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Institutions, capital flows and financial integration☆,☆☆

James R. Lothian*

Schools of Business, Fordham University, 113 West 60th Street, New York, NY 10023, USA

Abstract

The focus of this paper is on capital flows from developed to less developed countries and in particular on the question of why such flows are not much larger. I first outline the theoretical arguments with regard to such flows and then go on to review the historical evidence on international financial integration more generally. I then turn to the related literature on economic development, which over the past decade has shifted its emphasis from technology and capital accumulation to the underlying institutional factors that affect investment. I present evidence that such factors also affect to rich-to-poor country capital flows. Good policies – pursuit of price stability, fewer direct interventions and sound institutional structures – are accompanied by higher capital flows and bad policies by lower capital flows.

Keywords: Capital flows; Economic growth; Financial integration; Political institutions

1. Introduction

The central focus of this paper is on international capital flows, and in particular, capital flows from the developed to the less developed countries. Why are such flows not larger? The question has puzzled economists for the past four decades. What makes it especially

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* Tel.: +1 212 636 6147; fax: +1 212 765 5573.
E-mail addresses: lothian@fordham.edu, jrmlothian@aol.com

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puzzling today is the much greater degree of financial integration now than four decades ago. Adding to the puzzle is the fact – not always recognized – that at the start of the last century such flows were substantial when viewed either as a percentage of the total or relative to the incomes of the receiving countries. In the next two sections of the paper, I outline the theoretical arguments with regard to rich-to-poor country capital flows and then go on to review the historical evidence on international financial integration more generally. To try to answer the question I turn to the related literature on economic development, which over the past decade and a half has shifted its focus from technology and capital accumulation to the underlying factors affecting the returns to investment. Here government actions, both in the sense of the day-to-day policies pursued by various government agencies and central banks and the institutions like property rights that affect the basic business environment, have come to be increasingly emphasized. I then go on to present evidence that these factors also affect capital flows. Good policies – pursuit of price stability, fewer direct interventions and sound institutional structures are accompanied by higher capital flows and bad policies by lower capital flows.

2. The Lucas–Schultz paradox

Robert E. Lucas, Jr. (1990) in an article of the same title asks the question ‘‘Why doesn't capital flow from rich to poor countries?’’ It does not, he says, but should since such poor countries lack capital when viewed by rich-country standards and, therefore, have both high marginal products of capital and correspondingly high rates of return to investment. Lucas cites India as a case in point. By his calculations India has a marginal product of capital that is anywhere from a high of 58 times to 5 times that of the United States, depending upon whether one allows for differences in stocks of human capital.

The paradox as Lucas states it, therefore, is that ‘‘If the neoclassical model were even close to being accurate and if world capital markets were even close to being free and complete, it is clear that in the face of return differentials of this [58 times greater] magnitude, investment goods would flow rapidly from the United States and other wealthy countries to India and other poor countries’’. Even if the much lower estimate of 5 times greater is more nearly correct, he goes on to say ‘‘[I]t leaves the original paradox very much alive: a factor of 5 difference in rates of return is still large enough to lead one to expect capital flows much larger than what we observe’’.

Two decades earlier, Theodore W. Schultz puzzled over the same question but from a rather different perspective. Schultz's take on the issue was not that the capital stock in poor countries or poor sectors was low per se. He argued to the contrary that it was, in fact, quite high. Interestingly, given Lucas' example of India versus the United States, Schultz supported this contention with data for Senapur, India. The problem, he argued, was that the physical capital in poor countries was of the wrong kind. What were needed for growth were continual investments in higher quality physical capital – in agriculture, for example, tractors rather than bullocks – and the increased human capital that would enable farmers and other workers to make use of the higher quality physical capital. Rates of return to the higher quality inputs were high while rates of return to the existing traditional inputs were low. Looked at in his way, the puzzle is why investments in the higher quality inputs have in general not been made and the inflows of funds from abroad not been much greater. I will return to this question below. First, to provide some background to the subsequent discussion, I want to summarize what we have learned from some of the recent studies of capital-market integration.