are providing technical assistance to follow up our advice. All of these are essential elements of state-building.

Like the rest of the international community, we faced a steep learning curve in dealing with fragile states of sub-Saharan Africa during the 1970's and 80's. There were many disappointments, but at the same time we found in countries like Tanzania and Uganda that decisive improvements were possible in spite of difficult initial conditions. The quality of national leadership was typically a decisive factor. Later on, the earlier experience throughout Africa was an important foundation for helping transition and post-conflict countries in Central and Eastern Europe.

Our experiences in the Balkans in the late 1990s were particularly instructive. They demonstrated that it is both necessary and feasible to harmonize security, political, and economic assistance. The IMF played a pivotal role in state-building in the Balkans—with the extreme example being Bosnia and Herzegovina, where we appointed the Central Bank governor and were responsible for designing new tax and payments systems. Peacekeeping and state-building operations during this period generally commanded broad international support, generally under UN auspices. And I hope the international community will do a better job of dealing with future challenges in Africa and the Middle East, if its efforts are based on partnerships formed and lessons learned in the Balkans, Timor Leste, and South Asia.

Some of those lessons parallel the OECD's own 12 Principles for Good International Engagement in Fragile States. The point about harmonizing security, political, and economic assistance is a critical one. Similarly, it is hard to overstate the importance of the earliest possible involvement, flexible responses, and a clear division of labor with other development partners that avoid gaps, duplication, or overlap. We need to plan realistically for a long-term presence, each institution working within its own areas of competence. There will be time when the international community has to step in and fill gaps, especially in establishing physical security. But we cannot succeed unless we empower local structures, by tailoring our advice to a country's existing capacities while also trying to improve those capacities as quickly as possible.

While IMF lending is not usually a major element of financing packages for fragile states, in some of them our post-conflict emergency assistance and our Poverty Reduction and Growth Facility (PRGF) can be important. In addition, the IMF and World Bank work together to help many of the poorest member countries qualify for debt relief under the enhanced HIPC Initiative and the MDRI. Currently urgent discussions are underway to pin down the sources of financing for debt relief to Liberia, following up the commitments two years ago by the G7.

### **The Role of the Private Sector**

The private sector is always present in fragile states, even when government has essentially ceased to function. So in that sense it can provide an important element of stability in chaotic environments. As conditions begin to normalize, it is only natural for entrepreneurs to want to invest and expand. And to some extent this can happen even in the absence of formal legal frameworks and financial sectors, drawing on private remittances and transfers from abroad.

But at some stage the combination of poor infrastructure, institutional weaknesses and governance problems in the public and financial sectors, and macroeconomic imbalances, can become binding constraints on large-scale investment and growth in the private sector. To help overcome these constraints, much of what the IMF and other IFI's do in fragile states aims at an enabling environment for private activity. We contribute by helping countries to put in place sound economic policies, more reliable public institutions, and more fully developed financial sectors, and by encouraging better governance and the rule of law. And we have found that the private sector in turn can accelerate this process by supporting and encouraging sound policies, institutional reforms, and improved governance in fragile states.

Special issues can emerge in countries where public enterprises have traditionally had a monopoly or a dominant position in important sectors. In these circumstances privatization may sometimes be appropriate, but only as a means, not as an end in itself. The real objective is to have financially viable companies that can produce quality outputs. This requires putting in place appropriate regulatory frameworks, pricing mechanisms, and sound management.

Foreign direct investment has a special role to play. It can be an important source of financial resources and technology transfer for private sector development. But it also brings its own challenges, especially for countries with weak governance and those heavily dependent on natural resource revenues. In the best of circumstances, foreign investors can set a good example and help to in host country governments. But this works best if there are no free riders in the system, and if the legal and accounting frameworks in investors' home countries encourage transparency and accountability. For this reason, in parallel with our work to help build a good investment climate, institutions like the IMF and World Bank support international initiatives to strengthen national and corporate governance, such as UN Convention Against Corruption (UNCAC) and the Extractive Industries Transparency Initiative (EITI). The EITI is entering a new phase this as a multilateral initiative, with the promise of greater traction as a result of quality control through its validation mechanism. We owe a debt of gratitude to the Transparency International, Global Witness, and other NGOs of the Publish What You Pay Coalition, as well as UK DFID, for leading the EITI to this point.

### **Points for Reflection**

This conference—and this panel—have given bilateral donors and international financial institutions a unique opportunity to benefit from private sector perspectives on the challenges of institution-building in fragile states. It will be particularly useful to hear views on four sets of issues:

- (i) Priorities for action to create an enabling environment for private sector activity, on the security, political, and economic fronts.
- (ii) Areas where international support should be feasible, but is currently lacking, or where instruments that are now in use need further refinement.
- (iii) Successful experiences of private sector helping to champion institutional development and governance reforms.
- (iv) The potential importance of multilateral initiatives involving the private sector, such as the EITI and the UNCAC, in promoting better governance and accountability.