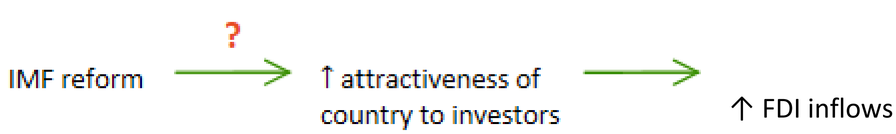
IMF Reform and FDI

Minahil Amin
21 April 2014

The International Monetary Fund has a mandate to maintain the stability of the international monetary system and promote efficient trade and productive resource use. Effectively, this mandate impels the IMF to have a vested interest in enhancing its members' access to international capital markets; its programs are partially designed with this goal in mind, and often include such measures as financial market liberalization, reduction of trade barriers, and privatization of state-owned enterprises. A country participating in an IMF program, then, should be seen as a more attractive investment choice then a country not participating. However, in a 2003 briefing paper, Oxfam referenced a survey that found that "while foreign investors in Africa see the existence of a reform program with the… IMF as a sign of stability, they do not rank this as an important factor in investment decision."

I will use this paper to explore the gap between the IMFs intentions and investors' perceptions – how does a country's engagement with an IMF-driven reform program influence FDI firms' decision to invest in that country?



Countries often sign on to IMF programs believing that they serve as a signal that the country has an amenable investment program and that the program may include provisions that give investors tangible benefits; however, not only are these two assumptions sometimes untrue, but also participation in an IMF program is a minor, tertiary consideration for investors.

Mechanisms

The mechanisms through which IMF reforms presumably catalyze FDI inflows, signaling and inclusion of FDI-amenable provisions, are ambiguous. In regard to signaling, IMF-supported programs do not provide a uniformly positive signal, partly due to the fact that many countries come to the IMF in wake of financial crises. Repeated engagements with the IMF without significant improvement alongside make investors less likely to invest in a country (Mody et al). Jensen finds that even after controlling for the factors that lead countries to seek IMF support, countries that sign IMF agreements attract 25% less FDI inflows than countries not under IMF agreements.

The other argument is that reform programs include provisions that give foreign investors intrinsic benefits. In regard to direct benefits, IMF bundles often include FDI-specific policy changes, including measures related to legal environment, non-discrimination, and property rights and protection. Mehic et al find that in the case of Southeastern Europe, FDI policy has a highly significant impact on FDI flows. Although the sample is limited, it is evidence in favor of IMF reform, given that these reforms include provisions that make FDI policy more congenial for investors. Other factors linked with positive FDI inflows include transparency of institutions and laws, bureaucratic quality, private ownership of business, banking sector reform, and foreign exchange liberalization (Campos and Kinoshita; Mehic et al). Campos and

Kinoshita assert that countries use reforms to implement financial liberalization, in particular, generate a higher growth payoff from FDI. The reasoning behind this finding is that not only do strong financial systems boost investor confidence, they also allow local suppliers to gain credit and invest in upgrading capital to provide better inputs that can then be leveraged in the FDI production process.

There is one major factor related to IMF reform which is inherently detrimental for foreign investors – ceteris paribus, IMF programs have been repeatedly found to be linked to poor economic outcomes (Biglaiser and DeRouen). It may be that that “the IMF simply gets the policy prescriptions wrong,” or it may be that IMF programs are intended to be short-run solutions for crisis relief and have unpredictable long-run costs for macroeconomic performance (Jensen). Whatever the cause, poor macroeconomic conditions are inhibitive for FDI.

FDI Decision-making

Beyond the question of whether IMF reform actually makes a country more amenable for foreign investors lies the question of whether and how investors take into account the presence of IMF reform and its associated factors in a given country. In foreign investment decision-making, one commonly-propagated argument is the eclectic paradigm – that investors decide to invest based on advantages in ownership, location, and internalization (Gastanaga et al). They are attracted to countries with more stable macroeconomic environments, higher levels of economic development, and better infrastructure (Campos and Kinoshita). As Jensen explains, investors react positively to IMF programs only in cases where the deterioration of macroeconomic indicators was minimal. The next major factor in FDI decisions is whether a firm is market-oriented or export-oriented. If the firm is market-oriented, its decision will be contingent on the size and growth prospects of a country's market (Campos and Kinoshita). If it is export-oriented, the decision will rely on the availability of raw materials and related extraction costs (Mehic et al). This consideration informs a firm's strategy in regard to selecting a country that possesses key capabilities and resources (such as an educated labor force). The consequent branch in the investment decision tree is that of cost-attractiveness. Firms choose investment sites that minimize the total cost of production (including labor and material inputs), transactions, and transportation (Campos and Kinoshita). In sum, FDI seems to be driven as follows:

Macroeconomic conditions → Export-oriented vs. Market-oriented FDI → Strategic factors → Cost-attractiveness → IMF reform

Whether an FDI firm considers IMF reform in its investment decision is contingent on several other factors. It is more of a tie-breaking factor than a primary consideration. To further nuance the consideration, participation in an IMF program is correlated with higher FDI only in cases where the program mitigates export volatility, solvency is not at stake, and the program is large in size (Mody et al).

Conclusion

The conventional wisdom is that IMF programs and conditionality should have a positive effect on FDI inflows. However, this paper has investigated the assumptions behind this wisdom and has found that it is dubious that IMF reforms increase the perceived attractiveness of a country to foreign investors, and are thus are a minor factor in FDI inflows. An IMF program is an effective signal to investors only when other available information does not negate its credibility. Although IMF reform generally provides tangible benefits for investors in regard to financial system credibility and regulatory structure accessibility, it is also generally linked to poor economic outcomes. Furthermore, these reforms tend to be a peripheral consideration for investors, after they take into account macroeconomic conditions, strategic factors based on the firm's FDI orientation (market vs export), and cost-attractiveness of a country.

The exploration of the relationship between IMF reform and FDI conducted in this paper can be expanded by looking into the nuances of the reform programs. We may find this relationship to be more nuanced if we differentiate between the different types of IMF programs. Furthermore, it may be that simple participation in an IMF program is not enough. Investors may need to confirm the success and credibility of a reform before using it to inform their investment decision. In this case, the extent and quality of a country's implementation of an IMF program becomes significant. Such an examination would also yield insight into which aspects of IMF programs generate the IMF's intended outcomes of maintaining the stability of the international monetary system, promoting efficient trade, ensuring productive resource use, and ultimately, of increasing member access to international capital markets.

Works Cited

Biglaiser, Glen, and Karl DeRouen. "The effects of IMF programs on U.S. foreign direct investment in the developing world." *The Review of International Organizations* 5.1 (2010): 73-95. *Springer Link*. Web. 16 Apr. 2014.

Campos, Nauro F, and Yuko Kinoshita. "Structural Reforms, Financial Liberalization, and Foreign Direct Investment." *IMF Staff Papers* 57.2 (2009): 326-365. *EBSCO Host*. Web. 15 Apr. 2014.

Gastanaga, V, J Nugent, and B Pashamova. "Host Country Reforms And FDI Inflows: How Much Difference Do They Make?." *World Development* 26.7 (1998): 1299-1314. *Science Direct*. Web. 15 Apr. 2014.

Jensen, N. M.. "Crisis, Conditions, And Capital: The Effect Of International Monetary Fund Agreements On Foreign Direct Investment Inflows." *Journal of Conflict Resolution* 48.2 (2004): 194-210. *Sage Publications*. Web. 16 Apr. 2014.

Mehic, Eldin, Sabina Silajdzic, and Vesna Babic-Hodovic. "The Impact of FDI on Economic Growth: Some Evidence from Southeast Europe." *Emerging Markets Finance and Trade* 49.0 (2013): 5-20. *EBSCO Host*. Web. 16 Apr. 2014.

Mody, Ashoka, and Diego Saravia. "Catalysing Private Capital Flows: Do IMF Programmes Work as Commitment Devices?." *The Economic Journal* 116.513 (2006): 843-867. *IMF publications*. Web. 15 Apr. 2014.

“Unwanted, Unproductive and Unbalanced: Six Arguments Against an Investment Agreement at the WTO.” Oxfam, May 2003.