

Bilateral Lucas Paradox

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Abstract

Using the bilateral investments data, we find that the returns on outward investments are lower for rich countries than poor countries, i.e., the rich countries do not seem to invest abroad rationally, consistent with Lucas Paradox. However, we also find that the excess returns on outward investments relative to domestic investments are higher for the rich than the poor i.e., rich countries are investing outward more wisely than poor countries. A question is why the poor invests abroad if relative returns on foreign investments are not high. We study the effect of institutional qualities of investor countries on these investment behaviors. We find that countries with better financial institutions, such as creditor rights and financial openness, react more to the relative returns.

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