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Volume Title: Capital Flows and the Emerging Economies: Theory, Evidence, and Controversies

Volume Author/Editor: Sebastian Edwards, editor

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-18470-6

Volume URL: <http://www.nber.org/books/edwa00-1>

Conference Date: February 20-21, 1998

Publication Date: January 2000

Chapter Title: Comment on "Is There a Curse of Location? Spatial Determinants of Capital Flows to Emerging Markets"

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Chapter URL: <http://www.nber.org/chapters/c13081>

Chapter pages in book: (p. 156 - 158)

- Rauch, James. 1996. Networks versus markets in international trade. NBER Working Paper no. 5617. Cambridge, Mass.: National Bureau of Economic Research.
- Wei, Shang-Jin. 1996. Intra-national versus international trade. NBER Working Paper no. 5531. Cambridge, Mass.: National Bureau of Economic Research.
- World Bank. 1997. *Private capital markets*. Washington, D.C.: World Bank.

## Comment Miguel A. Savastano

Swati Ghosh and Holger Wolf want to put geography considerations at the forefront of discussions of capital flows to emerging markets. To do this, they examine the role that geographical factors have played on an important and grossly overlooked regularity of the surge of private capital flows to emerging markets in the last decade: the fact that a handful of developing countries has received the lion's share of the flows and that, by and large, those flows have bypassed the vast majority of the developing world. The authors put forward two competing hypotheses to account for the uneven distribution of capital flows to less-developed economies: a "development threshold" hypothesis (i.e., the level of income and income per capita in the recipient countries) and a "location" hypothesis (i.e., geographical factors, including the bilateral distance between the recipient countries and the G7 economies). They then proceed to test the two hypotheses, first from the recipient countries' perspective by examining the determinants of access to international financial markets (using a probit regression and a "classification tree" procedure), and then from the source countries' side by estimating gravity-type equations for exports and four types of capital flows during the early 1990s using a fairly unconventional set of data.

The results do not help the authors' case. What Ghosh and Wolf find is that each hypothesis receives some empirical support when it is tested separately, but that when they are tested jointly the development threshold hypothesis (the GDP measures) overwhelmingly dominates the location hypothesis. This is what the authors obtain from the probit estimates in table 5.1 and from their original analysis of access based on "classification trees," and this is also what they obtain from the gravity-type regressions of outward capital flows reported in tables 5.4 to 5.7. In fact, not counting the results for bilateral exports (table 5.3), the coefficients of the "location"

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or “spatial” determinants reported in those tables turned out to be statistically significant in less than one-third of the regressions (six out of twenty-one), whereas the coefficient of (the log of) GDP was significant in twenty out of the twenty-one regressions and that of GDP per capita in about half of the cases.

Somewhat surprisingly, however, Ghosh and Wolf have a different reading of their results. They downplay the fact that the majority of coefficients of the “spatial” variables lose their statistical significance once they control for the countries’ size and per capita income, dismiss the severe problem of lack of degrees of freedom that plague their regression estimates, and make much of the negative sign of the (nonsignificant) distance elasticities in their gravity-type regressions (table 5.8). Thus, rather confidently, they conclude that “the[ir] findings support the view that location matters in a fundamental sense for development prospects.” I fully agree that location matters for growth and development and that further research in this area that builds on the recent work by Robert Barro, Jeff Sachs, and others will be rewarding. But this is not a conclusion that follows from the paper. As I see it, the main conclusion that follows from this work by Ghosh and Wolf is that *distance* (and hence gravity-type equations) is probably not among the factors that will help us understand the geography of capital flows. This may be a negative conclusion, but is nonetheless a useful conclusion; and it is the correct one.

The reason why distance and gravity-type models are not likely to shed much light on the geography of capital flows is the same reason that makes distance and gravity models perform so well in explaining bilateral trade flows: transaction costs, and in particular transportation costs. It is well known that the costs associated with transporting physical goods across borders and regions is what explains the robustness of distance variables in gravity models of bilateral trade. While it is entirely plausible to assume that private capital flows to emerging markets are subject to a variety of transaction costs, which are often hefty and even punitive, the notion that those transaction costs are somehow related to the *geographical distance* between the recipient countries and the capital-exporting countries is far-fetched—and that is what the evidence in the paper shows. Transaction costs of cross-border capital movements may have been highly correlated with geographical distance one hundred or two hundred years ago, but this has not been the case in the last few decades, and surely not in the 1990s. The possibility of making physical and, especially, portfolio investments in remote and unfamiliar markets and countries is one of the few spheres where globalization is not a myth.<sup>1</sup> Distance is not the central issue

1. Whether that is a positive development is a different question altogether, one that is beyond of the scope of the paper as well as of these comments.

anymore. Other types of costs and sources of asymmetric information are far more important. A fuller grasp of the nature of those costs and of their relation with location and other geographical factors seems a more promising route than the one taken by Ghosh and Wolf to put the geography of capital flows back on the map.