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# INTERNATIONAL CAPITAL FLOWS AND ECONOMIC GROWTH

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After a celebrated boom in capital flows to developing countries between 1990 and 1997, a series of international financial crises increased doubts about the benefits of such flows. Underlining this new skepticism were studies that implied only a weak relationship between capital flow liberalization and long-run growth. The concerns tempered the enthusiasm for capital inflows and have led to a reassessment of the policy approaches to attracting and managing them. This chapter presents a broad assessment of the relationship between capital inflows and the performance of developing economies. Specifically, it examines the association between international capital flows and domestic investment and productivity growth, and the costs that arise from capital flow volatility. Highlighted throughout is the diversity of developing countries' experiences, reflecting the heterogeneity of capital flows and differences in countries' absorptive capacity. The main conclusions are the following:

- Over the past three decades, private capital flows into developing countries have been associated with about an equal increase in domestic investment, although this relationship has weakened over time as the extent of financial integration across borders has increased. The relationship is strongest where, as in Africa, countries are least integrated with international financial markets and where, therefore, flows in the form of foreign direct investment (FDI) add to domestic saving and serve to identify and finance new investment opportunities. Elsewhere, as mergers and acquisitions (M&A) have increased relative to greenfield investments and as portfolio flows have risen, domestic investment and foreign inflows have become less tightly linked. However, the association remains relatively high where the conditions are favorable for domestic investment (high education levels, political stability, and well-developed financial systems).
- The relationship between productivity growth and private capital flows appears to have strengthened over time. The productivity benefits of capital flows—through the transfer of technology and management techniques and the stimulation of financial sector development—are significant in countries where a developed physical infrastructure, a strong business environment, and open trade regimes have facilitated the absorption of those flows, but not otherwise.
- Capital flow volatility significantly dampens economic growth. Indeed, the crisis-ridden later years of the 1990s were associated with enormous shocks to output and consumption in some countries. Even so, many countries appear increasingly able to manage volatility—and in the aftermath of the crises, growth rates have rebounded

quickly in many affected countries. Adjustment was promoted by greater exchange rate flexibility, more diversified production structures, and better risk-management techniques.

Taken altogether, the evidence suggests that capital flows reinforce a positive growth dynamic. They tend to go more to countries with strong investment climates, and their long-run benefits are most pronounced in such environments. As many of the countries with strong investment climates are middle- rather than low-income economies, international capital flows in recent decades may have contributed to a widening of income differentials between the developing countries, just as they did a century ago (Taylor 1996; O'Rourke and Williamson 1999).

For policymakers, the analysis in this chapter shows that both the celebration of capital flows in the early 1990s and the subsequent skepticism were both excessive. The reality is more complicated and therefore requires a more nuanced policy response. At issue is not whether international capital flows have long-term value or whether international financial integration offers real benefits. In the inevitable process of integration with international markets, capital flows can deliver enormous benefits. However, that transition also implies costs, some of which are important and others less so. The challenge for policymakers is to prepare their economies to best absorb the potential benefits of capital inflows while reducing the risks of sudden capital outflows. This implies a multiplicity of measures that not only foster absorption of international capital flows but also generate longterm domestic benefits. Capital inflows and domestic investment Summers (2000) maintains that "enormous social benefits" are made possible by the efficiency gains from the reallocation of capital from industrial to developing countries. The reallocation can improve living standards by mobilizing global savings to finance investments in countries where the marginal productivity of investment is relatively high. Private capital flows have been associated with a rise in domestic investment in many developing countries, although whether such flows have an independent role in raising investment, or simply finance investment that would have occurred in any event, is frequently unclear. The relationship between capital flows and investment is complex, and depends on the extent of integration of domestic economies into global capital markets, on the nature of the capital flows, and on the domestic investment climate:

• Long-term capital flows are strongly and positively related to domestic investment; shortterm flows have little or no relationship with investment. Further, whereas certain types of long-term flows, such as FDI and bank lending, are clearly associated with increases in investment, the relationship between portfolio flows and investment, although typically positive, has been less robust. The evidence also suggests that the relationship between private capital flows and investment is strong in those regions, such as Africa, where foreign investment is able to supplement domestic saving and to identify and realize investment opportunities.

• The relationship between private capital flows and domestic investment weakened in the 1990s, a period in which countries liberalized their capital accounts. The evidence is consistent with two possibilities. Either, as countries become more integrated into international markets, domestic saving and investment decisions are less correlated, and hence the relationship between capital flows and investment weakens. The evidence is also consistent with the increasing importance of portfolio flows as a part of total capital flows, and of M&A as a part of FDI, both of which have less of a relationship with domestic investment than other flows.

• A variety of domestic factors, such as the level of human capital, political stability, and the depth of domestic financial markets, define a country's ability to translate foreign capital into domestic investment. Capital inflows and investment: differences across types of flows and regions As a matter of theory, the impact of foreign capital inflows on domestic investment is ambiguous (Feldstein 1994). Inbound capital may raise domestic investment, but it may also increase imports and hence can dampen domestic production and investment. Moreover, even if access to foreign capital allows one firm to increase investment, that firm's expansion may induce another to reduce investment. From a more general perspective, understanding the impact of foreign capital on domestic investment requires considering the possibility that capital outflows may be induced. In a world of perfect capital mobility, an increase in inflows may have no impact on the level of domestic investment, since funds would move only to finance investment demand without actually increasing that demand.

**Capital Flows and Investment in the 1990s**

The relationship between capital flows and investment weakened in the 1990s. This trend may, in part, result from the growing importance of offsetting transactions on the capital account, reflecting increased integration of some countries and capital flight from some others (see chapter 2). Countries have typically also begun to divert a larger share of their capital inflows to reserve accumulation in order to safeguard against sudden capital outflows. The consequence of these changes has been that a smaller fraction of capital inflows is being channeled into domestic investment. Moreover, during the 1990s cross-border M&A activity accounted for an increasing fraction of FDI (United Nations Conference on Trade and Development 2000). Although M&A may have a positive impact on productivity, FDI of the greenfield variety implies an immediate increase in productive capacity, whereas M&A do not. As a consequence, the association between FDI and domestic investment became noticeably weaker in the 1990s. Absorptive capacity: policy and institutions The positive relationship between private capital flows and investment, which holds to varying degrees across various regions and over time, also depends crucially on a country's absorptive capacity. The capacity to absorb capital inflows is a multifaceted phenomenon. It encompasses not just the macroeconomic policy framework but also political stability, the health of the financial system, the educational attainment of the work force, the quality of physical infrastructure, the efficiency of government services, and the degree of corruption. Different types of capital flows are affected differently by these various aspects of a country's absorptive capacity. For instance, in a cross-country analysis Borensztein, De Gregorio, and Lee (1998) find that FDI is positively associated with investment, but only in a setting with sufficiently high levels of human capital. An extension of their analysis was done for this report across a different sample of countries and over a longer period. It was again found that FDI is positively associated with investment, and that this effect increases with the stock of human capital. Domestic investment is higher when FDI is greater and when domestic educational levels are higher; the synergy between FDI and schooling is seen to operate in this representation when human capital reaches medium to high levels.

**The Volatility of Capital Flows**

When financial markets are well integrated and functioning smoothly, access to foreign capital flows should reduce the volatility of growth, not increase it. During an economic downturn or following an external shock, access to financial capital should cushion the fall in consumption and reduce the damage to and depreciation of the country's infrastructure. In practice, however, the opposite has happened: private capital flows have been procyclical, plentiful in good times and scarce in bad times (see, for example, World Bank 2000). Such volatility can impose significant costs, not only in the form of periodic crises but also, the evidence suggests, through a reduction in long-run growth. This outcome reflects, in part, the imperfect integration of developing economies into world financial markets and informational asymmetries—hence the sometimes herd like behavior of foreign investors (Calvo and Mendoza 1999). However, the procyclical nature of capital flows also reflects volatility induced by a country's own actions—and inactions—through uncertain government policies and, especially, the underdeveloped state of its own financial markets. Thus, although opening up domestic financial markets to international competition has attracted more capital to developing countries and has bolstered growth in some, the larger volume of capital market transactions has also contributed to a more volatile climate. Where capital flows are large, any sudden effort by investors to withdraw from a country can precipitate or deepen a crisis. As the abundant literature on the Asian crisis has also shown, rapid reforms to liberalize the financial sector and to remove barriers to the entry of foreign capital often proceeded without the development of the institutions or practices that characterize a mature financial market. Particularly noticeable in their absence have been effective accounting practices, appropriate supervisory rules, and strong oversight of the banking system. Without these foundations, capital flows have often powered overinvestment and speculative booms. Eichengreen (1999) has described the mingling of foreign capital flows in a fragile financial sector as an "explosive mix." This need not be so. Kaminsky and Schmukler (1999) find that, although the exposure of domestic financial markets to foreign capital tends to increase instability in the first year, foreign inflows are ultimately (starting from about the third year) associated with greater, not less, stability. The evidence also suggests that volatility can be managed. Chile drew some important lessons from the severe financial crisis it suffered in the early 1980s, and that country's subsequent experience with strengthening the domestic financial sector while gradually liberalizing capital flows serves as an example of how to achieve the benefits from both. Finally, some have also proposed that flexibility of exchange rates has helped recently in containing the length of crises (Cline 2000), although this evidence remains controversial.

This section considers the costs of financial volatility, the sources from which it arises, and the techniques and prospects for managing it. Whereas the costs arising from volatility are real, other costs attributed to international capital flows have less of a basis. For example, no evidence exists of environmental degradation from an investor "race to the bottom"

**Suggestions**

- The effects for other regions are not described because data are available for fewer countries or a shorter time period, making the estimated effects imprecise.
- Results based on fixed-effects regressions suggest that foreign direct investment (FDI) is positively associated with investment but that threshold effects may be present: the effectiveness of FDI at low levels of schooling may be close to zero (or even negative).
- For a careful, annotated review of the literature on FDI and spillover effects, see Klein (2000).
- In another study of the Czech Republic, Kinoshita (2000) finds no evidence of technology spillovers to local firms from those with a foreign joint venture partner, except in the electrical machinery and consumer electronics industries. In these industries domestic firm capabilities are high, reflecting their greater research and development efforts.
- See Levine (2000) for a review of the literature and more extensive references.
- For forceful statements of the race-to-the-bottom argument, see Daly (2000) and Bonior (1999).
- Volatility may be particularly pronounced in small, open economies, where capital flows may be large and particularly lumpy in relation to gross domestic product (GDP). For instance, countries such as Guyana, Panama, Papua New Guinea, and Trinidad and Tobago have all received sizable and volatile capital flows relative to their GDP.

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