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ECONOMIC Synopses

The Direction of Capital Flows

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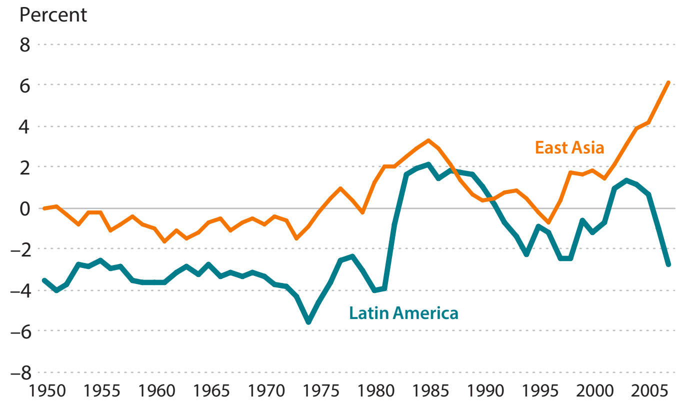
Standard economic theory predicts that people should invest more in countries with the highest capital productivity and economic growth. However, this doesn't always happen. Perhaps the most striking example is the contrast between capital flows into post-World War II Latin America and East Asia. Figure 1 shows trade flows (capital flows) as a percentage of gross domestic product (GDP) for these two regions.[1] Very little investment flowed into East Asia after World War II (especially between 1950 and 1980), even though the region's economic growth (Figure 2) and capital productivity were very high. In contrast, considerable capital flowed into Latin America during this period, despite the fact that neither its capital productivity nor its economic growth (Figure 3) was high. In fact, Latin American economic growth substantially lagged behind the economic growth of virtually all other countries in Western and Northern Europe, the Asian Tigers, and North America during this period.

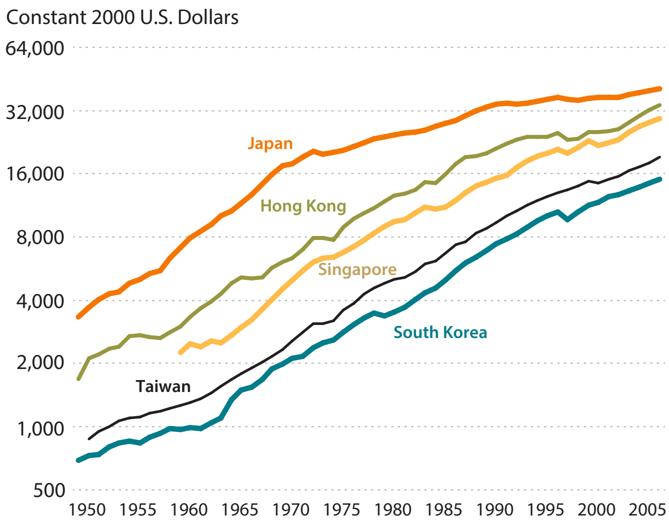
There are two very different interpretations of this pattern of international capital flows. One is that *international capital market imperfections*, including capital controls,[2] and other impediments to international transactions have prevented capital from flowing into high-growth regions. This hypothesis implies that much more capital would have flowed to East Asia and other high-growth regions had

Figure 1
Net Exports as a Percentage of GDP for East Asia and Latin America



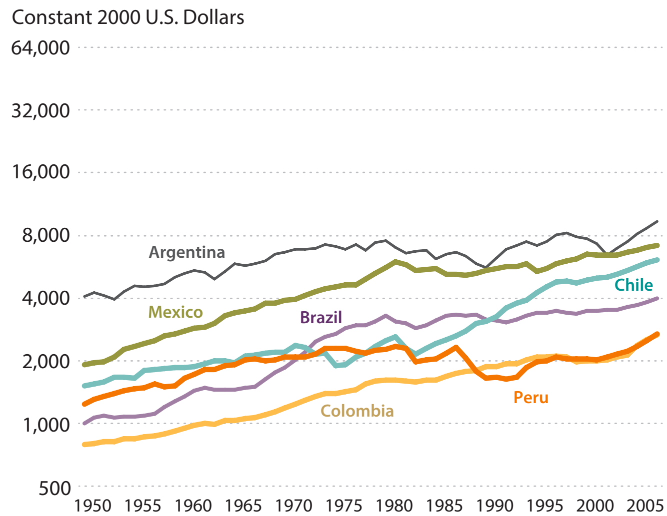
SOURCE: World Bank Global Development Indicators.

Figure 2
Per Capita GDP of East Asian Countries



SOURCE: World Bank Global Development Indicators.

Figure 3
Per Capita GDP of Latin American Countries



SOURCE: World Bank Global Development Indicators.

international capital markets been more open. This view is popular among economists who have studied Asia, as this region adopted severe regulations and controls on international capital flows after World War II.

Little is known about the comparative quantitative importance of international versus domestic market imperfections on international capital flows.

A very different interpretation is that *domestic imperfections*, particularly *domestic capital market distortions*, are the key to understanding international capital flows. So, for example, for the domestic (East Asian) capital market, credit controls, interest controls, privatization of banks, entry barriers to banking, and bank reserves and requirements, among others, kept international capital from flowing into East Asia.

However, relatively little is known about the comparative quantitative importance of international verses domestic market imperfections on international capital flows, because of the inherent difficulty in measuring them. More broadly, researchers still do not fully understand how large these imperfections have been, how they have changed over time, or how they have influenced global economic activity.

In our paper "Bad Investments and Missed Opportunities? Postwar Capital Flows to Asia and Latin America,"[3] we investigate some of the economic forces driving these flows. We find that although both international and domestic imperfections have had very large impacts on global capital flows, domestic distortions—more than typically recognized—have played a much larger role in accounting for international capital flows, particularly into East Asia. We also find that international capital market distortions have remained important even very recently, despite many countries having liberalized their international capital markets over time. This ongoing distortion partly reflects the legacy of accumulated international capital market distortions over time. Thus, even if international capital market imperfections are ultimately removed, their history can continue to have very large impacts into the future. ■

Notes

[1] Figure 1 shows a weighted aggregate of the net exports of East Asia and Latin America, where East Asia comprises Japan, Singapore, Hong Kong, Taiwan, and South Korea and Latin America comprises all of the main countries with the exception of Venezuela.

[2] Capital controls are measures implemented by a government, central bank, or other regulatory entity to control the flow of foreign capital. Examples include tariffs, taxes, laws, and quantity restrictions.

[3] Ohanian, Lee E.; Restrepo-Echavarria, Paulina and Wright, Mark L.J. "Bad Investments and Missed Opportunities? Postwar Capital Flows to Asia and Latin America." NBER Working Paper No. 21744, National Bureau of Economic Research, November 2015.

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