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# Capital account liberalization and foreign direct investment

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**Abstract**

We examine the impact of capital account policies on FDI inflows. Using an annual panel dataset of 83 developing and developed countries for 1984-2000, we find that capital account openness is positively but only very moderately associated with the amount of FDI inflows after controlling for other macroeconomic and institutional measures. To a large extent, other country characteristics seem to determine FDI inflows instead of capital account policies. We also find that capital controls are easily circumvented in corrupt and politically unstable regimes. We conclude that liberalizing the capital account is not sufficient to generate increases in inflows unless it is accompanied by a lower level of corruption or a decrease in political risk.


*JEL classification:* F21; F36

*Keywords:* Foreign direct investment; Capital controls; Capital flows; Capital account liberalization

## 1. Introduction

During the past thirty years, foreign direct investment (FDI) has grown in importance with a large number of developing countries able to attract inward FDI in increasing volumes. The theoretical literature that examines FDI identifies a number of channels through which FDI inflows will be beneficial to the receiving economy.[1] Yet, the empirical literature has lagged behind and

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[1] For a recent theoretical contribution, with a discussion of its empirical applicability, see Chakrabarti (2003).

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has had more trouble identifying these advantages in practice. Most prominently, a large number of applied papers have looked at the FDI-growth nexus.[2]

The consensus that is slowly emerging is that FDI is beneficial when compared to other types of capital inflows such as portfolio investment or syndicated bank loans, though some maintain that even this beneficial effect is limited.[3] Additional research efforts are devoted to identifying other features unique to FDI, such as its relative permanence or the positive externalities it generates.[4] Notwithstanding these fragile conclusions, most countries continue to vigorously pursue policies aimed at encouraging more FDI inflows; these include very significant tax breaks and other types of subsidies granted to multinationals in return for setting up domestic operations.[5] The multilateral public organizations, in particular the Organization for Economic Cooperation and Development (OECD), the World Trade Organization (WTO) and the International Monetary Fund (IMF), have also been vocal supporters of FDI promotion policies. One of the more common policies international institutions frequently prescribe within this context is liberalization of the capital account.[6]

Yet, very little empirical work has been done to examine the impact of capital account policies on FDI inflows. While neo-classical modeling suggests that capital account liberalization will increase FDI inflows, this might not be the case if the neo-classical assumptions of perfect information, a complete menu of contingent contracts, and competitive markets are relaxed. Developing countries, with their underdeveloped financial markets, lack of corporate transparency, insufficient national data-collection and dissemination, and susceptibility to large fluctuations in exchange rates—might be particularly vulnerable to perverse effects stemming from capital account liberalizations. In this paper, we aim to examine macroeconomic data to investigate the relationship between capital account policies and the inflows of foreign direct investment.

Table 1 presents recent trends in FDI inflows both as a percentage of output and as a percentage of fixed capital formation. Apparent is the worldwide trend increase in the importance of FDI (using both measures) in all geographical regions throughout the 1980s and 1990s, with FDI inflows after 2000 increasing to 4-5 times the level experienced during the 1980s. Yet, in several regions, net FDI flows peaked in the 1995-1999 period, and current levels are still below that peak. For emerging markets Fig. 1 shows that, while 2001-2003 have indeed been years of decline, FDI flows into this group have soared again in 2004 and were predicted to continue soaring through 2006. Their level today is appreciably higher than during the previous peak in 2001.[7] If these trends continue, an understanding of the determinants of foreign direct investment flows then only become still more important.

[2] While most papers identify FDI as a source of technological diffusion, productivity increases, and growth accelerations, the real significance of these effects is still in debate with a minority of papers disagreeing with all these positive conclusions. A prominent contribution, Borensztein et al. (1998), argues that FDI will lead to increased GDP growth only beyond a threshold level of accumulated human capital stock. With the availability of better data, the last few years have seen an especially large number of empirical papers devoted to this question (e.g., Alfaro et al., 2004; Durham, 2004; Hsiao & Shen, 2003; Li & Liu, 2005, Vu et al., 2007).

[3] Gray (2004) even goes so far as to suggest that countries should restrict FDI inflows, but his position is clearly in the minority among academic economists writing in English.

[4] For widely-cited examples, see Aitken and Harrison (1999), Fernández-Arias and Hausmann (2001), and Sarno and Taylor (1999).

[5] For a critical look at these domestic tax/subsidy policies, see Hanson (2001). For a discussion of the empirical evidence on tax policy's impact on FDI inflows see Hines (1996); and for a more recent survey, Mooij and Ederveen (2003). Gastanaga et al. (1998) analyze other host-country policies that aim to encourage FDI inflows.

[6] For the IMF's role in promoting capital account liberalization, see Joyce and Noy (2005).

[7] Mody (2004) offers more analysis of FDI flows over time and across regional groupings.