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Building New States: Lessons from Eritrea

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Abstract

With the Derg's overthrow in 1991, Eritrea embarked on the construction of a new state. New economic institutions were created, and considerable reform undertaken. Problems in co-ordinating reform and reconstruction were largely avoided, mainly because of the institutional ‘clean slate’ facing the country at independence and the high level of social solidarity and other social capital that characterize the country. A well-defined economic strategy, and careful use of aid, promised higher returns to investment (and fewer unsustainable projects) than found elsewhere in SSA. By the start of 1998, the country had achieved much in a short time. The 1998-2000 war threatens to undermine this achievement. The ashes of the war that ended in 1991 have reignited in a surprising and different way, and the fall out from the war endangers progress in development and democratization.

Keywords: sub-Saharan Africa, Eritrea, conflict, economic reform

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1 Introduction

Throughout their recent history the Eritrean people have struggled for independence, first against Italy—which established the colony of Eritrea in 1890—and then against the Ethiopian monarchy, and later the military dictatorship of the Derg (Pateman 1990). De facto independence and the end of the 30 year-liberation war was achieved in May 1991 with the defeat of the Derg by the Eritrean People's Liberation Front (EPLF) in alliance with Ethiopia's rebel forces. After a referendum in which the electorate voted overwhelmingly for formal independence, this was duly declared on 23 May 1993. Eritrea thereby honoured its ancient name: *Medri Geez*—the land of the free.

In addition to resettling returnees and helping communities rebuild their livelihoods (the subject of Kibreab 2001), this new state was faced with two additional and urgent agendas. First, transforming the political apparatus of the national liberation struggle into a set of political institutions suitable to peacetime politics. Second, creating the economic strategies and institutions necessary to transform the Derg's economic legacy. To create a true development state—one that is democratically accountable and capable of designing and implementing broad-based development—requires the achievement of both agendas (see Addison 2001a and 2001b). Accordingly, both sets of issues are discussed in this paper, in sections 2 and 3 respectively.

Considerable progress was made in the first years of independence but in May 1998 a border conflict between Eritrea and Ethiopia escalated into a war that continued until the cease-fire of June 2000. Both countries have mobilized considerable human and material resources for the war. In terms of the numbers of soldiers involved, military casualties, and numbers displaced, the Eritrea-Ethiopia war was the largest conflict of 1999. The economic roots of the war as well as its social and economic impact are discussed in section 4. We conclude, in section 5, by noting the dangers that the 1998-2000 war poses to the creation of a development state in both Eritrea and Ethiopia.

2 Building political institutions

Drafting a constitution was one of the first political tasks after independence. A constitutional commission was formed in 1994, comprising representatives from each ethnic group and the country's large diaspora. After wide-ranging consultations (in which more than half a million people participated) the 1995 ‘Constitutional Proposals for Public Debate’ set out an explicit and clear goal (CCE 1995a: 10):

> We Eritreans are engaged in creating our own government for the first time in our history. ... If we can create a strong government that is free from corruption and manipulation by foreign interests, and that has as its disposal effective institutions, it will be a decisive instrument in our nation building and development efforts.

Furthermore, it was stressed that the Eritrean political system '... ought to be based on the principles of nationalism [national unity and development], secularism [separation of religion from government] and democracy [ensure equal participation of all members of Eritrean society without any exception]' (CCE 1995a: 7). The Constitution duly came into effect on 24 May 1997.

The Constitutional Commission was well aware that considerable institutional investment was necessary to realize constitutional goals (CCE 1995a: 12). Here, we discuss four critical issues: the construction of political parties (and the ethnic dimension); decentralization; the choice of the electoral system; and the status of women.

Under the Constitution the National Assembly is elected every five years, and in turn the assembly elects the president for a five-year term (maximum two terms). However, the first national elections—originally scheduled for 1997—were delayed until 1998, and then postponed indefinitely when war broke out. For the present, the 150-seat Transitional National Assembly consists of 75 members from the central council of the People's Front for Democracy and Justice (PFDJ)—which was formed out of the EPLF and elements of the Eritrean Liberation Front (ELF)—and 75 non-PFDJ members, including representatives of the diaspora. The PFDJ remains the only legal party (although the PFDJ prefers to describe itself as a movement) and political-party legislation is still pending. Given its resources and high profile, the PFDJ will probably win the eventual elections. Indeed, President Isaias Afewerki has concluded that the opposition will be slow to develop (*Financial Times*, 18 January 1996: 13):

> If you're looking in terms of 5 or 10 years, you will be disappointed. Given our circumstances, the Front will continue to be dominant for several years to come.

There are nine ethnic groups with two of them (the Tigray and the Tigre) accounting for up to 90 per cent of the population. The peaceful management and reconciliation of ethnic differences is critical to stability and continuity in new states—a point on which the Constitutional Commission was very clear (CCE 1995a: 15):

> Building democracy has to follow the path of nation-building in which sub-nationalism and its concomitant religious, tribal and sectarian tendencies are not given any chance to grow, but rather, unity and stability are maintained. What we need is a participatory democracy that is based on, and reinforces, national consensus, one that serves the purpose of developing a stable political system as opposed to one that institutionalised exclusion.

The formation of political parties along ethnic or religious lines is therefore prohibited. This does of course conflict with what is normally seen as a basic human right—the right of assembly. Hence, Eritrea has not yet ratified the United Nations Universal Declaration on Human Rights. However, Article 19 of the Constitution, on ‘Freedom of Conscience, Religion, Expression of Opinion, Movement, Assembly and Organization’ includes what are normally considered to be central human rights, including guarantees for freedom of opinion and for the work of political parties.

Common hardship during the liberation war strengthened the bond between different ethnic groups—an important piece of social capital for the new state (see Kibreab 2001). Nevertheless, the ban on forming political parties along ethnic lines indicates that ethnicity is a sensitive political issue. Therefore in order to democratically resolve ethnic grievances as well as protect minorities, other types of formal institution (as well as informal practices) need to evolve.

A related issue is decentralization. Eritrea's population is much smaller than Ethiopia's (3.4 million and 58.2 million, respectively), its ethnic groups are less regionally concentrated, and Ethiopia has the potential for more serious ethnic tension (see Addison 2001b). Therefore a federal political structure, of the kind adopted in Ethiopia, has not been adopted in Eritrea (on Ethiopia's decentralization, see Bevan 2001). However, decentralization is certainly important since local administrations can respond more readily to local needs. But local capacities are underdeveloped and lack funding in Eritrea. Therefore although the constitutional proposal stressed the need for decentralization within the context of a unitary state, it also concluded that decentralization cannot be created or accelerated by policy decisions alone, but will instead evolve over time as regions, local economies and cultures transform themselves (CCE 1995a: 28, and CCE 1995b: 27).

The choice of electoral system is a crucial decision in creating a democracy (see for example Lijphart 1991 and Hydén 1993). No decision has yet been reached, although work on electoral law has started. A country aiming to achieve the widest democracy possible would tend to favour proportional representation. On the other hand, a plurality/majority system might be favoured when major economic reform is necessary. This is more likely to deliver a clear majority for one party, enabling it to carry through reforms more readily than the fragile coalitions sometimes (but not always) associated with proportional representation. Therefore Eritreans will have to carefully weigh the relative merits of each system.

Finally, there is the issue of women's status in Eritrean society. Twenty-one members of the Constitutional Commission were women, 40 per cent of participants in the commission's consultation meetings were women, and thirty per cent of seats in the National Assembly are reserved for women. Hence, the political voice of women is considerable. Nevertheless, discrimination against women in community life remains widespread; this reduces their access to land and employment despite formal equality in law (Kibreab 2001 discusses the implications for women's livelihoods).

In summary, Eritrea has participatory political processes, the state enjoys a large measure of legitimacy, and women have made some gains. However, the legal framework for the formation and finance of political parties is still nascent, the first national elections are still pending, and the media remains largely government controlled. Therefore unlike Mozambique—which has had two national elections since the end of its war in 1992—Eritrea is yet to consolidate itself as a multi-party system despite the leadership's stated commitment to democracy. This remains an important challenge.

3 Economic institutions and strategies

Eritrea's economy was devastated by 30 years of war and the Derg's economic policies. Assets were nationalized and the Derg ran a highly centralized economy from Addis Ababa; administrative directives, rather than price incentives, were intended to allocate resources under a command economy much influenced by the Soviet system (see Hansson 1995). As a result, the economy was extremely weak by the time Eritrean forces took control of the country in 1991. Poverty was widespread and human development was limited; UNDP's Human Development Indicator ranks Eritrea at 167th out of 174 countries—marginally ahead of Ethiopia—but well below the SSA average (UNDP 1999).

The early years saw efforts to build a consensus on economic strategy alongside the process of political consultation. In 1991, the University of Asmara hosted a conference on economic policy (see Gebre Hiwet Tesfagioris 1993). Agreement was reached on the need for a mix of private and public ownership, regional economic co-operation, and investment to diversify through tourism, financial services and manufacturing. These goals were incorporated into the 'Recovery and Rehabilitation Programme for Eritrea' (RRPE) which was launched shortly after the Asmara meeting (Ministry of Foreign Affairs 1995: 3) followed by the more detailed 'Macro-Policy' document in 1994 (GSE 1994: 10).

Eritrea has consistently followed a strategy in which interaction with the rest of the world—through foreign investment, international borrowing, and aid—is very cautiously managed. But the country's definition of national 'self-sufficiency' does not imply autarchy. In the field of food security, for instance, the stated objective is to reach self-sufficiency within five years but not through domestic food production—impossible since the country is in the Sahelian rainfall zone—but by developing export sectors to pay for food imports.[1] Likewise in investment goods, where the country has an obvious comparative disadvantage given its low level of development. Historically, Eritrea's location and access to the markets of the Middle East and SSA has favoured it as a trading nation.

Tourism and fisheries together with the exploitation of gold, high-quality marble and offshore oil deposits, require considerable resources. To this end, direct foreign investment (DFI) is actively sought when it meets national development goals. But policymakers can only evaluate the relative merits of DFI projects when those national goals are well specified, which in turn requires a clear economic strategy. Eritrea is better placed in this respect than many other SSA countries where economic strategy and DFI policy are underdeveloped (see Castel-Branco, *et al.* 2001 on weaknesses in Mozambique's DFI strategy). Foreign investment was negligible until 1995, but rose strongly over 1996 to 1998 when it averaged 5.5 per cent of GDP—about the same as Mozambique's ratio for 1998 (see Table 1). However, foreign interest in privatized enterprises has to date been limited (see section 4).

At independence, Eritrea had no external debt—Ethiopia inherited all the Derg's external debts. Eritrea is the only country in this study that is not in the 'Heavily Indebted Poor Countries' (HIPC) category. Eritrea therefore embarked on its reconstruction with a major advantage over Ethiopia, as well as other poor war-torn countries such as Guinea-Bissau and Mozambique, where external service has been a constraint on recovery (see Addison and Ndikumana 2001). The government has been cautious in its borrowing since independence, and the stock of external public debt (disbursed) amounts to only 9.1 per cent of GNP (see Table 2). Debt service was less than 1 per cent of Eritrea's total exports of goods and services in 1997 (IMF 1998: 76)

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1 The production of staple foods undergoes major fluctuations depending on the weather. The volume of staple foods produced in 1994—the best year in the 1990s—was nearly three times as great as in the drought year of 1996 (IMF 1998: 50).

This prudent borrowing strategy reflects Eritrea's relationship with the donor community, to which we now turn.

3.1 Foreign aid

Eritrea's attempt to avoid aid dependence, and to set the terms of the donor-recipient relationship—the government prefers the term 'partners in development' and emphasizes national ‘ownership’ of development projects—is of considerable interest given the aid dependence of much of SSA. The Government has confined aid to sectors such as infrastructure that are necessary to strengthen the economy to a point at which external trade and foreign investment, and not aid, become the main sources of foreign exchange and capital inflow. Large-scale balance of payments support (such as an IMF facility) has not been sought despite Eritrea's eligibility. Eritrea has borrowed only US$ 125.4 million from the World Bank; in comparison Ethiopia has borrowed US$ 3,036.3 million from the Bank, whereas Mozambique has borrowed US$ 1,812.0 million (World Bank 1999). In 1996, Eritrea borrowed less from the World Bank's International Development Association (IDA) than from Arab development banks (IMF 1997: 69). Foreign assistance (as measured by net official transfers) averaged only 10 per cent of GNP in the mid-1990s, and was around 5 per cent in 1997 (Table 2) which is below the average for low-income SSA countries. Indeed, remittances by the diaspora were more important; private transfers have exceeded official transfers in every year since independence: private transfers amounted to US$ 384.4 million in 1997, whereas official transfers were only US$ 41.4 million (down from an average of about US$ 75 million per year since independence) (see Table 2).

Eritrea's caution reflects a desire to avoid donor policy conditionality, which is seen as incompatible with national independence. The civil service has been downsized, taxation reformed, and trade and exchange controls liberalized—all policies that are normally associated with BWI conditionality—but the government emphasizes that this was its decision, not one imposed upon it (see section 4).[2] Before the outbreak of war in May 1998, the BWIs would almost certainly have wanted to lend more since Eritrea's government displays precisely the characteristic of policy 'ownership' that donors now emphasize as critical to aid's success (see for instance World Bank 1998a). But the Eritrea-Ethiopia war has now put donors in an awkward position with respect to both countries (more so in the case of Ethiopia, where donor lending is much larger).

The coherence of the government's strategy clearly facilitated reconstruction from 1991 onwards. The contrast with the fragmentation of policy-making and the lack of basic development strategy in, for example, Angola and Guinea-Bissau is striking (see the Aguilar 2001 and Kovsted and Tarp 1999). Yet, this strategy has entailed costs. Emphasis on ‘ownership’ of development projects has led to a reluctance to use foreign expatriates—a constraint on development given the country's shortage of professional skills (see Kibreab 2001 on this issue). There is a thin top layer of highly qualified staff in government, but the quality of skills quickly tails off as one moves down the

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[2] The government has accepted IMF technical assistance in the establishment of the Bank of Eritrea (IMF 1998: 4).

organizational pyramid. Aid, if wisely used, could ease the skill constraint thereby reinforcing the attainment of Eritrea's national goals.

Moreover, aid could do much more in the education, health and sanitation and water sectors—all are resource-intensive and all are critical to raising Eritrea's dismal human development indicators. Hence, the low educational level—adult illiteracy is 80 per cent (and 90 per cent for females)—is a major constraint in both the private and public sectors (World Bank 1996: 31). Foreign assistance to education could therefore have high returns. The government's Macro-Policy document declares that seven years of primary education should be available to all (GSE 1994: 39). However, this is a very demanding objective given the low enrolment rates at present; only 47.4 per cent for primary schooling, and 22.4 and 13.7 per cent for junior secondary school and secondary school, respectively (Ministry of Foreign Affairs 1995: 12). Accelerating enrolment, and providing quality education, require large capital and recurrent expenditures. Eritrea managed to raise spending on education from 1.4 per cent of GNP in 1992 to 3 per cent in 1995 and 1996 (World Bank 1998b), and this helped to raise the primary enrolment rate to around 54 per cent before the start of the war. But absolute levels of education spending remain low since Eritrea faces a fiscal constraint that is probably as severe as Ethiopia's (see Bigsten 1999). Aid to the education sector could therefore do much to help Eritrea rapidly close its educational gap—with temporary use of expatriates to help train nationals—without compromising the goal of national self-reliance. Moreover, foreign assistance to basic education could facilitate democratization, in particular the process of consensus-building which is a feature of Eritrean politics (section 2). The dissemination of information and public debate cannot work effectively when 80 per cent of adults are illiterate.

Aid could have similarly high returns in the health sector. Eritrea has embarked on an ambitious programme to build new health institutions and rehabilitate existing ones as well as to upgrade medical staff who received their basic education at the front during the liberation war. Some 70 health stations and 40 health centres were built between 1992 and 1996. The government is also encouraging private sector investment in health care as a complement to direct public provision. Public spending on health rose from 1.4 per cent of GNP in 1992 to 3 per cent in 1995 and 1996 (World Bank 1998b: 4). Yet the resource constraint remains large and therefore absolute spending is low—only US$ 1.6 in 1994 (although up from US$ 0.7 in 1992)—and aid to the health sector could raise this substantially. This is also the case in the water and sanitation sectors. Potable water is a major input into health, particularly child health and Eritrea's high infant mortality rate is in part the consequence of water-borne disease which must be eliminated through greater investment in water and sanitation infrastructure.

4 Economic transition prior to may 1998

Like the other countries in this study, Eritrea has had to reform the economy alongside reconstruction; specifically, to transform the policy legacy of the Derg with its emphasis on state planning and state ownership. The 1990s saw trade and exchange reform, as well as fiscal reform, privatization, regulatory decontrol, and other sector reforms. But unlike Angola, Ethiopia, Guinea-Bissau, or Mozambique, the Government of Eritrea had to create completely new economic institutions from scratch. These include a central bank, a system of public accounts, a national statistical office and (in November

1997) a currency. Starting with an institutional 'clean slate' has its advantages; opponents of reform in long-standing but ineffective institutions are a major constraint in countries such as Angola and Guinea-Bissau (see Aguilar 2001 on Angola for example). But institutional creation does stretch the weak capacities of a state that is short of professional skills.

4.1 Trade reform, currency arrangements, and financial reform

Nearly all quantitative restrictions on imports were eliminated over 1993-96 in order to facilitate reconstruction—which is very import-intensive—and to increase efficiency in the domestic economy. At independence Eritrea inherited very high tariff rates. However, a tariff reform in October 1994 reduced tariff rates to 2-3 per cent on imports of agricultural and capital goods and 5-50 per cent on intermediate goods and most manufactured goods. Tariffs on imports of luxury consumer goods remain in the range of 80 to 200 per cent (IMF 1998: 33). Public sector export and import agencies have been closed and the private sector can import and export directly (World Bank 1998b). These measures, together with the abolition of export taxes, have increased export incentives. The administration of foreign exchange has also been liberalized in order to promote Eritrea's role as a centre of regional trade and finance. In 1996, the Bank of Eritrea announced its intention to phase out all exchange controls (Bank of Eritrea 1996).[3] Up to 1998 the government had also liberalized most of the restrictions on foreign trade and investments (World Bank 1999: 3).

The Ethiopian birr continued to circulate in Eritrea after independence. The birr was devalued in September 1992 from 2.07 birr per US dollar (an exchange rate that had lasted since the early 1970s) to 5.00 birr per US dollar. This was a major step in correcting the currency's long-standing overvaluation which had undermined exports, and was therefore important to recovery in both countries. In May 1993 the Ethiopian government introduced a foreign-exchange auction system, and the exchange rate became largely market-determined (see Hansson 1995: 114, and Addison and Alemayehu Geda 2001).

The level of bilateral trade favoured the continuation of monetary union after independence. However, there were also two disadvantages for Eritrea. First, since the birr was issued solely by the National Bank of Ethiopia (NBE), Eritrea had no independent monetary policy. Close relations between the two governments facilitated co-operation between their central banks but, more fundamentally, at any given moment the interest rate set by the NBE was not necessarily appropriate to business conditions in Eritrea. Second, without its own currency, Eritrea had no seignorage revenue—an important consideration given the need to finance reconstruction and development spending.

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3 Under the 1996 reform, no declaration of exchange holdings is required when passing across the Eritrean border, exporters may retain their entire foreign exchange earnings, and both the negative list and restrictions on the transfer of profits dividends, patent rights and capital were dismantled. (Bank of Eritrea 1996).

Lack of administrative and policy experience in the Bank of Eritrea, which was established by temporary proclamation in 1993, precluded the early introduction of a national currency. But four years later the Bank of Eritrea had built up enough capacity to issue and manage a currency as well to conduct an independent monetary policy. The enactment of the 'Bank of Eritrea Proclamation and the Financial Institutions Proclamation' in April 1997 provided the bank with the necessary powers. And on 22 November 1997, a national currency, the nafka, was introduced thereby ending the monetary union with Ethiopia. As it turned out, this was one factor in the deterioration of political relations between the two countries over 1997-98, and the descent into war (see section 5).

As in other formerly state-socialist countries such as Ethiopia and Mozambique, the development of the financial system is important to reconstruction and longer-term development. Financial institutions are state owned with the exception of the Housing and Commerce Bank of Eritrea (HBCE) which is owned by the PFDJ (on the troubling implications of bank ownership by political parties see Addison 2001a). The Commercial Bank of Eritrea (CBE) accounts for 88 per cent of total bank assets and 87 per cent of total deposits (IMF 1998: 11). CBE has excess liquidity since the inflow of deposits (it is dominant in the deposit market) exceeds its lending (also the case with the Commercial Bank of Ethiopia—see Addison and Alemayehu Geda 2001). During the currency union, CBE's excess liquidity was deposited with the Bank of Eritrea, which then used it to advance credits to fund the fiscal deficit (IMF 1997: 15). A range of financial institutions and instruments—for example an inter-bank market and a treasury-bill market—must be created to absorb the excess liquidity, improve the financial-system's efficiency, and enable the Bank of Eritrea to deploy indirect methods of monetary control. Major tasks of financial development therefore remain.

Statements by the government and the Bank of Eritrea seem to favour foreign investment in the financial sector—the strategy therefore appears to be closer to that of Mozambique than of Ethiopia, where foreign ownership of financial institutions is prohibited (see Castel-Branco, *et al.* 2001 and Addison and Alemayehu Geda 2001). Certainly, Eritrea's ambition to create a regional financial centre will require foreign investment in banking, perhaps necessitating the privatization of CBE. But little has happened yet, and as a new country Eritrea has had to concentrate its efforts on establishing a central bank as a first priority.

4.2 Deregulation and privatization

A number of measures have been introduced to encourage private-sector development. Tax reform has reduced the marginal rate on a wide range of incomes, including those from business and trade, from 85 to 38 per cent. The process of starting a small business has been simplified through the establishment of a new licence office (EIU 1995: 29). As with the other countries in this study, it is vital to establish legal institutions such as commercial law to protect private property rights and thereby encourage private investment. The transition economies of the Former Soviet Union and Eastern Europe demonstrate how the neglect of early institutional investment can distort the private-sector's subsequent development (see Stiglitz 1999). This lesson is highly relevant to Africa's transition economies. Fortunately, through its more or less immediate introduction and implementation of a thorough reform program, Eritrea appears to be much better placed to develop such institutions than much of formerly state-socialist Africa.

Privatization began with small and medium-sized state-owned enterprises (SOEs). Some 700 small-scale shops were sold by the end of 1993. A national agency to supervise the privatization of large SOEs was established in December 1995. In contrast to Ethiopia, the Government of Eritrea's economic strategy appears to place greater emphasis on privatization (on Ethiopia, see Hansson 1995: 121). Therefore in 1997 it was decided to privatize all 39 SOEs in manufacturing (GSE 1995). However, the privatization of large SOEs has fallen behind target and only 11 enterprises had been privatized by mid-1998 (IMF 1998: 24). Foreign interest in buying SOEs was limited before May 1998—two state farms failed to sell, for example—and declined further with the onset of war. By May 1998 only 25 per cent of the SOEs slated for privatization had been sold (World Bank 1998b). As an interim measure, the government decided that SOEs should be run by autonomous boards and should operate on commercial conditions—thereby increasing management accountability and making the business more attractive if eventually privatized.

A comparison with Mozambique is instructive (see Castel-Branco, *et al.* 2001). As in Mozambique, the privatization of small SOEs created new livelihoods for ex-combatants and returning refugees. Eritrea's privatization process has been better organized—Mozambique's early privatizations were especially chaotic—and although we have no evidence on the transparency of Eritrea's privatization process, the low level of corruption in the state is a good augury (many of Mozambique's privatizations were highly non-transparent). But, Mozambique has one very strong advantage over Eritrea; a sustained peace has increased the country's attractiveness to foreign investors.

It is also important to introduce competition laws and regulation in the public interest in order to avoid the creation of new private monopolies out of old SOE monopolies (Hansson 1995: 121, Stiglitz 1999: 5). In this regard, it is unclear why the government granted the Gash Cigarettes Company (the only company fully purchased by a private investor) a monopoly over the domestic market for a period of 13 years. The company is protected by foreign competition by a very high import tariff, although it intends to export. The export revenues and positive externalities from the investment (skill enhancement and technology) may justify the loss of consumer welfare. However, such arguments for offering incentives to foreign investors must be carefully evaluated. In general, and with the exception of Gash, the government has avoided granting large incentives to DFI.

4.3 Fiscal reform

Over 1993-96, the government undertook major reconstruction expenditures. These included the resettlement of refugees, the demobilization of 54,000 ex-combatants, support to martyrs' families, and infrastructure reconstruction (see Kibreab 2001 on resettlement). Some 10,000 civil servants were also retrenched and paid severance wages (resulting in a 30 per cent reduction in the public sector workforce). Public spending on education and health grew significantly. As a result, and as is usual in reconstructing economies, expenditures substantially exceeded revenues in the immediate post-war years; the fiscal deficit before grants averaged 25 per cent of GNP over 1993-96, and 12.5 per cent after grants (IMF 1998: 63). However, the fiscal deficit after grants was then sharply reduced—to 5.5 per cent in 1997—mainly by cutting the fiscal deficit before grants to 10.4 per cent. The development of the fiscal position over the 1990s is shown in Table 3. Public expenditure increased sharply in 1998—the result of the rise in military spending with the outbreak of war—and the resulting sharp deterioration in the fiscal position (an issue we return to in section 5).

Revenues improved as a result of the overhaul of the tax and customs structure in 1994 and a rise in the tax base following the resumption of economic growth together with higher receipts from port fees and charges.[4] The latter also reflected the rapid growth in Eritrean and Ethiopian bilateral and external trade (itself a feature of reconstruction) until the 1998 war. Port fees and charges rose from ERN 224.5 million in 1993 to ERN 444.3 million in 1997—22.6 per cent of total public revenues excluding external grants (IMF 1998: 62).[5] Eritrea's high level of social capital has benefited revenue mobilization in two ways. First, it has not experienced the major problem of corruption that has afflicted the revenue and customs services of many SSA countries; Mozambique for example had to put out its customs service to private tender following a major shortfall in customs revenue (see Addison and Ndikumana 2001). Second, Eritrea is unusual among SSA countries in deriving significant revenue from its diaspora—another benefit of the strong social capital built up during the liberation war (see Kibreab 2001 on this point).

Improved profitability in SOEs followed their commercialization. The fiscal benefit of privatization has, however, been comparatively small; estimated at ERN 55 million in 1997, compared to total revenues of ERN 2,043 million and non-tax revenues of ERN 1,063 million in the same year (IMF 1998: 64). Proceeds from privatization over 1990-98 yielded US$ 2 million in total (World Bank 2000a: 288).

4.4 Economic performance prior to the war

GDP growth resulted from reconstruction and reform—reaching 6.8 and 7.9 per cent in 1996 and 1997 before the start of the new war—but growth is highly variable reflecting agriculture's vulnerability to drought. In 1995, for example, growth slumped to 2.9 per cent due to the 1995-96 drought (see Table 1). Eritrea has had some success in diversifying into manufacturing: therefore the value of manufactured output in 1997 was more than double its 1993 level while the value of agricultural output has remained roughly static, and its share of GDP has fallen from about 13 per cent at independence to about 9 per cent in 1997 (IMF 1998: 49).

Inflation has stayed relatively low for a reconstructing economy—consumer price inflation has averaged less than 10 per cent over the 1990s—which is less than Mozambique's average of 32 per cent (Table 1).[6] This is despite the partial liberalization of price controls; in 1996 controls for bread, flour, petroleum products and pharmaceuticals were the only ones remaining (IMF 1996: 2). In any case much of the

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4 Total tax revenues were 20 per cent of GDP in 1998, a higher ratio than Ethiopia's 11.7 per cent (World Bank 2000b). This difference partly reflects the more limited role for external grants in Eritrea, and therefore the greater need to mobilize domestic revenue than in Ethiopia.

5 The nafka is abbreviated to ERN.

6 Mozambique's average inflation rate for 1991-99 is calculated from World Bank (2000b).

economy was already operating at market prices prior to decontrol due to the inadequacy and collapse of the Derg imposed price-control apparatus, so decontrol itself had little impact on inflation. This was also the case in Ethiopia during the first years of deregulation and devaluation (Hansson 1995). Moreover, under the currency union, Eritrea's inflation was kept low by the conservative monetary policy pursued by the Bank of Ethiopia.

The current account deteriorated over 1995-97 since imports of investment goods increased as reconstruction stepped up (Table 1). Such a widening of the current account deficit is normal in reconstructing economies but, in contrast to most other countries, Eritrea's increased current account deficit was largely financed by remittances from its diaspora while donor support provided only a small share of the financing (Table 1). In summary, at the start of 1998 the economy was in reasonably good shape—certainly better than that of many comparable war-torn countries—and some economic diversification had been achieved. The government finances were well managed and inflation was under control.

5 The new war with Ethiopia

On 6 May 1998, fighting broke out between Eritrean and Ethiopian forces in the disputed border area of the Yirga triangle (sometimes called Badime after the area's major town). This is not the place to discuss in detail the course of the war or the successive cease-fires and peace plans brokered (unsuccessfully) by the Organization of African Unity (OAU) and others, until the cease-fire of June 2000 (see Gilkes and Plaut 1999). Instead, we focus on the war's economic causes, and its likely impact on Eritrea's development prospects.

Ostensibly, the war began over 390 km2 of barren desert and mountain. But in the period leading up to May 1998 two economic issues—Eritrea's introduction of the nafka and Ethiopia's use of the port of Assab—led to a serious deterioration in political relations. When the nafka was introduced in November 1997, Eritrea took the position that it should have parity with the birr in bilateral trade. Ethiopia rejected parity as disadvantageous to its trade and argued that the nafka/birr rate should be market-determined. With the new currency's introduction, Ethiopia required the settlement of all its trade with Eritrea in hard currency (except for border trade valued at below 2,000 birr).[7] This Ethiopian decision '... came as a shock and rebuff to the Eritreans' (Gilkes and Plaut 1999: 14).

Eritrea's independence left disputed areas along the 1,000 km Eritrea-Ethiopia border but neither country felt an urgent need to resolve the issue. The border's existence meant little to economic life in either country given the currency union and the scale of bilateral trade. But the nafka's introduction turned the border into a real trade barrier across which transaction costs were now incurred in the currency conversion. Therefore the disputed border areas themselves continued to have little economic value, but the

7 Previously, all transactions with Ethiopia, except the imports of spare parts for the Assab refinery and the purchase of certain exports, were settled in birr (IMF 1998: 36).

border itself now had tangible economic effects—which were largely negative in the view of the Ethiopians.

Second, Eritrea's independence left Ethiopia landlocked. But, relations between the two governments got off to a good start, a free trade pact was signed, and a 1992 agreement on transit trade established Assab as a free port for Ethiopia (UNDP 1993: 3). With the nafka's introduction, Ethiopia now had to pay in dollars for the use of the port and this, together with disagreements over its administration, led Ethiopia to divert an increasing amount of trade through Djibouti. This hit Eritrean revenues from port fees and charges which, as we saw in section 3, accounted for 22.6 per cent of total public revenues net of grants. The port of Assab alone provided some 5 per cent of total government revenue before the war (EIU 1999a: 25). As relations deteriorated, Ethiopia raised its tariffs on Eritrean imports.

For an economist it is tempting to ascribe the root causes of the war to economic factors, and indeed these have a significant role in many conflicts (see for example research by Collier 1999, Nafziger *et al.* 2000). Certainly, trade and exchange-rate issues played a large role in damaging bilateral relations. But it is equally clear that national pride and other ‘intangible’ factors soured the relationship: the conflict quickly escalated to a level from which neither side felt able to back away without loss of face. Moreover, any concessions to the foreign enemy were inevitably seen as signs of weakness by internal forces willing to challenge the current leaders.

The costs of the war to both countries are numerous. However, objective information is hard to obtain since both sides have an obvious incentive to spread disinformation. First, there is the human suffering. By June 2000 casualties on both sides totalled at least 100,000. About 250,000 Eritreans (and 300,000 Ethiopians) have been internally displaced, and both countries have expelled each other's citizens and confiscated their property (the Eritrean Relief Commission estimates the number of Eritrean deportees from Ethiopia at 65,000). Both countries will therefore have to spend large sums (which they can ill-afford) on resettling affected populations and demobilization, as they did in the early 1990s (see Daniel Ayalew *et al.* 1999 and Kibreab 2001).

Furthermore, the war is demanding large amounts of resources from both countries. Again, data are hard to obtain, both Eritrea and Ethiopia are downplaying the economic impact of the war, and therefore the credibility of recent statistics is unknown. Eritrea's defence spending may have jumped to 20 per cent of GDP in 1998 from 9 per cent in 1997 (EIU 1999a), and may have gone as high as 44 per cent (EIU 1999b: 22, citing the *Philadelphia Inquirer* of 7 September 1999).

The fiscal deficit (including grants) rose from around 7 per cent of GDP before the war began to 32 per cent in 1998 (World Bank 1999). The fiscal deterioration largely resulted from the loss of revenue from port fees and charges, together with the negative impact of the downturn in domestic economic activity on revenues from indirect taxes and income taxes. However, a war surtax has been introduced and the diaspora has stepped up its contributions; the most widely circulated estimate is US$ 400 million but again this cannot be confirmed (EIU 1999a). This inflow has partly substituted for the lost tax revenue and has slowed the nafka's depreciation against the dollar since the start of the war; therefore the diaspora's contributions have contained the war's inflationary effects—for the moment.

However, the longer-term macro-economic effects are potentially very serious. Both sides have spent prodigious sums in the international arms markets and this, combined with the downturn in exports—which fell by more than 33 per cent in 1998 (World Bank 1999)—has reduced foreign currency reserves: Eritrea's reserves are down from seven months import-coverage (their pre-war level) to three months (EIU 1999a: 25). The current account deficit (before capital grants) stood at about 33 per cent of GDP in 1998 (World Bank 1999). The war will most likely lead to a build up in external commercial debt—to finance imports as well as arms—and could, in the worst case, create a serious debt-service problem for the future.

It is obvious that in a situation like this the prospects for economic development are quite bleak. Preliminary figures for 1998 indicate that real growth dropped from just below 8 per cent in 1997 to 3 per cent in 1998 (World Bank 1999). The mobilization has denuded rural communities of labour (some 300,000 Eritreans have been drafted) thereby reducing agricultural output (although the army has kept agriculture going in some areas). Drought has compounded the loss of food output. In January 2000, the UN's humanitarian agencies launched simultaneous appeals for both Eritrea and Ethiopia. The US$ 42.7 million appeal for Eritrea solicited food and non-food aid for 583,000 people: 372,000 were categorized as war-affected and over 211,000 were drought affected. With a much larger population, Ethiopia has more people in need of emergency help (8 million).

Even if the present cease-fire holds—and this is by no means certain—the economic fallout will be long-lasting. The war has reduced and distorted the regional trade in the Horn of Africa thereby undoing much of the beneficial economic integration that occurred in the 1990s. The Horn needs more intra-regional trade if it is to overcome the constraints of small (and poor) national markets and attract more foreign investment. But mistrust will damage bilateral trade relations for years, undermining the ability of countries to develop through trade based on their respective comparative advantages. Eritrea is searching for new markets in Sudan and the Great Lakes region, but these can be only partial substitutes for the Ethiopian market. Foreign investment in Eritrea's infrastructure projects such as power supplies and telecommunications, together with an aluminium processing plant, is now stalled.

6 Conclusions: from ashes to fire

With the Derg's overthrow in 1991, Eritrea embarked on the construction of a new state. A Constitution was drawn up and promulgated, and the basis for a participatory political system was laid out. New economic institutions were created, and considerable reform undertaken. Problems in co-ordinating reform and reconstruction were largely avoided, mainly because of the institutional ‘clean slate’ facing the country at independence and the high level of social solidarity and other social capital that characterize the country. A well-defined economic strategy, and careful use of aid, promised higher returns to investment (and fewer unsustainable projects) than found elsewhere in SSA. By the start of 1998, the country had achieved much in a short time, and the basic structures of a development state were well-advanced. Some problems were evident—the country had not yet advanced as far as Mozambique in consolidating democratic institutions—but optimism about the future prevailed.

The 1998-2000 war threatens to undermine this achievement. The ashes of the war that ended in 1991 have reignited in a surprising, and different, way. This paper takes no position on the respective merits or otherwise of the two belligerents. It is, however, clear that both have suffered major damage which will be long-lasting. The disruption to their trade and investment relationships is particularly severe. Moreover, the war imperils the construction of a development state in both Eritrea and Ethiopia. In 1991, both had real prospects of achieving this, thereby reversing the misguided and venal policies of the Derg. But the war has strengthened nationalist forces in both countries and may endanger further progress in democraticatization. It is to be hoped that Eritrea's strong social capital can redirect the energies of the state back to development if peace can truly be secured.

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Table 1

Eritrea: Basic economic indicators

	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP per capita (US $)	..	132.2	120.5	146.4	160.5	172.0	173.5	167.5	n.a
GNP per capita (US $)	..	n.a.	n.a.	180.0	180.0	200.0	230.0	200	..
GDP growth rate (%)	..	n.a	- 2.5	9.8	2.9	6.7	7.9	3.0	5.0
Exports of goods & services, growth rate (real) (%)	..	n.a	64.6	- 8.6	8.6	13.3	4.7	- 33.5	56.9
Inflation (%)									
...GDP deflator	..	n.a	29.1	22.2	11.3	2.9	2.7	- 0.9	3.8
Consumer Price Index	..	n.a	4.6	11.6	10.7	9.3	4.6	7.0	n.a
Gross domestic investment (total) as % of GDP	..	5.4	15.1	17.8	19.2	29.3	40.9	40.9	44.1
Gross private investment as a % of GDP	..	1.8	1.0	7.3	8.2	13.9	22.0	24.0	25.9
Gross public investment as a % of GDP	..	3.6	14.1	10.5	11.1	15.4	18.9	16.9	18.2
Foreign direct investment as a % of GDP	..	0.0	0.0	0.0	0.0	5.8	5.9	4.6	..

.. not applicable

n.a. not available

data for 1999 are estimates

Source: World Bank (2000b)

Table 2

Eritrea: external accounts

	1993	1994	1995	1996	1997 (estimated)
Trade balance (US$ million)	-239.0	-331.4	-323.2	-418.5	-436.4
Exports (f.o.b) (US$ million)	36.1	64.5	80.6	95.3	53.1
Imports (c.i.f) (US$ million)	275.1	395.9	403.8	513.7	489.5
Private transfers (net) (US$ million)	165.4	276.3	215.3	243.9	384.4
Current account (excluding official transfers) (US$ million)	28.4	17.9	-53.2	-130.7	-36.5
Current account (excluding official transfers) as a percentage of GNP	5.6	2.7	-7.7	-17.2	-4.4
Current account (including official transfers as a percentage of GNP)	19.4	14.7	2.6	-6.7	0.6
Official transfers (net) (US$ million)	69.5	79.7	71.0	79.9	41.4
Official transfers (net) (as percentage of GNP)	13.8	12.0	10.3	10.5	5.0
Stock of External Debt (US$ million)	2.4	31.6	39.1	47.2	75.6
Stock of External Debt (as percentage of GNP)	0.5	4.8	5.7	6.2	9.1

Source: IMF (1998: 76), and author's calculations.

Table 3

Eritrea: fiscal position 1992-99 (percentage of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999
Fiscal Balance inc. Grants % of GDP	- 3.2	- 6.4	- 12.7	- 22.4	- 19.8	- 7.0	- 32.4	n.a
Fiscal Balance excl. Grants % of GDP	- 12.3	- 26.5	- 31.2	- 35.1	- 31.7	- 13.2	- 38.4	n.a
Capital grants as % of GDP	9.1	20.1	18.5	12.7	12.0	6.2	5.9	0.0
Revenue, incl. all Grants % of GDP	33.4	55.4	46.6	46.8	44.2	47.9	39.8	..
Expenditure, as % of GDP	36.7	61.8	59.3	69.2	64.0	54.9	72.2	..

Note: 1998 and 1999 numbers are estimates.

Private remittances from overseas contribute to a large portion of Eritrea's income. Therefore, ratios to GNP are more appropriate measures to GDP. In contrast, most SSA countries receive much smaller private remittance flows, and therefore ratios to GDP are appropriate for much of SSA. The World Bank reports fiscal data as ratios to GDP for all countries. IMF (1998: Table 14) provides some fiscal data as ratios to GNP, but does not cover all the fiscal indicators provided by the World Bank.

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