Economic Development and the Equilibrium Interaction of Financial Frictions*

Benjamin Moll  Robert M. Townsend  Victor Zhorin
Princeton  MIT  University of Chicago
August 6, 2014

Abstract

Given that micro data imply that the type of financial frictions varies across regions/sectors within a given country, we develop a general equilibrium framework that encompasses these underpinnings. We study the macroeconomic implications of a moral hazard problem due to unobserved effort and contrast them with those of limited commitment, the friction most studied in recent literature. The effects of moral hazard on aggregate productivity and the equilibrium interest rate differ dramatically from those of limited commitment, and the effect of moral hazard and limited commitment within the same economy gives rise to interesting interactions, e.g., interregional capital and labor flows.

*We thank Fernando Aragon, Paco Buera, Hal Cole, Matthias Doepke, Mike Golosov, Cynthia Kinnan, Tommaso Porzio, Yuliy Sannikov, Martin Schneider, Yongs Shin, Ivan Werning and seminar participants at the St Louis Fed, Wisconsin, Northwestern and the Philadelphia Fed for very useful comments. Hoai-Luu Nguyen and Hong Ru provided outstanding research assistance. For sharing their code, we are grateful to Paco Buera and Yongs Shin. Townsend gratefully acknowledges research support from the Eunice Kennedy Shriver National Institute of Child Health and Human Development (NICHD) (grant number R01 HD027638), the research initiative ‘Private Enterprise Development in Low-Income Countries’ [(PEDL), a programme funded jointly by the Centre for Economic Policy Research (CEPR) and the Department for International Development (DFID), contract reference MRG002,1255], the John Templeton Foundation (grant number 12470), and the Consortium on Financial Systems and Poverty at the University of Chicago (funded by Bill & Melinda Gates Foundation under grant number 51935). The views expressed are not necessarily those of CEPR or DFID. Previous versions of this paper were circulated under the titles “Finance and Development: Limited Commitment vs. Moral Hazard” and “Financial Obstacles and Inter-Regional Flow of Funds.”