Financial Market Frictions, Productivity Growth and Crises in Emerging Economies*

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Abstract

This paper documents that financial crises in emerging countries involve large and persistent losses in labor productivity. It then presents a model which features endogenous TFP growth through the adoption of new varieties of intermediates, and in which an agency problem in financial markets implies that technology adopters may be credit constrained. A crisis shock generates a decline in TFP of size and persistence comparable to the data. Financial frictions are quantitatively important, explaining half the medium run TFP decline. Both endogenous growth and the financial friction substantially contribute to a more persistent output decline and to an amplified short run response of consumption. These mechanisms also help in accounting for the time series properties of Argentina’s GDP and Solow residual, especially at medium frequencies.

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1 Introduction

In recent years, emerging economies have suffered frequent episodes of severe financial distress, often associated with sudden stops in capital inflows, and usually featuring large contractions in economic activity. Further, recent research by Cerra and Saxena (2008) has shown that the output drops due to these type of shocks tends to be very persistent. In this paper, I first present evidence that a large part of the output decline associated with these episodes is due to a fall in labor productivity, which also displays considerable persistence. As shown in detail in Section 2, productivity lost during financial crises tends not to be regained on average – if and when productivity growth resumes, it appears to do so from a level permanently below the pre-crisis trend.

I argue that these findings pose a challenge to conventional explanations for the decline in measured labor productivity and TFP during financial crises, such as reduced capacity utilization or labor hoarding. While these mechanisms offer a reasonable account for the short-run declines in measured factor productivity, it is hard to imagine why they might persist into the medium run, once the crisis episode is over. Instead, this paper proposes to model explicitly medium-run productivity growth through the introduction of new technologies and products, and to illustrate how this process may be disrupted by a large shock and the ensuing financial distress.

In the model, described in Section 3, TFP growth is endogenous through the adoption of new technologies. I use a formulation similar to Romer (1990), whereby endogenous growth results from the introduction of new varieties of intermediate goods. To motivate an imperfection in financial markets I use an approach similar to traditional “financial accelerator” models. In particular, I introduce a special class of agents, called entrepreneurs, who are assumed to be the only ones capable of introducing new varieties of intermediates. The activity of entrepreneurs consists of borrowing funds from households and from abroad to invest them in projects which, if successful, become usable designs for new intermediates. The financial friction takes the form of a limited enforcement problem between entrepreneurs and lenders, whereby at any point in time the entrepreneur can renegue on his debt and divert a certain fraction of the assets he controls, which consist of completed projects and projects still underway. The limited enforcement friction effectively introduces an endogenous constraint on entrepreneurial debt which potentially tightens as economic conditions worsen.

The mechanism just described is embedded in an otherwise reasonably conventional small open economy real business cycle model, modified to allow for variable capital utilization, habit formation in consumption and a working capital requirement which forces final goods producers to pay a fraction of the wage bill before production. The former feature is intro-
duced to illustrate the relative importance for productivity dynamics at different frequencies of variable input utilization versus the novel mechanism in the paper, namely endogenous TFP growth. Consumption habits and working capital help produce a more realistic behavior of consumption and hours in response to a crisis shock.

Section 4 presents a quantitative analysis of the model. The main experiment is meant as an illustration of how a crisis such as the one that occurred in East Asia in 1997, and the ensuing sharp deterioration in credit conditions, can generate the large and persistent decline in productivity observed in the data. The initiating disturbance is a shock to the country interest rate, as in Gertler, Gilchrist and Natalucci (2007). The interest rate increase, and the resulting drop in the prices of assets controlled by entrepreneurs, increases the severity of the agency problem between borrowers and lenders, making borrowers’ assets less collateralizable and constraining the flow of credit to entrepreneurs. The result at the macroeconomic level is a substantial reduction of the pace at which the entrepreneurial sector introduces new varieties of intermediates, leading TFP to drop permanently as a result of the interest rate shock. Financial factors contribute substantially to the TFP decline: for the baseline calibration presented below, the shock generates a permanent TFP decline of almost 6%, half of which is due to financial factors. Both endogenous growth and the financial friction contribute substantially to a more persistent output decline due to the crisis, and they also amplify considerably the movements in consumption in the short and medium run.

In a second experiment, I evaluate the ability of the model to generate fluctuations with statistical properties similar to those of Argentine data for the period 1950-2005. Over this period, Argentina’s GDP has displayed large and persistent fluctuations at medium frequencies, largely accounted for by movements in the Solow residual. I show that the novel mechanisms introduced in this paper contribute substantially to an improved model performance in that respect.

Related Literature. As mentioned above, the evidence presented in this paper on the effects of financial crises on output, labor productivity and employment extends a recent paper by Cerra and Saxena (2008), who document that financial crises and other large negative shocks tend to have lasting effects on output. Using a similar methodology, I study the response of a decomposition of output into employment and labor productivity, finding a significant role for labor productivity in emerging economies. Other authors have documented large TFP losses in certain episodes of financial crisis, for example Meza and Quintin (2005) or Kehoe and Ruhl (2009). The results presented in this paper are consistent with theirs, and further show that productivity losses tend to be very persistent and are extensive to other episodes in other emerging countries.

The model developed in this paper follows Comin and Gertler (2006) in using the ex-
panding variety formulation due to Romer (1990) to endogenize medium-run productivity dynamics. Comin and Gertler (2006) show that in the U.S. both TFP and R&D move procyclically at medium frequencies, and present a model that can account for short and medium term fluctuations in these and other variables. Comin, Loayza, Pasha and Serven (2009) also use an expanding variety formulation to model the diffusion of technologies from the U.S. to Mexico, and use their model to analyze how business fluctuations are interrelated in these two countries.

The financial imperfection introduced in this paper builds on ideas from the literature on financial factors in macroeconomics, reviewed for example in Bernanke, Gertler and Gilchrist (1999) or Gertler and Kiyotaki (2010). This paper follows Gertler and Kiyotaki (2010) and others in modeling credit market imperfections through a limited enforcement problem. The main difference with more traditional “financial accelerator” models and the present paper is that here the credit market imperfection affects technology adoption, which is the ultimate source of productivity growth in the model economy. Aoki, Benigno and Kiyotaki (2007, 2009) also introduce a model with credit constraints in which a crisis can endogenously generate a drop in aggregate TFP, in their case because of productive units which are heterogeneous in their productivities: in their model, a crisis shock affects relatively more the more productive agents which leverage more than the less productive agents, and aggregate TFP declines as a result.

Finally, this paper is related to a growing literature on quantitative business cycle frameworks for emerging countries. Uribe and Yue (2006) and Neumeyer and Perri (2005) find an important role for fluctuations in interest rates and country risk in accounting for emerging market business cycles. Gertler, Gilchrist an Natalucci (2007) present a model featuring a financial accelerator designed to capture the Korean crisis in 1997-98, which they model as a country interest rate shock, and use their model to illustrate how a fixed exchange rate regime can exacerbate the crisis. Aguiar and Gopinath (2007) argue that what differentiates emerging markets from small developed economies is a more volatile and persistent nonstationary component of TFP, a hypothesis which the evidence presented in this paper lends support to. Further, this paper shows that such TFP process, which is assumed exogenously in Aguiar and Gopinath (2007), can be a natural result in a context in which TFP growth is endogenous and potentially affected by imperfections in financial markets.

The rest of the paper is organized as follows. In Section 2, I present the evidence on the effects of financial crises. In Section 3 I describe the model. In Section 4 I present numerical simulations of the model. Section 5 concludes.
2 Financial Crises and Productivity: Evidence

This section provides evidence on the medium-run dynamics of output following financial crises, and examine the extent to which they are driven by movements in employment and in labor productivity. I begin by showing that the Asian crisis in 1997 resulted in permanent output losses for the countries involved, largely driven by a permanent decline in labor productivity. I then go on to show, using more formal VAR methods, that this is a quite general phenomenon across crisis episodes in emerging countries, and that it contrasts with the experience for rich countries, where there is a more important role for employment in accounting for the medium-run output decline, with little left to explain by labor productivity.

Figure 1 plots output, employment and labor productivity for a group of Asian countries around the crisis episode of 1997. The countries included are Indonesia, Malaysia, Philippines, Korea, Thailand and Hong Kong, labelled “SEA-6”. I compute area totals by adding constant dollar, PPP-adjusted GDP for each of the countries. Labor productivity is defined as output per employed worker. All data are from the Total Economy Database.

The first panel of Figure 1 illustrates a very persistent output loss following the crisis: trend output is not regained, but rather output growth appears to resume with a level permanently below the pre-crisis trend. Looking at the second and third panels, the behavior of output appears to be driven largely by labor productivity, with a more modest slowdown of employment growth.

Figure 2 examines more closely the behavior of labor productivity. The first panel includes the precrisis trend, calculated for the period 1980-1996 and linearly extrapolated thereafter. The picture suggests that productivity did not recover to its pre-crisis trend. As the second panel shows, it falls by about 10% relative to trend and it never rebounds. This is robust to different choices for the pre-crisis period.

Next I extend the evidence in Cerra and Saxena (2008), who analyze the response of output to financial crises, to investigate the roles of employment and labor productivity in accounting for the output loss. I use a decomposition of real output \( \log(Y_t) \) into employment \( \log(N_t) \) and labor productivity as follows:

\[
\log(Y_t) = \log\left(\frac{Y_t}{N_t}\right) + \log(N_t) = y_n + n_t
\]

where \( y_n := \log\left(\frac{Y_t}{N_t}\right) \) and \( n_t := \log(N_t) \). Following Cerra and Saxena (2008), I estimate
the following panel VAR:

\[ x_{i,t} = a_i + \sum_{j=1}^{4} A_j x_{i,t-j} + \sum_{s=0}^{4} B_s D_{i,t-s} + \epsilon_{i,t} \]  

(1)

where

\[ x_{i,t} = \begin{bmatrix} \Delta y_{i,t} \\ \Delta n_{i,t} \end{bmatrix} \]

\( D_{i,t} \) is a dummy variable indicating a financial crisis during year \( t \) in country \( i \). I estimate equation (1) separately for currency and banking crisis indicators, on data for both a group of emerging economies and another group of high-income countries. I use the same crisis indicators as Cerra and Saxena (2008): a currency crisis is an episode of extraordinary pressure in the foreign exchange market, as measured by the percentage depreciation in the exchange rate plus the percentage loss in foreign exchange reserves. The episodes of sudden stops in Asia and Latin America fall into this category. Banking crisis indicators are obtained from Caprio and Klingebiel (2003), who provide dates for episodes of systemic banking crises, defined as episodes in which a large fraction of bank capital is exhausted. Yearly data on real output and employment for the period 1950-2005 is from the Total Economy database.

Figures 1 and 2 contain impulse responses of labor productivity, employment and output to currency and banking crises respectively. The third row echoes the results in Cerra and Saxena (2008): while high income countries on average suffer little or no output loss due to currency crises, these episodes have large and persistent effects on output in emerging economies, with no evidence of recovery. Banking crises involve large and persistent output drops for both groups.

The decomposition of output into productivity and employment uncovers a large and highly persistent negative effect on labor productivity of currency crises in emerging countries, responsible for most of the output decline. After about 4 years, productivity has fallen about 5.5% and it never recovers. For the case of banking crises, there is some evidence of recovery in productivity, but the recovery is not complete - there is a permanent drop of about 3%. Further, this is in stark contrast with high income countries, where virtually all the drop in output is due to a decline in employment, with productivity essentially not responding at all.

The evidence described above confirms that the large productivity drop associated with financial crises in emerging countries is indeed a general phenomenon across episodes and countries. The magnitudes uncovered by the exercise are comparable to those found by

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2See appendix A for a list of the countries used in the analysis and details on the data.
other authors, such as Meza and Quintin (2005) or Kehoe and Ruhl (2009). Further, these productivity drops tend to have a very large permanent component in emerging markets, lending support to the hypothesis put forward by Aguiar and Gopinath (2007) that in these countries “the cycle is the trend”. In the following sections I introduce a model that is capable of generating drops in TFP and productivity of size and persistence comparable to those in the data, and show that frictions in the financing of the adoption of new technology contribute to a substantial degree in accounting for these drops.

3 The Model

The core framework is a small open economy model with endogenous TFP growth through an expanding variety of intermediates, as in Romer (1990) and Comin and Gertler (2006). The difference with respect to these frameworks is that there is an imperfection in financial markets in the form of costly enforcement that impedes the smooth flow of resources from savers (households and international investors) to entrepreneurs, who are the agents with the ability to introduce new intermediates. I introduce three further modifications that have become common in the DSGE literature recently, and that help the model produce a more realistic behavior of macroeconomic aggregates in response to the crisis: variable capital utilization, habit formation in consumption, and a working capital requirement on intermediate goods producers.

As in familiar “financial accelerator” models, the condition of borrower balance sheet determines the severity of the agency problem in financial markets, which manifests itself as an excess return to technology investments relative to country interest rates. The rise in country interest rates, and the consequent fall in the value of the assets controlled by entrepreneurs (adopted and unadopted technologies) have a negative impact on entrepreneurial net worth, implying a rise in spreads and a decline in new technology investments relative to the frictionless benchmark.

There are six types of agents in the model: households, entrepreneurs, prototype producers, capital producers, intermediate goods producers and final goods producers. Final output is produced by the latter using an expanding variety of types of intermediates. The entrepreneurial sector purchases prototypes, interpretable as “unadopted” technologies, using funds borrowed from abroad and from domestic households. If successfully adopted, a prototype becomes a new variety of intermediate. In what follows, I discuss the behavior of each of these agents in turn, and derive the aggregate relationships that characterize the balanced growth path of the model economy.
3.1 Households

Suppose there is a representative family with a unit measure of members. Households make
decisions on consumption, labor supply, investment in physical capital and saving through a
risk-free international bond. There are two types of members within each household: workers
and entrepreneurs, with measures $f$ and $(1 - f)$ respectively. A fraction of the workers are
specialized or “research” workers, and supply labor inelastically to the prototype-producing
sector. Their role will be clear as I discuss prototype producers below. Regular workers
supply labor elastically to intermediates producers. Both types of labor return wages to
the family. Entrepreneurs have the ability of adopting new types of intermediates, and also
transfer any earnings from this activity back to the household. The following subsection
describes the activity of entrepreneurs in detail. There is perfect consumption insurance
among family members. As in Gertler and Kiyotaki (2010), this formulation is a simple
way of introducing heterogeneity in terms of borrowers and lenders while maintaining the
tractability of a representative agent model.

There is random turnover between entrepreneurs and workers: an entrepreneur becomes
a worker with probability $(1 - \theta)$. At the end of their careers, entrepreneurs transfer to the
family the control of any assets they have accumulated. At the same time, each period a
fraction $(1 - \theta)\frac{1}{1 - f}$ of workers start a career as entrepreneurs, exactly offsetting the number of
entrepreneurs who exit. As explained below, it is assumed that the family transfers a small
amount of resources to entrepreneurs who start out so they are able to start operations.
Entrepreneur exit is introduced as a device to ensure that the financial imperfection will be
relevant: otherwise entrepreneurs might reach a point where internal resources are enough
to finance all desired investments in new technology.

Letting $C_t$ denote consumption and $L_t$ hours of work in the sector producing intermediates, a households’ utility function is

$$U(C_t, L_t) = \frac{1}{1 - \sigma} \left[ (C_t - \gamma C_{t-1})^{1-\xi} (1 - \mu_t W_t^{L_t})^{\xi} \right]^{1-\sigma} \quad (2)$$

$\mu_t W_t$ is a shock to the disutility of labor that acts as a labor supply shifter. It is assumed
to fluctuate around unity as a first-order autoregressive process. The households’ decision
problem is to choose stochastic sequences for consumption, labor supply, purchases of the
international bond and purchases of following-period physical capital to solve the following
problem:

$$\max_{(C_t, L_t, D_t^F, K_{t+1})} \mathbb{E}_t \sum_{i=0}^{\infty} \beta^i U(C_t, L_t)$$
subject to

\[ C_t + P_{K,t} K_{t+1} \leq [F_t + (1 - \delta) P_{K,t}] K_t + W_t L_t + Q_t D_t^F - D_{t-1}^F + \tau_t \]

Above, \( P_{K,t} \) is the price of capital, \( F_t \) is the cash flow per unit of capital stock, \( \delta \) is the depreciation rate of capital, \( W_t \) the wage rate and \( Q_t \) is the price of the international bond, which delivers one unit of final goods in the following period. \( D_t^F \) denotes the family’s choice of bondholdings and \( K_{t+1} \) is the choice for physical capital holdings. Finally, \( \tau_t \) denotes net transfers from entrepreneurs plus wages earned by research workers.

The price of the international bond depends on total net foreign indebtedness \( B_t \), equal to the sum of household and entrepreneurial debt, and on a random shock \( r_t \) as follows:

\[
\frac{1}{Q_t} = r + e^{r_t} + \psi \left[ e^{\frac{B_t - B_{t-1}}{r_t}} - 1 \right] \tag{3}
\]

As is usual in the small open economy literature, the reason for introducing a dependence of the cost of borrowing on net foreign indebtedness is to ensure stationary dynamics. I choose a very small value for \( \psi \) so that this feature does not affect the dynamics of the model. A raise in \( r_t \), interpretable as a country interest rate shock, is a simple way to model the sudden capital outflows that appear to be the trigger of many of the emerging market financial crises analyzed in the previous section.

The expression for marginal utility of consumption, \( U_{C,t} \) is the following:

\[
U_{C,t} = (1-\xi) \left[ (1-L_t)^{\xi(1-\sigma)}(C_t - \gamma C_{t-1})^{-[(1-\xi)\sigma+\xi]} - \beta \gamma E_t(1-L_{t+1})^{\xi(1-\sigma)}(C_{t+1} - \gamma C_t)^{-[(1-\xi)\sigma+\xi]} \right] \tag{4}
\]

Define the households’ stochastic discount factor between periods \( t \) and \( t+1 \), \( \Lambda_{t,t+1} \) as

\[
\Lambda_{t,t+1} := \frac{\beta U_{C,t+1}}{U_{C,t}} \tag{5}
\]

Then the household’s decision on bond and capital holdings are characterized by two conventional Euler equations:

\[
1 = E_t \left( \Lambda_{t,t+1} \frac{1}{Q_t} \right) \tag{6}
\]

\[
1 = E_t \left( \Lambda_{t,t+1} \frac{F_t + (1 - \delta) P_{K,t+1}}{P_{K,t}} \right) \tag{7}
\]

Labor supply is given by
\[
\frac{\xi C_t^{(1-\xi)(1-\sigma)} (1 - L_t) \xi^{(1-\sigma)-1}}{U_{C,t}} = W_t
\] (8)

3.2 Entrepreneurs

The activity of entrepreneurs consists in introducing new varieties of intermediate goods. Specifically, entrepreneurs use borrowed funds to purchase potential designs or "prototypes" for new intermediates. These prototypes are not yet usable for production however, and entrepreneurs are the only agents with the ability to turn them into marketable designs for new intermediates, or "adopt" them. The adoption technology is very simple: any unadopted project that the entrepreneur is holding becomes a usable design with probability \( p \) each period. Both adopted and unadopted projects are subject to the risk of becoming obsolete: \( \delta_A \) and \( \delta_M \) represent the respective obsolescense probabilities. When an entrepreneur is successful in one of his projects, he receives the exclusive right to rent that new design to an intermediates producer, which manufactures it and sells it to final goods producers. This reports a cash flow of \( \pi_t \) to the entrepreneur. In the description of intermediates producers below I show how \( \pi_t \) is determined. The value to the household of an adopted technology, call it \( v_t \), is the present discounted value of the profit flow it gives right to, where future uncertain profits are weighted by the household’s stochastic discount factor \( \Lambda_{t,t+1} \):

\[
v_t = \pi_t + (1 - \delta_A) \mathbb{E}_t(\Lambda_{t,t+1} \nu_{t+1})
\] (9)

The financial market imperfection takes the form of a costly enforcement problem between entrepreneurs and lenders: after making the decision on how much to borrow and invest in purchases of new prototypes, an entrepreneur can default on his debt and divert a fraction of the assets he controls, with lenders only being able to recover the remaining part. This imposes a limit on how much debt the entrepreneur is able to take on ex-ante, as lenders recognize that excessive debt will lead to default.

In what follows I formally describe an entrepreneur’s problem. I refer to Figure 5 for a description of the period-\( t \) timing protocol for an individual entrepreneur. Let \( a_t \) be the number of adopted technologies an entrepreneur controls at the beginning of period \( t \), \( m_t \) the number of unadopted technologies, and \( d_{t-1} \) his debt. The triplet \((a_t, m_t, d_{t-1})\) is the entrepreneur’s individual state in the beginning of period \( t \). His beginning-of-period value is \( V_t(a_t, m_t, d_{t-1}) \), where the subindex \( t \) on the value function reflects aggregate uncertainty. Once aggregate uncertainty is realized, the entrepreneur chooses how much to borrow, \( d_t \), and how many new prototypes to purchase, \( z_t \). The market for prototypes is competitive and a prototype has price \( P_{Z,t} \). It is not necessary that \( z_t > 0 \). The choice of \( d_t \) and \( z_t \) is
subject to a budget constraint and a no-default constraint. The entrepreneur then finds out whether he has to exit at the end of the period, which happens with probability \((1 - \theta)\), or if he stays as an entrepreneur. In the former case, he transfers his net earnings to the household, which consist of the value of the assets he controls (including the technologies he has managed to adopt during period \(t\)) net of his debt \(d_t\). In the case he does not die, he can default on his debt and divert a certain fraction of the assets he controls, which he then transfers to the household. I assume he can divert fraction \(\lambda_a\) of his adopted technologies and fraction \(\lambda_m\) of his unadopted technologies. I assume that when default occurs, the rental market for new designs is already closed, but the market for prototypes is still open and the household can sell the unadopted technologies transferred by the entrepreneur\(^3\). Thus the total payoff to an entrepreneur if he defaults is \(\lambda_a \mathbb{E}_t \Lambda_{t,t+1}(v_{t+1}a_{t+1}) + \lambda_m P_{Z,t} \mathbb{E}_t (m_{t+1})\). If he doesn’t default, he goes into period \(t + 1\). Therefore, the no-default constraint which the entrepreneur faces when choosing debt \(d_t\) requires that the continuation value be greater than the default payoff. An entrepreneur’s functional equation can thus be written as

\[
V_t(a_t, m_t, d_{t-1}) = \max_{\pi_t, d_t} (1 - \theta) \mathbb{E}_t [\Lambda_{t,t+1}(v_{t+1}a_{t+1} + P_{Z,t+1}m_{t+1} - d_t)] \\
+ \theta \mathbb{E}_t [\Lambda_{t,t+1}V_{t+1}(a_{t+1}, m_{t+1}, d_t)]
\]  

subject to

\[
P_{Z,t}z_t \leq \pi_t a_t + q_t d_t - d_{t-1}
\]

Equation (11) is the borrowing constraint, which requires expenditure on new projects, \(P_{Z,t}z_t\), to be no larger than the cash flow from adopted technologies plus increases in debt. Equation (11) is the no default constraint, requiring the continuation value to exceed the value of defaulting. Given the formulation for technology adoption, the expected number of adopted and unadopted technologies at \(t + 1\) is given by

\[
\mathbb{E}_t(a_{t+1}) = (1 - \delta_A) a_t + p [(1 - \delta_M) m_t + z_t]
\]

\[
\mathbb{E}_t(m_{t+1}) = (1 - p) [(1 - \delta_M) m_t + z_t]
\]

\(^3\)A possible interpretation for this formulation is that a household which attempts to sell a diverted asset can disguise itself as a honest household, and will only be caught with an exogenous probability.
The entrepreneur’s problem can be solved by first guessing that the value function is linear in each of the individual states:

\[ V_t(a_t, m_t, d_{t-1}) = V_{A,t} a_t + V_{M,t} m_t - V_{D,t} d_{t-1} \] (15)

with the marginal values \( V_{A,t}, V_{M,t} \) and \( V_{D,t} \) depending only on the aggregate state. One can then proceed by conjecturing that the constraint binds and using undetermined coefficients to solve for the value function, confirming the initial conjecture. Under the parameterization described below, and for reasonable variations around it, the constraint always binds along the balanced growth path.\(^4\)

Given a binding constraint, an entrepreneur’s choice for debt \( d_t \) and new projects \( z_t \) is given by the following:

\[ P_{Z,t} z_t = \pi_t a_t + Q_t \{ \gamma_{a,t} a_t + \gamma_{m,t} [(1 - \delta_m) m_t + z_t] \} - d_{t-1} \] (16)

\[ d_t = \gamma_{a,t} a_t + \gamma_{m,t} [(1 - \delta_m) m_t + z_t] \] (17)

where the variables \( \gamma_{a,t} \) and \( \gamma_{m,t} \) represent how collateralizable adopted and unadopted technologies are, respectively.\(^5\) These two variables depend only on aggregates. In particular, declines in asset prices \( v_t \) and \( P_{Z,t} \) will generate declines in \( \gamma_{a,t} \) and \( \gamma_{m,t} \), causing the constraint to tighten. Notice also that declines in the international bond price \( Q_t \) also tighten the constraint, since the entrepreneur’s assets are effectively less collateralizable. As in financial accelerator models, these effects are substantially amplified by leverage.

**Aggregation.** Since entrepreneurs’ decision rules (16) and (17) are linear in all individual variables \( (a_t, m_t, d_t \text{ and } z_t) \) aggregation is straightforward. Defining uppercase letters to be the aggregate values of their lowercase counterparts,\(^6\) from (16) we obtain an aggregate demand relation for new prototypes:

\[ P_{Z,t} Z_t = \pi_t A_t + Q_t \{ \gamma_{a,t} A_t + \gamma_{m,t} [(1 - \delta_m) M_t + Z_t] \} - D_{t-1} \] (18)

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\(^4\)See appendix B for details. Roughly speaking, two conditions need to be satisfied in order for the constraint to bind: returns from new projects cannot be too pledgeable, and investing in new projects needs to be profitable enough. If the first condition is not satisfied, a new project by itself generates enough borrowing capacity to pay for its cost, and therefore the entrepreneur is effectively unconstrained. If the second condition is not satisfied, the entrepreneur would rather not invest at all. Given that there are no diminishing returns at the level of an individual entrepreneur, if it is profitable to invest the entrepreneur will always want to borrow the maximum amount.

\(^5\)See appendix B for the corresponding expressions, which are functions of value function coefficients. Notice that unadopted projects inherited from the previous period, \( m_t \), have an additional penalty on their pledgeability, due to the fact that they become useless with probability \( \delta_M \).

\(^6\)That is, \( X_t = \int_{i=0}^f x_t(i) di \) for \( X_t = A_t, M_t, D_t, Z_t \).
The aggregate amount of debt carried over into next period, $D_t$, is given by the debt carried over by surviving entrepreneurs minus the resources transferred to the entrepreneurs who start out in period $t+1$. I assume that the cash transfer to each new entrepreneur is simply a fraction of the total value of the assets controlled by exiting entrepreneurs, which equals $(1 - \theta) [v_t A_t + P_{Z,t}(M_t + Z_t)]$. Accordingly, I set the transfer to new entrepreneurs to fraction $\hat{d}/(1 - \theta)$ of this value, where $\hat{d}$ is an exogenous parameter. Thus aggregate entrepreneurial debt at the end of $t$ is

$$D_t = \theta [\gamma_{a,t} A_t + \gamma_{m,t}(\delta_M M_t + Z_t)] - \hat{d} [v_t A_t + P_{Z,t}(M_t + Z_t)]$$

(19)

The aggregate number of intermediates adopted next period is obtained by adding to the existing number those projects attempted today that turn out to be successful. Accordingly, by the Law of Large Numbers the laws of motion for aggregate adopted and unadopted technologies are

$$A_{t+1} = (1 - \delta_A)A_t + p[(1 - \delta_M)M_t + Z_t]$$

(20)

$$M_{t+1} = (1 - p)[(1 - \delta_M)M_t + Z_t]$$

(21)

**The Frictionless Benchmark.** The frictionless benchmark is the case in which the opportunity to invest in the adoption of new intermediates is directly available to the household, i.e. as with physical capital, the household can directly purchase prototypes and receive the benefits if adoption is successful. In that case, the following Euler equation for new technology obtains:

$$1 = \mathbb{E}_t \left[ \Lambda_{t,t+1} \frac{pu_{t+1} + (1 - p)(1 - \delta_M)P_{Z,t+1}}{P_{Z,t}} \right]$$

(22)

Equation (22) is the first order condition for a household deciding how many prototypes to purchase. As shown in Appendix B, it can be derived from an entrepreneur’s problem with full enforcement (i.e., the default option yields negative infinity utility) and $\theta = 1$ (entrepreneurs live forever). In that case, entrepreneurial debt becomes irrelevant for aggregate dynamics, the number of projects undertaken by an individual entrepreneur is indeterminate, and $Z_t$ is pinned down by (22).

**The Spread.** Going back to the case with financial frictions, the remarks above motivate introducing a measure of domestic financial market disruption based on the frictionless Euler equation for new technology. Accordingly, I define the *spread* $s_t$ as
\[ s_t := \mathbb{E}_t \left[ A_{t,t+1} \frac{p v_{t+1} + (1 - p)(1 - \delta_M) P_{Z,t+1}}{P_{Z,t}} \right] \]  

(23)

The spread is a measure of excess returns arising due to the credit market friction. To a first order, \( s_t \) equals returns to new technology in excess of the risk-free rate or the expected return to physical capital, and in this sense it resembles an “external finance premium” (Bernanke and Gertler, 1989) for new technology. Financial market disruptions will constrain the credit flow to entrepreneurs and profitable investment opportunities will go unexploited, leading to a raise in the spread and to a fall in technology investments below the frictionless level. In appendix B, I show that \( s_t \) is closely connected to the Lagrange multiplier on the no-default constraint of the entrepreneur.

Toward obtaining a measure of leverage, I define beginning-of-period aggregate net worth as

\[ NW_t := v_t A_t + P_{Z,t} M_t - D_{t-1} \]  

(24)

Leverage is then the ratio of the value of assets to net worth, \( (v_t A_t + P_{Z,t} M_t)/NW_t \).

### 3.3 Prototype Producers

The prototypes that entrepreneurs purchase and attempt to turn into designs for usable intermediates are produced in a competitive sector that uses final output and research labor, interpretable as scientists or engineers, as inputs. Specifically, this sector has access to the following production function:

\[ Z_t = N_t^\eta (A_t L_{R,t})^{1-\eta} \]  

(25)

\( N_t \) is the amount of materials and \( L_{R,t} \) is the amount of research labor used. Prototypes sell at price \( P_{Z,t} \). Note that, as in Romer (1990), (24) incorporates an externality of the aggregate technological level, \( A_t \), on the efficiency of research labor in producing new prototypes. As Romer (1990) shows, this assumption is key to generate endogenous growth.

For simplicity, I assume that the aggregate supply of research labor is inelastic and fixed at \( \bar{L}_R \). This assumption, together with perfect competition in producing prototypes, can be shown to generate a positively sloped supply curve of new prototypes, with an elasticity that is increasing in \( \eta \), or decreasing in the weight of the fixed factor \( L_R \).
3.4 Final Output and Intermediates Producers

The final good is produced in a competitive sector which aggregates a continuum of measure $A_t$ of intermediates:

$$Y_t = \left[ \int_0^{A_t} Y_t(s)^{\frac{\theta-1}{\theta}} ds \right]^{\frac{\theta}{\theta-1}} \tag{26}$$

Given the aggregator above, demand for each intermediate $s$ is

$$Y_t(s) = \left[ \frac{P_t(s)}{P_t} \right]^{-\theta} Y_t \tag{27}$$

where the price level $P_t$ is defined as

$$P_t = \left[ \int_0^{A_t} P_t(s)^{1-\theta} ds \right]^{\frac{1}{1-\theta}} \tag{28}$$

Equation (26) gives the demand facing each intermediate good producer $s$. Intermediates are produced using a standard Cobb-Douglas technology with capital services $u_t(s)K_t(s)$ and labor $L_t(s)$ as inputs:

$$Y_t(s) = \left[ u_t(s)K_t(s) \right]^\alpha L_t(s)^{1-\alpha} \tag{29}$$

Intermediate goods firms need to pay a fraction $\theta_W$ of the wage bill in advance of production, and therefore need to borrow working capital. It can be shown that if $W_t$ is the market wage, the working capital requirement implies that the effective wage that the firm pays is $[1 + \theta_W(\frac{1}{Q_t} - 1)] W_t$, where $(\frac{1}{Q_t} - 1)$ can be interpreted as the net interest rate, which adds to the cost of fraction $\theta_W$ of the wage bill. An increase in the interest rate thus reduces the demand of labor by intermediates firms.

The objective of intermediates producers is to maximize period profits, including the value of the remaining part of capital they rent from households. Thus, their objective is to solve

$$\max_{P_t(s), Y_t(s), u_t(s), K_t(s), L_t(s)} P_t(s)Y_t(s) + [1 - \delta(u_t(s))] P_{K,t}K_t(s) - \left[ 1 + \theta_W(\frac{1}{Q_t} - 1) \right] W_tL_t(s) - R^K_tK_t(s) \tag{30}$$

Subject to (26) and (28). The first order conditions for labor, capital and utilization are

$$W_t = (1 - \alpha) \frac{Y_t}{L_t} \tag{31}$$
\[ R_t^k = \alpha \frac{Y_t}{K_t} + (1 - \delta_t)P_{K,t} \tag{32} \]

\[ \alpha \frac{Y_t}{u_t} = \delta'(u_t)K_t \tag{33} \]

Because all intermediates producers make the same choices, they all make the same per period profits \( \pi_t \), which can be shown to be equal to

\[ \pi_t = \frac{1}{\theta} \frac{Y_t}{A_t} \tag{34} \]

Given free entry into the business of manufacturing any particular type of intermediate, \( \pi_t \) is also the per-period cash flow to an entrepreneur from renting an adopted technology. Finally, combining the aggregator (25) with the equations for intermediates producers one obtains an expression for final output:

\[ Y_t = A_t \frac{1}{\theta - 1} (u_t K_t)^\alpha L_t^{1-\alpha} \tag{35} \]

### 3.5 Capital Producers

At the end of period \( t \), capital producing firms repair depreciated capital and produce new capital. As in and Gertler et. al. (2007), repair of old capital is not subject to adjustment costs, but there are stock adjustment costs associated with the production of new capital. Let \( I^n_t \) be net investment, the amount of investment used for construction of new capital goods:

\[ I^n_t = I_t - \delta(u_t)K_t \tag{36} \]

To produce new capital, capital producers combine final output with existing capital via the constant returns to scale technology \( \Phi(I^n_t/K_t)K_t \), where \( \Phi(\cdot) \) is increasing and concave and satisfies \( \Phi(I^n/K) = 0 \) and \( \Phi'(I^n/K) = 1 \), where \( I^n/K \) is the net investment to capital ratio along the balanced growth path.

The economy-wide capital stock evolves according to:

\[ K_{t+1} = K_t + \Phi \left( \frac{I^n_t}{K_t} \right) K_t \tag{37} \]

As in Gertler et. al. (2007), I assume that capital producing firms make production plans

\[7\]Given the assumptions on \( \Phi(\cdot) \), to a first order the evolution of capital along the balanced growth path is the usual \( K_{t+1} = [1 - \delta(u_t)] K_t + I_t \).
one period in advance, with the objective of capturing the delayed response of investment observed in the data. Accordingly, the optimality condition for capital producers is

\[ \mathbb{E}_{t-1}(P_{K,t}) = \mathbb{E}_{t-1} \left\{ \Phi' \left( \frac{i_t}{k_t} \right) \right\} \]

**3.6 Market Clearing**

The economy uses output and international borrowing to finance consumption, investment in physical capital, and investment in new technology. The resulting market clearing condition is

\[ Q_t B_t - B_{t-1} + Y_t = C_t + I_t + N_t \]

\( B_t \) is economywide foreign indebtedness, equal to the sum of aggregate family and entrepreneurial debt \( B_t = D_t^F + D_t \). Equation (38) can be derived by combining family and entrepreneur budget constraints with equilibrium conditions.

The description of the model is now complete.

**4 Model Analysis**

This section presents numerical simulations of the calibrated model. The first set of results concerns the response of the model economy to a “crisis” experiment. The aim is to illustrate how a sudden stop in capital inflows may lead to a medium run productivity decline as observed in the data, and how the financial sector disruptions often associated with sudden stop episodes may contribute substantially to the slowdown in productivity growth.

The second experiment compares the properties of the simulated model to a set of time series for Argentina for the period 1950-2005. The emphasis is on illustrating how the novel mechanisms introduced in this paper, endogenous growth and financial frictions, contribute to a more realistic behavior of output and the Solow residual *vis-á-vis* the Argentinian data, especially at medium frequencies.

**4.1 Parameter Values**

There are a total of twenty-one parameters in the model, of which twelve are standard in the emerging markets business cycles literature. Of the remaining nine, five relate to the endogenous growth process: the adoption probability \((p)\), the obsolescence rate of adopted
and unadopted technologies (δ_A and δ_M), the share of materials in the production of prototypes (η) and the endowment of research labor (L_R). The remaining four parameters relate to the financial market imperfection. They include the survival rate of entrepreneurs (θ), the divertable fractions of assets (λ_a and λ_m), and the transfer rate to new entrepreneurs (d).

I begin with the conventional parameters. I set the risk aversion parameter σ at 5, as in Gertler et. al. (2007). The habits parameter γ is set at 0.25, a relatively modest amount. As discussed before, I choose ξ, the weight of leisure in the utility function, to deliver a labor supply elasticity of 1/2, a relatively low value. This implies setting ξ = 0.3. I set the yearly interest rate in steady state at 2%.

Turning to technology parameters, I set the capital share α to 1/3, and the quarterly depreciation rate of physical capital, δ, equal to 2.5%. The parameter \( \delta \), representing the elasticity of marginal depreciation with respect to the utilization rate \( u \delta''(u)/\delta'(u) \), is set at 0.15, as in Jaimovich and Rebelo (2009) and Comin, Gertler and Santacreu (2009). I set the elasticity of the price of capital with respect to the investment-capital ratio at 0.2. Regarding the working capital constraint, I set \( \theta_W = 2.5 \), implying that firms need to pay two and a half quarters worth of the wage bill in advance.\(^8\) The debt to GDP ratio along the balanced growth path is set at 0.2, and the elasticity of the interest rate with respect to the debt-output ratio equals 0.0003.

I choose the parameter on the intermediate goods aggregator, \( \vartheta \), so that output is proportional to TFP along the balanced growth path, which by looking at equation (34) amounts to imposing \( (1 - \alpha)(\vartheta - 1) = 1 \). This restriction makes profits per period, \( \pi_t \), a stationary variable, and simplifies somewhat the characterization of the balanced growth path. Given \( \alpha = 1/3 \), the resulting value for the markup is \( \vartheta/(\vartheta - 1) = 1.66 \), close to the value of 1.6 chosen by Comin and Gertler (2006).

Turning to the parameters governing the TFP growth process, I choose the supply of research labor, \( L_R \), to generate an annual TFP growth of 4.8%, similar to the average in East Asia for the pre-crisis period. I set the adoption probability \( p \) to obtain an average diffusion lag of 3 years, a value in the high end of the estimates in Pakes and Schankerman (1984). Also following Pakes and Schankerman (1984) I set \( \delta_A \) to deliver an annual obsolescence rate of adopted technologies of 20%, and also assume a somewhat higher value for the obsolescence of unadopted technologies, which I set to 25% per year. Finally, based on the presumption that technology production is relatively labor-intensive, I set \( \eta = 1/4 \), which implies that

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8While this value is slightly above the usual range found in the literature, it is worth stressing that its purpose is to generate a realistic behavior of hours worked in response to a crisis shock – see Neumeyer and Perri (2005) for more on this point. On the other hand, the results regarding the novel mechanism of the paper, namely technology adoption subject to credit constraints, are robust to lower values of this parameter.
along the balanced growth path 10% of output is used for prototype-production purposes.

Finally, I turn to the financial sector parameters. I set the entrepreneur survival rate \( \theta = 0.995 \), implying an expected horizon of entrepreneurs of 50 years. To calibrate the divertable fractions, I assume that it is harder to divert an unadopted technology than a completed project, and for simplicity I set \( \lambda_m = \lambda_a/2 \), but emphasize that results are robust to variations in \( \lambda_m \). I then choose \( \lambda_a \) and the transfer rate \( \hat{d} \) to generate a small spread of 0.5% along the balanced growth path (i.e., distortions due to the financial imperfection are small along the balanced growth path) and a relatively conservative leverage ratio of 2. The resulting values for \( \lambda_a \) and \( \hat{d} \) are 0.61 and \( 1 \times 10^{-4} \), respectively.

Table 1 reports the values chosen for the model parameters together with a reminder of their meaning.

### 4.2 Crisis Experiment

I now analyze the effects of an unanticipated increase in the country interest rate. In particular, I consider a 500 basis point increase in \( r_t \) that persists as a first-order autoregressive process with a 0.86 coefficient. These magnitudes are close to the evidence for the crisis in East Asia in 1997.

Figure 6 plots the responses of a set of variables relating to the endogenous growth mechanism and to the financial friction. The top row plots the shock along with the degree of “pleadgeability” of adopted and unadopted technologies, \( \gamma_{a,t} \) and \( \gamma_{m,t} \). As shown in equation (18), downward movements in these variables go in the direction of lowering the aggregate demand for new prototypes, \( Z_t \), by tightening entrepreneurs’ credit constraints. The declines in \( \gamma_{a,t} \) and \( \gamma_{m,t} \) follow from reductions in asset prices \( v_t \) and \( P_{Z,t} \): as these prices decline, the agency problem between entrepreneurs and lenders becomes more severe, in the sense that entrepreneurs’ incentive to default increase. The degree to which these assets are collateralizable therefore decreases. The result is a reduction in the flow of credit to entrepreneurs.

The financial sector disruptions originated by the crisis are also reflected in the following two panels, which plot entrepreneurial net worth and the spread, as defined in the previous section. The spread, which is close to zero along the balanced growth path, skyrockets to 25% following the shock to the country interest rate. As in traditional financial accelerator models, entrepreneurial net worth is an important determinant of the degree of financial market strains: notice that the dynamic pattern of the decline in net worth closely mirrors the increase in the spread. Intuitively, as entrepreneurs’ percentage stake in the outcome of their projects decreases, their incentives to default in their debt increase, so the amount that
lenders are willing to lend diminishes.

The financial market disruptions that take place during the crisis imply that the aggregate number of new projects started, \( Z_t \), and the aggregate number of unadopted technologies, \( M_t \), all drop considerably more than they do in the frictionless benchmark. As a result, TFP growth \( g_t \) suffers a considerably more protracted slowdown in the case with financial frictions. As the last panel of Figure 6 shows, the medium-run decline in TFP in the case with frictions is about 6%, a value comparable to the evidence described above, and roughly double the decline in the frictionless case.

Figure 7 plots the response of a set of standard macro variables. For comparison, it also includes simulations from a model with the endogenous growth mechanism “turned off”\(^9\) under the label “Exogenous Growth”. Note first that the financial friction amplifies substantially the response of output with respect to the frictionless benchmark, which already displays a considerably larger drop than in the case with exogenous growth. In the short run, this is partly due to a more sizeable decline in capacity utilization. Most importantly, in the case with financial frictions there is a significant permanent component to the drop in output, of a bit more than half the size of the short-run response, which is due to the permanent decline in TFP. This permanent component is considerably smaller in the frictionless benchmark, and nonexistent in the case with exogenous growth.

A final point to highlight from Figure 7 is the substantial high frequency amplification due to the financial friction of aggregate consumption, a variable which is well known to display higher volatility relative to GDP in emerging markets when compared to more developed economies. The reason for this is the stronger negative response of the growth rate of TFP \( g \), which as in Aguiar and Gopinath (2007) implies a larger movement in permanent income, generating a larger decline in consumption relative to income.

Figure 8 shows the responses of labor productivity, the measured Solow residual and TFP for the three cases. Focusing on the solid blue line, the permanent decline in TFP induces a permanent decline in labor productivity of similar magnitude. As the second panel shows, the Solow residual falls sharply immediately after the initial shock, while TFP (third panel) follows a more gradual decline. The reason behind the behavior of the Solow residual is the short-run drop in capital utilization. The medium run declines in labor productivity and measured Solow residual, however, are driven by TFP. In fact, the dynamic pattern for labor productivity turns out to be very similar to that of TFP: the reason is that the two opposing forces that make labor productivity depart from TFP in the short run, which are a drop in

\(^9\)Specifically, the balanced growth path is the same as in the frictionless benchmark, with the economy using resources to adopt technologies, but these are assumed to be exogenously given rather than responsive to economic conditions.
capital utilization (making labor productivity drop more than TFP) and an increase in the capital-labor ratio due to the drop in labor input (making labor productivity drop less than TFP) turn out to roughly cancel each other. Comparing across the three versions of the model, the bottomline from Figure 8 is that the financial market imperfection contributes substantially in generating labor productivity declines as large and persistent as observed in the data, and that the model with exogenous growth has little hope of being able to match that evidence.

4.3 Argentina 1950-2005

Figure 9 plots filtered annual series for Argentina’s GDP and Solow residual for the period 1950-2005. The method to isolate medium frequency variation follows Comin and Gertler (2006): the medium-term cycle is defined as fluctuations at frequencies of 50 years and above; the medium-term component isolates movements associated with frequencies between 8 and 50 years. Figure 9 reveals large and persistent medium-term fluctuations in Argentinian GDP, largely accounted for by movements in the Solow residual: from Table 2, the volatility of the Solow residual over the medium-term business cycle relative to that of GDP is 88%, even higher than the corresponding ratio at the high frequency (79%). As Table 3 documents, the correlation between the two series over the medium term is also strong at a value of 0.9, also larger than its high-frequency counterpart (0.84).

To analyze the statistical properties of the three versions of the model economy (financial frictions, frictionless benchmark and exogenous growth), I examine simulated time series from the calibrated model driven by two forces: interest rate shocks and low-persistence labor supply shocks. In particular, I set the variances of the innovations so that the model exactly matches the volatility of Argentinian GDP at the high frequency, and so that each of the shocks explains fifty percent of that volatility. The first order autoregressive parameter of the labor supply shock process is set at 0.5. The experiment is then to assess the performance of the model at medium frequencies, and to analyze the contribution of financial frictions and endogenous growth to model performance.

Table 3 reports standard deviations for output, the Solow residual, consumption and investment for the data and for the three versions of the model economy. The case with financial frictions does substantially better at generating medium frequency movements in output and the Solow residual: the volatility of GDP over the medium-term cycle, equal to 7.9% in the data, is 6.47% for the case with financial frictions, while in the frictionless

\[ \text{While admittedly arbitrary, this calibration is roughly consistent with the findings in Neumeyer and Perri (2005) and Uribe and Yue (2006) on the role of interest rates in explaining high-frequency fluctuations in emerging economies.} \]
benchmark and in the exogenous growth case it takes values of 5.48% and 5.05%, respectively. Largely responsible for this improved performance is a better ability of the model with frictions to account for medium-run movements in the Solow residual, which displays a volatility over the medium term of 6.96% in the data, versus 4.03% in the model with frictions, 1.71% in the frictionless benchmark, and 1.60% in the exogenous growth case. Further, as Table 3 shows, the model with exogenous growth fails at reproducing the correlation between GDP and the Solow residual at medium frequencies. Finally, both endogenous growth and the financial friction contribute to a more realistic volatility of consumption at all frequencies.

I conclude this section with the bottomline that the case with financial frictions is better able to match important features of the data, especially regarding medium frequency fluctuations in GDP and the Solow residual.

5 Concluding Remarks

This paper has argued that the large and persistent productivity and TFP declines observed during crises in emerging economies can be a natural consequence of an adverse shock in an environment in which productivity growth is endogenous through the adoption of new technologies. Further, it has shown how domestic financial market disruptions can work to amplify these declines. The model is also shown to generate reasonable behavior of macroeconomic aggregates, with the financial friction substantially amplifying the response of GDP at high and especially medium frequencies. The mechanism introduced in the paper also implies an amplified short and medium run response of consumption. Finally, the model with frictions is shown to be better able to match Argentine data than a frictionless benchmark and a version with exogenous growth, especially with regard to the behavior of output and the Solow residual at medium frequencies.

Toward providing an explanation of the markedly different business cycle patterns of emerging markets with respect to more developed economies, both in terms of the evidence on crisis episodes reported in Section 2 and with respect to the more general business cycle patterns, the analysis in this paper hints at two complementary potential explanations. First, financial market imperfections might be more severe in emerging economies. For example, in the context of the Asian crisis some authors have argued\textsuperscript{11} that the countries involved tended to have very weak financial systems, and that the crisis was followed by an extraordinary collapse in credit. Second, it might be that the endogenous technology adoption mechanism is relatively more relevant for emerging economies, perhaps because they are further behind

\textsuperscript{11}See Krueger and Yoo (2001) or Radelet and Sachs (1998).
in the technological ladder. Both these explanations would make the responses in Figures 7 and 8 closer to the “Financial Frictions” case for emerging economies, and closer to the “Exogenous Growth” case for developed countries.

A potentially interesting application of the framework presented in this paper would be an evaluation of the welfare gains of government intervention in mitigating a financial crisis. Gertler and Karadi (2009), for example, analyze direct central bank intermediation in the context of the current crisis in the US, finding important welfare benefits of intervening. The endogenous productivity growth mechanism introduced in this paper would likely affect what is at stake when considering intervention during a financial meltown, and therefore it could have a substantial impact on the welfare gains of government policies directed at ameliorating the impact of a financial crisis.

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12 To elaborate on this point, imagine that productivity growth is driven partly by endogenous technology adoption and partly by other factors (basic research, human capital accumulation, institutional change) which are arguably exogenous to business cycle developments. The hypothesis would then be that in emerging market economies the technology adoption mechanism is relatively more important in determining growth, while in developed economies growth is determined mostly by the second set of factors.
6 Appendix

A Data

Financial crises. Dummies for currency and banking crises are taken from Cerra and Saxena (2008). A dummy for currency crisis in a particular year and country is assigned if an exchange market pressure index (EMPI) is in the upper quartile of all observations across the panel. The EMPI is defined as the percentage depreciation in the exchange rate plus the percentage loss in foreign exchange reserves. Banking crisis dates are obtained from Caprio and Klingebiel (2003).

I obtain output and employment data from the Total Economy Database\footnote{http://www.conference-board.org/economics/database.cfm}, maintained by the Conference Board and the Groningen Growth and Development Centre, which contains yearly series for 90 countries for the period 1950-2009. In what follows I provide a list of the countries included in each category.

Emerging countries: Argentina, Brazil, Chile, China, Colombia, Hong Kong, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Peru, Philippines, Poland, Singapore, Thailand, Turkey and Vietnam.

Developed economies: Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and the United States.

Argentina 1950-2005. Yearly data for consumption, investment and the trade balance from Garcia-Cicco, Pancrazi and Uribe (2009), and for output and total hours worked from the Total Economy Database.

B An Entrepreneur’s Problem

The problem for an individual entrepreneur is given by equations (10)-(14) in the text. Given the conjecture that the value function is linear in the individual states (equation (15)), one can substitute out the continuation value in the no default constraint (equation (12)). What emerges is a constraint on entrepreneurial debt:

\[ d_t \leq \gamma_{a,t}a_t + \gamma_{m,t} [(1 - \delta_M)m_t + z_t] \]  

where the coefficients \( \gamma_{a,t} \) and \( \gamma_{m,t} \) can be interpreted the collateral value of adopted and unadopted technologies. They depend on the value function coefficients as follows:
\[
\gamma_t^a = \delta_A \frac{\mathbb{E}_t \{ \Lambda_{t,t+1} [V_{A,t+1} - \gamma_a v_{t+1}] \}}{\mathbb{E}_t [\Lambda_{t,t+1} V_{D,t+1}]} 
\]

\[
\gamma_t^m = p \frac{\mathbb{E}_t \{ \Lambda_{t,t+1} [V_{A,t+1} - \gamma_a v_{t+1}] \}}{\mathbb{E}_t [\Lambda_{t,t+1} V_{D,t+1}]} + (1 - p) \frac{\mathbb{E}_t [\Lambda_{t,t+1} V_{M,t+1} - \gamma_m P_{Z,t}]}{\mathbb{E}_t [\Lambda_{t,t+1} V_{D,t+1}]} 
\]

Notice that it is possible to combine the participation constraint (40) with the entrepreneur’s budget constraint (11) to obtain a constraint on total expenditures on new projects, which reads as follows:

\[
P_{Z,t} z_t \leq Q_t \left\{ \gamma_a a_t + \gamma_m [(1 - \delta_M) m_t + z_t] \right\} + \pi_t a_t - d_{t-1} 
\]

The right hand side of (43) is interpretable as an entrepreneur’s “collateralizable net worth”, that is, the collateral value of her assets (given by the first three terms), plus her current period cash flow from adopted technologies, \( \pi_t a_t \), minus her debt inherited from the previous period, \( d_{t-1} \).

Toward obtaining expressions for the value function coefficients in (15), first define the following objects:

\[
\psi_{A,t} := \mathbb{E}_t \{ \Lambda_{t,t+1} [(1 - \theta) v_{t+1} + \theta V_{A,t+1}] \} 
\]

\[
\psi_{M,t} := \mathbb{E}_t \{ \Lambda_{t,t+1} [(1 - \theta) P_{Z,t+1} + \theta V_{M,t+1}] \} 
\]

\[
\psi_{D,t} := \frac{1}{Q_t} \mathbb{E}_t \{ \Lambda_{t,t+1} [(1 - \theta) + \theta V_{D,t+1}] \} 
\]

Note that (44)-(46) represent marginal “continuation values” from the viewpoint of an entrepreneur who has yet to find out whether he has to exit at the end of the period. Define also

\[
\bar{\psi}_t := p \psi_{A,t} + (1 - p) \psi_{M,t} 
\]

\( \bar{\psi}_t \) can be interpreted as the value to the entrepreneur of starting one additional project, which becomes an adopted technology with probability \( p \) and remains unadopted with probability \( (1 - p) \).

An entrepreneur’s problem simplifies to

\[
V_t(a_t, m_t, d_{t-1}) = \max_{z_t} \left\{ \bar{\psi}_t - \psi_{D,t} P_{Z,t} \right\} z_t + \psi_{A,t} a_t - \psi_{D,t} d_{t-1} 
\]

subject to (43). The Lagrange multiplier for this problem, denoted \( \lambda_t \), is
\[
\lambda_t = \frac{\bar{\psi}_t - \psi_{D,t}P_{Z,t}}{P_{Z,t} - Q_t \gamma_{m,t}} \tag{49}
\]

Thus, for the constraint to bind it is sufficient that \(\bar{\psi}_t - \psi_{D,t}P_{Z,t} > 0\) and \(P_{Z,t} - Q_t \gamma_{m,t} > 0\). If the former does not hold then it is not profitable for the entrepreneur to invest, while if the latter is not satisfied an entrepreneur can finance a new project by simply mortgaging it and does not need to borrow against her other assets. Along the balanced growth path of the calibrated model, both conditions hold. Given a binding constraint, \(z_t\) is given by (43) at equality. One can then combine the resulting expression for \(z_t\) with the value function (48) to solve for the coefficients \(V_{A,t}, V_{M,t}\) and \(V_{D,t}\) in (15):

\[
V_{A,t} = \psi_{D,t}\pi_t + \delta_A \psi_{A,t} + [\pi_t + Q_t \gamma^m_t] \lambda_t \tag{50}
\]

\[
V_{M,t} = \delta_M \bar{\psi}_t + \delta_M Q_t \gamma^m_t \lambda_t \tag{51}
\]

\[
V_{D,t} = \psi_{D,t} + \lambda_t \tag{52}
\]

The Lagrange multiplier and the spread. To illustrate how a rise in the spread, defined in equation (23), is associated with a tightening of entrepreneurs’ participation constraints, Figure A1 plots the response of the spread to a crisis shock as analyzed in the paper together with the response of the Lagrange multiplier on entrepreneurs’ constraint. Aside from differences in magnitude, the two variables display a very similar dynamic response to the shock.

The frictionless benchmark. Here I show that the Euler Equation characterizing the frictionless benchmark, equation (22), follows from a setting with full enforcement and \(\theta = 1\) (entrepreneurs never die). Full enforcement necessarily implies \(\lambda_t = 0 \forall t\). The value function coefficients then reduce to

\[
V_{A,t} = \psi_{D,t}\pi_t + \delta_A \psi_{A,t} \tag{53}
\]

\[
V_{M,t} = \delta_M \bar{\psi}_t \tag{54}
\]

\[
V_{D,t} = \psi_{D,t} \tag{55}
\]

In turn, if \(\theta = 1\) continuation values are simply
\[
\psi_{A,t} = \mathbb{E}_t(\Lambda_{t,t+1}V_{A,t+1}) \tag{56}
\]

\[
\psi_{M,t} = \mathbb{E}_t(\Lambda_{t,t+1}V_{M,t+1}) \tag{57}
\]

\[
\psi_{D,t} = \frac{1}{Q_t} \mathbb{E}_t(\Lambda_{t,t+1}V_{D,t+1}) \tag{58}
\]

The last expression into the expression for \(V_{D,t}\) above gives \(V_{D,t} = \frac{1}{Q_t} \mathbb{E}_t(\Lambda_{t,t+1}V_{D,t+1})\). Because of the consumer’s Euler Equation, one solution to this is \(V_{D,t} = 1 \ \forall t\). \(\lambda_t = 0\) then implies that

\[
\tilde{\psi}_t = P_{Z,t} \tag{59}
\]

Thus,

\[
V_{M,t} = \delta_M \tilde{\psi}_t = \delta_M P_{Z,t} \tag{60}
\]

Also, the expression for \(V_{A,t}\) reduces to

\[
V_{A,t} = \pi_t + (1 - \delta_A)\mathbb{E}_t(\Lambda_{t,t+1}V_{A,t+1}) \tag{61}
\]

a solution of which is \(V_{A,t} = v_t \ \forall t\).

Thus, the number of new projects undertaken in the economy is given by the break-even condition \(P_{Z,t} = p\psi_{A,t} + (1 - p)\psi_{M,t}\), or

\[
P_{Z,t} = \mathbb{E}_t \{ \Lambda_{t,t+1} [p v_{t+1} + (1 - p)(1 - \delta_M)P_{Z,t+1}] \} \tag{62}
\]
C The Complete Model

C.1 Conventional Part

Production function:

\[ Y_t = A_t^{1/\alpha} (u_t K_t)^\alpha L_t^{1-\alpha} \]  \hspace{1cm} (63)

Marginal utility of consumption:

\[ U_{C,t} = (1-\xi) \left[ (1 - L_t)^{\xi(1-\sigma)} (C_t - \gamma C_{t-1}) - \beta \gamma E_t (1 - L_{t+1})^{\xi(1-\sigma)} (C_{t+1} - \gamma C_t)^{\xi(1-\sigma) + \xi} \right] \]  \hspace{1cm} (64)

Labor market equilibrium:

\[ \frac{\xi (C_t - \gamma C_{t-1})^{(1-\xi)(1-\sigma)} (1 - L_t)^{\xi(1-\sigma)-1}}{U_{C,t}} = \frac{1}{1 + \theta_w \left( \frac{1}{Q_t} - 1 \right) (1 - \alpha)} \frac{Y_t}{L_t} \]  \hspace{1cm} (65)

Stochastic discount factor:

\[ \Lambda_{t,t+1} = \frac{\beta U_{C,t+1}}{U_{C,t}} \]  \hspace{1cm} (66)
International bond Euler Equation:

\[ 1 = \mathbb{E}_t \left( \Lambda_{t,t+1} \frac{1}{Q_t} \right) \]  \hspace{1cm} (67)

Capital Euler Equation (demand for capital):

\[ 1 = \beta \mathbb{E}_t \left( \Lambda_{t,t+1} \frac{\alpha \frac{P_{t+1}}{K_{t+1}} + (1 - \delta)P_{K,t+1}}{P_{K,t}} \right) \]  \hspace{1cm} (68)

Supply of capital:

\[ \mathbb{E}_{t-1}(P_{K,t}) = \mathbb{E}_{t-1} \left\{ \Phi' \left( \frac{I^n_t}{K_t} \right) \right\} \]  \hspace{1cm} (69)

Net investment:

\[ I^n_t = I_t - \delta(u_t)K_t \]  \hspace{1cm} (70)

Capital accumulation:

\[ K_{t+1} = (1 - \delta)K_t + I_t \]  \hspace{1cm} (71)

Optimal utilization:

\[ \frac{Y_t}{u_t} = \delta'(u_t)K_t \]  \hspace{1cm} (72)

Market clearing:

\[ Q_t B_t - B_{t-1} + Y_t = C_t + I_t + N_t \]  \hspace{1cm} (73)

International bond price:

\[ \frac{1}{Q_t} = r + e^{r_t} + \psi \left[ e^{\frac{\mu - B}{r_t}} - 1 \right] \]  \hspace{1cm} (74)

Interest rate shock:

\[ r_t = \rho_r r_{t-1} + \sigma_r \epsilon_t^r \]  \hspace{1cm} (75)

C.2 Endogenous Growth and Financial Frictions Part

Profits:
\[ \pi_t = \frac{1}{\vartheta} Y_t \]  \hspace{1cm} (76)

Value:

\[ v_t = \pi_t + (1 - \delta_A) E_t(A_{t,t+1} v_{t+1}) \]  \hspace{1cm} (77)

Projects:

\[ P_{Z,t} Z_t = \pi_t A_t + Q_t \{ \gamma_{a,t} A_t + \gamma_{m,t} [(1 - \delta_M) M_t + Z_t] \} - D_{t-1} \]  \hspace{1cm} (78)

Debt:

\[ D_t = \theta \{ \gamma_{a,t} A_t + \gamma_{m,t} [(1 - \delta_M) M_t + Z_t] \} - \hat{d}[v_t A_t + P_{Z,t}(M_t + Z_t)] \]  \hspace{1cm} (79)

Adopted technologies:

\[ A_{t+1} = (1 - \delta_A) A_t + p [(1 - \delta_M) M_t + Z_t] \]  \hspace{1cm} (80)

Unadopted technologies:

\[ M_{t+1} = (1 - p) [(1 - \delta_M) M_t + Z_t] \]  \hspace{1cm} (81)

Price of prototypes:

\[ P_{Z,t} = \frac{1}{\eta} \left( \frac{1}{L_R} \right)^{\frac{1-\alpha}{\eta}} \left( \frac{Z_t}{A_t} \right)^{\frac{1-\alpha}{\eta}} \]  \hspace{1cm} (82)

Materials used in research:

\[ N_t = \eta Z_t P_{Z,t} \]  \hspace{1cm} (83)

In the frictionless benchmark, (78) and (79) are replaced by

\[ 1 = E_t \left[ A_{t,t+1} \frac{p v_{t+1} + (1 - p)(1 - \delta_M) P_{Z,t+1}}{P_{Z,t}} \right] \]  \hspace{1cm} (84)

### C.3 Detrending

A stationary system can be obtained from the equations in the previous section by redefining the variables that exhibit growth as deviations from trend. In particular, and under the restriction that \((1 - \alpha)(\vartheta - 1) = 1\), the system above has a balanced growth path along
which \( Y_t, K_t, I_t, C_t, N_t, B_t, D_t, Z_t, M_t \) grow in proportion to \( A_t \), and prices \( v_t, P_{Zt}, \pi_t \), hours \( L_t \) and utilization \( u_t \) are stationary. The growth rate of TFP, \( g_t := A_{t+1}/A_t \), is also a stationary variable, and from (80) it is given by

\[
g_t = (1 - \delta_A) + p \left[ (1 - \delta_M) \frac{M_t}{A_t} + \frac{Z_t}{A_t} \right]
\]

(85)

Deviations from trend of \( M_t \) and \( Z_t \) lead to changes in the growth rate \( g_t \).

The simulation results reported in Section 4 are obtained by first solving for the steady state of the stationary system, and then computing approximate loglinear dynamics around the steady state.
References


<table>
<thead>
<tr>
<th>Symbol</th>
<th>Value</th>
<th>Description</th>
</tr>
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<tr>
<td><strong>Conventional</strong></td>
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<td>$\bar{\delta}$</td>
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<td>Elasticity of $P_k$ to $I^n/K$</td>
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<td>Elasticity of interest rate to foreign debt</td>
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<td>$\hat{T}_R$</td>
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<td>Research labor supply</td>
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<td>$\theta$</td>
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<td>$\hat{d}$</td>
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<td>Transfer to new entrepreneurs</td>
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Table 2: Standard Deviations and $\text{Corr}(\text{Solow Residual}_t, \text{GDP}_t)$, Model vs. Data

<table>
<thead>
<tr>
<th>Standard Deviations</th>
<th>High Frequency (0-8)</th>
<th>Medium-Term Cycle (0-50)</th>
<th>Medium Frequency (8-50)</th>
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<tr>
<td></td>
<td>Data</td>
<td>Financial Frictions</td>
<td>Frictionless Benchmark</td>
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<td>0.93</td>
<td>0.99</td>
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</table>
Figure 1: Total output, employment and output per employed worker (logs) for group of 6 South East Asian countries (Indonesia, Malaysia, Phillipines, Korea, Thailand and Hong Kong).
Figure 2: Labor productivity (log) for group of 6 South East Asian countries (Indonesia, Malaysia, Phillipines, Korea, Thailand and Hong Kong).
Figure 3: Estimated impulse responses to a currency crisis, for high income (first row) and emerging market (second row) country groups. First column: productivity. Second column: employment. Third column: output.
Figure 4: Estimated impulse responses to a banking crisis, for high income (first row) and emerging market (second row) country groups. First column: productivity. Second column: employment. Third column: output.
Figure 5: An entrepreneur’s problem – period-\(t\) timing.
Figure 6: Impulse responses to interest rate shock, financial and technology adoption variables.
Figure 7: Impulse responses to interest rate shock, standard macroeconomic variables.
Figure 8: Impulse responses of labor productivity, TFP and the Solow residual to interest rate.
Figure 9: GDP and Solow Residual for Argentina 1950-2005. Medium-term cycle defined as variation at frequencies below 50 years. Medium-term component isolates variation at frequencies between 8 and 50 years. Both are computed using a band-pass filter.