Macroprudential Policy with Firm Heterogeneity

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Abstract

I study how capital misallocation affects optimal macroprudential policy in a small open economy susceptible to sudden stops. I introduce a novel, tractable way of modeling misallocation that generates a link between investment and productivity and can be easily taken to the data. Because macroprudential policies such as capital controls affect investment, they lead to productivity losses. I show that, when the policymaker is constrained in their available instruments, this generates a policy trade-off between financial stability and productivity growth. I derive a formula for the second-best capital control that only requires a small number of sufficient statistics, including the productivity cost of capital controls. I leverage the tractability of my model to get a range of estimates for the latter using rich firm-level microdata for several European countries. The trade-off is quantitatively relevant: for the baseline crisis probabilities, productivity losses reduce optimal capital controls from 0.22% to a subsidy of almost 0.4%. Productivity losses are also a source of heterogeneity, with capital controls varying as much as 0.4% within the countries in the sample.

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