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A risk-based rationale for two-way capital flows: Why do capital flights and inward foreign direct investments co-exist?

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Abstract

This paper develops a positive theory of two-way capital flows—the outward flight of productive capital, and inward foreign direct investment that acquires ownership of local production units. The model exploits insights from decision-making under uncertainty, and traces out how entrepreneurial incentive to engage in risky production impacts equilibrium returns on capital. Contrary to expectation, productive assets tend to flow from capital-poor to capital-rich economies, while foreign direct investment follows the reversed pattern. By examining the nature of optimal interventions, the paper also demonstrates the inherent conflict of interests between host and source countries engaged in capital market liberalization.
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1. Introduction

Developing countries experiencing massive flights of domestic capital and productive assets abroad are nevertheless frequently major recipients of foreign direct investment. The two faces of this phenomenon of two-way capital flows involve (i) the flight of relatively liquid capital and productive

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Table 1
Per capita capital flight and per capita inward FDI (1989–1999) (East Asia and Pacific (EAP) and Latin America and Caribbean (LAC)) (current US$)

Year	EAP		LAC	
	Capital Flight	FDI	Capital Flight	FDI
1989	0.410	5.219	7.880	13.698
1990	10.404	6.305	18.907	13.955
1991	8.501	7.778	14.819	21.161
1992	34.842	11.044	−7.487	26.489
1993	14.875	21.369	−40.290	14.775
1994	30.468	26.037	28.274	29.698
1995	36.722	28.715	20.173	41.541
1996	8.729	32.852	47.365	86.213
1997	65.005	35.099	99.517	126.799
1998	67.827	32.589	203.810	145.634
1999	40.659	26.133	138.358	203.207
Average	28.949	21.195	48.302	65.743

assets that could have contributed to indigenous economic growth, and (ii) the inflow of foreign direct investment that shifts the benefits of ownership of local production units onto the hands of foreign entrepreneurs. Each of these challenges facing emerging economies has been studied extensively, but separately, in the capital flight and foreign direct investment literature[1]. As inter-related and simultaneous phenomena, however, the root causes of two-way capital flows, and their implications in terms of the welfare of host and origin countries, have nevertheless received very little theoretical attention.

Yet, there are good reasons to believe that the coexistence of capital flight and foreign direct investment in the reverse direction is not simply a matter of theoretical curiosity. We take thirty-seven countries under the two regional groupings of Latin American and the Caribbean[2], and East Asia and Pacific[3] from 1989 to 1999 as cases in point. Members of both sets of countries underwent substantial capital market liberalization throughout the 1990s, as can be seen from the more than many-fold increase in inward foreign direct investment on a per capita basis (Table 1). The size of foreign direct investment is defined here as net inflows of investment that acquire a lasting management interest in local enterprises (10% or more of voting stock)[4].

[1] See, for instance, Bhagwati (1964), Bhagwati, Krueger, and Wibulswasdi (1974), Dornbusch (1990), Batra and Ramachandran (1980), Caves (1982), Jones and Dei (1983).

[2] Estimates are computed based on World Development Indicators (2001). Countries and time period available under the regional grouping of Latin America are: Argentina (1989–1999), Barbados (1989–1999), Brazil (1989–1999), Bolivia (1989–1999), Chile (1989–1999), Colombia (1989–1999), Costa Rica (1989–1999), Dominican Republic (1989–1996), Ecuador (1989–1992), El Salvador (1989–1999), Grenada (1989–1996), Guatemala (1989–1994), Haiti (1989–1991), Honduras (1989–1999), Jamaica (1989–1999), Mexico (1989–1993), Paraguay (1989–1999), Panama (1998–1999), Peru (1995–1998), St. Lucia (1989–1996), St. Vincent and the Grenadines (1989–1996), Trinidad and Tobago (1989–1994), Uruguay (1989–1998), Venezuela, RB (1989–1999).

[3] Countries and time period available under the regional grouping of East Asia and Pacific are: China (1989–1999), Fiji (1989–1999), Indonesia (1989–1999), Lao PDR (1990–1999), Malaysia (1989–1999), Mongolia (1993–1999), Papua New Guinea (1989–1999), Philippines (1989–1999), Solomon Islands (1989–1999), Thailand (1989–1999), Tonga (1989–1993), Vanuatu (1989–1995), Vietnam (1993–1998).

[4] More specifically, it is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments (World Bank, 2001).

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