INSTITUTION-INDUCED PRODUCTIVITY DIFFERENCES AND PATTERNS OF INTERNATIONAL CAPITAL FLOWS

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Abstract
This paper studies theoretically how the cross-country differences in the institutional quality (IQ) of the domestic credit markets shape the patterns of international capital flows when such IQ differences also cause productivity differences across countries. IQ affects productivity by changing productivity-agency cost trade-offs across heterogeneous investment projects. Such institution-induced productivity differences are shown to have effects on the investment and capital flows that are opposite of exogenous productivity differences. This implies that the overall effect of IQ could generate U-shaped responses of the investment and capital flows. Among other things, this means that capital could flow from middle-income countries to both low-income and high-income countries, and that, starting from a very low IQ, a country could experience both a growth and a current account surplus after a successful institutional reform. More generally, the results here provide some cautions when interpreting the empirical evidence on the role of productivity differences and institutional differences on capital flows. It also calls into question the validity of treating the degree of financial frictions as a proxy for the quality of financial institutions, as commonly done in the literature. (JEL: E22, F49, O16)