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International Financial Liberalization, Corruption, and Economic Growth

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Abstract

This paper examines the effects of capital account liberalization on the long-run growth of a developing economy. A general-equilibrium, endogenous growth model is constructed in which corruption forms an integral part of the governance system of the country. By undermining the profitability of innovations, corruption lowers the rate of return to capital and reduces the rate of technological change. The impact of international financial liberalization on long-run growth in this model can be either positive or negative. A drop in growth is obtained when the level of corruption is high enough to cause domestic rates of return to capital before liberalization to drop below those in the rest of the world. In this case, liberalization generates capital outflows, which act as a constraining force on innovation, reducing the rate of technological change and lowering output growth. On the other hand, if the level of corruption is sufficiently low, the capital account liberalization will serve as a boost to the country's technical change and growth.