IMF Lending and FDI Outflows: A Sectoral Perspective

Michael Breen & Patrick J. W. Egan explain the key policy takeaways from their peer-reviewed article, "The Catalytic Effect of IMF Lending: Evidence from Sectoral FDI Data," published in International Interactions *Vol. 45 Issue 3.*

Country partnership with the International Monetary Fund (IMF) is ideally rare and short in duration. States turn to the IMF in times of economic crisis, which usually involve some combination of increasing national debt, balance of payments problems, and dwindling foreign reserves. The conditional loans provided by the IMF serve as a temporary solution to balance of payments issues, providing a capital influx in exchange for various policy shifts designed to bring about macroeconomic stabilization. The IMF has always viewed its loans as a stopgap measure; normally only a portion of the capital flows necessary to correct a deficit are lent to countries in crisis. The rest is expected to come from private capital markets. Indeed, the entire rationale for IMF lending rests on a conundrum: private capital is unwilling to finance a current account deficit, yet the IMF's involvement is supposed to be a signal for private capital flows to resume. This 'catalytic' mission of the IMF is expressly stated as one of its three main goals, alongside adjustment to shocks and avoiding future crises.

IMF programs are supposed to function as seals of approval for various forms of investment to resume, but there is precious little evidence to support the catalytic ideal. What explains this gap between expectations and reality? This paper proposes that the potential for IMF catalysis depends in part on the characteristics of incoming investment in crisis-hit countries. We argue that the IMF is indeed sending multiple and potentially contradictory signals to private capital with the announcement of a rescue package. We consider the varieties of audiences receiving IMF signals. That is, the sectoral distributions of direct investment in countries before and after IMF agreements. We argue that IMF programs can have varied effects on different forms of investment, depending on the attitudes toward risk and other intrinsic characteristics of firms, which vary systematically across sectors. While the overall evidence linking IMF partnership with a resumption of capital flows in crisis-hit countries is underwhelming, there are important variations in the catalytic effect by industry. Certain sectors are likely less receptive to the catalytic signal of IMF programs (if it exists) than others.

Like previous studies, we find a reliable anti-catalytic effect of IMF programs on the overall stock of inward FDI. However, our central empirical finding is that this exodus is primarily driven by a select few sectors, including the financial industry and construction. We argue that the anti-catalytic effect of IMF lending depends crucially on two sector characteristics: dependence on external finance and fixed assets, which become sunk costs in host countries. We argue that when sectors couple high dependence on external finance with low sunk costs, firms are more likely to use an IMF agreement and attendant funds as an opportunity to deleverage or reduce risk exposure in crisis-hit countries. This results from moral hazard, but not for future investments. Rather, IMF liquidity provision encourages firms that have already taken on risk to exit. In contrast, we find no evidence of an anti-catalytic effect in sectors with high sunk costs. We argue that these sectors are less vulnerable to moral hazard, and instead interpret an IMF agreement as a signal that their assets are less likely to be expropriated. However, our results do not demonstrate a catalytic effect in these sectors, only an absence of exodus. Therefore, our results suggest that an IMF agreement is on balance unlikely to generate substantial broad-based inflows of any

long-term capital. Instead, FDI flight may be severe depending on the type of investments prominent in the country at the time of crisis.

IMF programs are associated with a substantively large and negative effect on investment in financial and construction-related FDI, two sectors that exhibit a high degree of external capital dependence and low sunk costs. The prospect of austerity measures, limited growth, and structural adjustment likely combine with these sectors' relatively leveraged positions at the time of crisis to prompt exit. The funds provided by the IMF also likely allow these firms to recoup some losses before leaving. IMF support may allow risk-imbued actors to survive and either exit or prevent new entrants from entering the market. In either case, the IMF program does not prompt a new wave of investment but instead signals the fulfillment of moral hazard dynamics for firms already in country. In contrast, FDI in high sunk cost, low external dependence sectors do not experience similar exodus after IMF programs. Where investors are tied and perhaps risk-averse, the information provided by partnership with the IMF may serve as a critical signal regarding the returns on future investment, diminished likelihood of expropriation, and/or the possibility of future bailouts.

One implication of our findings is that the failure of IMF programs to generate sustained inflows of international capital may have less to do with the IMF itself and more to do with the changing nature of international investment. Since the 1990s, FDI has diversified greatly in developing countries. Natural resource FDI has declined as a proportion of overall FDI flows in these countries, and service sector investments have increased substantially. As investment patterns change, large outflows of investments after crises and IMF interventions perhaps become more understandable.

Our findings also have implications for host country governments and international organizations. Greater attention should be paid to the specific types of investments entering developing countries before and after economic crises. If mobile firms with high external dependence do indeed anticipate crises and subsequent bailouts, it would suggest that these types of investments do not represent sustainable vehicles for industrial upgrading in fragile economies. High acceptance of risk and financial hedging against crises may produce outflows of investment. At minimum, analysts and policymakers alike should consider the types of investment common in crisis-hit countries and how these investors are likely to respond to an IMF agreement.

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