

Bad Investments and Missed Opportunities? Capital Flows to Asia and Latin America, 1950-2004

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Abstract

From the end of the Second World War to the beginning of the Twenty-First Century, per-capita GDP in the economies of East Asia grew almost three times as fast as in the economies of Latin America. Specifically, in 1950, the economies of the Asian Tigers (Japan, South Korea, Singapore and Taiwan) had just 17 percent of US per capita GDP, but grew to have 67 percent by 2001. In contrast, Latin America had 28 percent of US per capita GDP in 1950, and only had 23 percent in 2001. Despite this large growth differential, with Latin America falling behind the US, and with Asia catching up, capital predominantly flowed out of Asia and into Latin America. This paper studies this apparent gross misallocation of capital, and how the global development process after World War II would have differed had capital flowed to the region with the highest returns.

We present an analytical framework for analyzing the incentives facing investors who allocate capital internationally. Applying the framework to data on the major Asian and Latin American economies, we account for the pattern of observed capital flows by quantifying distortions in the markets for labor, domestic capital, and international capital. We find that inefficiencies in the allocation of resources within countries play a significant role in determining how capital is allocated across them. Specifically we observe that the reallocation of capital from Asia to Latin America is motivated by a quantitatively important labor market distortion that is isomorphic to a very high labor income tax in Asia. We then use the framework to explore the effect of different policy interventions in labor, domestic capital, and international capital markets at different stages in history, and on the sequencing of these interventions, on capital flows and development.

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