Domestic Institutions and the Bypass Effect of Financial Globalization

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Summary

This paper proposes a simple model to study how domestic institutions affect patterns of international capital flows. Inefficient financial system and poor corporate governance may be bypassed by two-way capital flows in which domestic savings leave the country in the form of financial capital outflows but domestic investment takes place via inward FDI. While financial globalization always improves the welfare of a developed country with a good financial system, its effect is ambiguous for a developing country with an inefficient financial sector or poor corporate governance. Interestingly, financial and property rights institutions can have opposite effects on capital flows.