Credit Mismatch and Breakdown

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Abstract: This paper studies the phenomenon of mismatch in a decentralized credit market where borrowers and lenders must engage in costly search to establish credit relationships. Our dynamic general equilibrium framework integrates incentive based informational frictions with a matching process highlighted by (i) borrowers’ endogenous market entry and exit decision (entry frictions) and (ii) time and resource costs necessary to locate credit opportunities (search frictions). A key feature of the incentive compatible loan contract negotiated between borrowers and lenders is the interaction of informational frictions (in the form of moral hazard) with entry and search frictions. We find that the removal of entry barriers can eliminate incentive-based equilibrium credit rationing. More generally, entry and incentive frictions are important in understanding the extent of credit rationing and credit mismatch, while search and incentive frictions are important for understanding credit market breakdown.

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Time runs a close second to cash on every entrepreneur’s list of scarce resources.
(W. E. Wetzel, Jr., The Portable MBA in Entrepreneurship, Wiley & Sons: New York, 1997, p. 185)

1 Introduction

Credit markets are far from perfect, capricious and susceptible to occasional breakdown. The widespread panics over the past two decades – the 1997 Asian financial tsunami and the 2008 financial crisis – have motivated economists to devote greater effort in studying the workings of credit markets and the accompanied problems. Although notable because of their severity and macroeconomic consequences, these recent events highlight the fragility of credit markets that have been observed historically and in countries under various phases of financial development. For example, in the late 1920s, nearly half of the several thousand cooperative credit associations in Burma had mushroomed from their peak. Cooperative credit breakdowns also occurred during the U.S. savings and loan crisis of the 1980s, in Uganda in the early 1990s and in Japan and Vietnam in the mid-1990s. Similar patterns emerge from specialized loan markets, such as the venture capital and angel investment markets, following the internet bubble of early 2000 and the recent financial collapse.

A commonly observed phenomenon during times of credit markets distress is the mismatch between borrowers and lenders, where there is both an excess demand for and an excess supply of loanable funds.\(^1\) Kanoh and Pumpaisanchai (2006) document the coexistence of an idle supply of funds and unfulfilled demand in Japan during its lost decade. Similar credit mismatches have been observed in several developing countries in Asia prior to the 1997 crises (cf. Hwang, Jiang and Wang, 2007). In the presence of credit mismatches, funds remain under utilized despite the existence of potentially profitable but unexplored investment opportunities.\(^2\) This not only generates undesirable social inefficiencies, but also increases the likelihood of a financial market crisis where credit markets can eventually cease to operate (breakdown). The importance of asymmetric information regarding

\(^1\)The concept of spatial mismatch was established in the labor literature by Kain (1968) who observes the coexistence of unemployment and job vacancies in Chicago and Detroit. Coulson, Laing and Wang (2001) argue that the presence of search and entry frictions is crucial for explaining the spatial mismatch phenomenon beyond racial discrimination.

\(^2\)One may think of the episode delineated in William Shakespeare’s The Merchant of Venice as an example of credit mismatch. Specifically, the loan provided by the money lender (Shylock, who practices the unpopular “usury”) to the merchant (Antonio) remains idle (to back up his friend, Bassanio, in his pursue a highly demanding girl, Portia), leaving potentially productive borrowers unfunded.
borrower types or unobserved actions as an explanation for the turbulence of credit markets has been well advanced in the literature. Yet such informational asymmetries focus only on the unfulfilled demand for credit. They, by themselves, can neither account for credit mismatch nor the role it plays in determining credit-market participation and tightness (measured by the difficulty of both borrowers and lenders in establishing credit relationships) and the likelihood of breakdown.

To uncover the importance of credit mismatch and the underlying forces which may lead to the phenomena of breakdowns, this paper develops a decentralized model of credit which integrates frictions arising from both asymmetric information and the matching of borrowers and lenders.\(^3\) The decentralized nature of our credit market resembles the informal financial sectors of developing countries and rural loan markets, including merchant money lenders and cooperative credit institutions. By emphasizing the roots of financial development, we hope to better understand why these early credit markets were particularly vulnerable to catastrophic breakdowns.\(^4\) However, the dynamic matching framework is also consistent with three observations that are prevalent even in well-functioning credit markets. First, there is a continuous flow into and out of the credit market by borrowers, mostly small and medium-sized firms, that face entry barriers (entry frictions). Second, borrowing firms must race against time as they search for funding opportunities while lenders must also invest time and resources to convert their idle funds into active investments (search frictions). Third, part of the costs incurred in identifying viable credit relationships are information-based; lenders may face considerable risk given the uncertainty of the investment outcomes of borrowers (incentive frictions in the form of moral hazard).

The basic structure we propose is one in which borrowers and lenders choose whether or not to participate in a decentralized loan market where search for bilateral credit relationships is costly. Over time, the formation of credit relationships enable the financing of investment projects which yield a productive rate of return. These returns are divided up between the lender, in the form of an interest payment, and the borrower, in the form of residual profits. The incentive frictions that arise from asymmetric information allow the possibility of borrowers to abscond with the funds subject to a default cost. Hence, when loan contracts are negotiated they must be incentive compatible to overcome this moral hazard problem; credit rationing, where borrowers receive fewer funds than desired, may emerge endogenously. In equilibrium, optimal loan contracts and the extent

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\(^3\)While not mutually exclusive, the difference between the two frictions is that the former emphasizes the limits on knowledge and the latter emphasizes the limits on time.

\(^4\)The focus on rudimentary credit markets follows earlier works by Diamond (1990) and Becsi, Li, and Wang (2005). Different than theirs, however, this paper considers incomplete information and endogenizes credit market tightness. A more detailed discussion will be relegated to the literature review at the end of the introductory section.
of credit rationing are determined jointly with market liquidity (aggregate lending), borrower market participation (endogenous entry), and the tightness of the credit market (the excess demand for loans as measured by the ratio of unmatched borrowers to unmatched lenders).

The interaction of entry, search, and incentive frictions provides a rich structure with which to capture the flow of credit along both the intensive and extensive margins. In particular, we find that, in the absence of search frictions, the optimal incentive-compatible contract and the extent of credit rationing are independent of credit market tightness. While entry frictions are crucial for credit-market participation, market breakdown may still occur in the absence of entry barriers as long as both search and incentive frictions are present. However, even with entry and search frictions, credit market breakdown will never arise as an equilibrium outcome in a world without asymmetric information.

We also find that the equilibrium nature of the optimal loan contract varies with aggregate fundamentals as represented by borrower productivity. If productivity falls below a threshold that is determined by default costs, credit markets break down and cease to operate. When productivity begins to exceed this threshold, an active credit market arises but firms will be rationed. Even high productivity may be associated with rationing if the discount rate is sufficiently low or the length of the loan contract period is sufficiently short. Intuitively, a low discount rate raises the value of absconding with borrowed funds and a short contract duration lowers the value of the match for a borrower who must search again after the match is dissolved. Also, we find that credit market tightness and the extent of credit rationing are positively related when entry is exogenous. However, with endogenous entry, there generally does not exist a monotonic relationship between the two. That is, credit may continue to be rationed in a market where it is relatively easy for borrowers to locate lenders if high equilibrium interest rates induce firm exit out of the loanable funds market. Finally, we show that incentive frictions and entry frictions are important in determining the extent of credit rationing, while entry and search frictions are important for understanding the likelihood of credit market breakdown. Moreover, eliminating entry barriers can completely rule-out incentive-based credit rationing in equilibrium, while search frictions continue to affect whether or not credit markets fail.

**Search Frictions and Credit Markets**

Characterization of the loan market with search and matching highlights the conventional notion that locating funding sources and investment opportunities can be a paramount problem, especially in the types of less formal credit arrangements mentioned above where capital markets are largely absent. For example, the locating and financing of riskier outside opportunities with surplus funds
was the primary role of moneylenders who were prevalent in medieval Europe (Kohn 1999) and in developing countries (Chandavarkar 1987). In rural India, Chaudhuri and Gupta (1996) report that small and marginal farmers often resort to informal credit due to long delays in the loan application process from established financial institutions, borrowing nearly 80% from money lenders. While these rudimentary loan markets are most relevant to a literal application of our model, various forms of search frictions have also been recognized in more developed financial systems. Blanchflower and Oswald (1998) document that 20% of the entrepreneur respondents to the 1987 U.K. National Survey of the Self-Employed report that \textit{where} to get financing was the biggest difficulty they encountered. Evans and Jovanovic (1989) find that many entrepreneurs in the U.S. who have been denied a loan continue to search for funding. Brewster and Mizruchi (1993) and Berlin and Mester (1998) rationalize the prevalence of bilateral lending relationships, particularly among small firms, by the difficulty for borrowers to identify new lenders who tend to specialize in particular sectors or regions. Ramey and Shapiro (2001) make a complementary explanation for idle or displaced capital that emphasizes costly search in the thin resale market for physical capital. Complementing the empirical work of Dell’Arriccia and Garibaldi (2005), Craig and Haubrich (2006) compile evidence regarding gross credit flows via loan creation and destruction and the entry and exit of banks. They further demonstrate that a simple search theoretic model may capture the lending flows evident in the data and argue that the credit market may have “as strong a claim to search frictions as the labor market.” A search and matching environment is also consistent with the formation of private financing relationships between entrepreneurs and lenders, such as those in venture capital markets. As indicated by Sahlman (1990) and Gompers and Lerner (1999), the market for venture capital most resembles one where creditors who specialize in a particular type of lending must sort through a variety of heterogenous investment opportunities to identify the most suitable match. Although the size of the venture capital market is small relative to that of the entire financial system, there is evidence that increases in the supply of venture capital positively affect firm starts, employment, and aggregate income in regional economies.\footnote{In their study of U.S. metropolitan areas, Samila and Sorenson (2011) identify a “multiplier” effect whereby financing an additional firm with venture capital can indirectly create as many as twelve new establishments via spillover effects.} Venture capital investment also appears substantially more volatile and susceptible to breakdowns during times of widespread economic disruptions.\footnote{Woodward and Hall (2009) indicate that venture capital investment was extremely volatile in the onset of the 2008 financial crisis, falling more than six times compared to overall investment spending on plant and equipment.}

While the difficulties entrepreneurs face in raising funds mentioned above have been widely acknowledged, only recently have the search characteristics of credit markets been explicitly recognized.
in theoretical research. Our paper contributes to a small but growing literature that advocates a search and matching framework to model credit market activity. Within the search theoretic framework, Den Haan, Ramey, and Watson (2003) illustrate how liquidity shocks are propagated and amplified in credit markets when lending relationships can be renegotiated and Acemoglu (2001) and Wasmer and Weil (2004) study the interaction between search frictions in the credit and labor markets. Inderest and Muller (2004) emphasize the importance of search where the relative scarcity of capital affects the terms of optimal loan contracts between venture capitalists and entrepreneurs and Broadway, Vigneault, and Secireu (2007) integrate search externalities in venture capital markets to uncover the linkages between financial markets and frictional unemployment. Additionally, Silveira and Wright (2010) analyze the match between lenders and entrepreneurs to characterize equilibrium returns accrued from the venture capital market.

There is an extensive literature exploring the quantitative implications of credit market imperfections for aggregate fluctuations, beginning with the agency cost models of Bernanke and Gertler (1990) and Carlstrom and Fuerst (1997). More recently, researchers have attempted to identify how both demand and supply shocks interact to amplify the size of the financial accelerator in the presence of such informational asymmetries. Nicoletti and Pierrard (2006) and Kurmann and Petrosky-Nadeau (2007) complement this line of work by investigating whether matching frictions in capital markets enhance the quantitative predictions of real business cycle models by amplifying the financial accelerator and Li (2011) extends the analysis to focus on the role of such frictions in the propagation of monetary shocks.

Two closely related studies to ours are Diamond (1990) and Becsi, Li, and Wang (2005). In the former paper, Diamond characterizes bilateral exchange in credit markets with exogenously fixed matching probabilities and populations of borrowers and lenders. In our earlier work, we examine how the entry of heterogeneous borrowers can affect their aggregate composition under perfect information. In the present paper, we endogenize matching probabilities and market participation and, more importantly, consider the issue of asymmetric information. Under this generalized setup,

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7 There is a literature on money and credit in search equilibrium, either with bilateral random matching (e.g., Aiyagari and Williamson 2000) or with a competitive “night” market (e.g., Berentsen, Camera and Waller 2007, Telyukova and Wright 2008, and Sanches and Williamson 2010). This literature, however, focuses on identifying conditions under which money can co-exist with credit, which is very different from ours.

8 For example, Iacoviello (2005) and Iacoviello and Neri (2010) studies the effect of supply and monetary policy shocks on housing prices when nominal loan contracts feature collateral constraints. Gerali et al (2010) uses a DSGE model with imprefect competition in the banking sector to explore the propogation of supply and financial sector shocks.
we show that endogenous participation can interact with search, matching and incentive frictions to affect the extent of credit rationing and lead to credit mismatch and breakdown as equilibrium outcomes.

Finally, we would like to relate our concept of credit breakdown to the credit collapse model of Matsuyama (2007). While the concepts are essentially the same, the underlying channels mushrooming the credit market are quite different. Matsuyama’s analysis is based on the conventional multiple-equilibria setup where borrowing constraints and investment technologies lead to non-convexities and the possibility of a non-active credit market “trap." Our paper instead is based on the interplay between incentive frictions and search frictions in the presence of matching externalities between borrowers and lenders.

2 The Basic Environment

Time is continuous. There are two types of economic agents, those endowed with resources (“lenders”) and those endowed with an “investment” technology which uses those resources to generate a positive return (“borrowers”).

Our model focuses on the loanable funds market where available funds provided by a continuum of lenders are channeled to a continuum of potential borrowers through a decentralized credit market. Let \( N_L \) and \( N_B \) represent the mass of lenders and borrowers in this environment. For convenience, we normalize the measure of lenders to unity. Lenders and borrowers (bilaterally) meet with each other for the purpose of establishing a credit relationship and the matching technology that brings borrowers and lenders together is given by,

\[
m = m_0 M(N_u^L, N_u^B)
\]

where \( m \) measures flow matches, \( m_0 > 0 \) indicates the efficacy of credit market matching, and \( M \) is strictly increasing and concave, satisfying the constant-returns-to-scale property, the standard Inada conditions, and the boundary conditions \( M(0, \cdot) = M(\cdot, 0) = 0 \). We define \( N_u^i \) to be the number of unmatched agents and \( N_m^i \) as the number of matched agents of type \( i \) where \( i = L, B \). By normalizing the mass of lenders to unity, we have: \( N_u^L + N_m^L = 1 \). Similar to the labor literature, the matching technology represents the physical process by which both borrowers and lenders meet in a completely decentralized loan market. It captures an environment where lenders with incomplete information must spend time and resources when identifying and evaluating the ideas of
various potential borrowers without explicitly modeling the underlying heterogeneity. This would be consonant with our focus on informal loan markets or venture capitalists. It can also be loosely viewed as a “black box” encompassing the role of financial intermediaries as matchmakers in modern credit markets. Under this interpretation the productivity parameter $m_0$ can represent the degree by which intermediation alleviates the search frictions in the loan market.\footnote{For example, search costs on the part of lenders can be loosely thought of as encompassing the time element of \textit{ex ante} screening in the spirit of Boyd and Prescott (1986).}

A central feature of the loan market highlighted by our model is that market liquidity is determined by credit market tightness. Given the populations of lenders and borrowers, a measure of \textbf{credit market tightness} in our setup is given by the ratio of unmatched borrowers to unmatched lenders: $\tau \equiv \frac{N_B}{N_B + N_L}$. Intuitively, if $\tau$ is high, then there are many potential borrowers relative to lenders with idle funds. Because it is more difficult for borrowers to locate potential lenders under these circumstances, we say that the credit market is “tight” from the perspective of borrowers.\footnote{Even though spatial mismatches are not a major friction in more developed financial systems (borrowers can easily contact well know lenders), the matching technology reaffirms that not every match results in financing for every borrower.}

Utility generated from consumption is assumed to be linear for both types of agents. Since the focus of this paper is on how credit market frictions and market liquidity affect credit arrangements between borrowers and lenders rather than the intertemporal consumption and saving decisions of households, this simplifying assumption is adopted without loss of generality. Each lender own an asset of $\Omega$, which generates an income stream of $\omega = r\Omega$, where $r > 0$ is the rate of asset return that equals the discount rate. An unmatched lender consumes the income stream $\omega$ generated from his asset endowment as he continues searching for borrowers with whom to trade this endowment for the promise of a future payment. A borrower begins the search period with only his investment technology and searches for potential lenders to finance their project. Lenders contact borrowers at a rate of $\mu$, while borrowers contact lenders at a rate of $\eta$. Due to asymmetric information about the borrower’s behavior, the lender is unsure about whether the borrower will invest in a productive project or abscond (take the funds and run). Thus, once a borrower and a lender meet, the lender will set an incentive compatible loan contract to prevent the borrower from absconding with the funds. The contract specifies a gross interest payment, $R > 1$, and the fraction of available funds actually lent out, $q \leq 1$. When this loan contract is established, the lender gives up a
portion of his asset $q \Omega = q \frac{\omega}{r}$ to the borrower, which generates a stream of funds $q \omega$ to finance the investment project, and consumes the residual income stream $(1 - q) \omega$ while waiting for the end of the contract period. In the meantime, the funds used to implement production provides the borrower a flow return of $A q \omega$, where $A > 0$ represents the exogenous level of productivity. The contract period ends when borrowers and lenders are separated, at which time the lender, in the absence of credit market imperfections, returns the asset to the borrower with cumulated interest (i.e., loan repayment): $(1 + \tilde{r}) q \Omega$, where $\tilde{r}$ is the loan rate over the entire contract period.\footnote{The assumption that interest is paid at the end of the match is made for convenience, and is especially amieable to endogenizing contract duration. Modeling a flow interest payment, as in Besci, Li and Wang (2005), would not make any qualitative difference.} It is convenient to write $R = \frac{1+\tilde{r}}{r}$, so the loan repayment simply becomes $R q \omega$. In the benchmark setup, the exogenous separation rate is given by $\delta$. The (average) length of the contract period is thus $1/\delta$, so the corresponding gross interest rate can be captured by $\delta R$. After both members of the match become separated, they re-enter the pool of unmatched borrowers and lenders and again search for credit opportunities.

If borrowers in this model know with certainty that the loan will be repaid, our preferences imply that it will be optimal for the lender to set $q = 1$ and lend all of the endowment to the borrower in exchange for the future payment. However, due to unobserved motives, borrowers in our model may choose to default on the loan and abscond without repayment. When this occurs, the defaulter bears two costs. First, we assume that the defaulter is excluded from any future credit transactions. Second, we assume that the borrower must forfeit a real resource cost that is measured as a fraction $\theta$ of total loanable funds. This cost is meant to capture the outside penalty of default which arises from legal or institutional features. For example, a higher default cost maybe the outcome of a more efficient monitoring system which increases the likelihood of an absconder being caught. This moral hazard feature may cause loanable funds to be rationed (i.e., $q < 1$). That is, lenders will use this quantity rationing feature of the loan contract so as to insure incentive compatibility and repayment.

We can now characterize the dynamic problem facing borrowers and lenders in our economy. Let $J_u$ and $J_m$ denote the lender’s value associated with being in the unmatched ($u$) and matched ($m$) states. These asset values can be expressed as:

$$r J_u = \omega + \mu (J_m - J_u)$$

$$r J_m = (1 - q) \omega + \delta [R q \omega + (J_u - J_m)]$$

(2)  
(3)
Equation (2) says that the flow value associated with an unmatched lender is the flow of consumption from his endowment and arrival rate of borrowers times the net value gained when a loan contract is implemented and the match is formed. Equation (3) says that the flow value associated with a matched lender is the flow of consumption of the residual endowment and the rate at which the contract expires times the interest payment and net value of returning to the unmatched pool.

Similarly, let $\Pi_u$ and $\Pi_m$ denote the borrowers’s value associated with being in the unmatched and matched states, respectively. Their asset values in the two states are:

\[ r\Pi_u = \eta (\Pi_m - \Pi_u) \tag{4} \]
\[ r\Pi_m = Aq\omega + \delta [-Rq\omega + (\Pi_u - \Pi_m)] \tag{5} \]

Equation (4) simply states that the flow value associated with an unmatched borrower is the rate at which they contact lenders times the net value gained when becoming matched with a lender. Equation (5) says that the flow value associated with a matched borrower is the stream of returns the borrower obtains from implementing the investment project and the value associated with separation which occurs at rate $\delta$. When this occurs, the borrower makes the interest payment $Rq\omega$, gains the state of returning to the unmatched borrowers’ pool, and looses the state of being a matched borrower.\(^{13}\)

Subtracting (2) from (3) gives us the lenders’ value of being matched relative to being unmatched as:

\[ J_m - J_u = \frac{(\delta R - 1)q\omega}{r + \delta + \mu} \tag{6} \]

Notice that equation (6) implies that a necessary condition for an active loan market requires $J_m - J_u > 0$ or $\delta R > 1$. Otherwise, the economy will degenerate into an autarkic state where no credit activity occurs. We will assume that this condition holds.

Similarly, subtracting (4) from (5) gives us the borrowers’ value of being matched relative to being unmatched as:

\[ \Pi_m - \Pi_u = \frac{(A - \delta R)q\omega}{r + \delta + \eta} \tag{7} \]

We note that the relative values given by (6) and (7) are aggregate expressions. However, each individual borrower is atomistic and take their unmatched value $\Pi_u$ as given when evaluating their

\(^{13}\)For simplicity we have assumed that borrowers do not have any assets. More generally, if borrowers also have an asset $\omega^B$, equation (3) must be modified to $r\Pi_u = \omega^B + \eta (\Pi_m - \Pi_u)$. If these assets are jointly productive with the endowment of the lender then equation (4) changes to $r\Pi_m = A(q\omega + \omega^B) + \delta [-Rq\omega + (\Pi_u - \Pi_m)]$. Another possibility (that is also beyond the scope of this paper) is that borrower’s assets could be used as collateral for loans. For a discussion of these and related issues see, for instance, Hart and Moore (1994).
matched value. Taking this into account, we can rewrite (5) as:

\[ \Pi_m = \frac{(A - \delta R) q \omega + \delta \Pi_u}{r + \delta} \]  

(8)

In the presence of the moral hazard problem, a loan contract must be **incentive compatible** to eliminate borrowers’ default in equilibrium. In the benchmark setup, we follow Sappington (1983), Benerjee and Newman (1993) and Fender and Wang (2003), assuming that the moral hazard problem takes the form of absconding. This means that incentive compatibility is met if the value associated with being a matched firm is at least as large as the value associated with taking the funds and absconding: \((1 - \theta) q \Omega \leq \Pi_m\), or,

\[ (1 - \theta) \frac{q \omega}{r} \leq \Pi_m \]  

(9)

where the left hand side of (9) gives the value of absconding as the value of the funds borrowed net of the cost expressed as a fraction \(\theta\) of the loan and the penalty for defaulting is permanent exclusion from the credit market.\(^{14}\) Our incentive compatibility constraint is similar in spirit to the pledgeability constraint in Matsuyama (2007), the costly enforcement constraint in Gertler and Karadi (2011), and the loan-to-value borrowing constraint in Kiyotaki and More (1997), Iacoviello (2005), and Gerali, Neri, Sessa and Signoretti (2010).

Substitution of (8) into this above inequality (9) gives:

\[ q \omega \left[ (1 - \theta) \left( \frac{r + \delta}{r} \right) - (A - \delta R) \right] \leq \delta \Pi_u \]  

(10)

From (10) we see that an increase in the loan interest rate \(\delta R\) or an increase in the total quantity of the loan \(q \omega\) increases the likelihood of absconding. An incentive compatible loan contract is defined as a pair \((q, R)\) such that (10) is satisfied.

Given the absence of an auctioneer in the decentralized loan market, borrowers and lenders who meet bargain over the terms of the contract.\(^{15}\) We will assume that the outcome of this bargaining game is consistent with the symmetric Nash bargaining solution. That is, under incentive

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\(^{14}\)There are two interesting alternative setups for the default process. First borrowers can use the loanable funds to produce before absconding, and second is where credit market participation is permitted after payment of the default penalty. We consider these alternative specifications later in Section 7.2 and compare the results with our benchmark setup. Moreover, one may also assume that borrowing is in forms of flows and only the flow amount \(q \omega\) can be absconded. This alternative assumption would not change any of our qualitative results.

\(^{15}\)A bargaining mechanism naturally describes lending relationships in both less formal credit markets as well as modern venture capital markets. Inderest and Muller (2004) emphasizes the importance of contracting and search where the relative scarcity of financing affects the bargaining power of venture capitalists, citing evidence supporting the shift in bargaining power from entrepreneurs to lenders following the internet bubble of 2000.
compatibility and feasibility, the contract \((q, R)\) is designed to maximize the joint surplus of the funds suppliers and demanders:

\[
\max_{q, R} S = (J_m - J_u)^{1/2}(\Pi_m - \Pi_u)^{1/2}
\]

\[
\text{s.t. } (10), \; q \in [0, 1] \text{ and } R \geq 0.
\]

In our model borrowers enter the credit market endogenously to be matched with a fixed mass of lenders.\(^{16}\) Hence, the borrower’s unmatched value \(\Pi_u\) is given exogenously at the bargaining stage but the lender’s unmatched value \(J_u\) should be endogenously accounted. Notably, whether the unmatched values should be treated as given in the bargaining stage of general equilibrium random matching models depends crucially on whether the pool of agents to be matched is fixed. In the case of exogenous entry, as in the standard Diamond-Mortensen-Pissaridis framework, these unmatched values should be endogenous. In the case of the endogenous entry of agents on both sides of the market, as in competitive search equilibrium models, both of these unmatched values should be treated as given in the bargaining process.

### 3 Characterization of the Loan Contract

We proceed by describing the optimal loan contract in the presence of incentive frictions that cause a moral hazard problem.

The optimal contract must be incentive compatible and satisfy the Nash bargaining condition. Using (6) and (7), maximization of the joint surplus features \(\frac{dS}{dq} > 0\), so \(q\) must be as high as possible provided that incentive compatibility and feasibility conditions are met. Moreover, we can use \(\frac{dS}{dR} = 0\) to obtain:

\[
\delta R q \omega = (A q \omega - r \Pi_u) \Gamma + (1 - \Gamma)
\]

(11)

where \(\Gamma \equiv \frac{r + \delta + \mu}{2(r + \delta) + \mu}\) is monotone increasing function of \(\mu\). We can also show that if the pair \((q, R)\) is not incentive constrained (that is, the incentive compatibility constraint is not binding), then it is always optimal for the lender to loan out his entire endowment: \(q = 1\). The following provides a formal definition of the optimal loan contract.

**Definition 1.** An **optimal loan contract** is a pair \((R, q)\) such that

(i) \(q = 1\) and \(R\) solves (11) if (10) does not bind, or otherwise,

\(^{16}\)In our model, the crucial element is the relative masses of borrowers to lenders (credit market tightness). Thus, it is natural to normalize one of the two masses (in our case, the mass of lenders).
(ii) $q < 1$ and $R$ solves (11) and (10) with equality.

We define this latter case as a situation where the optimal loan contract is characterized by credit rationing. Defining $Q \equiv q\omega$, we can then express the optimal loan contract in terms of the amount of rationed funds and the gross interest rate, $(Q, \delta R)$, by rewriting equations (11) and (10) as:

$$\delta R = \left( A - \frac{r\Pi_u}{Q} \right) \Gamma + (1 - \Gamma)$$

$$\delta R \leq B + \frac{\delta\Pi_u}{Q}$$

where $B \equiv A - (1 - \theta)r\frac{\pi + \delta}{\pi}$.

The determination of the optimal incentive compatible loan contract can be characterized graphically in $(Q, \delta R)$ space with the origin defined as $Q = 0$ and $\delta R = 1$. We construct the graph in three steps.

First, we plot the surplus maximization condition (12) and call it the SM locus. This locus is upward-sloping and concave with a horizontal intercept $Q_{SM} = \frac{r\Pi_u}{A - 1}$ and slope $\frac{r\Pi_u}{Q^2}$. An optimal loan contract must be along this SM locus. The slope of the SM locus can be interpreted in terms of the bargaining power of borrowers versus lenders. For example, a steep SM curve, resulting from a faster arrival rate of borrowers, $\mu$, or longer loan contract period, low $\delta$, increases the bargaining power of lenders. Hence lenders can command a higher interest rate ($\delta R$) for a given increase in the loan quantity $Q$ and this implies a steeper SM locus.

Second, we plot the incentive compatibility condition (13) with equality in $(Q, \delta R)$ space and call it the IC locus. This locus is downward-sloping and convex to the origin such that $\lim_{Q \to 0} \delta R = \infty$ and $\lim_{Q \to \infty} \delta R = B$ and has slope $-\frac{\delta\Pi_u}{Q^2}$. Also, for $B < 1$, IC has a horizontal intercept at $Q_{IC} = \frac{\delta\Pi_u}{1 - B}$. Any $(Q, \delta R)$ in the area below the IC locus satisfies the incentive compatibility constraint.

Third is the property that an optimal loan contract must always have $q$ as large as possible within the feasible range $[0, 1]$. Formally, we can plot $Q = \omega$ as the upper bound for $q$. This means that if an optimal loan contract exists, it must be on the part of the SM locus that is below the IC locus and to the left of the $Q = \omega$ line with the highest $q$. The existence of an active loanable funds market for all $\delta R > 1$ requires the condition that $A > 1$ and this is satisfied for a sufficiently productive economy.

Figure 1 segments our characterization of the optimal loan contract into three cases, depending on the relative position of the SM and IC loci. Case I indicates a situation when the SM locus is
everywhere below IC. Hence all combinations of \((Q, \delta R)\) along the SM locus are incentive compatible and the optimal loan contract is the one with the highest value of \(q\), implying \(Q^* = \omega\) and the absence of credit rationing (see point E).

When the IC locus crosses the SM locus as in Case II, the amount of funds available in the economy is central for characterizing the optimal incentive compatible loan contract. When the amount of funds available is low (say, \(\omega = \omega^L\)), the optimal loan contract represented by \((Q^L, \delta R^L)\) is at point \(E^L\) where credit rationing is absent (i.e., \(q = 1\)). However, when the amount of funds available is high with \(\omega = \omega^H\), the incentive compatibility constraint is now binding. As a consequence, there will be a unique optimal loan contract represented by \((Q^H, \delta R^H)\). In this case credit rationing only occurs conditionally, depending on a sufficiently large endowment, we will refer to this as a case of “conditional” credit rationing.

Finally, Case III shows that if the IC locus crosses the horizontal axis at a point lower than SM, there exists no incentive compatible combination of \((Q, \delta R)\) and no underwriting of a loan contract. This is the “non-active” credit market outcome and is comparable to a credit market breakdown. After completely characterizing the steady-state equilibrium, we will return to a more detailed analysis of the conditions consistent with each of these possible equilibrium outcomes.

### 4 Steady-State Equilibrium

The previous section discussed the properties of incentive compatible optimal loan contracts given the rates by which borrowers and lenders are matched. We now close the model by characterizing the steady state process by which lenders and borrowers meet. This will in turn pin down the equilibrium contact rates by which agents are matched, the steady state population of matched and unmatched borrowers and lenders, and hence equilibrium credit market tightness.

The flow of lenders into the state of being matched is given by \(\mu N_u^L\) and the flow of borrowers into the matched state is given by \(\eta N_u^B\). In equilibrium, the flow of funds supplied must be equal to the flow of funds demanded:

\[
\mu N_u^L = \eta N_u^B = m
\]

(14)

Recalling the credit market tightness measure \(\tau \equiv \frac{N_u^B}{N_u^L}\), we can use (1) and the constant returns property of the matching technology to rewrite the steady state condition in terms of our tightness
measure:
\[ \mu = \eta \tau = m_0 M(1, \tau) \]  
(15)
It is straightforward to show that (15) implies \( \mu \) is increasing in \( \tau \) whereas,
\[ \eta \equiv \eta(\tau) = m_0 M\left(\frac{1}{\tau}, 1\right) \]  
(16)
is decreasing in \( \tau \); moreover, both \( \mu \) and \( \eta \) are increasing in \( m_0 \), \( \frac{\mu}{\eta} = \tau \) (independent of \( m_0 \)), \( \lim_{\tau \to 0} \mu(\tau) = 0 \) and \( \lim_{\tau \to \infty} \eta(\tau) = 0 \). This relationship is often referred to as the **Beveridge curve** in the search equilibrium literature. For labor markets the curve relates the unemployment rate to the vacancy rate (or establishes a relationship between the associated flow contact rates), while for credit markets we relate the capital unemployment rate to a measure of how much idle funds there are in the system. We are now able to define a steady state loanable funds equilibrium under exogenous and endogenous entry.

**Definition 2.**  *Given credit market tightness \( \tau \), a steady-state loanable funds equilibrium with exogenous entry of borrowers is a tuple \((Q^*, \delta R^*, \mu^*, \eta^*)\) satisfying:*

(i) the optimal incentive compatible loan contract (12) and (13), and

(ii) the Beveridge curve relationship (15) and (16).

Finally, we consider a loanable funds equilibrium with endogenous entry. From (7) and (8), we can eliminate \( \Pi_m \) to obtain the unmatched value facing each potential borrower:
\[ \Pi_u = \frac{\eta}{r + \delta + \eta} (A - \delta R) Q \]  
(17)
There is a large mass of potential borrowers. Borrower entry into the loan market is determined by assuming each borrower faces a fixed cost \( v \) for setting up the investment technology. Under **equilibrium entry**, borrowers enter into the unmatched pool of borrowers until their unmatched value is driven down to the entry cost, or,
\[ \Pi_u = v \]  
(18)
Using the Beveridge curve relationship, we can substitute (17) into (18) to yield:
\[ \frac{\eta(\tau)}{r + \delta + \eta(\tau)} (AQ - \delta RQ) = rv \]  
(19)
or, after substituting in (12) and \( \frac{\mu}{\eta} = \tau \),
\[ Q = \frac{rv}{A - 1} \left( 1 + \tau + \frac{2(r + \delta)}{\eta(\tau)} \right) \]  
(20)
This is referred to as the ex ante zero profit (ZP) locus, which is strictly increasing and strictly concave in \((Q, \tau)\) space with a horizontal intercept \(\frac{ru}{A - 1}\).\textsuperscript{17}

**Definition 3.** A steady-state loanable funds equilibrium with endogenous entry of borrowers is a triplet \((Q^*, \delta R^*, \tau^*)\) that satisfies:

(i) the optimal incentive compatible loan contract (12) and (13), and

(ii) the Beveridge curve relationship and ex ante zero profit condition given by (20).

Figure 2 provides an illustration of this steady-state equilibrium with endogenous entry by combining Case II from Figure 1 in the top panel with the ZP locus in the bottom panel (whereby we note that this locus has the same horizontal intercept as the SM locus). Thus, a loanable funds equilibrium is determined in a recursive manner. The optimal incentive compatible contract pins down the equilibrium \((Q^*, \delta R^*)\). Then the ZP locus determines equilibrium entry and hence the market tightness measure \(\tau^*\) that is consistent with the optimal contract.

Once this triplet is determined, it is straightforward to derive the steady state populations of matched and unmatched borrowers and lenders. From (16) and (15), we have \(\eta^*\) and \(\mu^*\), respectively. Because the inflow of unmatched lenders being matched must equal the outflow of matched lenders being separated: \(\mu^* N_u^L = \delta N_m^L\). Substituting the population identity, \(N_u^L + N_m^L = 1\), into this equilibrium flow condition gives:

\[
N_m^{L*} = \frac{\mu^*}{\delta + \mu^*} = N_m^{B*} \quad \text{and} \quad N_u^{L*} = \frac{\delta}{\mu^*}.
\]

From this it is easy to see that the equilibrium number of unmatched borrowers is \(N_u^{B*} = \tau^* N_u^{L*}\). It is straightforward to verify that when a loanable funds equilibrium exists, it is unique. Hence, in general, not only does the optimal loan contract determine market tightness and liquidity, but market tightness in turn also affects the optimal loan contract.

An important implication arrives immediately. In the presence of search frictions where the matching rate \(\mu\) is finite, one can see that the masses of unmatched lenders and unmatched borrowers are positive so long as the contract does not last forever (\(\delta > 0\)). Thus, credit mismatch is a generic phenomenon in our economy under which there is coexistence of unused funds by lenders and unfulfilled demand by borrowers.

\textsuperscript{17}A sufficient condition for the concavity of the ZP locus is given by the envelope condition \(\frac{(\gamma / \tau)M_{HH}}{M_H} > -2\). For example, this is trivially satisfied when the matching technology \(M(\cdot)\) is Cobb-Douglas.
5 Equilibrium Credit Rationing and Market Breakdown

We now analyze the properties of the steady-state loanable funds equilibrium. Unless otherwise specified, the following applies to both equilibrium with exogenous and endogenous entry. We identify the conditions that are consistent with existence of the steady state and differentiate between three possible regimes. Specifically, based on the equations underlying Figure 2, we have:

Proposition 1. (Steady-state Loanable Funds Equilibrium) A steady-state loanable funds equilibrium features one of the following three outcomes:

(i) If \((A - 1) < (1 - \theta)\), then there does not exist an incentive compatible loan contract and the loan market is non-active (Case III).

(ii) If \((1 - \theta) \leq (A - 1) < 2(1 - \theta)\) and \(\omega\) is sufficiently high, then there exists a credit rationing equilibrium with \(q < 1\) (Case II).

(iii) If \(2(1 - \theta) \leq (A - 1)\) and \(\omega\) is sufficiently high, then,

a. there exists a credit rationing equilibrium with \(q < 1\) for \(r < r^* = \frac{(1-\theta)[2\delta+\mu]}{(A-1)-2(1-\theta)}\) (Case II);

b. the incentive compatibility constraint never binds and the equilibrium loan contract is not rationed for \(r \geq r^*\) (Case I).

Proof: See Appendix. □

Proposition 1 outlines the region of the parameter space consistent with the various possible equilibrium outcomes discussed in the previous section. This Proposition has a very intuitive interpretation and can be divided into three cases as illustrated by Figure 1. Loosely, if the productivity of the investment project is sufficiently low relative to the incentive friction, then there will always be an incentive to abscond for any loan contract along the SM locus. In this case (Case III), there is no active loanable funds equilibrium and the loan market breaks down. Once productivity begins to exceed a threshold level (Case II), lenders begin channeling loanable funds to borrowers, but the quantity is rationed. Finally, if productivity is sufficiently high, then whether or not there is rationing can be expressed in terms of the discount rate. In particular, if the discount rate is sufficiently low, then the value of consumption generated from absconding for the borrower becomes greater than the value of being matched in the loanable funds market. Lenders must continue to ration loans so that the incentive compatibility binds (Case II). If, on the other hand, the discount
rate is very high, there will never be an incentive for the borrower to abscond and all loan contracts are incentive compatible (Case I).

Proposition 1 implies that with sufficiently low investment productivity and sufficiently high default risk, credit markets will break down. This is because, in the presence of search frictions (finite matching rate $\mu$ and finite matched values), no loan contract with positive loan rate and nontrivial duration can be incentive compatible. As a consequence, credit markets cease to operate. That is, credit breakdown in our model is a result of the interplay between incentive and search frictions, which contrasts sharply with the equilibrium trap setup in Matsuyama (2007). In summary, we can conclude that the likelihood of credit breakdown is higher with more search/matching barriers, greater default risk and less investment profitability.

Proposition 1 also establishes that credit rationing of productive firms depends on a threshold discount rate $\bar{\tau}$. In this case, credit mismatch is more damaging in the sense of production efficiency as productive borrowers are rationed. This scenario is more likely if the default cost are sufficiently low and the contract duration is sufficiently short. That is, credit rationing has more severe consequences in the case of higher default risk and more temporary lending relationships.

Next, we consider the underlying changes to this threshold that make credit rationing more likely.

**Proposition 2.** (Duration of Loan Contract) Suppose that the investment project is sufficiently productive such that $(A - 1) > 2(1 - \theta)$. Then in a steady-state loanable funds equilibrium, an increase in the duration of the loan contract (lower $\delta$) leads to an increase in the set of incentive compatible contracts and an increase in the loan market equilibrium interest rate ($\delta R$). If the latter effect dominates the former, credit rationing is likely to occur.

**Proof:** Observe that $\lim_{Q \to \infty} \delta R_{SM}$ and $\lim_{Q \to \infty} \delta R_{IC}$ are decreasing in $\delta$. $\square$

A longer contract duration (low $\delta$) increases the set of incentive compatible contracts since the borrower can enjoy the productive benefits supported by the loanable funds for a greater period of time. This is captured by an upward shift of the IC locus. However, a longer contract duration also makes the match more valuable to the borrower and biases the bargaining power towards lenders. Consequently, the SM locus shifts upwards as well. In Case II, the market equilibrium loan rate increases in both the case where there is no rationing ($\omega=\omega^L$) and when there is rationing ($\omega=\omega^H$). Whether or not credit rationing is more likely depends upon whether the bargaining effect dominates the incentive compatibility effect. If the bargaining effect dominates, then a longer contract period both increases rationing and the equilibrium loan rate.
We next study the linkage between the tightness of the credit market and credit rationing in an exogenous entry equilibrium and one where borrower entry is endogenized. In particular, we find:

**Proposition 3.** *(Market Tightness versus Credit Rationing)*

(i) *In an exogenous entry equilibrium satisfying Definition 2, there is a positive relationship between market tightness (τ) and the likelihood of credit rationing. For all r > 0, there exists τ < ∞ sufficiently large such that equilibrium credit rationing will occur.*

(ii) *In an endogenous entry equilibrium satisfying Definition 3, there is no necessary monotonic relationship between credit market tightness and the extent of credit rationing.*

Part (i) follows directly from Proposition 1. From (15) an (exogenous) increase in increases the frequency at which lenders meet borrowers, μ. Since \( \frac{δτ}{dB} > 0 \) it follows that an increase in market tightness expands the set of feasible discount rates consistent with the credit rationing equilibrium. As τ becomes arbitrarily large, \( τ \to \infty \). To see the intuition behind part (i) suppose that the initial steady state equilibrium is given by Case I. In this case, every loan contract that maximizes the joint match surplus of borrowers and lenders is incentive compatible. The Beveridge curve relationship given by (15) implies that an increase in market tightness increases the rate that lenders contact borrowers. This increases the threat point and bargaining power of lenders when negotiating the loan contract. As a result, the SM locus shifts upwards and this shrinks the set of \( Q \) and \( R \) combinations consistent with incentive compatibility. If the increase in market tightness is sufficiently large, IC will eventually intersect with the SM locus and credit will begin to be rationed at a higher equilibrium interest rate. Thus, we are more likely to see credit rationed in an illiquid credit market where it is difficult for borrowers to find loan opportunities.

To illustrate part (ii), consider the following comparative steady state analysis of an increase in funds matching efficacy \( (m_0) \) that improves matching for both lenders and borrowers in Case II. This is illustrated in Figure 3. Under our funds matching framework, a rise of \( m_0 \) raises the effective contact rate of funds suppliers \( \Gamma \) and strengthens their bargaining power. As a consequence, joint surplus maximization grants relatively higher returns to the suppliers, implying an increase in \( R \) for each given value \( Q \). That is, the SM locus rotates upwards. From the ZP relationship, an increase in \( m_0 \) will raise the matching rate \( η(τ) \) of borrowers. For a given \( Q \) determined by the optimal loan contract, more potential borrowers enter and hence the loan market becomes tighter. That is, the ZP locus twists toward the vertical axis.
For the case of $\omega = \omega^L$ where the incentive compatibility constraint is not binding, the equilibrium loan rate rises as market participation (or tightness) increases. For the case of $\omega = \omega^H$, rationing increases in response to the increased entry of potential borrowers and a higher equilibrium loan rate is required to satisfy incentive compatibility. However, the increased severity of credit rationing reduces potential borrowers’ expected profit, thereby decreasing their entry. Due to this latter opposing effect, the net change in the tightness of the loan market is ambiguous. Hence, an observed increase in credit rationing need not imply increased tightness in the credit market.

6 The Role of Market Frictions

We next explicitly consider the impact of search frictions ($m_0$), market entry frictions ($v$), and incentive frictions ($\theta$) on the structure of optimal lending arrangements and steady state equilibrium in the loanable funds market. Each of these frictions is considered separately so that their relative contributions to explaining credit rationing and market breakdown can be isolated and analyzed.

6.1 Search Frictions

Without search frictions, credit market participants do not have to wait to set up a credit arrangement. When matches are instantaneous, we have

**Proposition 4.** (Search Frictions) In the absence of search frictions, credit mismatch and credit breakdown will never occur and the equilibrium loan contract and the existence of equilibrium credit rationing are independent of market tightness.

**Proof:** The absence of search frictions occurs in the limiting case where $m_0 \to \infty$. The Beveridge curve relation implies that while $\mu$ and $\eta \to \infty$, $\tau = \mu/\eta$ will remain bounded by the constant returns to scale property of the matching technology. By definition, immediate matching implies that there is no credit mismatch. Using these and $\lim_{m_0 \to \infty} \Gamma = 1$, the steady state equilibrium conditions (12), (13), and (20) are now given by $\delta R = A - \frac{r}{Q}$, $\delta R \leq B + \frac{\delta}{Q}$, and $Q = \frac{r}{A-1} (1 + \tau)$, respectively. Since $\tau$ no longer appears in the SM and IC loci, the optimal loan contract is independent of market thickness. Substituting $Q$ into the IC locus yields $\delta R \leq B + \frac{\delta (A-1)}{\tau (1+\tau)}$. Since $\tau$ is indeterminate and arbitrary in this case, the IC constraint can be met and credit breakdown will never occur. □

This result says that search frictions are crucial for a linkage between market tightness, the optimal loan contract, and credit rationing. If borrowers and lenders instantaneously match and
enter into a lending agreement, there is no credit mismatch and their relative bargaining position will not be affected by the tightness of the market. In this situation the only equilibrium outcomes that always exist turn out to be the conditional steady states (Case II). Because of the entry costs on the borrower’s side, a reduction in search frictions increases the relative ease with which lenders locate borrowers. As in Proposition 3, this causes an upward shift in the SM locus. As the loan equilibrium interest rate rises, lenders must ration in order to keep the contract incentive compatible. The absence of search frictions in general equilibrium can be seen as a limiting case of this sequence of these events.

6.2 Entry Frictions

Here we consider costless entry of borrowers into the credit market. Under these circumstances, the demand for funds is perfectly elastic and we establish:

**Proposition 5. (Entry Frictions)** In the absence of entry frictions, there does not exist a credit rationing equilibrium. Equilibrium in the loan market is characterized by either an active no rationing loanable funds market or a non-active loan market.

**Proof:** The absence of firm entry frictions occurs in the limiting case where \( v \to 0 \). Since there is now unrestricted borrower entry, the steady state conditions described (12), (13) are now given by \( \delta R = \Gamma(A - 1) + 1, \delta R \leq B \). Existence of an active loanable funds market requires \( \Gamma(A - 1) + 1 < B = A - (1 - \theta)(\frac{\Gamma + \delta}{r}) \). Satisfaction of this condition implies that all combinations of \((Q, \delta R)\) along the (horizontal) SM locus is incentive compatible and there is no credit rationing, \( q = 1 \).

To obtain intuition behind this result, suppose that the initial steady state equilibrium is given by the active no rationing equilibrium of Case I. In this situation, \( B > \Gamma(A - 1) + 1 \). Lower entry frictions encourages the entry of borrowers and this drives down their unmatched value. This rotates the SM locus clockwise as lenders take advantage of their increased bargaining power. At the same time, a lower unmatched value for the borrower must be compensated by a decrease in the loan rate or loan quantity to maintain incentive compatibility. In the limiting case as these costs vanish, the SM and IC loci are horizontal with SM everywhere below IC. No contract that offers an interest rate above \( B \) will be incentive compatible and no interest rate above \( \Gamma(A - 1) + 1 \) will be consistent with the optimal loan contract. Hence, there will only be an active no rationing equilibrium.

To show that credit rationing disappears with free entry, suppose that the initial steady state equilibrium is given by the conditional equilibrium of Case II. In this situation, \( B < \Gamma(A - 1) + 1 \).
Lower entry frictions encourages the entry of borrowers and this drives down their unmatched value. As lenders take advantage of their increased bargaining power, the interest rate consistent with the optimal loan contract rises and the SM locus rotates clockwise. In the limiting case as entry costs vanish, the SM locus is horizontal and the interest rate approaches its maximum value given by \(\Gamma(A - 1) + 1\). At the same time, a lower unmatched value for the borrower must be compensated by a decrease in the loan rate or loan quantity to maintain incentive compatibility and this is captured by a counterclockwise rotation of the IC locus. In the limiting case as these entry costs vanish, the IC locus is horizontal as no contract that offers an interest rate above \(B\) will be incentive compatible. Hence, Case II degenerates to a non-active equilibrium where no optimal loan contract will be incentive compatible and the credit market fails to function.

Furthermore, recall that Case I captures an active loan market equilibrium with no credit rationing only if the potential supply of loanable funds (\(\omega\)) is sufficiently large. If \(\omega\) is small then there may not be any positive rate of interest consistent with the optimal loan contract. However, as entry costs for borrowers are driven to zero, there will emerge an active non-rationing credit market equilibrium. If, on the other hand, the economy was initially characterized by the conditional Case II, possibly with credit rationing, then a removal of entry barriers will lead to a breakdown of the credit market and non-existence. This situation corresponds to a problem of “over-crowding” in entry of borrowers with limited loanable funds supply.

### 6.3 Incentive Frictions

Finally, we investigate the role of moral hazard for credit arrangements in the decentralized market. We detail how the equilibrium is affected if the cost of absconding is so high that incentive frictions are completely eliminated.

**Proposition 6.** (Incentive Frictions) In the absence of incentive frictions, there only exists an active, no rationing loanable funds market equilibrium.

**Proof:** The absence of incentive frictions corresponds to the limiting case where the costs of absconding as a fraction of total funds, \(\theta \to 1\). It is immediate from Proposition 1 that for any given \(A > 1\), we can rule out (i) the non-active equilibrium and (ii) the credit rationing equilibrium with \((A - 1) \in (1 - \theta, 2(1 - \theta))\) = \(\emptyset\). In the case where \((A - 1) > 2(1 - \theta)\), \(\tau = \frac{(1-\theta)(2\delta + \mu)}{(A-1)-2(1-\theta)} = 0\). Hence, all \(r > 0\) satisfies \(r > \tau\) and in this case there exists the active, no rationing equilibrium. \(\square\)

Proposition 6 says that the moral hazard problem arising from incentive frictions is crucial in explaining the existence of both credit rationing and credit market breakdown. In the presence
of these incentive frictions, search frictions provide a link between market liquidity, credit market tightness and credit rationing.

7 Further Discussion

In this section, we examine the duration of incentive compatible loan contracts and consider alternative loan default processes.

7.1 Duration of Loan Contracts

An innovative aspect of our search model of the credit market is that it incorporates a parameter that corresponds to the duration of the loan period. For example, in the previous section we discussed how an increase in the length of the loan contract can affect the incentive compatibility, the interest rate offer, and the possibility of credit rationing. An interesting application of this framework would be to study how the duration of the loan contract affects the interest rate offer and vice versa.

A simple illustration of how the contract’s duration affects the loan rate would be to consider the active equilibrium without credit rationing (Case I). Here, the optimal contract interest rate is just given by substituting \( Q^* = \omega \) into (12) to get:

\[
\delta R^* = \left[ A - \frac{rv}{\omega} \Gamma \right] (1 - \Gamma)
\]

Notice that \( R^* > 0 \) as long as \( (A - 1) > \frac{rv}{\omega} \), which is satisfied if the supply of loanable funds \( \omega \) or the productivity of the investment project \( A \) is sufficiently large. In this case a decrease in \( \delta \), or increase in the length of the loan contract, increases \( \Gamma \) and hence the optimal loan interest rate \( \delta R^* \). One could interpret the result as an upward sloping yield curve in \( (\frac{1}{\delta}, \delta R) \) space. While beyond the focus of this paper, it would be of interest in future work to more completely analyze the term structure properties of a search model of credit.

A related issue would be to extend our model to address the endogenous joint determination of the quantity, loan rate, and loan contracting period. One way to approach pinning down \( (Q, \delta R, \delta) \) is to have all three objects be the outcome of decentralized bilateral bargaining between lenders and borrowers. In other words, have them be a solution to a Nash bargaining problem \( (P) \) which
maximizes the joint surplus of the lender and borrower:

$$\max_{q, \omega, \delta R, \delta} (J_m - J_u)^{1/2}(\Pi_m - \Pi_u)^{1/2}$$  \hspace{1cm} (P)$$

s.t. \hspace{0.5cm} J_m - J_u = \frac{(1 - q)\omega + \delta R q \omega - r J_u}{r + \delta} \quad \text{and} \quad \Pi_m - \Pi_u = \frac{(A - \delta R) q \omega - r \Pi_u}{r + \delta}$$

In addition to the bargaining condition for $\delta R$ given in (12), we now have an additional first order condition associated with $\delta$ that, after simplification, is given by,

$$R q \omega \left(\frac{1}{J_m - J_u} - \frac{1}{\Pi_m - \Pi_u}\right) = \frac{1}{r + \delta}$$  \hspace{1cm} (23)$$

Because the expression in brackets is equal to zero $(J_m - J_u = \Pi_m - \Pi_u)$, this implies an optimal choice of $\delta^* \to \infty$. That is, instantaneous credit transactions and separations maximize the joint surplus of a borrower-lender pair when production is instantaneous at the time of a match. This result delivers an important message. In our admittedly highly stylized framework, where long-term relationships only lower search costs but do not alter incentive frictions, there exists no reason to continue a “long-term” credit relationship. This is because the marginal gain in matched values from continuing a relationship is dominated by the marginal loss in unmatched values (via the bargaining threat points). Undoubtedly, adding more realistic features to the model will provide additional incentive to prolonging credit relationships. For instance, allowing learning and diminishing incentive frictions over the time agents are matched may yield outcomes that favor long-term relationships. Although it is beyond the scope of the current paper to go further along this path, we would like to point out that there is an active literature exploring long-term credit relationships.\footnote{For instance, Hart and Moore (1998) investigate mechanisms and incentives to renegotiate debt contracts in the face of credit market imperfections and incomplete contracting.}

### 7.2 Alternative Default Processes

The benchmark model assumes a default process where (i) borrowers abscond before production and (ii) in addition to the penalty cost $\theta$ borrowers who default are permanently excluded from the credit market. We now consider two alternative setups for the default process which relaxes these assumptions. It is straightforward to verify that most of the features and results from our benchmark specification remain valid and we highlight some interesting differences.

First, following Hart and Moore (1998), borrowers may have the ability to divert returns as well as assets. In this case production occurs before absconding and the incentive compatibility condition given by (9) becomes:

$$(1 - \theta) \frac{A q \omega}{r} \leq \Pi_m$$
Then equation (13) is the same except for \( B^* = A[1 - (1 - \theta) \frac{r + \delta}{r}] < B \). This implies that the IC locus is everywhere below the original IC curve derived above. Hence, the set of incentive compatible contracts shrinks and credit rationing becomes more likely relative to our benchmark case.

Second, the Diamond (1990) assumption that the penalty of default is exclusion from the credit market forever may be viewed as too harsh in light of modern bankruptcy laws. If instead credit market participation is allowed after payment of the default penalty, the incentive compatibility constraint becomes:

\[
(1 - \theta) \frac{q \omega}{r} + \Pi_u \leq \Pi_m
\]

In this case, the IC locus is upward-sloping as \( \delta R \leq B - r \frac{\Pi_u}{Q} \) and the uniqueness of the steady state equilibrium is not guaranteed. In particular, it is possible to have coexistence of a credit rationing equilibrium and an inactive equilibrium.

8 Concluding Remarks

This paper has presented a simple search-theoretic model of the credit market. The model focuses on endogenous entry and moral hazard as particularly important factors in determining the fortunes of entrepreneurs. Our analysis describes the optimal incentive compatible loan contracts and equilibria that emerge in such an environment. While we tie the extent of mismatch to the tightness of credit markets, we find that mismatch and tightness are somewhat of a “red-herring” for understanding the extent of credit rationing; endogenous entry of borrowers can break the conventionally positive relationship between credit market tightness and credit rationing. We also establish the following regarding the interrelationship between incentive and matching frictions. Incentive frictions continue to be necessary in accounting for credit rationing and market breakdown. Given these incentive frictions, search frictions are important for understanding the possibility of market breakdown, where credit markets cease to function, while entry frictions are important for determining the extent of credit rationing.

There are several other possibilities for future work. First, it would be interesting to re-examine the optimal loan contract and the likelihood of market breakdown in an incomplete contract framework, as in Hart and Moore (1998). To do so, one would need to modify the moral hazard problem. In particular, rather than absconding, a borrower may “consume” part of the loan without converting that portion into a productive investment project. This loan-eating tendency measures the degree of shirking, though it cannot be perfectly monitored or verified by a court of law (due, for example, to a concurrent change in the state of nature). Then allowing renegotiations of the
repayment schedule between the borrower and the lender would not only enhance the interaction between search/entry and incentive frictions, but also make the loan contract “performance based,” depending on the realized rate of returns on the investment project. The latter consideration may, in turn, lead to a greater likelihood of a long-term borrowing-lending relationship

Second, one might argue there is too much “randomness” in our matching model and that this exaggerates the moral hazard problem and diminishes the benefit of long-term relationships. One way to address this issue is to adopt the directed-search price-posting game developed by Peters (1991). Specifically, there are two segregated submarkets: the first is similar to the environment in the present paper and the second with lenders requiring borrowers to provide costly credit documentation prior to granting loans that partially mitigate the incentive frictions. Since all borrowers are identical \textit{ex ante}, each lender in each segregated submarket posts for all borrowers the flow interest rate and the duration of the loan contract to maximize the expected value subject to a no-arbitrage condition that ensures all borrowers receive equal value \textit{ex ante}. As a consequence, the loan contracts are generally different between the two submarkets, and free mobility of borrowers results in different matching probabilities and hence different measures of tightness within the two credit markets. Along these lines, one may further extend the adverse-selection framework developed by Guerrieri, Shimer and Wright (2010) to investigate the interaction between informational and search frictions in credit markets.

Finally, by incorporating an intertemporal role for financial markets allowing consumers to smooth consumption over time via endogenous saving decisions, the model can be extended to explicitly analyze the linkage between credit markets, rationing, and aggregate economic activity. Such a framework can then be calibrated for numerical and quantitative analysis. In particular, it may provide a novel approach to understanding how impulses arising from aggregate and financial market shocks are propagated through a decentralized credit channel via search and entry frictions. For example, one may consider a productivity shock in a way similar to that in the discrete-time search model by Petrosky-Nadeau and Wasmer (2010). It is posited that while there is a direct effect implying that the loan rate responds procyclically to the productivity shock, the presence of such uncertainties makes absconding more likely to occur in a downturn which results in a countercyclical response. In addition, with such uncertainties, the duration of the loan contract becomes more important as intertemporal smoothing helps mitigate productivity fluctuations. Thus, the loan rate would become more sensitive to changes in the contract length.
Appendix

Measure of Credit Market Tightness

An alternative measure of credit market tightness is given by the ratio of unmatched borrowers to the total pool of borrowers or the “capital unemployment rate”: \( \kappa = \frac{N_u^B}{N_u^L + N_u^L} \). Since \( N_u^B = \tau N_u^L \) and \( N_m^B = N_m^L = \frac{\mu}{\delta} N_u^L \), we have:

\[
\kappa = \frac{\tau}{\tau + \mu/\delta} = \frac{\tau}{\tau + m_0 M(1, \tau)/\delta} = \frac{1}{1 + \frac{\mu}{\delta} M(1, \tau)} \equiv \kappa(\tau)
\]

It is easily verified that \( \kappa \) is monotonically increasing in \( \tau \).

Proof of Proposition 1

(i) Consider the case where \((A - 1) < (1 - \theta)\). This implies that \( B \equiv A - (1 - \theta)(\frac{r+\delta}{r}) < 1 \) so that the IC locus has a horizontal intercept at \( Q_{IC} = \frac{\delta}{1-B} \). Suppose there exists an active loanable funds equilibrium. This implies: \( \frac{\delta}{1-B} = Q_{IC} < Q_{SM} = \frac{\delta}{A-1} \), or, \( r(1-B) < \delta(A-1) \), or by manipulating,

\[
r[(1-\theta) - (A - 1)] \leq \delta[(A - 1) - (1 - \theta)] \tag{A1}
\]

Since the right hand side of this expression is negative while the left-hand side is positive, we have a contradiction. Hence, no active loanable funds equilibrium exists. (Case III)

(ii) Consider the case where \((1 - \theta) \leq (A - 1) \leq 2(1 - \theta)\). From the SM locus given by (12) notice that \( \lim_{Q \to \infty} \delta R_{SM} = \Gamma(A - 1) + 1 \). Similarly, from the IC locus given by (13), \( \lim_{Q \to \infty} \delta R_{IC} = B \). If \( B < 1 \), then from (A1) we know \( Q_{IC} \leq Q_{SM} \) and there exists a loanable funds equilibrium. Since the SM locus must cross the IC locus, we have the credit rationing case where \( q < 1 \) for \( \omega \) sufficiently large. For \( B > 1 \), we need to verify that, \( \lim_{Q \to \infty} \delta R_{SM} > \lim_{Q \to \infty} \delta R_{IC} \), or, \( \Gamma(A - 1) + 1 > B \), which can be rewritten as:

\[
\frac{(r+\delta+\mu)}{2(r+\delta+\mu)}(A - 1) + 1 > A - (1 - \theta)(\frac{r+\delta}{r}), \text{ or,}
\]

\[
r[(A - 1) - 2(1 - \theta)] < (1 - \theta)[2\delta + \mu] \tag{A2}
\]

Since the right-hand side of (A2) is non-positive and the right-hand side is strictly positive, this condition holds. Thus, there is a unique credit rationing equilibrium where the SM locus intersects the IC locus (Case II).

(iii) Consider now \((A - 1) > 2(1 - \theta)\). Solving for \( r \) in (A2) gives, \( r < \frac{(1-\theta)(2\delta+\mu)}{(A-1)-2(1-\theta)} = \overline{r} > 0 \). This condition is sufficient to guarantee that \( \lim_{Q \to \infty} \delta R_{SM} > \lim_{Q \to \infty} \delta R_{IC} \) and the existence of a credit rationing equilibrium (Case II). However, if \( r \geq \overline{r} \), then \( \lim_{Q \to \infty} \delta R_{SM} \leq \lim_{Q \to \infty} \delta R_{IC} \) and every loan contract along the SM locus is incentive compatible. The incentive compatibility constraint does not bind in this case and there is no rationing (Case I). □
References


Chart 1: The Structure of the Economy

Lenders ($N_u^L$)
- Flow endowment: $\omega$
- Unmatched value: $J_u$

Credit Market
- Matching: $\mu N_u^L = \eta N_u^B - m_0 M(N_u^L, N_u^B)$
- Production: $Aq\omega$
- Surplus sharing:
  - $(1-q)\omega + \delta R q\omega$ to L
  - $(\Lambda + \delta R)q\omega$ to B

Borrowers ($N_u^B$)
- Entry cost: $v$
- Unmatched value: $\Pi_u$
Figure 1: Optimal Incentive Compatible Loan Contract (Q = ωq and δR)

Case I: \( (A-1) > 2(1-\theta) \) and \( r \geq \bar{r} \)

Case II: \( (A-1) > 2(1-\theta) \) and \( r < \bar{r} \) or \( (1-\theta) \leq (A-1) \leq 2(1-\theta) \)

Case III: \( (A-1) < (1-\theta) \)

Notes: There are three cases, depending on the relative position of the SM and IC loci:
1. Case I  incentive compatibility constraint never binds;
2. Case II  incentive compatibility constraint binds only when funds available are high and in that case, the amount of loan is rationed;
3. Case III  optimal incentive compatible loan contract does not exist.
Figure 2: Steady-State Loanable Funds Equilibrium

Figure 3: Equilibrium Responses to a Reduction in Search Frictions (Higher $m_0$)
Figure 3: Multiple Equilibria When Defaulters May Re-enter the Credit Market