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Financial liberalisation, foreign aid, and capital mobility: evidence from 90 developing countries☆

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Abstract

The methodology of Feldstein and Horioka (Econ. J. 90 (1980) 314) is used to gauge the degree of capital mobility and accessibility to international financial markets following financial liberalisation. The sample consists of 90 developing countries divided into four regions: Africa, Asia, Latin America, and the Middle East. The sample period is 1975–1995, split into two periods. Our results indicate that for developing countries capital is relatively immobile. There is also evidence that access to international financial markets increases following financial liberalisation. Finally, including foreign aid in the saving–investment regression has an important positive effect on the saving coefficient. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

In the past three decades, many developing countries have liberalised their financial markets and, in addition, opened up their capital accounts. An expected consequence thereof is that these countries' access to international financial markets should improve. Potentially, there are many gains from increased financial integration. For instance, international capital mobility is crucial to global resource allocation, since it helps to smooth consumption and reduce risk. Furthermore, it allows for investment, and hence growth, beyond the premises of domestic saving. Theoretically at least, unrestricted capital flows facilitate specialisation in the production of financial services, and so benefit the international economy. Competition from abroad is introduced in the financial industry and innovation is stimulated. All this creates dynamic efficiency. Under the circumstances that the global financial market is able to properly price the risks and returns inherent in financial claims, global saving can be allocated to the most productive investments. Thus, potentially there are important welfare gains to be made from external financial liberalisation.

In the literature, two main methods are used to gauge the degree of international capital mobility: The first is by studying the rates of return on capital across countries, a common approach when interest is in analysing financial capital flows. Second, by studying the correlation between domestic saving and investment rates. Since the focus is on long-run real capital flows, this paper dwells on the second approach. However, it should be noted that even with external financial reform the possibilities for capital flow might be limited by obstacles, such as transaction costs, taxes, and official restrictions.

The main objective of this paper is to gauge the degree of international capital mobility in the developing world. Another important objective of this paper is to determine whether financial market liberalisation has led to increased international capital mobility in the sense of Feldstein and Horioka (1980). To do this we use a dataset that runs from 1975 to 1995 and that consists of 90 developing countries from Africa, Asia, Latin America, and the Middle East. First, using cross-section as well as panel-data techniques the entire sample is employed to investigate the overall degree of capital mobility and also whether capital mobility has increased over time. Thereafter, to allow for inter-regional comparisons, the paper makes use of the four aforementioned geographical regions and repeats the exercise for each region.

The first step follows previous research in its objective, but the dataset used for it, to our knowledge, is the largest used so far. Previously used datasets of similar size have been combinations of industrial and developing countries, whereas this dataset exclusively consists of developing countries. The second step, with its regional comparisons, is a clear extension of the literature. It reveals the different timing and evolution of capital mobility across regions following financial liberalisation, something that is otherwise hidden in full sample estimations. It also remedies any pooling of the data that is unjustified, at least the one that pertains to structural regional differences.