Domestic Institutions and Financial Globalization

The stronger the country's property rights protection, the more likely it wil benefit from capital mobility

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Cross-border capital flows have been increasing in real value at a pace of about 6% a year since 1980, faster than those of the world's GDP and trade. The progress has been particularly rapid since 1990 (though with a temporary dip during 1997-2002). This reflects falling barriers to capital flows in many parts of the world. Yet, the composition of these flows varies across countries. Many developing countries are net importers of foreign direct investment (FDI) on the one hand, but net exporters of financial capital on the other, while many developed countries do the reverse.

Consider the example of China. Its large and growing current account surplus implies that it is exporting capital on net to the rest of the world, especially to the US. At the same time, it is a top recipient of FDI in the world. While traditional explanations for its large inward FDI center on China's cheap labor and large market, MIT political scientist Yasheng Huang suggested a novel hypothesis: the large volume of inward FDI is a reflection of China's inability to allocate its household savings efficiently through its financial sector, rather than its economic strength. FDI effectively serves as a tool for Chinese private firms to circumvent the inefficient domestic financial sector.

Two-way capital flows are certainly not unique to China. In 2004, a typical emerging market economy imported US$1,671 of net cumulative FDI per person, but exported US$5,556 of net cumulative financial capital per person (see Table).

Capital Flows in Developed and Emerging Markets, 1990–2004 (current $/person)

Year	Country Group	Per Capita Net FDI Outflows (average)	Per Capita Net Financial Capital Outflows (average)
1990	Developed countries	165	-1564
	Emerging markets	-756	1541
2000	Developed countries	1204	-2486
	Emerging markets	-1668	3680
2004	Developed countries	1120	-1382
	Emerging markets	-1671	5556

Using a simple theoretical framework we study the relationship between domestic institutions and patterns of international capital flows. Our model shows that two-way capital flows are a natural consequence of cross-country differences in the quality of financial systems and the strength of corporate governance. In other words, financial globalization allows inefficient domestic financial system and weak corporate governance to be bypassed through a combination of inward FDI and the outward flow of financial capital.

Our model also defines a notion of "effective capital abundance", whereby a country has either a high ratio of physical capital to labor or weak property rights. By reducing the profitability of investment, weak property rights protection discourages inward FDI and encourages the outflow of savings.

Improving Domestic Institutions Should Be a Priority

Our model makes a surprising prediction: in a world free of any barriers to international capital flows, financial capital and FDI not only move in the opposite directions but also reinforce each other in a way that would lead to a complete bypass of inferior financial institutions and corporate governance. In a sense, the removal of barriers to capital mobility and reforms of domestic financial systems are substitutes. While the extreme proposition of a complete bypass effect may not be realistic, an open capital account may partially make up for the shortcomings of a domestic financial system and corporate governance.

Our analysis points to the benefits and costs of capital account liberalization, which depend on a country's quality of financial institutions:

- From a world perspective, as inferior financial institutions are bypassed, savings in all countries are served by the best financial system, and capital is efficiently allocated across all countries. The world's welfare improves.
- A country with a strong financial system also gains: not only its domestic savings will receive a higher return, but also its financial institutions and entrepreneurs will reap greater reward.
- For a country with an inferior corporate governance/financial system the welfare effect is not clear-cut as it involves a trade-off between an efficiency gain from free capital mobility on the one hand and a revenue loss by its financial institution and local entrepreneurs on the other. The stronger the country's property rights protection, the more likely it would benefit from capital mobility.

It is often observed that many developing countries are wary about full capital account liberalization whereas the U.S. and other advanced countries are typically enthusiastic about advocating or even pushing for such liberalization around the world. Our study provides a way to understand this pattern. It suggests further that developing countries could improve the benefit/cost calculus of financial globalization for themselves if they make an effort to improve domestic institutions first.

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