“Endogenous Credit Cycles and Financial Dampening in an Adverse Selection Economy”

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Abstract

We propose an adverse selection framework in which the financial sector has a dual role. It amplifies or dampens exogenous shocks and also generates endogenous fluctuations. We fully characterize constrained optimal contracts in a setting in which entrepreneurs need to borrow and are privately informed about the quality of their projects. Our characterization is novel in analyzing pooling and separating allocations in a context of multi-dimensional screening: specifically, the amounts of investment undertaken and of entrepreneurial net worth are used to screen projects.

We then embed these results in a dynamic competitive economy. First, we show how endogenous regime switches in financial contracts may generate fluctuations in an economy that exhibits no dynamics under full information. Unlike previous models of endogenous cycles, our result does not rely on entrepreneurial net worth being counter-cyclical or inconsequential for determining investment. Secondly, the model shows the different implications of adverse selection as opposed to pure moral hazard. In particular, and contrary to standard results in the macroeconomic literature, the financial system may dampen exogenous shocks in the presence of adverse selection