



Capital mobility among advanced countries[☆]

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Abstract

Mobility of capital has been studied by examining savings–investment correlations, real interest rates differentials, covered and uncovered interest parity, and equity home bias. All these examine the capital mobility question indirectly. This paper directly tests the return/total flow specification of the Mundell–Fleming model. It finds that while portfolio equity and debt flows are, direct investment is not; and in every case, the inclusion of direct investment makes the aggregative-capital variable unresponsive to interest rates. Asset-based exchange rate models may benefit by looking at the composition of cross-border assets, countries can have independent monetary policies with full capital mobility, and macroeconomic policy trilemma for open economies disappears.

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1. Introduction

There are many ways the question of international mobility of capital has been approached in the economics literature. First, savings investment correlations within a country have been examined. This investigation was set-off by [Feldstein and Horioka \(1980\)](#) who

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found that countries' investment rates are highly correlated with their national savings rates. Their finding that added savings in a country are associated with an almost equal further investment in that country has been taken as evidence of international capital immobility. Feldstein–Horioka result was confirmed by many subsequent studies (e.g., Bayoumi, 1990; Dooley, Frankel, & Mathieson, 1987) in the following decade. Nevertheless, some of the more recent writings on this topic present mixed evidence.¹

Further, real interest rates/rates of return have been found to vary across countries (see, e.g., Kempa & Nelles, 1999; Lane & Milesi-Ferretti, 2001; Macdonald & Nagasayu, 2000; Miyakoshi, 1999; Limosani, 2000). If there were no barriers to capital mobility, real return differentials should not exist among advanced economies. In fact, Dooley et al. (1987) define international capital mobility as the condition under which the expected differential yields on physical capital in different countries are eliminated by net savings flows. Dooley et al. point out that one ought to distinguish between real or physical capital mobility and financial capital mobility. The savings investments correlations and real return differentials indicate physical capital immobility. Still, physical capital immobility can exist and, is consistent with, financial capital mobility.

Financial capital mobility has been studied in the literature by examining the covered and uncovered interest parity conditions. Following Frankel (1993), the former applies when capital is perfectly mobile, and the latter when capital is perfectly substitutable. Perfect capital mobility between countries means that actual portfolio composition adjusts instantaneously to desired portfolio composition. Assuming no risk of default or future capital controls, perfect capital mobility implies that the interest rate on a domestic bond is equal to interest rate on a similar foreign bond plus the forward premium on foreign exchange, i.e., it implies covered interest parity.² Perfect substitutability is the much stronger assumption that asset holders are indifferent as to the composition of their bond portfolios as long as the expected rate of return on the two countries' bonds is the same when expressed in any common numeraire. It would imply the uncovered interest parity: the interest rate on a domestic bond is equal to the interest rate on a foreign bond plus the expected rate of appreciation of foreign currency.³

Uncovered interest parity (and, by implication, perfect substitutability) can be tested jointly with market efficiency by examining the ex post excess return on domestic currency where the latter is defined as the interest differential in excess of ex post depreciation. Under the joint null hypothesis, the ex post excess return should be random. It is difficult

¹ Alexakis and Apergis (1994), Murphy and Navajas (1998), Sarno and Taylor (1998), and Tsoukis and Alyousha (2001) either find increased financial market integration in the post-1979 period or stronger short-run saving-investment correlations than in the long run. On the other hand, Ghosh (1995), Nam (1998), and Pelagdis and Mastroianni (2003) either find high saving-investment correlations or excessive short-term capital flows.

² This condition permits risk premium on foreign bonds to exist where the risk premium equals the excess of forward discount over expected depreciation. It implies that domestic and foreign bonds are imperfect substitutes; we have the portfolio-balance approach to asset holdings where the asset holders wish to allocate their wealth among different assets dependent on their risks and expected rates of return.

³ Under this condition, the risk premium on foreign bonds is zero and domestic and foreign bonds are perfect substitutes. Then, portfolio shares and bond supplies are irrelevant. The responsibility for determining the exchange rate shifts to the money market: we have the monetary approach to exchange rates that focuses on demand and supply of money.

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