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The interaction effects of financial openness and institutions on international capital flows

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ABSTRACT

This paper examines how financial openness and institutional quality affect international capital inflows, using data of 112 countries from 1985 to 2009. Our main findings are two-fold. First, while financial openness and institutional quality do not individually have a significant impact on international capital inflows, their interaction effects are significant. More specifically, the partial effect of financial openness on international capital inflows is increasing in the level of institutional quality. Second, among institutional factors, bureaucratic quality and law and order play an important role in foreign direct investment.

1. Introduction

Why doesn't capital flow from rich to poor countries? This is the title of the seminal paper written by Lucas (1990), and this phenomenon is called the "Lucas Paradox." In a standard neoclassical theory, where a production function has decreasing returns to scale and economy is frictionless, capital is moved from rich to poor countries. However, in reality, capital flows to developed countries are much larger than that to developing countries. This paper examines why international capital inflows do not move from rich to poor countries, focusing on the role of financial globalization and institutional quality, using data from 1985 to 2009.[1]

Fig. 1 illustrates the trends of per capita foreign direct investment (FDI) inflows from 1985 to 2009. FDI, one of the major international capital flows, has increased together with economic globalization since the late 1990s. Also, it is clear that FDI inflows to developing countries are far fewer than those to developed countries, defined as the Organisation for Economic Co-operation and Development (OECD) countries. This is consistent with the Lucas paradox. Furthermore, capital inflows have been more volatile since the middle 1990s. Lane and Milesi-Ferretti (2007) also points out that international capital flows has increased dramatically in recent years.

Capital flows are thought to be a potential source of economic growth, and therefore the government initiates policies to actively attract capital flows.[2] Capital flows not only have direct effects that enhance the accumulation of capital in a host

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[1] Kose et al. (2009) provide a comprehensive survey on financial globalization and its effects on economic growth.

[2] Fox example, Borensztein et al. (1998), Alfaro et al. (2004), and Azman-Saini et al. (2010) find that FDI enhances economic growth, given that education, financial markets, and economic freedom are sufficiently developed, respectively.

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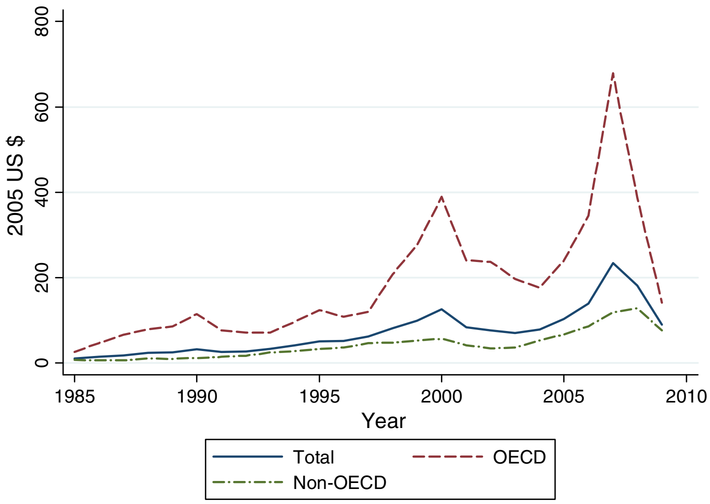
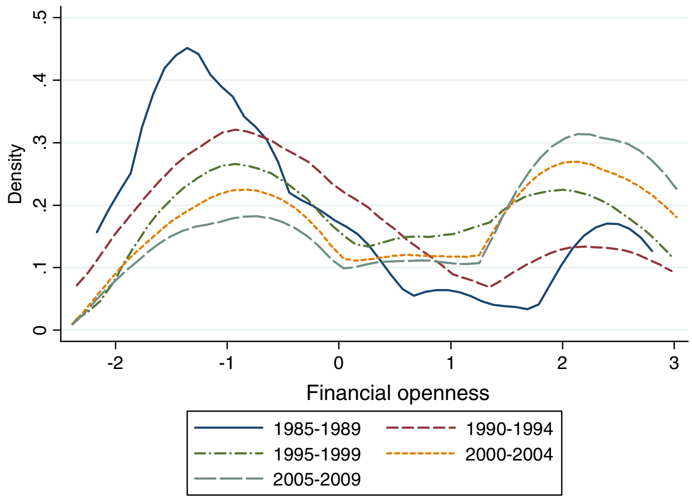


Notes. This figure is based on 112 countries, which listed in Table A1 in Appendix. "OECD" includes countries which are affiliated with OECD in a given year.

Fig. 1. Foreign direct investment inflows per capita, 1985–2009.



Notes. This figure is created using the Epanechnikov kernel density estimation, based on the data in 112 countries listed in Table A1 in Appendix. Financial openness is the 5-year averaged Chinn-Ito index (Chinn and Ito, 2006, 2008).

Fig. 2. Distribution of financial openness.

country, but they also have indirect effects that contribute to economic growth in a host country by promoting productivity growth through technology transfer. This paper focuses on two factors to determine international capital inflows: financial globalization and institutional quality. First, we consider the effect of financial globalization on international capital inflows, which still remains controversial. Asiedu and Lien (2004) provide evidence that the effect of capital controls on FDI varies by region and has changed over time. It is unclear, therefore, whether or not financial globalization is necessarily conducive to capital inflows in all countries.[3] Fig. 2 illustrates the distribution of the financial openness index created by Chinn and Ito (2006, 2008). Interestingly, financial openness is polarized, and countries have generally liberalized over time. This result is consistent with that of Lane and Milesi-Ferretti (2007), who find that the speed of financial integration is different among countries.

[3] Previous studies on the effect of financial globalization on economic growth also provide mixed results. While some studies argue that capital controls hinder economic growth (e.g., Edison et al., 2002; Quinn and Toyoda, 2008), Rodrik (1998) demonstrates that capital account liberalization has no significant effect on economic growth.