Violent political conflict causes drop in domestic company investments

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Firms based in countries experiencing violent political conflicts see their inventory purchases drop as much as 20% on average as a result of economic uncertainty and fluctuating demand, according to research from Imperial College Business School.

According to a paper authored by Claudia Custodio, Associate Professor of Finance at Imperial College Business School, small companies in developing countries were more likely to suffer from the consequences of violence and political unrest compared to bigger firms in the same regions.

The researchers, who included experts from Imperial College London and the Stockholm School of Economics, sought to understand the impact of violent conflicts such as war and terrorism on economic activity. They studied the inventory purchases – items purchased to be sold to customers - of 650 firms based in Mozambique – a country where political conflicts, instability and crime are identified as both regular occurrences and an obstacle to private enterprises.

Data was collected on each company's inventory purchases over a 22-month period, as well as the occurrence of violent political conflicts within a 10km radius. By doing this, the researchers were able to identify the direct impact that such events had on each firm's inventory purchases.

The researchers found that, on average, companies based in areas with local violent conflict reduced their investment in inventory by as much as one-fifth. This effect was even worse for smaller companies, which experienced the greatest damage during such conflicts and cut investments by a third.

Commenting on the findings, Dr Custodio said: "A large fraction of the world's population lives in regions affected by violent political conflicts. This has been accelerated even further by the ongoing conflict in Ukraine, causing not only more people to be plunged into uncertainty, but also firms in these regions too. Our research clearly shows that political conflicts have a dramatic impact on the businesses that are based in the affected regions, not only causing war and devastation but economic obscurity for organisations too."

The research also found that the negative effect of violent political conflicts on small firms persisted for two months, suggesting this reduction in inventory purchases was most likely due to increased uncertainty rather than capital or property destruction for some of the firms.

Dr Custodio said: "Firms typically respond to violent conflicts by purchasing less inventory in anticipation of a decrease in consumer demand. This is often done for precautionary reasons, as violence might lead to property destruction including storage facilities, or because firms' operations are disrupted."

She said that in the short-run, firms might decide to increase their inventories despite an expected decrease in consumer demand if they anticipate the conflict to escalate and disrupt supply chains in the future.

To avoid being caught out by unexpected shocks, the researchers suggest that firms adjust their inventory purchases for precautionary motives, rather than solely in reflection of changes in demand.

The study also revealed that such events can impact management decisions when it comes to business growth. Managers of firms exposed to an increase in violent conflict were found to be more likely to express their intentions to expand to less violent areas. This suggests that managers incorporate the likelihood of conflict into their strategic decisions, not only their operational ones. As a result, local economies in areas hit by regular or ongoing conflict could see further difficulty as companies seek alternative customer bases and suppliers.

The full paper, Inventory Decisions Under Political Violence is available to download from the Social Sciences Research Network.

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