Discussion of:
"Foreign Capital and Economic Growth"
by Prasad, Rajan, and Subramanian

Aart Kraay

The World Bank

Simple Theory to Help Understand Puzzles

- Two assets, risky domestic capital k and safe foreign loans f

- Representative agent chooses c and k to maximize

$$E\int_0^\infty \ln(c)\cdot e^{-\delta\cdot t}\cdot dt$$

subject to budget constraint

$$da=\left[\pi\cdot k+r\cdot(a-k)-c\right]\cdot dt+k\cdot\sigma\cdot d\omega$$

- Solution is:

$$c=\delta\cdot a \qquad x\equiv\frac{k}{a}=\frac{\pi-r}{\sigma^2} \qquad f=(1-x)\cdot a$$

Theory, Cont'd

- Average (i.e. Expected) Growth and the Current Account

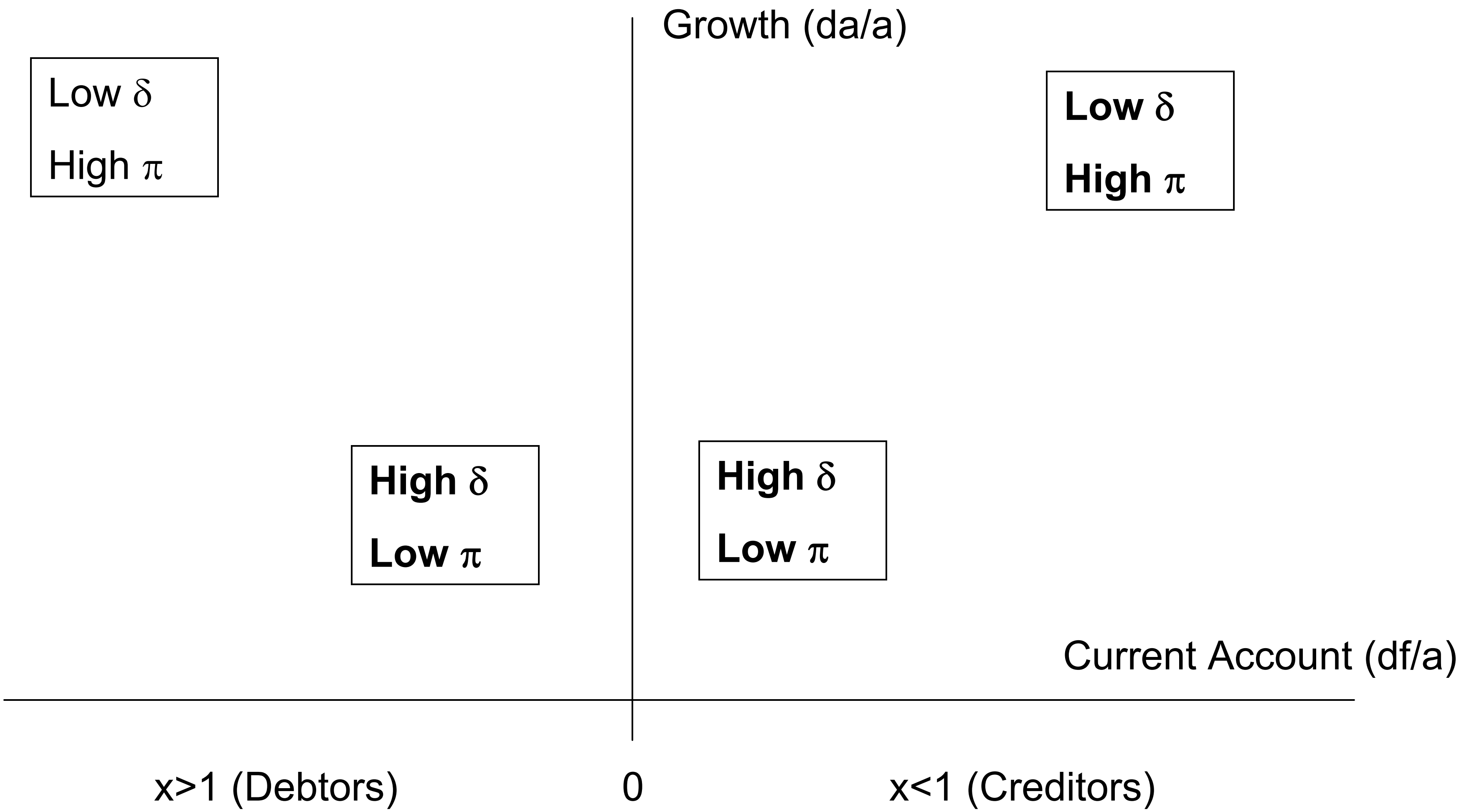
$$\frac{da}{a} = \sigma^2 \cdot x + r - \delta$$

$$\frac{df}{a} = (1 - x) \cdot \frac{da}{a} = (1 - x) \cdot \left(\sigma^2 \cdot x + r - \delta\right)$$

- Assume countries differ in
  - productivity π (and so the portfolio share x)
  - patience δ (and so the growth rate of wealth)

- Assume also growth rate of wealth always positive

Current Accounts and Growth



Implications of Theory

- No reason to expect *any* correlation between CA and growth looking across all countries. Correlation depends on
  - whether country is a debtor or creditor
  - what the sources of variation in saving rates and portfolio shares are
- PRS puzzle is a puzzle only if most of the developing countries in their sample:
  - are debtors ($x>1$), and
  - have high (low) discount rates *and* low (high) productivity
- Sounds plausible, but worth investigating before declaring a puzzle

PRS Resolution of Puzzle

- Poor countries with lousy financial systems but rapid productivity growth:
  - might invest a lot
  - but can’t reduce saving to borrow against higher future income
- Not clear this does the trick in the theory
  - lousy domestic financial system doesn’t mean you can’t borrow *from abroad* to tilt consumption
  - countries with fast productivity growth invest a lot and also borrow -> CA deficits go with growth -> puzzle is back

Is the Problem Lousy Financial *Intermediation*?

- Suppose financial system can't intermediate saving to productive investments (Ju and Wei (2006))

- In high-productivity growth countries
  - FDI finances domestic investments
  - Domestic savings flows abroad
  - fast growth but no big current account deficit

- Does this work empirically? Stock implication is that countries with lousy financial intermediation should have less negative NFA positions

Does the Intermediation Story Work?

	Dependent Variable is NFA/Wealth
ln(Per Capita Wealth Relative to World Average)	0.129
	(0.022)***
Rule of Law	-0.095
	(0.043)**
Ease of Access to Finance	0.029
	(0.038)
China Dummy	0.242
	(0.024)***
Constant	-0.191
	(0.137)
Observations	76
R-squared	0.48

Is the Problem Kleptocracy?

- Kleptocratic governments borrow like crazy and put the proceeds in Swiss Bank Accounts
  - low growth
  - large current account deficits (since illegal capital outflows not recorded)

- Not implausible given scale of global current account imbalances!
  - try controlling for kleptocracy in regressions