Graham Bird. 1999. How important is sound domestic macroeconomics in attracting capital inflows to developing countries? Journal of International Development 11, pp. 1-26.

The problem

Developing countries tend to run current account balance of payments deficits on their trade in goods services. Reducing international reserves as a means of financing such deficits is not a long term option, and may not even be a short term option if reserves are already meagre. Inflows of capital, in the form of either aid or FDI offer a potential alternative, Failing to attract foreign capital inflows implies that national income and domestic living standards will have to decline, as an imbalance where domestic savings fall short of domestic investment call for foreign financing or for corrective measures which reduce consumption and investment. Given the related adjustment costs, developing countries will try to make themselves attractive to foreign creditors or investors. How can they do this?

Can good macroeconomics attract foreign investment?

All creditors/investors stress the importance of sound macroeconomics and the involvement of the IMF may be seen as a necessary condition for sound macroeconomics be pursued.

However, there are three inter-related problems with this. First, what is sound macroeconomics? Second, how effective is sound macroeconomics likely to be? Third, what are the more important factors that drive investment decisions by foreign firms?

The first question is crucial: there is strong disagreement about what is sound in macroeconomic theory and policy, and this disagreement then compounds with large uncertainty about outcomes of macroeconomic policy to create a very significant problem to define sound macroeconomics.

There is a general agreement that economies that run large and systematic fiscal and current account deficits, have hugely overvalued exchange rates and inflation rates are dangerous and have their macroeconomics wrong. The problem is that there is no agreement about what is the right macroeconomics for such economies. How does such an economy correct for its wrongdoings? Through demand management or supply promotion policies? Slowly or fast? Is the economy too vulnerable to shocks, and have shocks occurred/likely to occur? Have these shocks destroyed (or are these shocks going to destroy) the “good macroeconomic” policy?

The first question has strong implications to the second question in four ways. Firstly, economies that got their macroeconomics completely wrong are penalised by investors and creditors, but there is no equivalent reward for getting macroeconomics right. Secondly, because of the uncertainty surrounding macroeconomics, investors are unlikely to follow very rigorous processes for analysing macroeconomic data and context. They are more likely either to have un-scientific procedures or to put weight on some variables like economic growth, exchange rate and current account. Thirdly, because of the two previous points, investors are more likely to define thresholds below which they penalise, above which they may or may not reward, but the reward is not a continuous, proportional function of macroeconomic improvement. Fourthly, rewards do not necessarily follow as investors may wait and see.

The IMF claims that its support to macroeconomic programs helps in attracting foreign capital. This is not very likely because: (i) countries tend to turn to the IMF when their macroeconomics are completely wrong and their economies in deep trouble; (ii) many IMF

programs break down before completion; (iii) of the uncertainty about what sound macroeconomics is and what the results of macroeconomic policy are likely to be.

Third, the vast literature about the determinants of FDI argues that microeconomic factors important for the industry/firm concerned, together with general macroeconomic soundness and political stability, are the issues behind investors decision to locate their resources and productive capacities. The most important factors in investors' decisions are the rate of economic growth and strategic interests of the corporation concerned.

How important is macroeconomic soundness and how detailed and good it has to be? There is no evidence suggesting a link between the degree of macroeconomic soundness and inflows of foreign capital, although the evidence points out that: (i) a general sound macroeconomic situation is a necessary condition for inflows of capital; (ii) it is not a sufficient condition though, nor the most important; and (iii) although getting macroeconomics terribly wrong is penalised, getting it right beyond correcting for terribly bad policies is not rewarded.

Hence, it seems that investors place microeconomic conditions and corporate strategy at the core of their decision making process, and general political and macroeconomic stability is required to reduce uncertainty.

Beyond correcting for terrible mistakes, countries cannot expect to be rewarded for getting their macroeconomics right.