The Micro and Macro Dynamics of Capital Flows

CFM-DP2021-21

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We study empirically and theoretically the effects of international capital flows on resource allocation. Using the universe of firms in Hungary, we show that financial openness triggers input-cost and consumption channels, with the latter dominant and reallocating resources toward high expenditure elasticity activities in the short-run. A multi-sector heterogeneous firm trade model replicates these dynamics. In the long-run, the model predicts that resources will shift towards manufacturing exports to service debt. Owing to endogenous terms of trade dynamics, countries face a trade-off between the speed of convergence and their long-run capital stock; thus, financial openness can lead to welfare losses.