

Eswar S. Prasad, Raghuram G. Rajan, and Arvind Subramanian
“Foreign Capital and Economic Growth”
Brookings Papers on Economic Activity, 2007:1, pp. 153-209

Nonindustrial countries that have relied more on foreign finance have not grown faster in the long run as standard theoretical models predict. The reason may lie in these countries' limited ability to absorb foreign capital, especially because their financial systems have difficulty allocating it to productive uses, and because their currencies are prone to appreciation (and often overvaluation) when such inflows occur. The current anomaly of poor countries financing rich countries may not really hurt the former's growth, at least conditional on their existing institutional and financial structures. Our results do not imply that foreign finance has no role in development or that all types of capital naturally flow “uphill.” Indeed, the patterns associated with foreign direct investment flows have generally been more consistent with theoretical predictions. However, we find no evidence that providing financing in excess of domestic saving is the channel through which financial integration delivers its benefits.

JEL classification codes: F21, F32, F43, O16