Are Failed Infrastructure Projects Linked to the Presence of the IMF or World Bank? Read on ...

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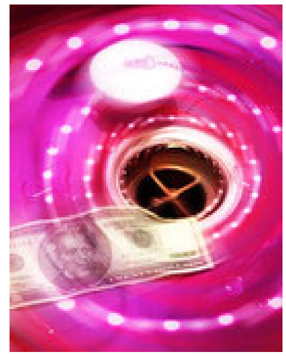

Witold Henisz calls it the "mob-on-the-street story."

He's heard it time and again from Western investors who have financed infrastructure improvement projects in developing countries. It goes something like this: Angry crowds protesting on the street. Political unrest. Governments caving in. Privatization failing. Money being lost. And, Henisz says, one last common denominator that made him more than a little curious: The involvement of the International Monetary Fund or the World Bank.

"When we first had investors telling us this, we thought, 'Well, they're just giving us a line,'" says Henisz, a Wharton management professor. "But we kept hearing it. So then we said, 'Well, we've got an anecdote, and now we have to find some way to prove whether it's true.' The mob-on-the-street story cropped up enough times that we wanted to pursue it."

Henisz and his colleagues -- Bennet A. Zelner from the University of California at Berkeley, Guy Holburn from the University of Western Ontario and Mauro F. Guillèn, a Wharton professor of management and sociology -- did just that. They combed through three decades of market reform and industry decentralization projects in dozens of countries the world over, looking for a link between failed or troubled reform efforts and the presence of the IMF or World Bank.

They found one. Working on two separate papers, Henisz and his colleagues turned up striking evidence that suggests the "mob-on-the-street story" -- and the idea that the IMF and World Bank were at least partly to blame for it -- isn't all that far-fetched. According to their research, the IMF and World Bank can and do play a significant role in implementing market reform and infrastructure projects in developing countries -- but often in a negative way. Further, the team found that when the IMF and World Bank are involved in these projects, disputes between investors and the government, government renegotiations of contracts, and even rollback of privatization efforts can follow. The two papers are called "The Worldwide Diffusion of Market-Oriented Infrastructure Reform, 1977-1999" and "Deinstitutionalization and Institutional Replacement: State-Centered and Neo-liberal Models in the Global Electricity Supply Industry."

Lessons for Investors

Their research suggests that the ongoing criticism of the IMF and World Bank -- that the institutions have strayed from their mission, that their policies are counterproductive and that they have not done enough to help needy nations -- might be partially justified. It also holds a lesson, Henisz says, for potential overseas investors. "If you see the IMF and the World Bank influencing reforms in a country, recognize that there are risks associated with that. There's risk of backlash against you and against the IMF or World Bank. It's not a seal of approval. It's a warning flag, and one you have to recognize and deal with."

Before Henisz could reach that conclusion, he first had to answer a much simpler question: Do the IMF and World Bank, via their money lending, actually impact domestic policy decisions?

After analyzing dozens of nations' efforts to privatize and deregulate their power and telecommunications industries, Henisz and his co-authors found the answer to be an emphatic "yes." They established that it's not just the political state of a country that investors should look at when deciding whether to put their money there, but also a range of other factors -- the presence of the IMF or World Bank included.

Henisz, Zelner and Guillèn first studied telecommunication and electricity market reforms in 71 countries and territories between 1977 and 1999 and found that multilateral lenders' coercive actions "may not produce ideal outcomes." It's difficult enough to get such reforms passed, they note, when the conditions are right: Of the 190 nations and territories that have attempted to privatize their electric industries, just 2% have fully completed the transition. Even as the researchers noted "deregulation and liberalization do, in many cases, improve the economic performance of industries previously owned by the state," they also are quick to point out how difficult such transitions are -- and say outside pressure from groups like the IMF or World Bank can lead to inappropriate policy mixes.

"We find that, after taking domestic political and economic factors into account, international forces have a strong effect on the domestic adoption of market-oriented infrastructure policies," the researchers write. "International coercive pressures increase the likelihood of majority privatization and regulatory separation, but not of regulatory depoliticization and liberalization of competition." All four of these reform elements are needed to generate sustainable market involvement in infrastructure services.

But why should the involvement of these large multilateral institutions -- founded, as they were, in the interest of global good and having a positive impact on regulatory reform and privatization -- be a bad thing? The reason, Henisz says, is rooted in their lending policies. Loans from those groups inevitably come along with certain conditions -- and a good degree of pressure -- that can stir unrest among populations resenting what they may perceive to be foreign control over their country. "I think for a long time people have focused on the potential benefits of the reforms," Henisz says. "People thought, 'Well, you just deregulate the market and that's the answer.' But the market part is only focused on efficiency, and people can be resentful that foreign [institutions] are forcing you to make a change. That can cause a dynamic that can have a real impact." In fact, Henisz, Holburn and Zelner found that investors who sent their money to nations facing above-average pressures to enact reforms from the IMF or World Bank are 63% more likely to face subsequent government interference with those reforms -- a sign that the reforms may fail -- than investors in countries where the World Bank and IMF are exerting less pressure.

The researchers say that if the IMF and World Bank push through inappropriate reforms in nations not politically ready for them, failure -- and the appearance of that "mob on the street" -- is increasingly likely. "Citizens in a country pressured into market-oriented reform when poor industry performance does not create demands for such reform, or when the national policymaking apparatus lacks sufficient checks and balances to support a well-organized market," they write, "may fare worse than those in a country adopting reform as the result of clear performance shortfalls and in the presence of domestic institutional support."

The old story about the IMF and World Bank -- that "you find firemen at fires" -- is not sufficient to explain the lenders' track record of showing up in troubled nations, the research suggests. "I don't think people previously had talked about that backlash, and the idea that [IMF or World Bank involvement] is not a sign of approval, but a warning flag," Henisz says. "It's not just that these lenders are going to troubled countries and that these countries are more likely to have additional trouble down the road. We're finding that the association with the IMF and the World Bank increases the risk for investors."

Triggers of Trouble

What does the research mean for investors and multinational corporations? To Henisz, that answer is simple: It proves how delicately foreign investments must be handled and how difficult they can be. And it proves that the IMF and World Bank, somehow, appear to be triggers of trouble.

"There's been a lot of criticism of the World Bank and the IMF, but this is the first study, conducted across dozens of countries, that shows the IMF and World Bank really do have a micro-level impact," Henisz says, adding that, unfortunately, many managers -- especially at the board and upper management levels -- don't yet understand that. The problem of domestic backlash, he notes, continues to be underestimated. "When we were in Latin America and Thailand and Indonesia, we were there when this was becoming a big issue, and now it's even larger," he says. "We were intrigued and we wanted to be at the center of what's going on. But for a number of Western investors, they haven't grasped the nature of it. You have to do things in Bolivia that you wouldn't do in Texas to sell power."

Selling decentralization and market reforms in these nations is a politically tricky task, and making them work will require companies to be more than simply good businessmen. They will have to be able to win over a populace that is just as likely to protest their intrusion as celebrate their arrival. That means companies banking on making money in these developing countries can't waltz in and expect a warm greeting. To win approval in Third World and developing nations, investors and corporations should expect to play politics, win over the populace with community work or take other unusual steps.

"Some of the people [against reforms] really are neo-Marxists, but if enough people believe them, you have to be able to do more than just say, 'That's wrong,'" he says. "You have to be able to talk to them on their terms."

The issue isn't going away soon, says Henisz, who hopes to visit Georgia and Bolivia -- countries that recently faced domestic unrest over market reforms -- and talk with more investors who have had trouble dealing with the multilateral lenders. Eventually, he hopes to more fully understand the dynamics caused by IMF and World Bank involvement -- and protect investors in years to come. "I'm fascinated by this," he says. "I want to be at the center of this backlash, learn what's happening on the ground, and figure out what a manager can do to secure investments and, through sophisticated management of political risk and opportunities, increase returns for the shareholders."

