

International Capital Flows and Demographics: The Role of Foreign Direct Investment

Naohisa Hirakata (Bank of Japan) , Mitsuru Katagiri* (Hosei University)

This paper investigates the role of foreign direct investment (FDI) in accounting for the long-term trend of capital flows under demographic changes. For this purpose, we incorporate horizontal FDI under the proximity-concentration trade-off a la Helpman, Melitz, and Yeaple (2004) into a two-country DSGE model and conduct a quantitative analysis using long-term Japanese data since the 1960s. The quantitative analysis finds that the trend of the current account and sectoral savings in Japan can be well accounted for solely by demographic changes and that multinational firms' endogenous decision on FDI is key to explaining those trends.