ACCOUNTING FOR UNPREDICTABILITY IN PRIVATE INVESTMENT

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EXECUTIVE SUMMARY

The uncertainty inherent in conflict settings presents a vast challenge to private sector activity. Governments seeking to attract business must prioritize establishing regulation, providing infrastructure and security, and promoting inclusive policies. The private sector can maximize its impact in fragile states by supporting the supply and demand of the labor market, and by supporting local business development.

INTRODUCTION

This summer marks the centenary of the start of World War I and seems an opportune time to address the impact of conflict-ridden and fragile states. One hundred years on, war and conflict are raging in many parts of the world, while the global economy is yet to recover from the economic malaise rooted in the post-Lehman financial crisis. The challenges in boosting the economies of conflict states are enormous, but as we have learned from the World Wars, the combined efforts of governments, multilateral institutions and corporations are vital to restoring normality and stimulating growth.

CONFLICT STATES AND THE TRAP

A World Bank report, published in 2011, identified 1.5 billion people, or over 20 percent of the global population, as living in countries with repeated cycles of criminal or political violence.[1] Many of the worst conflicts take place in the world's poorest countries.

While conflict is still widely prevalent, optimists argue that levels of violence and conflict have decreased in recent years and should continue to do so as a result of development progress. However, conflict is not just about poverty and economics. Examples abound of conflicts where the root causes are predominantly non-economic: historic (Israel/Palestine); sectarian (Sunni/Shia in the Middle East); religious (Northern Nigeria); political (Balkans); or more commonly, a combination of these factors. Transnational militant groups, such as al-Qaida or ISIS, with radical ideologies and disdain for existing national boundaries, pose a major challenge to future stability and order. Furthermore, future conflicts could also arise around issues such as increasing wealth disparities in society or competition for water and trade routes.

Conflict settings lead to economic stagnation and a range of social and political problems. Breaking away from the "conflict trap" is a key challenge: 20 percent of the 146 cases of civil conflict in 94 countries examined in an International Monetary Fund study relapsed into a subsequent conflict in the first year, and 40 percent returned to conflict within five years. Also, post-conflict states averaged annual GDP growth of a measly 1.5 percent. It is not surprising therefore that international investors generally shy away from such states.

WHAT SHOULD GOVERNMENTS OF CONFLICT-AFFECTED ECONOMIES DO TO SUPPORT BUSINESS?

Governments in conflict states have a daunting role in creating an environment that attracts business and enables economic growth and development. Businesses ultimately require a degree of certainty in order to operate successfully. This makes conflict states a hard sell to corporations as such settings are, by their very nature, risky and often poorly governed. Even marginal improvements in the business environment may not be enough to allay business fears absent the promise of outsized returns.

Given the plethora of opportunities that is usually available to foreign capital, it takes a patient, long-term investor, with a special incentive or impetus, or perhaps a prod from their home nation, to invest in a post-conflict state. Standard Chartered Bank's entry into Iraq in 2013 was premised on the need to follow and serve the needs of Western and Asian multinational clients who were beginning to invest in the country, particularly in the oil and infrastructure sectors. Or, in the case of a consumer products company, it could be the ability to secure a first mover advantage for a global brand. Often the stand-alone returns in these situations may not be sufficient to compensate for the risk, but it is the totality of the return to the network or the impact on the brand that becomes the "swing" factor.

Governments cannot manufacture strong economies on their own. First, they have to work effectively in partnership with other governments, policymakers and the international community to absorb aid from bilateral and multilateral sources. This was the case in Rwanda during its recovery from the horror of its genocide. The private sector and multilateral agencies also need to be encouraged and incentivized to have a shared interest in helping countries transition out of fragility.[2] Governments should also harness the power of philanthropy in the rebuilding process by engaging in wider private-philanthropic-public partnerships. Long-term stability is best achieved by promoting inclusive growth that maximizes the pool of stakeholders with an enlightened self-interest in not retreating to conflict.

Investors providing private capital require financial security and protection for their investment. Partnering with multilateral organizations, such as the International Finance Corporation (IFC), to share risk is a common tactic. Other institutions like the Multilateral Investment Guarantee Agency and export credit agencies that focus on insuring investments have a key role to play, and bilateral investment treaties between governments also serve to protect investors.

Policymakers must ultimately prioritize among multiple objectives and needs, given their finite resources. The three most essential areas in which governments can make a difference in attracting business are: establishing regulation, providing infrastructure and security, and promoting inclusive policies.

Regulation

A robust institutional infrastructure underscored by strong rule of law is of paramount importance. A key factor is the quality and stability of political institutions and other quasi-political factors such as levels of corruption, free speech, and the status of ethnic or religious minorities. An attractive regulatory environment helps domestic entrepreneurs to blossom, while also acting as a magnet for foreign investment.

Conflict states need help in drafting rules and regulations, but these cannot be simply transplanted from outside. There needs to be a genuine emphasis on national dialogue, but this is often an area where multilateral agencies and foreign governments can provide useful inputs.

Infrastructure and Security

Post-conflict states need rapid investment in hard and soft infrastructure. Investments in electricity, transport, banking, telecommunications, education, and technology infrastructure determine the pace of economic rehabilitation. Linked to infrastructure is the basic requirement for businesses to be, and feel, physically safe. Guaranteeing the security of employees and assets is critical to building investor confidence. It was concerns around the safety of staff that precipitated Standard Chartered's departure from Afghanistan in 2012.

After the end of the civil war in Lebanon in 1989, which decimated the electricity sector, the private sector stepped in, helped by a strong entrepreneurial culture and a relatively open economy. By 1994, 98 percent of businesses in the country were estimated to have access to round-the-clock electricity, much of it from the private sector.[3] In the Democratic Republic of Congo, the construction of a bridge linking the cities of Kikwit and Tshikapa cut travel times, helping reduce the price of both fuel and food.

Inclusion

Supporting the recovery and role of women—both socially and economically—can have significant and positive consequences on a fragile state and the firms operating within them. When women are fully free to join the labor force, companies benefit from enhanced business opportunities and access to new market segments.[4] Enabling women to become full participants in the economy has massive social benefits: women-headed households reinvest 90 percent of their income into their families whereas men reinvest only 30 to 40 percent. Moreover, women's economic empowerment positively affects the nutrition and education levels of children.[5]

To fully realize the multiplier effect of empowering women, governments must ensure that local legislation provides equal opportunities for women and men. Rwanda provides an excellent case study: after the genocide, it adopted a gender-sensitive constitution. During the first post-conflict parliamentary election in 2003, women held nearly 50 percent of the seats.[6] Arguably, this approach helped Rwanda achieve accelerated stability after the genocide.

THE ROLE OF BUSINESS IN PROMOTING ECONOMIC STABILITY

The private sector can play many roles to encourage economic development in fragile and post-conflict states—from investing in the value chain and paying national tax to establishing strong levels of corporate governance and advancing sound monetary and regulatory policy. As the private sector accounts for 90 percent of the jobs in the developing world, its presence is crucial in ensuring employment opportunities.[7]

Companies can help a conflict-affected state without establishing a physical presence in the country. This is true for service providers such as consulting firms but also for financial institutions. For instance, Standard Chartered provided sizeable financing to the Angolan oil sector many years before it established a physical presence in Angola, and the funds helped the country on its journey towards becoming Africa's second largest oil producer.

The private sector can maximize its impact and catalyze sustained economic growth in fragile states in two specific ways: by supporting the supply and demand of the labor market, and, by facilitating the growth of micro and small enterprises (MSEs).

Jobs – Improving the Supply and Creating the Demand

Globally, 200 million people—75 million under the age of 25—are unemployed.[8] Moreover, 621 million young people are neither working nor studying, according to a recent World Bank report.[9] The unemployment problem in the Middle East is even more acute: 25 percent of young people in the Middle East are unemployed.[10] This is an ominous recipe for political turmoil and violence.[11]

Over the years, many donors and multilateral institutions have transferred their development assistance to the provision of basic needs like health, education, water, and sanitation. This is understandable in light of the focus on the Millennium Development Goals, but this shift has been detrimental to job creation and vocational programs.[12] Although many recovery and reconciliation plans emphasize the important role of growth, most neglect the value of employment in terms of violence prevention and social cohesion.[13]

Create the Demand for Local Jobs. One of the main ways the private sector can help is by creating jobs. This approach is also more sustainable, as the jobs and income generated will outlast most development assistance programs.

In 2013, Coca-Cola was one of the first U.S. companies awarded an investment permit in Myanmar. In recognition of the importance of investing in the local economy and facilitating employment opportunities, Coca-Cola announced a $200 million investment in a new production facility as well as marketing and logistics functions that it estimates will generate more than 22,000 jobs in Myanmar over the next five years.[14] As a first step, Coca-Cola inaugurated a bottling plant near Yangon, working with a local company, Pinya Manufacturing, to produce and distribute Coca-Cola and Sprite nationwide—a tactic that not only created employment opportunities for the local population, but also helped build the capacity of a local MSE.[15]

Improve the supply. While employment opportunities are absolutely critical in facilitating growth and tempering violence and unrest, not all populations are employable. Low levels of skill, especially among former combatants, are often a limiting factor.[16] The problem is especially acute in the Middle East where many young people lack marketable skills, experience, and knowledge.[17] Yet, research has shown that traditional vocational programs, without connectivity to specific jobs, are ineffective.[18] Thus, the private sector has an opportunity to improve the supply of talent in addition to creating the demand. Vocational training programs and higher education opportunities not only foster employment, but spawn innovation in fragile states.[19]

In Sri Lanka, the Virtusa Corporation, a U.S.-based information technology company, is committed to furthering the rehabilitation and employability of ex-combatants. The ex-combatants, who had been involved in a conflict lasting 30 years, posed a significant security risk to the company and the country, so Virtusa created a software infrastructure to match ex-combatants to training and employment opportunities. It also provided digital literacy training. By the end of the initiative, Virtusa had trained over 12,000 ex-combatants and placed thousands more in vocational and employment programs.[20]

Infrastructure as a Job Generator. As noted before, hard infrastructure is crucial to economic recovery in post-conflict countries: infrastructure facilitates growth and, in turn, jobs.
In Djibouti, East Africa, Standard Chartered took the lead in structuring and co-underwriting a $400 million facility for the establishment of a new port. The Djibouti port has been fully operational since 2010. As one of the most technologically advanced container terminals on the continent, it has emerged as a major service provider to many of Africa's landlocked countries. For example, 90 percent of Ethiopia's imports and exports flow through it. The port—in conjunction with the Djibouti Free Trade Zone, where over 100 leading regional and global companies are located—forms a major hub for Eastern and Central Africa, serving over 380 million people. The port was a crucial infrastructure project for the country, but it also had a massive impact on local employment through the facilitation and enhancement of trade.

Enabling Small Business

In the developing world and in most fragile states, MSEs account for the majority of employment. According to the IFC, MSEs employ 66 percent of the full-time, permanent, employed population.[21] In Africa, the informal sector, of which micro-enterprises are a key component, constitutes approximately 55 percent of sub-Saharan Africa's GDP and 80 percent of the labor force.[22] Informal is normal.

Small firms face a variety of challenges that inhibit their development, but the two main constraints are access to electricity and access to finance.[23] These are areas the private sector can and should address to help unlock the growth of MSEs.

The constraint of power. Royal Dutch Shell's actions in Bonny Island in the Niger Delta prove that a relatively small investment can have an outsized economic and social impact on fragile communities. In the Delta, a region starved of power, Shell provided capital to a local electricity company, Kingdom, to increase its generation capacity. Kingdom now supports the needs of over 10,000 local households and businesses, as against the original estimates of 3,000 customers.[24] By early 2013, the project had generated 200 jobs.[25] The removal of the electricity bottleneck also helped MSEs in the Delta grow their own businesses, leading to a virtuous circle of increased revenues and more opportunities for employment.

The need for financing. China Development Bank's (CDB) actions in Tajikistan serve as a good case study of how the private sector can facilitate access to finance for MSEs. Tajikistan was confronting a fraught transition to independence after a five year long civil war. Sixty percent of the population depended on agriculture, but most farmers lacked access to finance. This was a major bottleneck to Tajiki growth and made the community vulnerable to social unrest.

CDB decided to work with Amonatbonk (the State Savings Bank of Tajikistan) to expand the availability of agri-finance in the country. CDB and Amonatbonk signed a $10 million financing agreement to support loans of up to $20,000 to agriculture-based MSEs. When CDB examined the outcomes of their $10 million credit facility, they discovered that the MSEs that received credit were able to increase their revenues, enhance employment opportunities, and facilitate growth of their local economy.[26]

CONCLUSION

There are a range of things that can be done to manage risks in conflict settings. There is no "silver bullet," but a combination of targeted action and interventions by governments, multilateral agencies, philanthropic players, and the private sector can help to establish stability, stimulate growth, and create jobs. Reconciliation and economic stability take time and require coordination, collaboration and partnership by all stakeholders involved. The gains from boosting economic growth in conflict states will not only benefit a particular state and its citizens, but also facilitate global prosperity and geo-political stability.

[1] see http://web.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/EXTWDRS/0,,contentMDK:23252415~pagePK:478093~piPK:477627~theSitePK:477624,00.html
[2] Third International Dialogue Global Meeting. "The New Deal: Achieving Better Results and Shaping the Global Agenda". 19 April 2013.
[3] See World Bank, World Development report, 2011 http://siteresources.worldbank.org/INTWDRS/Resources/WDR2011_Full_Text.pdf p.157
[4] IFC Jobs Study "Assessing Private Sector Contributions to Job Creation and Poverty Reduction." January 2013. Page 116.
[5] IFC Jobs Study "Assessing Private Sector Contributions to Job Creation and Poverty Reduction." Page 117; "*In Pakistan, the inclusion of more women in the labour force would grow GDP by 0.8 per cent a year; in Nigeria, GDP would increase by 0.9 per cent a year."* Goldman Sachs 2008 "Women Hold up Half the Sky"
[6] Powley, Elizabeth. "Rwanda: women hold up half the parliament."
[7] Leo, Benjamin, Vijaya Ramachandran, and Ross Thuotte. "Supporting Private Business Growth in African Fragile States." Center for Global Development 2012. Page 5. http://www.cgdev.org/files/1426061_file_Leo_Ramachandran_Thuotte_fragile_states_FINAL.pdf
[8] World Bank World Development Report on Jobs 2013.
[9] World Bank World Development Report on Jobs 2013. Page 4.
[10] World Economic Forum. "Addressing the 100 Million Youth Challenge: Perspectives on Youth Employment in the Arab World." 8
[11] Leo, Benjamin, Vijaya Ramachandran, and Ross Thuotte. Page 7.
[12] World Bank World Development Report 2011. Page 200.
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[14] Coca-Cola Starts Local Production in Myanmar. 4 June 2013. http://www.coca-colacompany.com/press-center/press-releases/coca-cola-starts-local-production-in-myanmar
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[23] IFC Jobs Study. Page 38.
[24] UN Global Compact. "Responsible Business Advancing Peace. 2013. Page 56.
[25] UN Global Compact. "Responsible Business Advancing Peace. 2013. Page 56.
[26] UN Global Compact. "Responsible Business Advancing Peace. 2013. Page 19.