

# Why Doesn't Capital Flow into Faster Growing Economies? : The Role of Utility Functions

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The standard neo-classical growth model says that economies that have higher per-capita output growth prospects run current account deficits and that economies that have slower output growth prospects run current account surpluses. However, this hypothesis is not robust through empirical tests as is well known as Lucas paradox or “allocation puzzle.” We examine theoretically the robustness of this hypothesis and find that the crucial presumption concerns concavity of the period utility functions, or variability in the elasticity of marginal utility with respect to consumption. We also find that the level of economic development or relative per-capita output to the rest of the world is crucial.

When adopting two-period models, the hypothesis that a country growing relatively faster than the rest of world (the ROW) runs a current account surplus is robust only when the period utility function has a constant elasticity of intertemporal substitution. However, if we assume a utility function of which the elasticity of marginal utility increases with respect to consumption, or less concave than the CES utility, less developed countries that grow faster compared with the ROW, can then run current account surpluses under selected conditions.

Less concave utility function means that households in a less developed country derive more utility from a one-percentage point increase in future consumption than those in a higher developed country. In other words, the agents in a less developed economy evaluate future consumption more than the agents in a more developed economy do; thus, the former more inclines to save. This hypothesis does not seem to be unrealistic.

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