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Capital mobility and underdevelopment traps

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Abstract

In a two-country model with threshold effects, we study the robustness of underdevelopment traps to capital mobility. It is shown that capital mobility can make a country cross the threshold and bifurcate toward sustained growth, subject to household expectations. Another result is, however, that a multiplicity of growth patterns such as long-run divergence and convergence clubs can co-exist with perfect capital mobility, hence with an identical rate of return across countries. In this model, efficient development policies are a combination of, first, liberalization—as capital mobility makes growth *possible*—and, second, government intervention coordinating expectations into self-fulfilling growth beliefs.

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1. Introduction

Despite the consensus that prevails in the professional development community, the importance of foreign investment for growth remains a disputed issue. On the one hand, the notion that foreign finance spurs development has indeed shaped policies and aid programs to a remarkable degree. For example, a large number of developing countries, generally with active donor support, have set up foreign investment promotion programs.[1] Openness, particularly to foreign capital, has been a central prescription of the "Wash-

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[1] World Bank (1997a) and Hanson (2001).

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ington consensus''.[2] An empirical study by Cohen (1994) did support the view that foreign finance helps recipient countries improve the efficiency of their production processes and therefore facilitates growth. A host of static, partial-equilibrium models have correspondingly provided theoretical arguments showing how foreign investment—particularly foreign direct investment—can influence the recipient country's productivity at the micro level.[3] Still, the debate is far from closed. Critics of what Rodrik (2001)[4] calls the 'obsession with global integration' forcefully point at the diversion of 'human resources, administrative capabilities and political capital' toward the donor-imposed imperative of opening up borders—and away from the more difficult task of developing domestic growth policies. In this view, foreign investment is undoubtedly useful, but only when supported by adequate, country-specific domestic policies for growth. The empirical research reported by Hanson (2001) confirms that foreign investment alone is not likely to modify the growth prospects of host countries.

What is the contribution of general equilibrium models of endogenous growth to the debate? In fact, one would hard-pressed to find any theoretical justification in this literature for the belief that foreign investment helps growth. The research pioneered by Grossman and Helpman (1991) provides convincing arguments that opening up a stagnant economy can improve its growth prospects. But there are no *intentional* capital flows—no foreign investment—from rich to poor countries in this line of analysis. Convergence effects are due to international flows of R&D, as knowledge bears some features of a public good. Even in an extended concept of capital incorporating knowledge, flows of capital are involuntary side effects resulting from cross-border spillovers, and can thus hardly be interpreted as describing the profit-maximizing competitive flows of foreign investment observed in the real world.[5] In the neoclassical economy of Barro et al. (1995), intentional flows of private capital to poor economies do happen—at the expense of the analysis of long-run growth patterns.

A seemingly unrelated branch of the growth literature has studied underdevelopment traps in closed economies. As recently surveyed in Hoff and Stiglitz (2001), several mechanisms have been modeled that give rise to coordination problems and the accompanying development traps/threshold effects. The celebrated ''big push'' analysis of Rosenstein-Rodan (1943) and its reassessment by Murphy et al. (1989) analyze demand spillovers: growth in the high-productivity sector leads to higher incomes, which in turn leads to high demand for the goods in that sector—hence creating a coordination problem. In Azariadis and Drazen (1990), an overlapping generation model is used to show that if the private return to human capital is increasing in its aggregate stock, then a multiplicity of steady state growth paths will exist, including a no-growth path. D'Autume and Michel (1993) and Zilibotti (1995) similarly use reduced-form convex–concave technologies to

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[2] For example, see OECD (1997) and Hanson (2001).

[3] In Rodriguez-Clare (1996), the presence of multinationals increases the productivity of domestic firms through better access to the stock of knowledge embodied into specialized intermediate goods used by multinationals. In Markusen and Venables (1999), linkage effects to supplier industries raise domestic productivity. See Hanson (2001) for a survey of this literature.

[4] See also Rodrik (1999).

[5] See World Bank (1997b) for an account of the rise of private capital flows to developing countries. In 1996, private foreign investment to poor countries amounted to US$240 billion, five times the official aid flows.

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