<div align="center">The Allocation of Capital When It Becomes Internationally Mobile</div>

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The initial allocation of capital between the home country and the foreign country (*) assumes no capital mobility. This means that capital stocks in the two countries are at $K(0), K^*(0)$ and rental rates in the two countries differ as the home country is relatively capital rich so that $r(0) < r^*(0)$. People in each country own all their capital.

In the initial allocation, home capital earns E+F and home labour earns A+B+C+D. Foreign capital earns I+J. Foreign labour earns G.

Now let capital flow to find the highest rate of return. This results in an allocation of capital in which rates of return on the mobile factor (capital in this case) is equalized at rate $r = r(1) = r^*(1)$ Capital used in the home country is reduced from K_0 to K_1. Capital in the foreign country is increased to $K^*(1)$.

Location and ownership are not the same. Even though $K(1) K(0)$ home capital has been reallocated to the foreign country, the home residents still own it and receive the international rate of return <u>r.</u>

In the new equilibrium in which capital is mobile, capital owned by home residents is located both at home and abroad earns B+C+E+F+D+L. Home labour earns A.

Foreign capital (owned by foreigners) earns J. Foreign labour earns H+I+G.

Who gains and who loses from international mobility of capital?

Home labour finds that it earns A whereas before it earned A+B+C+D.
Home (owned) capital now earns B+C+E+F+D+L whereas before it earned E+F.
There has been a transfer of income from labour to capital of B+C+D. Capital earned E+F before. There has been a net increase of income of L to the home country. This is paid to owners of capital.

Foreign labour now earns H+I+G whereas before it earned G.
Foreign (owned) capital now earns J whereas before it earned I+J.
There has been a transfer of income from foreign capital to foreign labour in the amount of <u>I</u>. There has been a net increase in income, H, to the foreign country. This increase is received by labour.

World income is higher by H+L. Both countries have gained.

r

r*

G

A

r*(0)

I

H

r*(1)

r(1)

L

B

C

D

J

r(0)

E

F

MPK

MPK*

O

O*

K(1)K*(1)   K(0)K*(0)

World Stock of Capital