Financial openness – the ability of domestic residents to purchase and hold foreign stocks and bonds – has once been praised as a recipe for a successful path to economic development. Financial openness in the European Union allows German companies to operate in Poland, creating new jobs, and possibly disseminating parts of their technology. It allows Polish firms to raise funds abroad for their domestic investment projects, by issuing bonds or stocks that foreign investors would buy. In a fast-growing, emerging economy, it allows households to improve their standards of living more rapidly, by keeping the interest rates at a lower level than they otherwise would be, thus making it easier to buy durable goods such as cars or houses.

Yet, financial openness received also some criticism. A persistent current account deficit, while allowing households to improve their standards of living and firms to raise funds abroad, can make an economy more vulnerable to external shocks, especially when those shocks coincide with spikes in the cost of new credit. Excessive reliance on foreign ownership of domestic capital stock (foreign direct investment) raised fears that it could crowd out domestic investment expenditures. Following the financial crisis of 2008-09, a number of policy changes were suggested that would limit the extent of financial openness. In this project, we address two important questions, relevant for the evaluation of policies that attempt to limit financial openness.

The first question is about the degree to which foreign ownership of domestic capital stock can be replaced with domestic ownership of that same capital stock. Will it matter for the way that capital is used? Will it matter for the overall performance of the whole economy? This question is a new approach to a classic problem in open economy macroeconomics: does foreign direct investment crowd out domestic investment expenditures? The novelty of our approach is that rather than relying on empirical correlations alone, we extend the standard open economy macroeconomics model to allow for (limited) substitutability between domestic and foreign owned capital.

The second question is about the consequences of the various policies, discussed in academic and political circles, and aimed at reducing or eliminating the so-called "global imbalances" – the large and persistent trade deficit of the United States coinciding with persistent trade surpluses in a number of developed and developing economies, most notably in China, Japan, Netherlands, and Germany. We will evaluate how the way the re-balancing is achieved affects households with different levels of income and wealth within each country, as well as what impact it will have on the level of income and wealth inequality in each country.

Our project is can be characterized as an applied theory project – in that we will use economic theory, and a formal, theoretical models to assess the impact of these policies, but the quantitative predictions of the models will be disciplined using various statistics from the data.