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Does openness to international financial flows raise productivity growth?

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ABSTRACT

Economic theory has identified a number of channels through which openness to international financial flows could raise productivity growth. However, while there is a vast empirical literature analyzing the impact of financial openness on output growth, far less attention has been paid to its effects on productivity growth. We provide a comprehensive analysis of the relationship between financial openness and total factor productivity (TFP) growth using an extensive dataset that includes various measures of productivity and financial openness for a large sample of countries. We find that de jure capital account openness has a robust positive effect on TFP growth. The effect of de facto financial integration on TFP growth is less clear, but this masks an important and novel result. We find strong evidence that FDI and portfolio equity liabilities boost TFP growth while external debt is actually negatively correlated with TFP growth. The negative relationship between external debt liabilities and TFP growth is attenuated in economies with higher levels of financial development and better institutions.

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1. Introduction

A central debate in international finance is whether openness to foreign capital has significant growth benefits and whether, in the case of developing countries, these benefits outweigh the risks. In

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theory, there are a number of direct and indirect channels through which financial openness should increase economic growth. Yet there is little robust empirical evidence of a causal link between financial openness and economic growth. This is not for want of effort – a number of empirical studies have attempted to systematically examine whether financial openness contributes to growth using various approaches. The majority of these studies, however, tend to find no effect or at best a mixed effect for developing countries (see Kose et al., in press, for an extensive survey).

The failure of most empirical studies to detect these presumed growth benefits has been used as ammunition by the critics of financial globalization who view unfettered capital flows as a serious impediment to global financial stability (e.g., Rodrik, 1998; Bhagwati, 1998; Stiglitz, 2004). By contrast, proponents of financial globalization argue that increased openness to capital flows has, by and large, proven essential for countries aiming to upgrade from lower to middle income status, while also enhancing stability among industrialized countries (e.g., Fischer, 1998; Summers, 2000). This is clearly a matter of considerable policy relevance, especially with major emerging market economies like China and India opening up their capital accounts and even a number of low-income countries experiencing large cross-border financial flows.

This paper attempts to change the direction of this debate by focusing on the impact of financial openness on productivity growth, rather than output growth. Why does financial openness have the potential to enhance aggregate efficiency and, by extension, total factor productivity (TFP) growth? Recent studies suggest that there are many channels through which financial openness can have a positive impact on productivity growth. For example, Kose et al. (in press) identify a set of indirect benefits of financial openness and argue that these could have a positive impact on TFP growth because they lead to more efficient resource allocation (also see Mishkin, 2006). These indirect "collateral" benefits could include development of the domestic financial sector, improvements in institutions (defined broadly to include governance, the rule of law, etc.), better macroeconomic policies, etc., all of which could result in higher growth through gains in allocative efficiency. Moreover, an earlier literature has argued that certain types of capital flows such as foreign direct investment (FDI) can yield productivity gains in recipient countries directly through transfers of technology and managerial expertise.

The nature of the relationship between financial openness and TFP growth has important welfare implications, especially in light of the recent literature emphasizing the role of TFP growth as the main driver of long-term per capita income growth. Although the earlier literature argued that factor accumulation is the key determinant of economic growth, a consensus is building that TFP growth is far more important than factor accumulation (Hall and Jones, 1999).[1]

In parallel to this shift in the broader growth literature, the classical notion that capital mobility allows capital-poor countries to grow faster by relaxing the constraints on domestic investment has also been challenged. Gourinchas and Jeanne (2006) argue that capital controls constitute only a transitory distortion since even a financially closed economy can eventually accumulate capital domestically and so the distortion vanishes over time. Hence, viewing the benefits of financial openness as being equivalent to a permanent reduction in this distortion may be an overstatement of the benefits. In other words, the direct welfare or growth gains from capital mobility are likely to be small. Instead, the theory implies that the benefits from financial openness should be reflected in TFP growth.

In this paper, we provide a comprehensive analysis of the relationship between financial openness and productivity growth using an extensive dataset that includes various measures of productivity and financial openness for a large number of developed and developing countries. We distinguish between de jure capital account openness—the absence of restrictions on capital account transactions—and de facto financial integration, which we measure by stocks of foreign assets and liabilities relative to GDP. We find that economies with more open capital accounts generally have higher TFP growth. More

[1] Also see Easterly and Levine (2001), Klenow and Rodriguez-Clare (2005) and Parente and Prescott (2005). Jones and Olken (2008) present evidence that TFP growth fluctuations constitute the primary determinant of not just long-term but also short-term growth. Bosworth and Collins (2003), by contrast, argue that previous studies over-estimate the importance of TFP growth; they argue that factor accumulation and TFP growth are about equally important, even for long-run growth. Caselli (2005) contends that factor accumulation cannot explain observed differences in growth across countries but that this may simply reflect problems in measurement of factors and how they enter the production function.

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