Conflicts affect investments—IMF

The Q&A

In a recent Regional Economic Outlook, the International Monetary Fund (IMF) focused on the economic consequences of conflict. In a question and answer interview, IMF resident to Zimbabwe Patrick Imam (PI) tells *Business Times* (BT) that conflicts have negative effects on economies.

Find excerpts below:

BT: Why did the IMF focus on the economic consequences of conflicts in its recent Regional Economic Outlook? What are the key messages and findings of the study?

PI: We focused on conflicts, because they have significant negative consequences on the economy. One key message is that after declining through the 2000s, there has been an uptick in conflict in sub-Saharan Africa in recent years, although its intensity remains well below the levels observed in the 1990s. Overall, the region remains prone to conflict, with a third of the countries being affected in recent years. As of 2017, over 6 million refugees have originated from the region, with a majority resettling on the continent. An additional 10 million people have been internally displaced.

The Sahel region in particular has experienced a significant increase in violence since 2010, accounting for over 50 percent of all conflict-related deaths in sub-Saharan Africa. The nature of conflicts appears to have changed as well, with traditional civil wars being largely replaced by non-state-based conflicts, including the targeting of civilians through terrorist attacks. Besides the human suffering, conflicts impose significant economic costs. First, it impacts growth negatively, as this is not unexpected.

We find that conflicts have large and persistent effects on living standards. Growth is, on average, about 3 percentage points lower in conflict cases than otherwise, driven in part by a decline in investment, exports, and productivity. Counterfactual analysis suggests real GDP per capita is 15 to 20 percent lower five years after conflict onset relative to a no-conflict scenario. Furthermore, the effect of conflicts is found to be nonlinear. What I mean by this is that the conflict becomes more intense, the effect on growth increases exponentially.

The second major toll is on human capital. Health and education outcomes deteriorate substantially during conflicts. Primary enrolment rates are lower, with girls often affected more, and maternal mortality is higher during conflicts.

Thirdly, the spillover of conflicts on neighbors is significant.

Conflict can have substantial spillovers on nearby countries by depressing economic activity or by creating social strains, for example, due to a large influx of refugees.

And finally, conflicts tend to complicate public finances. They lower real revenue growth by over 10 percentage points, while tilting the composition of spending away from capital expenditures toward military spending. Fiscal deficits and public debt rise as a result.

BT: What are the main policy implications? What should sub Saharan Africa countries do to limit the impact of conflict on their economies?

PI: Given the large humanitarian and economic costs associated with conflicts, it is imperative to prevent conflicts in the first place.

The causes of conflict are often complex and depend on the context and history of the country. But they encompass a host of economic, social and political factors. We find that low income levels, poor growth outcomes, weak state capacity matter. But inequality of opportunities especially across ethnic, religious and regional groups also tend to be associated with a greater likelihood of conflict. These factors point to the need to build institutional capacity, promote inclusive growth, and foster social cohesion. Moreover, economic policy alone is unlikely to be enough, with the political process playing a pivotal role in conflict prevention.

If things come to a head, and a conflict cannot be prevented, then mitigating the negative effects becomes key. For countries in conflict, efforts should focus on limiting the loss of human and physical capital, including protecting social and development spending. Maintaining well-functioning institutions and fiscal fundamentals can help to mitigate the adverse effects of conflicts by providing room for governments to respond.

Obviously, there is also a role of external assistance. Well-targeted and coordinated humanitarian aid can create room to respond to the ravaging effects of conflict. External assistance may also be essential for countries suffering from the spillover effects of conflict to protect displaced populations and alleviate the strains generated in host countries.

BT: What role can the IMF play in conflict-affected countries?

PI: Your question is not just theoretical, as the IMF is directly involved in conflict-affected countries. There are three main channels through which the IMF helps conflict-affected countries, namely policy advice, financing, and capacity building.

At the level of policy advice, the IMF is cognisant of the tremendous challenges faced by conflict-affected countries and has been implementing a medium-term approach to engage with countries in fragile situations, giving due consideration to the local context. Its policy advice in these countries focuses on preserving macroeconomic stability and building resilience to security-related vulnerabilities by trying to protect social and developmental spending. However, as you can imagine, this is very challenging.

The Fund also provides technical assistance (TA) to conflict-affected countries to build institutional capacity. Very often, the most qualified staff has left the country, and therefore human capital needs to be rebuilt. Technical assistance activities are provided on a broad range of issues ranging from revenue mobilisation to tackling the financing of terrorism by strengthening Anti-Money Laundry and Combatting of Financial Terrorism frameworks. Since 2017, the Fund is beginning to implement, but this is currently only on a pilot basis, a capacity building framework for five countries in fragile situations, including conflict-affected countries like the Central African Republic and Mali. These frameworks are based on a medium-term strategy agreed with the authorities and aim to coordinate TA activities across TA providers. We will have to see how successful this is.

And finally, the Fund is also providing financial assistance to conflict-affected countries where it is required. The Fund has increased access to concessional facilities, including the Rapid Credit Facility, which carries zero interest, which is often used by conflict-affected and other fragile countries, or more recently in a country like Mozambique impacted by natural disasters. Moreover, in dialogue with donors, the Fund highlights the financing needs faced by conflict-affected countries, including for additional security spending where warranted, and attempts to catalyse official financing.

BT: Do conflicts have large spillover effects on neighbouring and other countries, especially due to the large number of displaced persons, including refugees? How can these effects be mitigated?

PI: Absolutely, conflicts can have substantial spillover effects by depressing economic activity in nearby countries, in particular by increasing uncertainty or by disrupting trade. There is evidence for this in sub-Saharan Africa. The effect of conflict on growth in nearby countries is about one-third of the local effect.

In addition, conflicts can also create social strains in other non-conflict regions due to a large influx of displaced persons. This issue is especially relevant for Africa. In 2017, over 6 million refugees have originated from the region, and an additional 10 million have been internally displaced. What is notable is that most of the refugees originating from Africa have resettled within the continent.

For example, refugees form 3 percent of the population of Uganda and Chad, with a much smaller share settling in advanced economies. This is not always the impression one gets by looking at the international press.

While the influx of many displaced people can produce social strains in host countries and communities, steps can be taken to mitigate some of these effects. In particular, integrating refugees into the local community, including through access to education, health, and labour markets, can help refugees to acquire the skills to productively contribute to the economy of their host country. However, providing public services to a large displaced population can put pressure on public finances, and in this regard external assistance in the form of humanitarian aid and concessional financing may be essential to protect displaced populations and alleviate the fiscal strains generated in host countries.

BT: What is the effect of conflict on a country's public finances?

PI: Public finances typically deteriorate significantly during conflicts. First, on the revenue side, conflicts can reduce collections by disrupting economic activity, destroying part of the tax base, and lowering the efficiency of tax administration. In sub-Saharan Africa, revenue growth can fall by over 10 percentage points during intense conflicts or about 2 percent as a share of GDP.

Second, conflicts render expenditures less pro-poor. While, on average, overall expenditures do not appear to increase during conflicts, there is a change in the composition of expenditures, with military spending in real terms increasing by about 9 percent, while growth-friendly real public capital expenditure decreases by about the same amount.

Finally, conflicts impact deficits and debt levels. The net effect is an average increase in the overall fiscal deficit of about 2 percent of GDP, which contributes to an increase in public debt. On average, public debt increases by about 8 percent of GDP.

BT: Does the Fund's advice regarding fiscal policy and debt sustainability reflect challenges faced by conflict countries?

PI: Yes, absolutely. Fiscal policy in Low-Income Countries often requires a balancing act between undertaking much needed development spending and reducing debt vulnerabilities. These trade-offs can be especially acute in countries facing intense conflicts where deteriorating public finances can potentially limit the government's ability to respond to the conflict, accentuating the conflicts' debilitating effects and increasing the likelihood of the conflict becoming prolonged. The IMF advice in this context is country-specific and takes this difficult trade-off into consideration.

In this context, creating fiscal space to safeguard social and developmental spending in conflict cases is essential, while accommodating an increase in security spending if needed. In this regard, the Fund has been emphasising the need to mobilise domestic revenues and improve spending efficiency where possible. Protecting the quality of institutions, such as the revenue authority, can help in this regard and the IMF has provided TA on these topics to fragile and conflict-affected countries. Moreover, as I already mentioned, in dialogue with donors, the Fund highlights the financing needs faced by conflict-affected countries, including for additional security spending where warranted, and attempts to catalyze concessional official financing for fragile countries.

BT: Does the Fund advocate an increase in military/security spending in conflict countries?

PI: The key priority for conflict-affected countries is to maintain macroeconomic stability while building resilience to security challenges. In this regard, Fund advice and programmes take into account country specific circumstances, including increased security spending where such spending is considered vital for mitigating security risks.

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