

# Capital Account Liberalization, Financial Frictions, and Belief-Driven Fluctuations\*

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## Abstract

To investigate macroeconomic effects of capital account liberalization, we apply a dynamic general equilibrium model with two production sectors. In contrast with the literature on belief-driven sunspot fluctuations caused by production externalities, our model does not assume any production externalities. In our model, agents face financial constraints and production heterogeneity. Although indeterminacy of equilibrium and belief-driven sunspot fluctuations never occur in a closed economy, they do occur in a small open economy if financial constraints are fully relaxed under the condition that the investment goods sector is more labor intensive than the consumption goods sector. Our result must be one of the theoretical grounds and references for a policy debate on macroeconomic effects of capital account liberalization for which many researchers have warned an inherent risk such as the surge of capital inflow and outflow that amplifies economic fluctuations and often causes financial crises.

**Keywords:** Two-sector growth model; small open economy; financial constraints; heterogeneous agents; indeterminacy; belief-driven fluctuations.

**JEL Classification Numbers:** E32; F36; F43; O41

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