Delayed Capital Reallocation

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May, 2014

Abstract

How do firms reallocate capital stock in response to recurrent productivity or profitability shocks? Why is capital reallocation procyclical and more volatile than investment? To answer these questions, this paper develops a tractable dynamic general equilibrium model. In the model, firms face idiosyncratic productivity shocks while at the same time are restricted by partial capital irreversibility and financing constraints. The model shows that irreversibility and financing constraints interact and generate capital reallocation delays. These delays result in cross-sectional productivity dispersion and losses of total factor productivity (TFP), which become more severe during recessions.

*I am indebted to Nobu Kiyotaki, Markus Brunnermeier, and Ben Moll. Special thanks go to Tom Sargent for encouragement and support. I am also very grateful for the insightful discussions with Mark Aguiar, Marco Bassetto, Jonas Fisher, Mike Golosov, Francois Gourio, Ji Huang, Jakub Jurek, Richard Rogerson, Esteban Rossi-Hansberg, Hyun Shin, Chris Sims, Gabriel Tenorio, and Mark Wright, as well as seminar participants at the 2012 and 2013 SED Conference, Princeton University, Humboldt University, Chicago Fed, New York Fed, Duke University (Fuqua), St. Louis Fed, University of Michigan (Ross), UCLA Anderson, University of Iowa, UCL, LSE, IHS Vienna, EIEF, University of Maryland (Smith), Kansas City Fed, HKU, HKUST for helpful comments. All remaining errors are my own. Address: Department of Economics, University College London, 30 Gordon Street, London, WC1H 0AX, UK. Email: w.cui@ucl.ac.uk.
1 Introduction

Reallocation of input factors from less productive firms to more productive firms determines the efficiency usage of the factors. This process is especially crucial for the recovery after recessions. Unfortunately, during the past three recessions, the level and the turnover activity of capital reallocation appear to be lower than normal times. Figure 1 plots cyclical components of aggregate capital reallocation and GDP: reallocation of existing productive capital is highly procyclical.\(^1\)

This observation is in sharp contrast with the “creative destruction” conventional wisdom: more capital stock should be liquidated and more restructuring should be seen in recessions. Since two important sources of recessions are drop of the aggregate productivity and tighter financing constraints, this paper investigate which type of shocks generate lower reallocation activities in recessions. Both shocks may reduce the purchase of used capital. However, given that reallocation is similarly procyclical as new investment but more volatile (10.91 v.s. 3.86 units of GDP’s standard deviation), the buying side is not enough to explain the data and the selling side will play an important role. Finally, I discuss the ambiguous impacts on capital reallocation after uncertainty shocks.

I construct a tractable dynamic general equilibrium model in which firms face idiosyncratic productivity shocks while being restricted by two frictions: capital stock’s partially irreversibility and financing constraints. The two frictions interact and generate capital reallocation delays from unproductive firms. In response to credit crunches, the delays are prolonged and the TFP dispersion among firms expands.

Consider an economy with firms who face (1) collateralized borrowing constraints, (2) capital resale discount\(^2,3\) (assets will be sold at discount in liquidation), and (3) fixed costs in running business. In this economy, idiosyncratic productivity shocks create the benefits to reallocate capital stock. Productive firms expand by borrowing, but collateral constraints restrict the expansion so that not every capital stock can be reallocated. For example, not

\(^1\)Following Eisfeldt and Rampini (2006), capital reallocation includes sales of property, plants, and equipment and acquisitions from the COMPUSTAT database. Jovanovic and Rousseau (2002) also use this measure for studying the purchase of used assets. To give a sense of reallocation market size, in 2011, the reallocation from COMPUSTAT is about $0.65 trillion whereas the total U.S. fixed investment is about $1.6 trillion. Non-listed firms probably buy more used assets according to Eisfeldt and Rampini (2007). In sum, capital reallocation is comparable to new investment.

\(^2\)Shleifer and Vishny (1992) summarize two usual reasons for resale costs. First, when firms are liquidating, the potential buyers with the highest valuation are often those in the same industry who generally also have financial troubles. Assets may not go to the highest valuation users. Second, because of antitrust reasons, assets may need to be sold to industry outsiders, causing lower values for assets.

\(^3\)Ramey and Shapiro (2001) provide empirical evidence of investment specificity and selling costs. They estimate the wedge between purchase price and resale price for different types of capital. Machine tools are sold at about a 69% discount off the purchase value, and structural equipment is sold at a 95% discount. These estimates suggest a large degree of specificity.
every production line of electric cars can be transferred to productive car companies.

In contrast, firms whose productivity falls are hesitant to sell assets because of the resale discount, gambling on the hopes that they might regain productivity soon. Meanwhile, these firms have accumulated a large amount of debt. The interest rate on debt is higher than the rate of return on capital stock if low productivity is realized again tomorrow. They let the capital depreciate while pay down existing debt by shrinking dividends (consumption). If they persist in this unproductive way, profitability stays low and they gradually shrink. Eventually, they give up capital when the option value of maintaining the depreciated capital is not enough to compensate for the fixed costs of operation.

The main result is that tighter borrowing constraints prolong the selling delay through the general equilibrium. Consider a credit crunch that further limits efficient firms from expanding. Aggregate TFP drops and thus the saving interest rate in risk-free assets will be lower. In addition, aggregate labor demand drops and wage rates decrease such that the labor costs to run firms are lower. In response to a lower saving interest rate and lower input costs, the more inefficient firms postpone liquidation and less capital will be sold. At
the same time, these inefficient firms slowly pay down debt to reduce interest payments and to increase future borrowing capacity. In summary: When a financing problem restrict productive firms to expand, reduce interest rate and demand for labor, both the benefits after liquidation and the costs for staying are smaller. Therefore, keeping assets and slowly deleveraging are more attractive to inefficient firms.

Because capital reallocation slows down during recessions, the idiosyncratic TFP dispersion across firms expands and the aggregate TFP declines with the tightened financing constraints, leading to a deepening recession. Thus, aggregate shocks to financing constraints interact with capital irreversibility, which helps explain why capital reallocation slows down in spite of larger potential benefits to reallocate during recessions. A major credit crunch after a banking crisis, such as the one in the U.S. in 2008, exemplifies these interactions.4

Aggregate TFP shocks, however, generate different dynamics. When adverse aggregate TFP shocks hit, the profit rate is lower because of a lower productivity. Keeping capital is less profitable and inefficient firms have higher incentives to liquidate. Therefore, more reallocation and smaller TFP dispersion should be seen during recessions i.e., the “creative destruction” phenomenon. I estimate aggregate shocks to financing constraints and aggregate TFP and simulate the economy with only one type of shocks. I confirm that aggregate TFP shocks alone cannot generate both observed procyclical capital reallocation and countercyclical TFP dispersion. Financial shocks are necessary to capture both dynamics. The joint dynamics thus are informative on the source(s) of business cycles.

Finally, I discuss impacts from uncertainty shocks in the spirit of Bloom (2009). In my model, because there are credit markets, risk-free saving rate affects firms’ liquidation decisions. Then, a mean preserving spread shock to idiosyncratic productivities will have ambiguous impacts on reallocating capital stock, because the value after liquidation can go either way. This result, together with equilibrium response after financial shocks, implies that linking uncertainty shocks and financial markets such as Gilchrist, Sim, and Zakrajsek (2010) and Christiano, Motto, and Rostagno (2014) will be important for explaining cross-sectional and aggregate data together.

The contribution of this paper is to consider the interaction of financing constraints and capital irreversibility. Without partial irreversibility, there will not be selling delay. Without financing constraints, productive firms can borrow freely and push up both interest rate and wage rate, leaving a very small incentive for unproductive firms to delay selling assets.

The technical innovation might be of some independent interest. The model features

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firm dynamics with capital irreversibility and distribution evolution of firms. Solutions to such model are usually complex and sometimes infeasible with aggregate shocks (not to mention estimations). To maintain tractability, I simplify the problem by solving portfolio choices between bonds and capital stock with (real) “option values”, using finance portfolio choice theory e.g., in Campbell and Viceira (2002). Using the closed-form portfolio choice, individuals’ decision rules are easily aggregated. Note that finite moments are not enough to characterize the firm distribution. But the tractability of the distribution still leads to exact aggregation and avoids the approximation method as in Krusell and Smith (1998).

**Literature Review.** Real option is the salient feature of this paper. Dixit and Pindyck (1994) and Caballero and Engel (1999) focus on the timing of irreversible investment. This paper focuses on asset selling. Since assets may turn to be productive, running unproductive firms has an option value which may exceed the resale value. I show how to directly quantify the option value which is history dependent and summarized in firms’ leverage ratios.

The real option is linked to the delayed capital reallocation which generates larger dispersion during recessions. Implication of shocks to the dispersion of firm-specific conditions can be found, for example, in Bloom (2009), Arellano, Bai, and Kehoe (2012), Gilchrist, Sim, and Zakrajsek (2010), and Panousi and Papanikolaou (2012). But Bachmann and Bayer (2012a,b) show that large dispersion shocks are difficult to reconcile with other observations such as the investment rate dispersion. This paper shows how standard credit crunches can increase the dispersion endogenously through general equilibrium. Similarly, Bachmann and Moscarini (2011) study endogenous dispersion through firms’ risk-taking behaviors.

Further literature of macroeconomic implications of asset illiquidity and implications of financing constraints can be found in surveys by Caballero (1999) for capital illiquidity, and Bernanke, Gertler, and Gilchrist (1999) and more recently Brunnermeier, Eisenbach, and Sannikov (2012) for financing constraints. Whether asset illiquidity or financing constraints can quantitatively amplify TFP and output losses is a matter of some debate.

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5See, for example, Bloom, Bond, and Reenen (2007), Bloom (2009), and Khan and Thomas (2011), who use piece-wise functions to approximate individual value functions.

6I follow and extend previous works by Angeletos (2007), Kiyotaki and Moore (2011), and Buera and Moll (2012). Under the class of CRRA preferences, if individual production functions feature constant returns to scale, the wealth spent on capital and bonds is simplified to a portfolio choice between the two.

7Partial irreversibility is important. Previous work on investment irreversibility focuses on zero resale value, or completely irreversible investment, such as in Abel and Eberly (1996, 1999) and Thomas (2002). With zero resale value, firms only consider when to buy instead of when to sell.

8Thomas (2002) and Veracierto (2002) argue that irreversibility is not important in general equilibrium since idiosyncratic adjustments will be smoothed out. However, Kashyap and Gourio (2007) show that whether lumpy investment is important in aggregate depends on production function of firms and the distribution of fixed costs. Recently, Kiyotaki and Moore (2011) study the illiquidity shocks and the amplification. Eisfeldt (2004) and Kurlat (2011) model the illiquidity through asymmetric information.

9See financial constraints’ impact on long-run output and TFP losses in Buera, Kaboski, and Shin (2011), Moll (2010), and Midrigan and Xu (2012). For example, Midrigan and Xu (2012) argue that financing
Finally, innovation of this paper is to consider the interactions between capital irreversibility and financing constraints. In this sense, the closest recent papers are perhaps Kurlat (2011) and Khan and Thomas (2011). Kurlat (2011) shows analytically why the secondary market for existing capital may shut down and its macroeconomic implications through adverse selection. He focuses on the resale prices by simplifying outside financing: entrepreneurs are not allowed to borrow. Instead, I focus on different degrees of borrowing constraints. Khan and Thomas (2011) quantitatively examine reallocation efficiency for given degrees of resale costs and financing frictions, focusing mainly on numerical aspects. I extensively use analytical methods (by focusing on more specific process of idiosyncratic shocks) to explain the interaction of the two frictions on the capital reallocation delays through changes of interest rates and wages. More importantly, in contrast to both papers, I look at the firms’ capital structure through the portfolio choice perspective.

2 The Model

Time is discrete and the horizon is infinite. There are two types of agents: entrepreneurs and households. Both are with measure 1. Households supply labor, consume, and save in bonds. Entrepreneurs own production technology and some of them run firms.

2.1 Entrepreneurs

Preferences. At time $t$, a typical entrepreneur $j$ has preferences over the consumption stream $c_{jt}, c_{jt+1}, c_{jt+2}, \ldots$, and leisure stream $(1-h_{jt}), (1-h_{jt+1}), (1-h_{jt+2})\ldots$, given by

$$E_t \sum_{s=t}^{\infty} \beta^{s-t}[u(c_{js}) + \eta(1-h_{js})]$$

where $\beta \in (0, 1)$ is the discount factor, $E_t$ is the conditional expectation operator, and $u(c) = \frac{c^{1-\sigma} - 1}{1-\sigma}$. $\sigma$ is the relative risk-aversion parameter. To simplify, I use $\sigma = 1$ i.e., frictions cannot generate the misallocation observed in Hsieh and Klenow (2009). Moll (2010) suggests that as firms have persistent idiosyncratic productivity shocks, they save enough to undo financial frictions. See also financing constraints’ effect on short-run output and TFP fluctuations in Kocherlakota (2000), Cordoba and Ripoll (2004) and more recently Chen and Song (2012).

The interactions in the model occur through general equilibrium. Credit crunches reduce wage rates because of a frictionless labor market. Empirically, despite wage rigidities, real wage rates decline during recessions, as found by Solon, Barsky, and Parker (1994) and Haefke, Sonntag, and Van Rens (2012). The decline of real wages is a consequence of lower wages of newly hired workers, in spite of moderate wage rigidity for longer term employees. Caggese and Cunat (2008) show firms can substitute flexible employment contracts for permanent employment contracts to reduce efficiency wages.

Recently, Guerrieri and Lorenzoni (2011) look at households’ deleveraging and balance sheet after credit crunches. These households face durable consumption goods illiquidity and financing constraints.
\( u(c) = \log(c) \). If \( j \) runs the firm, \( h_{jt} = 1 \); if \( j \) does not run the firm, \( h_{jt} = 0 \), and there is \( \eta \) extra leisure utility. Though a utility costs, \( \eta \) represent the fixed costs to run the business. Modeling this way enable me to solve the exit conditions in closed-form.\(^{12}\)

*Production.* In the beginning of time \( t \), \( j \)'s firm uses capital stock \( k_{jt} \) (installed in \( t - 1 \)) and hire labor \( l_{jt} \) at a competitive wage rate \( w_t \), to produce output:

\[
y_{jt} = \tilde{z}_{jt} k_{jt}^\alpha (A_t l_{jt})^{1-\alpha} = (z_{jt} k_{jt})^\alpha (A_t l_{jt})^{1-\alpha},
\]

where \( \alpha \in (0, 1) \), \( z_{jt} \) is the idiosyncratic productivity, and \( A_t \) is aggregate productivity. Both \( z_{jt} \) and \( A_t \) are realized at the beginning of \( t \). For convenience, \( \tilde{z}^h = (z^h)^\alpha \) and \( \tilde{z}^l = (z^l)^\alpha \) denote the “measured” idiosyncratic productivity levels. The idiosyncratic productivity follows a two state Markov process where the transition probabilities are\(^ {13}\)

\[
\text{Prob}(z_{jt+1} = z^l \mid z_{jt} = z^h) = p_h, \quad \text{Prob}(z_{jt+1} = z^h \mid z_{jt} = z^l) = p_l.
\]

There is no insurance market for idiosyncratic productivity risks.

*Capital Accumulation.* Capital depreciates at a rate \( \delta \). Firms can invest in new capital stock, buy, or sell existing assets. Inactive investment decisions are also allowed i.e., \( j \) can choose to neither buy nor sell capital. One unit of efficient used assets, after being installed, is the same as one unit of new assets. Thus, \( j \)'s capital stock evolves according to

\[
k_{jt+1} = (1 - \delta)k_{jt} + i_{jt},
\]

where \( i_{jt} > 0 \), \( i_{jt} < 0 \) and \( i_{jt} = 0 \) denote buying, selling, and inaction in investment.

As in a neoclassical growth model, a buyer pays one unit of consumption goods for investment goods. But for each unit of used assets, only \( (1 - d) \) fraction is useful for other buyers. This transaction lost implies that sellers receive a payment of \( (1 - d) \) for each unit of asset sold from them. \( d \) represents the reallocation costs, the partial irreversibility of the capital stock due to capital specificity or adverse selection problems.

In sum, it costs \( 1 \) to invest (new or old capital) and \( (1 - d) \) to retire a unit of old capital. If the firm changes its quantity of capital from \( k \) to \( k' \), the cost of doing so is

\[
\psi(k', k) = \begin{cases} 
  k' - (1 - \delta)k, & \text{if } k' > (1 - \delta)k \\
  0, & \text{if } k' = (1 - \delta)k \\
  -(1 - d)[(1 - \delta)k - k'], & \text{if } k' < (1 - \delta)k
\end{cases}
\]

\(^{12}\)Alternatively, one can think of the case in which an entrepreneur’s engagement produces output that are the fixed costs necessary for production.\(^ {13}\)Note that, \( 0 < p^hl < 1, 0 < p^lh < 1, \) and \( p^hl + p^lh < 1 \).
**Budget and Collateral Constraints.** Entrepreneur $j$ has access to the financial market. Denote the bond position as $b_{jt}$ at the beginning of $t$ and the interest rate from $t-1$ to $t$ as $R_t$. The budget constraint of $j$ can be written as

$$c_{jt} + b_{jt+1} + \psi(k_{jt+1}, k_{jt}) = y_{jt} - w_t l_{jt} + R_t b_{jt}.$$  

$j$ earns profits and interests, which are spent on dividends (consumption), new bonds, and paying the capital adjustment costs. Note that one can simplify profits further: because of a constant return to scale (CRS) production technology, the instantaneous profits of $j$ are linear in $k_{jt}$:

$$\Pi(z_{jt}, k_{jt}; w_t) = \max_{l_{jt}} \{(z_{jt} k_{jt})^\alpha (A_t l_{jt})^{1-\alpha} - w_t l_{jt}\} = (z_{jt} \pi_t) k_{jt},$$

where labor demand and aggregate profit rate is

$$l^*_t = z_{jt} k_{jt} \left[ \frac{(1-\alpha) A_t^{1-\alpha} }{w_t} \right]^{1/\alpha}, \quad \pi_t = \alpha \left[ \frac{(1-\alpha) A_t^{1-\alpha} }{w_t} \right]^{1-\alpha \alpha}.$$  

(2)

Thus, the budget constraint can be rewritten as

$$c_{jt} + b_{jt+1} + \psi(k_{jt+1}, k_{jt}) = z_{jt} \pi_t k_{jt} + R_t b_{jt}. \quad (3)$$

Entrepreneur $j$ can short bonds (borrow), but not capital stock. Borrowing is bounded because $j$ faces collateral constraints similar to those in Kiyotaki and Moore (1997) and Hart and Moore (1994).\(^{15}\) The collateral constraint here includes resale frictions and an extra degree of financing frictions $\theta_t$:

$$R_{t+1} b_{jt+1} \geq -\theta_t (1-d) (1-\delta) k_{jt+1}$$  

(4)

\(^{14}\)To see this, the first-order condition for labor is $A_t^{1-\alpha} (z_{jt} k_{jt})^\alpha (1-\alpha) l_{jt}^{-\alpha} = w_t$, so that the optimal labor demand is $l^*_t = z_{jt} k_{jt} \left[ \frac{(1-\alpha) A_t^{1-\alpha} }{w_t} \right]^{1/\alpha}$, from which profits are

$$\Pi(z_{jt}, k_{jt}; w_t) = (z_{jt} k_{jt})^\alpha (A_t l_{jt})^{1-\alpha} - w_t l_{jt} = A_t^{1-\alpha} z_{jt} k_{jt} \left[ \frac{(1-\alpha) A_t^{1-\alpha} }{w_t} \right]^{1-\alpha \alpha} - w_t \left[ \frac{(1-\alpha) A_t^{1-\alpha} }{w_t} \right]^{\alpha}$$

$$= A_t^{1-\alpha} z_{jt} k_{jt} \left[ \frac{(1-\alpha) w_t}{w_t^{1-\alpha} - w_t} \right]^{1/\alpha} = z_{jt} \pi_t k_{jt}.$$  

The total output produced by entrepreneur $j$ can be written as $y_{jt} = \frac{z_{jt} \pi_t k_{jt}}{\alpha}$. To interpret this result, $\alpha$ fraction of the output becomes $j$’s profits while the $1-\alpha$ fraction is paid through wages.\(^{15}\)

\(^{15}\)This is a consequence of the fact that the human capital of the agent who is raising outside funds is inalienable. To ensure no “run away” default, the lender should be able to seize the tangible assets.
Collateral constraint (4) says that debt value cannot exceed $\theta_t$ fraction of the resale value of the residual capital at $t+1$. In addition, the collateral constraint implies that the investing entrepreneur only needs to pay $1 - \theta_t (1 - d) (1 - \delta) / R_{t+1}$ as down payment. $\theta_t$ fluctuates and measures the external financing difficulties. For example, a permanently higher $\theta_t$ represents a better financial development, whereas a temporary decline in $\theta_t$ indicates a sudden banking problem.

$\theta_t$ of (4) constrains capital stock allocation efficiency. Without (4), $z^h$ owners can obtain any funds needed to invest in capital stock. The economy would reach the efficient production frontier, and as many entrepreneurs as possible can enjoy leisure.

A Summary. Each entrepreneur $j$ maximizes (1) subject to (3) and (4), by choosing consumption $c_{jt}$, leisure $h_{jt}$, labor input $l_{jt}$, capital $k_{jt+1}$, and bonds $b_{jt+1}$, while taking the wage rate $w_t$ and the interest rate $R_{t+1}$ as given.

2.2 Households

A representative household has preferences over the consumption stream $c_{ht}, c_{ht+1}, c_{ht+2}, \ldots$, and labor supply $l_{ht}, l_{ht+1}, l_{ht+2}, \ldots$, given by

$$
E_t \sum_{s=t}^{\infty} \beta_h^{s-t} \left[ \frac{c_{1-h}^{1-\gamma} - 1}{1 - \gamma} - \frac{\kappa (l_{hs})^{1+\nu}}{1 + \nu} \right],
$$

where $\beta_h \in (\beta, 1)$ is household’s discount factor, $\gamma$ is the relative risk-aversion, $\nu$ is the inverse Frisch elasticity of labor supply, and $0 \leq l_{ht} \leq 1$. The household do not have production technology and therefore do not own physical capital. They can save in bonds so that the budget constraint is

$$
c_{ht} + b_{ht} = w_t l_{ht} + R_t b_{ht}.
$$

That is, labor income and return from bonds are used to finance new consumption and new bonds. The household problem is standard and the optimal solution is (assuming interior solution for labor supply)

$$
\kappa c_{ht}^\gamma l_{ht}^\nu = w_t, \quad \frac{\beta_h (c_{ht+1})^{-\gamma}}{(c_{ht})^{-\gamma}} R_{t+1} = 1.
$$

2.3 Recursive Equilibrium

I rewrite the entrepreneur’s problem recursively and then define recursive equilibrium. Denote aggregate state as $X = (\Gamma (k, b, z), \theta, A)$ where $\Gamma (k, b, z)$ is the distribution of individuals’ capital stock, bonds, and productivity at the beginning of each period. To emphasize,
financial disturbances $\theta$ and aggregate productivity fluctuations $A$ are exogenous shocks.

Let $V$ be the optimal value of an entrepreneur with $k$, $b$, and $z$, given the aggregate state variable $X$. The value function $V(k, b, z; X)$ satisfies the Bellman equation:

$$V(k, b, z; X) = \max\{W^1(k, b, z; X), W^0(k, b, z; X)\} \tag{5}$$

\begin{align*}
W^1(k, b, z; X) &= \max_{k' > 0, \theta'(1-\delta)(1-\delta)k'} \{u(z\pi k + Rb - \psi(k', k) - b') + \beta \mathbb{E}_{z,X}[V(k', b', z'; X')])
\}
W^0(k, b, z; X) &= \max_{b'} \{u(z\pi k + Rb + (1 - \delta)(1 - d)k - b') + \eta + \beta \mathbb{E}_{z,X}[V(0, b', z'; X')])
\}
\end{align*}

The first step maximization is over the two actions: (1) to run the firm and get $W^1$ and (2) not to run the firm and get $W^0$. The second step is to choose the optimal consumption and savings (a portfolio of capital stock and bonds). Note that $W^0$ has the leisure utility $\eta$, as an entrepreneur who gets $W^0$ does not run the firm today (and there is no output tomorrow).

Finally, I define the recursive equilibrium to close the model:

**Definition 1 (The First Recursive Equilibrium Definition):**

The equilibrium consists of households’ policy function $\{c_h(X), l_h(X), b_h(X)\}$, entrepreneurs’ policy functions $\{l(k, b, z; X), k'(k, b, z; X), b'(k, b, z; X)\}$, a law of motion $\Gamma(k, b, z) \rightarrow \Gamma(k', b', z')$, and pricing functions $\pi(X)$ and $R'(X)$, given an exogenous evolution of $(\theta_{-1}, A_{-1}) \rightarrow (\theta, A)$ such that:

(i) $l$, $k'$ and $b'$ solve the entrepreneur’s problem in (5) given wages and interest rates.

(ii) $c_h$, $l_h$, and $b_h$ solve the household’s problem i.e.,

$$\kappa_{c_h} l_h = w, \quad \mathbb{E}_X \frac{\beta_h (c' h)^{-\gamma}}{(c_h)^{-\gamma}}R' = 1, \quad c_h + b_h = wl_h + Rb_{h,-1}$$

(iii) Markets for labor and bonds clear

$$\int l_{jd} = l_h, \quad \int b'_{jd} = 0$$

(iv) The distribution evolution $\Gamma(k, b, z) \rightarrow \Gamma(k', b', z')$ is consistent with policy functions, given an initial condition.

Note that I chose to be brief in describing the evolution of firm distribution. The reason is that I will simplify the firm distribution and rewrite the equilibrium.
3 Equilibrium Characterization

I focus on the interesting equilibrium where there is an active secondary capital market. I begin by describing the decision rules of entrepreneurs, leaving the mathematical details for later. Doing so will give readers an idea of where the argument flow is and allow them to skip the details.

3.1 Entrepreneurs’ Decision Rules

A Quick Preview. An individual entrepreneur’s policy depends on idiosyncratic productivity and the leverage ratio i.e., capital stock over equity

$$\lambda = \frac{k}{(k + b)}$$

. The interesting equilibrium features that \(z^h\) owners buy capital while \(z^l\) owners hold on to it before liquidation. This type of equilibrium is the main concern because it has imperfect capital reallocation and possible binding financing constraints for productive firms.

In steady state, the optimal policy functions can be shown in the following way. Consider the dynamics of \(k\) and \(b\) (Figure 2). \(z^h\) owners always go to \(z' = z^h\) line or expand through the \(z' = z^h\) line such that the leverage is \(\bar{\lambda}\) and the slope \(k/b\) is \(\frac{\bar{\lambda}}{1-\bar{\lambda}}\). For example, when \(\bar{\lambda}\) is the leverage ratio associated with the borrowing constraint, \(z^h\) owners reach the credit

Figure 2: Policy function illustration

Dynamics of \(k\) and \(b\). When entrepreneurs draw \(z^h\), their firms expand (increase \(k\) while decrease \(b\)) along the solid line. Whenever entrepreneurs draw \(z^l\), they step on the dashed line (one specific path): let \(k\) depreciate while paying back existing debt (increase \(b\)) until \(k/b = \frac{\lambda}{1-\lambda}\) when they liquidate the firm.
limit. zt owners, on the other hand, let the capital depreciate and shrink their debt by reducing consumption until they reach leverage \( \lambda \) (i.e., \( k/b \) ratio is \( \frac{\lambda}{1-\lambda} \)). Then, their firms are liquidated.

The region characterized by the two lines with slope \( \frac{\lambda}{1-\lambda} \) and \( \frac{\lambda}{1-\lambda} \) denote the inaction region. Inside the region, the reward for changing capital stock is insufficient. From outside the region (to the right of the \( \frac{\lambda}{1-\lambda} \) slope line), the optimal policies are such as to proceed instantly to the \( k = 0 \) line i.e., to liquidate in order to avoid the fixed costs.

The illustration above is in the steady state. When there are aggregate shocks, \( \tilde{\lambda} \) and \( \lambda \) will change in response. Now, I show the detail steps to derive the decision rules.

**3.1.1 Policy Functions When \( k' > 0 \)**

First, I explore useful properties of the value function. The value function behaves normally, differentiable at \( k > 0 \), and has a “scale-invariant” property.

**Lemma 1 (Properties of the Value Function):**

The value function \( V \) has the following properties

1. \( V(k, b, z; X) \) is increasing in \( k \), \( b \), and \( z \), and concave in \( (k, b) \).
2. \( V \) satisfies
   \[ V(\gamma k, \gamma b, z; X) = V(k, b, z; X) + \frac{\log \gamma}{1 - \beta}. \]
3. \( V(k, b, z; X) \) is differentiable at \( k > 0 \) and satisfies the envelope condition.

**Proof.** See the Appendix.

One can prove properties 1 and 2 of Lemma 1 by contraction mapping, which maps the space of functions with properties 1 and 2 to itself. Let leverage of a firm be

\[ \lambda = k/(k + b). \]

Lemma 1 says that value functions of entrepreneurs with the same pair of \( (\lambda, z) \) are affine transformations of each other. A firm with \( \gamma \) times of the size as another firm but the same \( (\lambda, z) \) is simply a scale up version of the latter. More importantly, target leverage of these entrepreneurs will be the same.\(^{16}\) Notice that the fixed costs \( \eta \) affect the liquidation decision and the decision is based upon \( (\lambda, z) \) but not the level of \( k \) and \( b \).

\(^{16}\)Their policies are \( (k', b') \) and \( (\gamma k', \gamma b') \) so the target leverages are \( k'/(k' + b') \) and \( \gamma k'/((\gamma k' + \gamma b')). \)
Because of potential inaction investment decisions, it is useful to work with the marginal value of capital. Let \( q(k, b, z; X) \) be the marginal value of capital that satisfies the envelope condition:

\[
V_k(k, b, z; X) = u'(c(k, b, a; X))[z\pi + q(k, b, z; X)(1 - \delta)],
\]

for \( k > 0 \). \( q \) measures the value of capital in consumption goods unit and shows how much entrepreneurs value their capital internally, particularly when the investment decision is inaction. It turns out to be useful in solving policy functions because it only depends on leverage, keeping everything else fixed:

**Lemma 2 (Scale Invariance and Shadow Prices):**

The value function \( V \) and the shadow value \( q \) have the following properties

1. \( V_k \) is homogeneous with degree \(-1\).
2. For given \( z \) and \( X \), \( V_k/u'(c) \) depends only on \( k/(k + b) \), but not on \( k \) or \( b \).
3. \( q(k, b, z; X) \) can be simplified to \( q(\lambda, z; X) \), where \( \lambda = \frac{k}{k+b} \).

**Proof.** See the Appendix. \( \square \)

\( q \) is equivalent to the marginal reward to adjust capital. When the marginal reward to increase capital reaches 1, a firm buys capital. When the marginal reward to decrease capital reaches \( 1 - d \), the firm sells it. When there are no active purchases or sales, the marginal reward to increase or decrease capital is \( q \), which should be less than 1 but greater than \( 1 - d \). Therefore, it is not optimal to adjust capital stock when

\[
1 - d < q(\lambda, z; X) = \frac{V_k/u'(c) - z\pi}{1 - \delta} < 1.
\]

Inside the inaction region, \( q \) is the option value of staying. Such characterization is similar to that in Dixit (1997). One may also interpret \( q(\lambda, z; X) \) as the “price” of each share of a firm with leverage \( \lambda = k/(k + b) \) and productivity pair \( z \). When the firm is investing, each share of the stock is priced at 1. When sold, each share of the stock is priced at \( 1 - d \). When firms are inactive in investment, each share of the stock is \( q \in (1 - d, 1) \).

The properties of the value function provide useful knowledge to solve entrepreneurs’ policy functions. To see this, let the (internal) rate of return on capital \( (k' > 0) \) \( r' \) be

\[
r'(\lambda', z'; X'|\lambda, z; X) = \frac{z'\pi' + (1 - \delta)q(\lambda', z'; X')}{q(\lambda, z; X)}.
\]
let the net worth of an entrepreneur using the shadow value of capital be

\[ n(k, b, z; X) = z\pi k + q(\lambda, z; X)(1 - \delta)k + Rb, \]

and let \( \phi \) denote the fraction of net worth spent on capital. We then have the following analytical solution

**Proposition 1 (Closed-form Policy Functions):**

Consumption \( c = c(k, b, z; X) \), capital \( k' = k'(k, b, z; X) > 0 \), and bonds \( b' = b'(k, b, z; X) \) can be expressed as

\[
c = (1 - \beta)n(k, b, z; X), \quad k' = \frac{\phi}{q(\lambda, z; X)}\beta n(k, b, z; X), \quad b' = (1 - \phi)\beta n(k, b, z; X).
\]

where \( \phi \) satisfies

\[
\begin{cases}
\mathbb{E}_{z,X} \left[ \frac{\phi' - R'}{\phi r' + (1 - \phi)R'} \right] = 0, & \text{if } \mathbb{E}_{z,X} \left[ \frac{\phi' - R'}{\phi r' + (1 - \phi)R'} \right] = 1 \\
\phi = \frac{1}{1 - \theta(1 - \delta)(1 - d)/qR'}, & \text{if } \mathbb{E}_{z,X} \left[ \frac{\phi' - R'}{\phi r' + (1 - \phi)R'} \right] < 1.
\end{cases}
\]

When entrepreneurs invest, they invest such that they target the same \( \phi \).

**Proof.** See the Appendix.

The above policy function implies the usual Euler equation used in asset pricing. To see this, notice that portfolio weight on capital stock is \( \phi = qk'/\beta n \) then

\[
\frac{1}{\phi r' + (1 - \phi)R'} = \beta \left[ \frac{\beta u'(c')}{u(c)} \right] \frac{\beta}{\phi} \frac{1}{\phi r' + (1 - \phi)R'} = \frac{\beta(1 - \beta)n}{(1 - \beta)n'} = \frac{\beta u'(c')}{u(c)},
\]

which is the stochastic discount factor. Then, when entrepreneurs are not financing constraint, the portfolio weight \( \phi \) solves

\[
\mathbb{E}_{z,X} \left[ \frac{\beta u'(c')}{u(c)} \frac{z'\pi' + (1 - \delta)q(\lambda', z'; X')}{q(\lambda, z; X)} \right] = 1,
\]

the classic asset pricing formula \( \mathbb{E}[\Lambda'R] = 1 \), where \( \Lambda' \) is the stochastic discount factor.

In summary, a typical entrepreneur consumes \( (1 - \beta) \) fraction and saves the other \( \beta \) fraction of the net worth (that uses the option value of capital). She uses the savings to
invest in a portfolio. The portfolio consists of risky assets (capital stock) and risk-free assets (bonds), allowing shorting on risk-free assets but not on risky ones. If she invests \( \phi \) fraction of a dollar in risky assets and the other \( 1 - \phi \) fraction in risk-free assets, the next period’s rate of return is \( \phi r' + (1 - \phi)R' \). The goal of portfolio choice is to maximize the expected log rate of return (i.e., the solution of \( \phi \)).\(^{17}\) Even though the saving rate is a constant \( \beta \) under log utility, different entrepreneurs save different fractions of the “accounting” net worth which is either \( z\pi k + (1 - \delta)k + Rb \) or \( z\pi k + (1 - \delta)(1 - d)k + Rb \). Unlike the accounting net worth, the “economic” net worth evaluates capital at shadow prices, which varies across entrepreneurs when the investment decisions opt for inaction.

### 3.1.2 Inaction Regions and Liquidation

In equilibrium, there may or may not be inaction in investment. When there is, there exists at least an option value \( q \in (1 - d, 1) \). To characterize the inaction region, one only needs to check how the shadow price \( q(\lambda, z; X) \) varies as \( \lambda \) and \( z \) change (for a given \( X \)). Further, given that we have two productivity levels \( z^h \) and \( z^l \), \( z^h \) firms invest to the same leverage as shown in Proposition 1. The inaction region is thus the set of \((\lambda, z^l)\) such that the shadow price is between \( 1 - d \) and 1.

Therefore, some (and usually all) \( z^h \) owners invest and borrow. Because of the linear rate of return in individual level, they have the same target leverage \( \lambda' = k'/ (k' + b') \) tomorrow regardless of their leverage today (Proposition 2).\(^{18}\) For \( z^l \) owners, investment decisions are either to hold or to sell. It turns out that an entrepreneur who persistently draws \( z^l \) hold capital for finite periods. The shadow price during the holding process monotonically decreases until it reaches \( (1 - d) \) when the capital stock is liquidated. During the holding process, the leverage also decreases.

**Proposition 2 (Leverage and Deleverage):**

*In the neighborhood around steady state with \( \delta(1 - \delta) < \beta R \),*

1. The shadow price (option value) \( q(\lambda, z; X) \) is an increasing function of \( \lambda \).

2. \( z^h \) owners borrow and invest. Moreover, they have the same target leverage \( \frac{k'}{k' + b'} = \lambda' \).

\(^{17}\)Policy functions have closed-form expressions for any \( \sigma \) (available upon request). But under general CRRA utility, the saving rate (not necessarily \( \beta \)) and portfolio weight \( \phi \) intertwine with each other. The reason is that with general CRRA utility the income and substitution effect do not offset each other, for example illustrated in Campbell and Viceira (2002). The combination of the two effects are so-called “hedging demand” in the asset pricing literature. Depending on the investment opportunities in the long time frame, agents put different weights on capital and consume differently.

\(^{18}\)\( k'/ (k' + b') \) may or may not reach the leverage under credit limits, depending on the equilibrium.
3. Denote today’s shadow price as \( q \) and tomorrow’s shadow price as \( q' \). Then,

\[
q' \begin{cases} 
1 & \text{if } z' = z^h \\
< q & \text{if } z' = z^l
\end{cases}
\quad \text{and} \quad k' \begin{cases} 
\bar{\lambda} & \text{if } z' = z^h \\
k' + b' & \text{if } z' = z^l
\end{cases}
\]

Proof. See the Appendix.

The assumption \( \delta(1 - \delta) < \beta R \) is not hard to satisfy for usual quarterly data model i.e., when \( \delta \) is around 0.025 and \( \beta R \) is close to 1. In addition, the delveraging when being inactive in capital are intuitive. For \( z^l \) entrepreneurs, running business is not profitable compared to risk-free rate. Without resale costs, they will liquidate and repay all the debt immediately after turning from \( z^h \) to \( z^l \). If they sell but become productive tomorrow, they can still buy back capital at the same price. With resale costs, in contrast, they have the same incentive to shrink the debt. But if they sell capital at a cost immediately, they will have to buy back at a higher price tomorrow if they turn productive again. Instead, dividends payments from the firm decrease to compensate debt payment, a painful process for the entrepreneurs.

Not surprisingly, capital is less and less valued during the inaction process. The fixed costs of running a business eventually force the \( z^l \) owners to liquidate. The intuition behind is that capital stock will eventually shrink to a very small amount. Even if turned to productive again tomorrow, the firm cannot generate much profits to compensate fixed costs. That is, there exists a stopping rule:

**Proposition 3 (Optimal Stopping Time):**

For \( z^l \) owners, there exists an optimal capital liquidation rule (stopping-time rule or exit rule). Let \( n = z^l \pi + (1 - \delta)(1 - d) + R \Lambda^{-1}(1 - \Delta) \) and suppose a finite \( \Lambda \in [0, \bar{\lambda}] \) is a root of

\[
\eta = \frac{\beta}{1 - \beta} p^{sh} \mathbb{E}_X \left[ \log \left( 1 + \frac{(1 - \delta) z^h \pi' + (1 - d) - (1 - d) R'}{\beta n R'} \right) \right] \\
+ \frac{\beta}{1 - \beta} p^{sh} \mathbb{E}_X \left[ \log \left( 1 + \frac{(1 - \delta) z^l \pi' + (1 - d) - (1 - d) R'}{\beta n R'} \right) \right]
\]

1. When \( \frac{k}{k + b} > \Lambda \), \( z^l \) owners are inactive in adjusting capital. When \( \frac{k}{k + b} < \Lambda \), they liquidate the whole firm. When \( \frac{k}{k + b} = \Lambda \), they are indifferent between holding or liquidating capital.

2. If no \( \Lambda \) satisfies equation (17), then no \( z^l \) entrepreneur sells capital.

Proof. See the Appendix.

The indifference condition (17) implies that the gains of liquidation (extra \( \eta \) utility)
equals the expected discounted costs of not doing so (the right hand side, extra value of
holding capital stock one more period). Note that, holding onto capital is similar to gambling
for \( z^h \) draw in the future. The gambling is not worthwhile when the size of capital stock
is so small that profits are not enough to compensate fixed costs, even when drawing \( z^h \)
tomorrow.

### 3.2 Recursive Equilibrium Revisit

Now, we are ready to simplify the distribution of firms and rewrite equilibrium definition.
We know that entrepreneurs with the same leverage \( k/(k+b) \) and productivity put the same
portfolio weights on \( k \) and \( b \). Thus, I can define aggregate capital stock and aggregate bonds
for a specific \( k/(k+b) \) ratio, given a productivity pair \( a \), i.e.,

\[
K(x,a) = \int_{\{(k,b): \frac{k}{k+b} = x\}} k \Gamma(dk, db, a), \quad B(x,a) = \int_{\{(k,b): \frac{k}{k+b} = x\}} b \Gamma(dk, db, a)
\]

Equilibrium can be redefined as a mapping \((K(x,a), B(x,a), \theta, A) \rightarrow (K'(x,a), B'(x,a), \theta', A')\).
Since drawing \( z^h \) always means investment,\(^{19}\) keeping track of the firm distribution is equiva-
rent to keeping track of firms with the time length of having been drawing \( z^l \).

At the beginning of \( t \), let \( s = 1, 2, ... \) denote the \textit{vintage} of entrepreneurs, who have been
drawing \( s \) times of \( z^l \). These firms did not invest in \( t-1 \). Let \( s = 0 \) denote the state in which
the entrepreneur just finished investing. That is, drawing \( z^h \) means that entrepreneurs will
go to vintage \( s = 0 \), whereas drawing \( z^l \) means that they will go to the next vintage i.e., the
vintage whose number equal 1 plus the number of current vintage.

Inside each vintage, the leverage ratio \( \lambda = k/(k+b) \) is the same, which allows me to
replace \( q(\lambda, z; X) \) by vintage-specific price. When entrepreneurs decide to go from vintage
\( s \) to \( s' \), the shadow price of capital will be \( q_{s'}(X) \), which is vintage-specific and corresponds
to a specific \( \lambda' = k'/k' + b' \). When the secondary market is active, there exists an integer
\( N_t < +\infty \) at time \( t \), such that (1) vintage \( N_t + 1, N_t + 2, ... \) entrepreneurs who draw \( z^l \) will
hold no capital stock; (2) vintage \( 0, 1, ..., N_t \) entrepreneurs who draw \( z' \) are from vintage
will be inactive in capital; (3) vintage \( N \) entrepreneurs will be indifferent between staying
or liquidating i.e., a fraction \( f_t \) of them stays while the other fraction \( 1 - f_t \) liquidate.

For simplicity, I focus on small exogenous shocks around the steady state such that the
equilibrium vintages do not change, i.e., \( N_t = N \). Note that \( N \) is an endogenous constant
integer, as \( N \) itself varies in different steady states. In addition, I can leave the aggregate

\(^{19}\) For most parameters, every \( z^h \) entrepreneurs invest; for some parameters, some \( z^h \) entrepreneurs invest
and others do not run firms (in which obviously \( z^l \) entrepreneurs do not run firms as well).
state $X$ out and denote variables with vintage subscripts. For example, at time $t$, the shadow price of capital for those entrepreneurs who are going to vintage $i$ is $q_i$. Then, $q_0 = 1$ denotes the buying price and $q_{N+1} = q_{N+2} = 1 - d$ denote the selling price.\footnote{“Shadow price” of capital of entrepreneurs who are going to invest and go to vintage 0.} In summary,

1. Entrepreneurs go to vintage 0 once they draw $z^h$.

2. For those vintage $i$ entrepreneurs who draw $z^l$, they hold onto capital stock if they are from vintage 0, 1, ..., $N$. Their vintage number will be $i + 1$ and they value capital at price $q_{i+1}$.

3. For those vintage $N$ entrepreneurs who draw $z^l$, a fraction $f_t$ of them stays in the business (going to vintage $N + 1$) while $1 - f_t$ liquidates their firms (going to vintage $N + 2$). They value capital at price $q_{N+1} = q_{N+2} = 1 - d$.

4. Entrepreneurs in vintage $N + 1, N + 2, ..., N + 2$, do not run firms if they draw $z^l$.

Notice that one can group vintages after $N + 1$ together to be vintage $N + 2$, since entrepreneurs in vintages $N + 2, N + 3, ...$ only hold bonds. To express portfolio choices in each vintage, first define the transition probability and the associated productivity of each vintage as

\[
p^{ih} = \begin{cases} p^{hh}, & \text{if } i = 0 \\ p^{il}, & \text{if } i > 0 \end{cases}, \quad p^{il} = \begin{cases} p^{hl}, & \text{if } i = 0 \\ p^{ll}, & \text{if } i > 0 \end{cases}, \quad z_i = \begin{cases} z^h, & \text{if } i = 0 \\ z^l, & \text{if } i > 0 \end{cases}
\]

Second, let the (internal) rate of return on capital from time $t$ to time $t + 1$ be $r'_{ij}$ for those entrepreneurs who are going to vintage $i$, where $i = 0, 1, ..., N - 1$ and $j \in h, l$ indicates drawing $z^h$ and drawing $z^l$ at time $t + 1$.\footnote{For example, an entrepreneur going to vintage 3 in time $t$ draws $z^h$ at time $t + 1$, her rate of return on capital from $t$ to $t + 1$ is $r'_{3h}$.} The vintage $i$ specific rate of return on capital when $z^h$ or $z^l$ is realized can be written as

\[
r'_{ih} = \frac{z_0 \pi' + (1 - \delta)q_0}{q_i}, \quad r'_{il} = \frac{z_{i+1} \pi' + (1 - \delta)q_{i+1}}{q_i}
\]

for $i = 1, 2, ..., N$.

According to Proposition 1, the portfolio weight $\phi$ on capital can be simplified to

**Corollary 1 (Vintage-specific Portfolio Choices):**

*Suppose $\tilde{\phi}_i$ $(i = 0, 1, 2, ..., N)$ is a solution to the following equation of $\tilde{\phi}_i$*

\[
p^{ih} \mathbb{E}_X \left[ \frac{r'_{ih} - R'}{\tilde{\phi}_i (r'_{ih} - R') + R'} \right] + p^{il} \mathbb{E}_X \left[ \frac{r'_{il} - R'}{\tilde{\phi}_i (r'_{il} - R') + R'} \right] = 0
\]
The capital weight \( \phi_i \) \((i = 0, 1, 2, \ldots, N)\) for entrepreneurs who are going to vintage \( i \) solves
\[
\phi_i = \min \left\{ \frac{1}{1 - \theta(1 - \delta)(1 - d)/R'}, \tilde{\phi}_i \right\}
\]
Finally, \( \phi_{N+1} \) will be such that entrepreneurs choose to be inactive in capital stock and value the capital at price \( q_{N+1} = 1 - d \).

Once we know \( \phi_i \) \((i = 0, 1, 2, \ldots, N + 1)\), one could back out the leverage ratio at the beginning of time \( t + 1 \) i.e.,
\[
\lambda_i' = \frac{\phi_i}{\phi_i + q_i (1 - \phi_i)}.
\] (9)

I can fully characterize the firm distribution evolution from \( t \) to \( t + 1 \) in Figure 3 using the vintage formulation. In addition, I can simplify the equilibrium definition with the vintage structure. To see this, Let \( K_{i,t} \) be the aggregate capital in each vintage \( i = 0, 1, \ldots, N + 1 \) and \( B_{N+2,t} \) be the aggregate bonds in vintage \( N + 2 \). Capital transition is characterized by aggregate capital in vintage 0, 1, ..., \( N + 1 \):
\[
q_0 K_0' = \phi_0 \sum_{i=0}^{N+1} p^{h \beta}[z_0 \pi + q_0 (1 - \delta) + R \frac{1 - \lambda_i}{\lambda_i} K_i],
\] (10)
\[
q_i K_i' = \phi_i p^{i-1 \beta}[z_i \pi + q_i (1 - \delta) + R \frac{1 - \lambda_{i-1}}{\lambda_{i-1}} K_{i-1}], \quad i = 1, 2, \ldots, N
\] (11)
\[
q_{N+1} K_{N+1}' = \phi_{N+1} p^{N+1 \beta} f[z_{N+1} \pi + q_{N+1} (1 - \delta) + R \frac{1 - \lambda_N}{\lambda_N} K_N]
\]
\[
B_{N+2}' = p^N (1 - f) \beta[z_{N+2} \pi + q_{N+2} (1 - \delta) + R (1 - \lambda_N)/\lambda_N] K_N + p^{N+2 \beta} R B_{N+2}
\] (12)
The aggregate capital in vintages \( i = 1, 2, \ldots, N + 1 \) satisfies
\[
K_i' = \begin{cases} 
  p^{i-1 \beta}(1 - \delta) K_{i-1}, & \text{if } i = 0, 1, \ldots, N \\
  p^{i-1 \beta} f(1 - \delta) K_{i-1} & \text{if } i = N + 1
\end{cases}
\] (13)
To pin-down \( f \), the indifference condition is
\[
\eta = \frac{\beta}{1 - \beta} p^{h \beta} \mathbb{E}_X \left[ \log \left( 1 + (1 - \delta) \frac{z^h \pi' + (1 - \delta) - (1 - d)R'}{\beta(z^N \pi + (1 - \delta)(1 - d) + R \frac{1 - \lambda_N}{\lambda_N})R'} \right) \right] + \frac{\beta}{1 - \beta} p^{l \beta} \mathbb{E}_X \left[ \log \left( 1 + (1 - \delta) \frac{z^l \pi' + (1 - \delta)(1 - d) - (1 - d)R'}{\beta(z^N \pi + (1 - \delta)(1 - d) + R \frac{1 - \lambda_N}{\lambda_N})R'} \right) \right]
\] (14)
Figure 3: Evolution of the distribution

Each box represents a vintage in which firms have the same $\lambda = \frac{k}{b+h}$ leverage ratio. The vintage number is identical to how many periods an entrepreneur has been drawing $z_i$. Entrepreneurs who draw $z_0$ invest and move to vintage 0 (black lines). Entrepreneurs who are from vintage 0 to $N$ and draw $z_i$ are possibly inactive (black dash lines). Entrepreneurs in vintage $N+1$ or the last vintage $N+2$ hold only bonds if drawing $z_i$ (liquidate the firm or continuing holding only bonds). $f_t$ denotes the fraction of vintage $N$ entrepreneurs who draw $z_i$ but choose to hold onto capital stock. $1 - f_t$ then denotes the other fraction who liquidate their firms (red dotted lines).

Market clearing conditions for credit and labor are

$$\sum_{i=0}^{N+1} \frac{(1 - \lambda_i) K_i}{\lambda_i} + B_{N+2} + b_h = 0, \quad \left(\frac{\pi}{\alpha}\right)^{\frac{1}{1-\alpha}} \left(\sum_{i=0}^{N+1} z_i K_i\right) = A\lambda_h$$

where the labor market clearing condition is obtained from

$$\left[\frac{(1-\alpha)A^{1-\alpha}}{\omega}\right]^{\frac{1}{\alpha}} \left(\sum_{i=0}^{N+1} z_i K_i\right) = l_h$$
together with the relationship between the real wage and the profit rate
\[ \pi = \alpha \left[ \frac{(1 - \alpha)A}{w} \right]^{\frac{1-\alpha}{\alpha}} \] (16)

**Definition 2** (The Second Recursive Equilibrium Definition):
The recursive competitive equilibrium is a function \((\{\phi_i\}_{i=0}^{N+1}, \{q_i\}_{i=0}^{N+1}, \lambda_i^{N+1}, \{K_i^{N+1}\}_{i=0}^{N+1}, B_{N+2}^r, f, \pi, R\prime)\) of state variables \((\{\lambda_i\}_{i=0}^{N+1}, \{K_i\}_{i=0}^{N+1}, B_{N+2}, R, \theta_{-1}, A_{-1})\) and a given initial condition, such that\(^{22}\)

1. equations (10) to (16) are satisfied
2. \(\{\phi_i\}_{i=0}^{N+1}\) solve the portfolio choice problems in Corollary 1 and \(\lambda_i^{N+1}\) solve (9)
3. \(q_0 = 1, q_{N+1} = 1 - d,\) and \(q_{N+2} = 1 - d\)
4. together with the law of motion of \((\theta, A)\)

### 3.3 Delayed Capital Reallocation

The inaction region can be easily expressed by the set of leverage ratios and productivities such as in Figures 2:

\[ \{(\frac{k}{k + b}, z) : \underline{\lambda} \leq \frac{k}{k + b} \leq \bar{\lambda} \text{ and } z = z^t\} \]

where \(\underline{\lambda}\) is the lower bound and \(\bar{\lambda}\) is the upper bound. Any changes that lead to increase of \(\bar{\lambda} - \underline{\lambda}\) will expand the inaction region.

One can directly check the stopping condition (17) to examine how does \(\underline{\lambda}\) change in response to changes in prices. For convenience, I repeat the (17).

\[
\eta = \frac{\beta}{1 - \beta} \rho_0 \mathbb{E}_x \left[ \log \left( 1 + (1 - \delta) \frac{z^h\pi' + (1 - \delta) - (1 - d)R'}{\beta(z^h\pi + (1 - \delta)(1 - d) + R\frac{1 - \lambda}{\lambda})R'} \right) \right] \\
+ \frac{\beta}{1 - \beta} \rho_1 \mathbb{E}_x \left[ \log \left( 1 + (1 - \delta) \frac{z^l\pi' + (1 - \delta)(1 - d) - (1 - d)R'}{\beta(z^l\pi + (1 - \delta)(1 - d) + R\frac{1 - \lambda}{\lambda})R'} \right) \right] 
\] (17)

Since the right hand side of (17) is a decreasing function of \(R'\) and an increasing function of \(\pi'\) and \(\underline{\lambda}\), therefore a lower interest rate \(R'\) or a higher profit rate \(\pi'\) can lead to the

\(^{22}\) The capital market clearing is embedded in the capital transition dynamics, and one can easily verify that the goods market clearing condition is satisfied (i.e., Walras’ Law holds).
decrease of $\lambda$ (in steady state). That is, the inaction region expands and low productive firms are less willing to liquidate.

**Corollary 2 (Changes of Inaction Region):**

The inaction region expands when

1. $\pi'$ is higher
2. $R'$ is lower

In steady state, $A_t = 1$ and $R'$ will be fixed as $\beta_h^{-1}$. Then, tighter financing constraints will limit the expansion of productive firms and thus create misallocation. Wages will tend to be lower and thus the profit rate $\pi_t$ for entrepreneurs will be higher. Therefore, entrepreneurs with low idiosyncratic productivity are more willing to hold onto their assets.

However, we still have to be careful because tighter financing constraints at the same time decrease $\bar{\lambda}$, so the inaction region $\bar{\lambda} - \lambda$ might not increase. But if the response of $\pi'$ to $\theta$ changes are strong enough, the inaction region $\bar{\lambda} - \lambda$ will increase and so are the waiting periods (the number of vintages). I will show this result in numerical simulation.

In dynamics, tighter financing constraints lead to lower demand for borrowing and a drop of interest rate $R'$; at the same time it creates misallocation and reduce wages which increase profit rate given a constant aggregate productivity $A_t$. In response, $f_t$ increases as more $z^t$ firms are willing to keep their assets. Note that we focus on the equilibrium in which the number of vintages $N_t + 2$ does not change. Potentially the response to credit shocks could be large enough such that the number of vintages increase for a short period of times. In that case, there could be zero reallocation of capital for some time.

Reallocation is directly linked the economic efficiency. The longer the waiting periods, the more capital reallocation is delayed, and the less efficient is the economy (i.e., the lower is the aggregate TFP). To see this, the aggregate TFP can be measured by

$$TFP = \frac{Y}{K^\alpha L^{1-\alpha}}$$

where $Y$ is the total output, $K$ is the total capital stock, and $L$ is the total labor hours used in production, including labor hours from households (i.e., $l_h$) and labor hours from entrepreneurs (i.e., $l_e$)

$$L = l_h + l_e.$$ 

To compute $l_e$ i.e., the measure of entrepreneurs who run firms, I use the transition probability of idiosyncratic technology and the fraction $f_t$ of entrepreneurs who liquidate (with details in the appendix). Note that $\alpha$ fraction of the output produced from a firm is the
associated entrepreneur’s profits. Output can be written as

\[ Y = \frac{\pi}{\alpha} (z^h K_h + z^l K_l), \]

where \( K_h = K_0 \) and \( K_l = \sum_{i=1}^{N+1} K_i \) denote the capital stock under \( z^h \) and \( z^l \) technology respectively. Together with the labor market clearing condition \( \left( \frac{\pi}{\alpha} \right)^{\frac{1}{1-v}} (z^h K_h + z^l K_l) = A l_h \), TFP can be simplified to

\[ TFP = \frac{\frac{\pi}{\alpha} (z^h K_h + z^l K_l)}{(K_h + K_l)^\alpha \left[ \left( \frac{\pi}{\alpha} \right)^{\frac{1}{1-v}} (z^h K_h + z^l K_l) / A + l_e \right]^{1-\alpha}}. \]  

(18)

When \( K_l \to 0 \), all capital is installed under \( z^h \) technology and a measure 0 entrepreneurs run firms, so that \( l_e \to 0 \) and the TFP reaches the upper bound \( z^h = (z^h)^\alpha \). When \( K_l > 0 \), aggregate TFP from (18) is

\[ TFP = \frac{\frac{\pi}{\alpha} (z^h K_h / K_l + z^l)}{(K_h / K_l + 1)^\alpha \left[ \left( \frac{\pi}{\alpha} \right)^{\frac{1}{1-v}} (z^h K_h / K_l + z^l) / (K_h / K_l + 1) + l_e / K_l \right]^{1-\alpha}} < \left( \frac{z^h K_h}{K_l} + z^l \right)^\alpha. \]

Therefore, we know that the relative capital stock ratio \( \frac{K_h}{K_l} \) determines the economy efficiency. The smaller is \( \frac{K_h}{K_l} \) ratio, the lower is the upper bound for TFP since \( z^h > z^l \). Intuitively, the longer the waiting period, the more capital is held by \( z^l \) firms which implies the smaller \( \frac{K_h}{K_l} \) ratio and thus a lower aggregate TFP. The quantitative effects of delayed reallocation and aggregate TFP losses are the main targets in the next section.

## 4 Numerical Examples

I calibrate the parameters to match the steady state result to several U.S. long-run economy characteristics in quarterly frequencies (Table 1). Following Veracierto (2002), the capital abstracts from components such as land, residential structure, and consumer durables. Thus, the capital corresponds to non-residential structures, plant, and equipment while the investment corresponds to the non-residential investment in the National Income and Product Accounts (NIPA). Meanwhile, the empirical counterpart for consumption should be non-durable goods and services consumption. Output is then defined as the sum of the consumption and the investment. The investment/output ratio is found to be 0.16 and the capital to output ratio is 6.0 which set targets for \( \alpha \) and \( \delta \). \( \beta_h \) targets the interest rate from households’ investment in financial assets. The risk-free interest rate is low but equity return is high (e.g. Mehra and Prescott (1985)). Thus \( R_t \) is commonly chosen to be 4% annually.
as a balance. Entrepreneurs’ discount factor is set close to but smaller than households discount factor such that they are willing to accept 0.5% higher interest rate if they borrow. I set households’ risk-aversion $\gamma = 2$ and $\nu = 0.33$ common in macro literature. Finally, $l_h$ is set to 0.33 of total hours which calibrates $\kappa$.

**Table 1: Baseline calibration**

<table>
<thead>
<tr>
<th>Preferences and Production Technology</th>
<th>Parameter</th>
<th>Value</th>
<th>Target/Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household discount factor</td>
<td>$\beta_h$</td>
<td>0.9900</td>
<td>annual interest rate 4%</td>
</tr>
<tr>
<td>Relative risk aversion</td>
<td>$\gamma$</td>
<td>2</td>
<td>exogenous</td>
</tr>
<tr>
<td>Inverse Frisch elasticity of labor supply</td>
<td>$\nu$</td>
<td>0.3300</td>
<td>exogenous</td>
</tr>
<tr>
<td>Utility weight on leisure</td>
<td>$\kappa$</td>
<td>8.9682</td>
<td>working time: 33%</td>
</tr>
<tr>
<td>Production Technology</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation rate of capital</td>
<td>$\delta$</td>
<td>0.0252</td>
<td>capital-to-GDP ratio: 6.0</td>
</tr>
<tr>
<td>Capital share of output</td>
<td>$\alpha$</td>
<td>0.2471</td>
<td>investment-to-GDP ratio: 16.0%</td>
</tr>
<tr>
<td>Entrepreneurs discount factor</td>
<td>$\beta$</td>
<td>0.9890</td>
<td>exogenous</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>$\eta$</td>
<td>1.0590</td>
<td>waiting periods: 12.0</td>
</tr>
<tr>
<td>Transition probability 1</td>
<td>$p^{hh}$</td>
<td>0.9375</td>
<td>expected 4 year turn-over</td>
</tr>
<tr>
<td>Transition probability 2</td>
<td>$p^{ll}$</td>
<td>0.9375</td>
<td>expected 4 year turn-over</td>
</tr>
<tr>
<td>Idiosyncratic high productivity</td>
<td>$\Delta$</td>
<td>0.0570</td>
<td>cross-sectional std 5.70%</td>
</tr>
<tr>
<td>Financial and Resale Frictions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financing Constraint</td>
<td>$\theta$</td>
<td>0.4135</td>
<td>average debt/asset = 0.325</td>
</tr>
<tr>
<td>Resale Discount</td>
<td>$d$</td>
<td>0.0971</td>
<td>reallocation/capital expenditure = 0.35</td>
</tr>
</tbody>
</table>

Notes: The model is calibrated to quarterly frequency.

For the productivity transition matrix, one only needs $p^{hl}$ and $p^{lh}$. I set them equal and to match 4 year (8 quarters) turn-over rate i.e., half of average 8 year business cycle similar to Eisfeldt and Rampini (2006). For the idiosyncratic productivity, I specify

$$\log(\tilde{z}_h) = \Delta, \quad \log(\tilde{z}_l) = -\Delta$$

such that the standard deviation of idiosyncratic productivity is $\Delta$ in annual frequency.\(^{23}\) I follow the cross-sectional standard deviation of productivity (5.7%) in Basu, Fernald, and Kimball (2006) and set $\Delta = 0.057$.

The parameters left are $\eta$, $\theta$, and $d$. These three affect leverage, investment, and liquidation. The haircut $\theta$ targets leverage where empirically, the debt-to-asset ratio is averaged to be 0.325 from flow of funds data. The degree of asset irreversibility $d$ targets reallocation, where fraction of capital reallocation over total capital purchase is roughly 35%. Finally, the leisure utility $\eta$ measures “fixed costs” and controls how long a persistently unproductive firm will hold the assets and deleveraging. I chose $\eta$ such that there will be about 3 years (12 quarters) of waiting periods.

\(^{23}\)The standard deviation is $2\Delta \sqrt{1 - (p^{hl})^4}$. 

23
**Figure 4: Capital, bond and leverage dynamics of a firm**

The firm’s physical capital is normalized to be 1 at the end of period 1. Solid line: productivity draws normalizing the low productivity to be 1. Dash line: physical capital. Dash dotted line: bond. Dotted line: leverage ratio \( k/(k+b) \).

### 4.1 A Sample Path of Firm Dynamics

Under the calibrated parameters, there are 11 to 12 inactive quarters in the steady state. That is, entrepreneurs who turn from \( z^h \) to \( z^l \) and draw \( z^l \) for 11 quarters in a row neither buy nor sell capital during those 11 quarters. When they unfortunately draws the 12th \( z^l \), one fraction of them sells the firm and saves in bonds while the other fraction decides to be inactive for another quarter. For those who still run firms but draw a 13th \( z^l \), they liquidate the entire firm and save the revenue in bonds until they become productive again.

Consider a specific sample path of a firm. Suppose entrepreneur \( j \) has one unit of capital and was investing and borrowing before. Her bond position is \( -\theta(1-\delta)(1-d)/R \). Then, \( j \) draws 12 quarters of \( z^l \) in a row from time \( t = 2 \) on. In the 13th quarter, \( j \) draws \( z^l \) again and decides to liquidate the entire firm. After that, \( j \) keeps drawing two \( z^l \) for quarter 14 but draws \( z^h \) afterwards.

\( j \) lets the capital depreciate in the first 12 quarters and liquidates it in the 13th quarter.
(firm dynamics in Figure 4) i.e., capital at the end of the 13th quarter is 0. During the inactive investment process, debt is being paid and leverage decreases. After liquidation, \( j \) saves only in bonds and consume \((1 - \beta)\) of the bond value.

\( j \) continues to hold bonds until drawing \( z^h \) again in the 15th quarter. Then, she uses her net worth as a down payment to borrow and invest. Though she borrows to the limit, capital stock after investing is less than one, the amount \( j \) started with. The firm size is not as large as before because \( j \) does not have enough resources to expand. Her business was not profitable under \( z^l \) technology and capital was sold at a discount in quarter 13. If \( j \) keeps drawing \( z^h \), she can continue investing and capital stock can gradually go back to one.

### 4.2 Comparative Statics

To examine the interactions of financial friction and capital partially irreversibility, I vary \( \theta \) to see the changes of aggregate total factor productivity (TFP) and the fraction of entrepreneurs who liquidate their firms. Let \( \theta \) decrease from \(+\infty\) to 0. The economy features no borrowing constraint when \( \theta > \theta^d_1 = 0.6540 \). \( z^h \) firms have enough credit to reallocate all available capital from \( z^l \) firms. For the calibrated \( d = 0.1 \), which is not too large compared to some empirical evidence, every \( z^l \) owners liquidate their firms when \( \theta \) is above \( \theta^d_1 \). Capital stock is fully under \( z^h \) technology and thus aggregate TFP equals \( \tilde{z}^h \). Notice that if \( d \) is large enough, \( z^l \) owners may not sell their capital regardless of the level of \( \theta \).

When \( \theta \) reaches \( \theta^d_2 = 0.6214 \), some previous \( z^h \) entrepreneurs who just drew \( z^l \) start to hold capital for one period (Figure 5). \( z^h \) owners invest and borrow to the limit. As \( \theta \) becomes even smaller, the inaction region starts to expand and waiting periods increase i.e., persistently unlucky \( z^l \) owners wait longer and longer before selling capital. Capital reallocation is less which reduces aggregate TFP.

When \( \theta = \theta^d_3 = 0.3689 \), the secondary market shuts down so that no single \( z^l \) owner sells capital (Figure 6). All entrepreneurs effectively save only through running firms. The reason is that a larger degree of financial frictions further limit borrowing and reallocation and wage rate drop further lower. Then, \( \pi \) will tend to be very large while \( R = \beta_h - 1 \) is still fixed in steady state. When \( \theta < \theta^d_3 \), the condition \( R' \geq z^l \pi' + (1 - \delta) \) under which \( z^l \) owners do not invest is no longer satisfied. Therefore, \( z^l \) owners always find investing in capital stock better than saving in bonds. The economy is thus characterized by no productivity risk-sharing, in contrast to some degree of risk-sharing through financial market. As a comparison, I plot the simple economy with \( d = 0 \).

The important message is that both markets can shut down together if the two frictions interact. \( \theta \in [0, \theta^d_3] \) is an extreme interaction between asset irreversibility and financial constraints. Asset illiquidity delays liquidation and tighter borrowing constraints prolong
Figure 5: **Aggregate TFP Losses and Waiting Periods**

Steady state TFP and waiting periods as a function of $\theta$ (when the steady state has capital reallocation). The red solid line denotes the waiting periods $N$. The blue dashed line denotes aggregate TFP as percentage of $\tilde{z}^h$.

![Figure 5: Aggregate TFP Losses and Waiting Periods](image)

Figure 6: **Aggregate TFP Losses in $d > 0$ and $d = 0$ economy**

Aggregate TFP as percentage of $\tilde{z}^h$ in the steady state, when only $\theta$ changes. The red solid line: $d > 0$ economy. The blue dashed line: $d = 0$ economy.

![Figure 6: Aggregate TFP Losses in $d > 0$ and $d = 0$ economy](image)
the delay. Once the profit rate is high enough and the interest rate is low enough due to large financial frictions, no liquidation takes place and the credit market effectively shuts down. Then, the economy is as if in the $d = 0$ economy with $\theta = 0$, even though $\theta^d$ is still far from zero (which exemplifies the interaction).

Finally, notice that such TFP losses are large and significant compared to the literature on financial frictions’ impact on capital misallocation.\footnote{For example, Midrigan and Xu (2012) found that misallocation results in TFP losses of only about 0.3% in the benchmark calibrated economy and at most 5% when the credit market completely shuts down. In Moll (2010) the magnitude of TFP losses depends on the persistence of idiosyncratic productivity shocks.} Given a degree of financial frictions, capital partially irreversibility can add losses about 0.5% to 1.5% of the efficient economy aggregate TFP ($\tilde{z}^h$). In the extreme case, there is about 2.5% more losses when borrowing is still allowed but both credit market and secondary market are effectively shut down. The studies in the literature are thus sensitive to the introduction of capital irreversibility, a common phenomenon in the secondary market.

### 4.3 Equilibrium Response to Shocks

For estimating the shocks and their persistence, I use output and capital reallocation (both after HP-filtered) as the observations. The unobservable shocks are financial shocks and aggregate productivity shocks. I use maximum likelihood methods to back out the information of the shocks, conditional on the observations. Specifically, I assume:

$$
\log \theta_t = (1 - \rho_\theta) \log \theta + \rho_\theta \log \theta_{t-1} + \epsilon^\theta_t,
$$

$$
\log A_t = \rho_A \log A_{t-1} + \epsilon^A_t.
$$

Innovation process $\epsilon_t = [\epsilon^\theta_t, \epsilon^A_t]^T$ is Gaussian with $E[\epsilon_t] = 0$, $E[\epsilon_t \epsilon'_s] = 0$, $E[\epsilon_t \epsilon'_s] = \Sigma$ and

$$
\Sigma_{\epsilon} = \begin{bmatrix}
\sigma^2_{\epsilon_{\theta}} & \sigma_{\theta A} \\
\sigma_{A \theta} & \sigma^2_{A}
\end{bmatrix}.
$$

I use the HP-filtered cyclical components of real reallocation and real GDP data from 1984Q1 to 2011Q4 to estimate the standard deviation and the persistence parameters. The correlation in the variance-covariance matrix represents channels that are not modeled. For example, one rationale could be that adverse aggregate TFP shocks are from less capital utilization resulting from less funding resources (so that $\sigma_{\theta A} > 0$).

I experiment with standard aggregate TFP shocks and financial shocks. With large aggregate shocks, the model becomes intractable because the number of vintages changes after large shocks, leaving complex dynamics to solve. Instead, I focus on small aggregate
shocks such that the equilibrium vintages do not change. I solve the dynamics around the steady state using first-order perturbation methods. Then I verify that the shocks are small enough through the response of the fraction \( f_t \) of entrepreneurs that stay in vintage \( N = 12 \). If \( f_t \) is still less than 1, the vintages do not change.

The standard deviation of aggregate TFP shocks (shocks to \( A \) ) is 0.45%, which is close to other estimation results found in the literature such as in Thomas (2002) (with 0.53%). Second, the size of the credit shocks (about 1.15%) is larger than aggregate TFP shocks (0.45%). Finally, credit shocks (\( \rho_\theta = 0.9701 \)) are more persistent than TFP shocks (\( \rho_A = 0.8721 \)). The correlation between financial shocks and aggregate TFP shocks is 0.27. Even though I only use the two observed series (output and reallocation) for estimation (to avoid stochastic singularity issues because I focus on two shocks), the estimated aggregate TFP shocks and financing shocks generate key business cycle statistics that are close to the data (Table 5 in the Appendix). Figure 7 show the impulses to a one standard deviation (1.15%) credit shocks and a one standard deviation (0.45%) aggregate productivity shocks, by neglecting the correlation of the two shocks.

In response to credit shocks, tightened financing constraints largely reduce the investment from \( z^h \) firms. Because high productive firms are constrained, aggregate TFP drops which reduces real interest rate for saving i.e., the benefits after liquidation are smaller. In addition, demand for labor shrinks and real wage rate declines in equilibrium. Running firms now has lower labor input costs (i.e., \( \pi \) increases). Therefore, since both the benefits after liquidation and the costs of keeping running business are smaller, more \( z^l \) firms delay selling assets. These selling delays lead to less reallocation and thus a larger further drop of aggregate TFP and output.

Notice that investment drops because productive firms are more constrained. Purchase of used assets will drop at the same time. But the selling margin intensifies the drop of used assets. Reallocation thus appears to be more volatile than new investment.

Shocks to aggregate productivity, however, generate completely different dynamics. First, capital reallocation is more initially and the turn-over of capital will be high for about 3 years. Since aggregate productivity drops, the profit rate of investing in capital declines (see \( \pi_t \) responses). The \( z^l \) owners thus have less incentive to hold capital, and more capital is liquidated. Second, compared to the economy before the shocks, fewer \( z^l \) owners stay to operate firms such that the measured TFP dispersion will be smaller. In fact, aggregate TFP (correcting the drop of \( A_t \)) increases slightly after the shocks.

To better illustrate, when productivity \( A_t \) is lower, the first order effect is that profit rate
Figure 7: Experiment: Responses to two types of shocks
Responses to one standard deviation of negative financial shocks (shocks to \( \theta \)) and negative aggregate productivity shocks (shocks to \( A \)). Reallocation: capital reallocation. Turn-over: capital reallocation as percentage of total assets. Aggregate TFP: the Solow residuals after adjusted by \( A \) changes. The solid line denotes the response to financial shocks while the dashed line denotes the response to aggregate productivity shocks.

is instantaneously lower since

\[
\pi_t = \alpha \left[ \frac{(1 - \alpha) A_t}{w_t} \right]^{\frac{1-\alpha}{\alpha}}. \tag{19}
\]

Though wage rate \( w_t \) will also drop, it will decrease less than \( A_t \) because demand for labor will not drop equally with \( A_t \). In addition, (saving) interest rate \( R_t \) will change slightly because households’ savings make it stable. In steady state, \( R_t \) is \( \beta^{-1} \) regardless of aggregate productivity. Then, \( z^l \) firms find keeping assets very unattractive as the return generated from business is low. Reallocation from \( z^l \) firms thus increase after negative \( A_t \) shocks, similar to “creative destruction” conventional wisdom.
4.4 Full Simulation

Whether aggregate shocks can generate less reallocation in recessions depends on whether shocks can delay \( z^l \) firms in selling assets. To examine more thoroughly the reallocation-output co-movement, I simulate the model (i.e., when financial shocks or aggregate productivity shocks repeatedly hit the economy), using parameters from the estimation. Table 2 shows the result, using one type of shocks each time.

<table>
<thead>
<tr>
<th>Volatility</th>
<th>Co-movement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard deviation to that of output</td>
<td>Correlation with output</td>
</tr>
<tr>
<td>Output Reallocation Reallocation Turn-over</td>
<td></td>
</tr>
<tr>
<td>Data:</td>
<td>1.42% 10.91 0.85 0.79</td>
</tr>
<tr>
<td>Model:</td>
<td></td>
</tr>
<tr>
<td>Only financial shocks</td>
<td>1.38% 11.03 0.83 0.71</td>
</tr>
<tr>
<td>Only aggregate TFP shocks</td>
<td>1.31% 1.77 0.18 -0.33</td>
</tr>
</tbody>
</table>

First, reallocation is more volatile in the economy with only financial shocks. From the impulse responses, aggregate TFP shocks have the opposite effects on reallocation. That is why we should observe a more volatile reallocation in responses to only financial shocks.

Second, aggregate TFP shocks still generate a slightly positive correlation between reallocation and output. This fact is because after one-time aggregate TFP shock, eventually capital available for reallocation will be less, as in the impulse responses in Figure 7. To clearly see the delay of capital reallocation, the reallocation turnover is negatively correlated with output if aggregate productivity shocks are the only driving force.

In summary, one needs both aggregate TFP shocks and credit shocks to generate consumption, investment, and output dynamics as in Table 5; however, to capture both procyclical reallocation, financial shocks are necessary. The dynamics of capital reallocation thus provide some useful information of the source(s) of business cycles.

5 Discussion

Without irreversibility, there is no inactive investment decisions such that there is no waiting periods. Without borrowing constraints, \( z^h \) firms can borrow as much as possible to reallocate assets. The number of waiting periods is small and in fact is zero in our calibrated
economy. In order to generate prolonged capital reallocation delay during recessions, the interactions between the two frictions are the key ingredients.

What about shocks to the cross-sectional dispersion of idiosyncratic productivities, such as in Bloom (2009)? Uncertainty shocks increase the real option value of holding assets. However, there is no definite answer in this paper. For example, when the gap of $z^h$ and $z^l$ increases while the unconditional mean are kept the same, it is ambiguous whether the right-hand side of (17) is larger or smaller, keeping everything else equal. Such “uncertainty shock” might not lead to the decrease of $\lambda$ i.e., the inaction region might not expand. Intuitively, when $z^l$ becomes smaller, the scenario of drawing $z^l$ again tomorrow could be very unattractive given the interest rate and the fixed costs. At the same time, the dynamics of profit rate $\pi$ and interest rate $R'$ are ambiguous, which further adds to the “uncertain” response after uncertainty shocks. Note that the key reason for this ambiguous result is that the benefits after liquidation is not trivially determined, once we introduce credit markets.

Importantly, the illustration does not suggest that aggregate productivity shocks or uncertainty shocks are not important. Instead, it shows that aggregate productivity shocks alone have difficulties in explaining the selling margin, while uncertainty shocks alone may give ambiguous direction of capital reallocation. The key message is that a tougher outside financing condition seem to be necessary, even if aggregate productivity or uncertainty shocks are the driving force. While I consider the reallocation margin, Gilchrist, Sim, and Zakrajsek (2010) and Christiano, Motto, and Rostagno (2014) illustrate the similar issues with the consideration of default over business cycles.

Finally, this paper does not model changes of illiquidity. The first reason is that if illiquidity comes from asymmetric information, good quality assets might be forced to be liquidated in recessions and mitigate the information problem as in Eisfeldt (2004). Second, if the increases of illiquidity are all because of fire-sale of real assets as in Shleifer and Vishny (1992), the larger TFP dispersion during recessions is hard to be justified. Fire-sale theories suggest the most efficient firms of using the assets are also in financial troubles, which should lead to a smaller TFP dispersion. The last and probably the most important one is that if the illiquidity can be amplified, then this paper proposes one cause for the initial drop of asset liquidity: a credit crunch can reduce the number of buyers and sellers simultaneously and lead to endogenous change of capital irreversibility, as shown in Lanteri (2014).

6 Final Remark

This paper shows that why inefficient firms might want to hold onto capital stock in recessions and delay the reallocation process, in contrast to the “creative destruction” conventional
wisdom. The reason is that lower saving interest rate and wage rate in recessions will make keeping assets more attractive to unproductive firms. Therefore, lowering interest rate as a policy response in recessions might delay capital reallocation further, though it can help productive firms to expand. The trade-offs are thus worthy of careful consideration.

The challenge to link individual firm’s asset liquidation and aggregate capital reallocation is the complex distribution of firms. I model the selling decision as a stopping-time problem that turns out to simplify the aggregate distribution dramatically. Meanwhile, the real option value of capital stock before liquidation shed some light on how firms price their assets internally.

One future prospect is how the resale costs endogenously interact with the depth of asset markets. The reallocation costs, in that case, come from matching between buyers and sellers. Sellers may find it costly to search potential buyers, especially during downturns. In contrast, asset markets are generally deeper in economic booms. The resale discounts are smaller in boom times and delayed selling by inefficient firms is shortened. A better allocation of assets will deepen asset markets further, and labor market conditions will improve too. Therefore, policy targeted the resale market depth may have a large effect by improving the efficiency of asset allocation. This channel may also shed light on unemployment issues.

References


Appendices

A Data Description

For capital reallocation, the quarterly COMPUSTAT contains useful information for ownership changes of productive assets from 1984Q1. Following Eisfeldt and Rampini (2006), who use annual COMPUSTAT data from 1971, I measure capital reallocation by sales of property, plant and equipment (SPPE, data item 107 with combined data code entries excluded), plus acquisitions (AQC, data item 129 with combined data code entries excluded). The measure captures transactions after which the capital is used by a new firm and new productivity is thus applied. The advantage of using quarterly data compared to annual data is more observations. However, quarterly data is shown in the “cash flow statement” and there is a substantial seasonal pattern. Therefore, I apply seasonal adjustment to the data.

For aggregate consumption, investment, and GDP, I obtain the data from FRED, a macroeconomic dataset managed by Federal Reserve Bank at St. Louis. Note that I exclude residential investment, consumer durables, government expenditure, and net export because the model abstract from these components.

B Extra Tables

Table 3: Summary Statistics for COMPUSTAT Capital Reallocation
Level variables are in millions of 2005 dollars for a given calendar quarter. “PP&E” stands for property, plant and equipment, “CapEx” for capital expenditures, “Reallocation” is the sum of acquisitions plus sales of PP&E, and “Investment” is defined as the capital expenditure plus acquisition. Total Reallocation/Total Previous PP&E ratio is computed as the sample mean of the numerator over the sample mean of the denominator to avoid the problem of firms with extremely large assets.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>2435.11</td>
<td>129.94</td>
<td>15712.73</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>602.24</td>
<td>17.16</td>
<td>3851.315</td>
</tr>
<tr>
<td>CapEx</td>
<td>20.12</td>
<td>1.23</td>
<td>101.23</td>
</tr>
<tr>
<td>Acquisitions</td>
<td>6.12</td>
<td>0.00</td>
<td>45.67</td>
</tr>
<tr>
<td>Sales of PP&amp;E</td>
<td>3.51</td>
<td>0.00</td>
<td>18.50</td>
</tr>
<tr>
<td>Total Sales of PP&amp;E/Total Reallocation</td>
<td>30.71%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Reallocation/Total Investment</td>
<td>32.1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Reallocation/Total Previous PP&amp;E</td>
<td>1.44%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Table 4: Capital reallocation
Correlation of real GDP and the various definitions of capital reallocation, after taking natural log and then HP filtered. Numbers in the bracket are the standard deviation after correcting heteroscedasticity and autocorrelation. Acquisition: COMPUSTAT data items 129. SPPE: sales of property, plant and equipment, COMPUSTAT data item 107. AQC turnover: acquisition divided by total asset (item 6) last period. SPPE turnover: SPPE divided by total property, plant and equipment (item 8) last period. Total Reallocation is the sum of acquisition and SPPE. GDP is real GDP in 2005 dollars. All series are seasonal adjusted and “***” denotes 1% significance level.

<table>
<thead>
<tr>
<th>Corr with GDP</th>
<th>Acquisition</th>
<th>SPPE</th>
<th>Reallocation</th>
<th>SPPE turnover</th>
<th>AQC turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>Correlation</td>
<td>0.840***</td>
<td>0.430***</td>
<td>0.854***</td>
<td>0.411***</td>
<td>0.786***</td>
</tr>
<tr>
<td></td>
<td>(0.064)</td>
<td>(0.148)</td>
<td>(0.057)</td>
<td>(0.128)</td>
<td>(0.071)</td>
</tr>
</tbody>
</table>

Table 5: Key statistics in the data and in the model
Data are cyclical components of HP filtered series from 1984Q1 to 2011Q4. Standard deviations denote the standard deviations of percentage deviations from trends.

<table>
<thead>
<tr>
<th>Volatility</th>
<th>Co-movement</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard deviation</td>
<td>Standard deviation to that of output</td>
<td>Correlation with Output</td>
</tr>
<tr>
<td>Output</td>
<td>Consumption</td>
<td>Investment</td>
</tr>
<tr>
<td>Data: 1.42%</td>
<td>0.55</td>
<td>3.86</td>
</tr>
<tr>
<td>Model: 1.35%</td>
<td>0.61</td>
<td>4.01</td>
</tr>
</tbody>
</table>

C Proofs

C.1 Lemma 1 and Differentiability
First, I prove (i) and (ii) of Lemma 1. Define the Bellman operator $T$ as

$$TV(k, b, z; X) = \max \{ W^1(k, b, z; X), W^0(k, b, z; X) \}$$

$$W^1(k, b, z; X) = \max_{k' > 0, Rb' \geq \theta(1-d)(1-\delta)k'} u(z\pi k + Rb - \psi(k', k) - b') - \eta + \beta \mathbb{E}_{z,x}[V(k', b', z'; X')]$$

$$W^0(k, b, z; X) = \max_{b'} \{ u(z\pi' k + Rb + (1-\delta)(1-d)k - b') + \beta \mathbb{E}_{z,x}[V(0, b', a'; X')] \}$$

The value function is the fixed point of the contraction mapping in some closed space $\mathcal{V}_1$ of functions (see Stokey, Lucas, and Prescott (1989)). I will show that $\mathcal{V}_1$ includes the properties (1) and (2) in the Lemma. To simplify notation, let

$$w^1(k, b, k', b', z; X) = u(k, b, k', b', z; X) - \eta + \beta \mathbb{E}_{z,x}[V(k', b', z'; X')]$$

$$w^0(k, b, k', b', z; X) = u(k, b, 0, b', z; X) + \beta \mathbb{E}_{z,x}[V(0, b', a'; X')]$$
with slight abuse of notation of utility function $u(\cdot)$.

1. Increasing in $z$, $k$ and $b$, and concavity

2. $V$ satisfies the following property

$$V(\gamma k, \gamma b, z; X) = V(k, b, z; X) + \frac{\log \gamma}{1 - \beta}$$

I will prove the contraction mapping $TV$ satisfies the same property (2) if $V$ satisfies (2). Then, the unique fixed point $V$ satisfies (2).

Consider an agent with state $(k, b, a)$ with $(k', b')$ as the optimal policy. Now, consider another agent with $(\gamma k, \gamma b, a)$, where $\gamma > 0$. First notice that the policy $(\gamma k', \gamma b')$ is feasible, i.e., it satisfies budget and borrowing constraints. Second, given a consistent choice $h \in \{0, 1\}$,

$$TV(\gamma k, \gamma b, z; X) \geq w^h(\gamma k, \gamma b, \gamma k', \gamma b', z; X)$$

$$= \log \gamma(z \pi k + Rb - \psi(k', k) - b') - \eta h + \beta \mathbb{E}_z, X[V(k', b', z'; X')] + \frac{\beta \log \gamma}{1 - \beta}$$

or

$$TV(\gamma k, \gamma b, z; X) \geq TV(k, b, z; X) + \frac{\log \gamma}{1 - \beta}.$$  

Conversely, starting at $(\gamma k, \gamma b, z)$, scaling by $1/\gamma$, and following similar procedure above, one has

$$TV(k, b, z; X) \geq TV(\gamma k, \gamma b, z; X) - \frac{\log \gamma}{1 - \beta}.$$

Combining the two gives

$$TV(\gamma k, \gamma b, z; X) = TV(k, b, z; X) + \frac{\log \gamma}{1 - \beta}.$$  

Therefore, the mapping $TV$ has the same property. Because $V$ is the unique fixed point, $V(\gamma k, \gamma b, z; X) = V(k, b, z; X) + \frac{\log \gamma}{1 - \beta}$.

(iii) Differentiability

The differentiability of $V(k, b, \eta, a; X)$ when $k' \geq (1 - \delta)k$ is standard, which relies on the differentiability of standard dynamic programming problem as proved by Benveniste and Scheinkman (1979) (or see Stokey, Lucas, and Prescott (1989)). When $k' = (1 - \delta)k$, I follow methods from Clausen and Strub (2012) in Banach space (the space of $k$ and $b$) and adjust to the dynamic programming problem of my model. The general idea is that the value function is the upper envelop of value function of buying, inactive and selling. It is therefore super-differentiable. At the same time, it has potential downward kink (sub-differentiable) because of $\psi(k', k)$ function. Therefore, the value function will be both super-differentiable and sub-differentiable, and therefore differentiable. The detail derivation is long and tedious but available upon request.

C.2 Lemma 2

I will use the results in the previous Lemma.
(i) To save notation, I abstract from aggregate state variable $X$. From Lemma 1, 

$$V(\gamma(k + e), \gamma b, z) = V(k + e, b, z) + \frac{\log \gamma}{1 - \beta}$$

Take a derivative with respect to $e$ and evaluate it at $e = 0$; one has $\gamma V_k(\gamma k, \gamma b, z) = V_k(k, b, z)$. Divide $\gamma$ on both sides and one can prove that $V_k$ is homogeneous with degree $-1$.

(ii) Consider two entrepreneurs with $(k_0, b_0, z)$ and $(\gamma k_0, \gamma b_0, z)$. Using equation (6) of Lemma 1, the targeted capital stock and bonds are scaled up by $\gamma$ and thus the optimal consumption choices are $c_0$ and $\gamma c_0$ from the budget constraints. Therefore, using property (i) of this Lemma, $
 V_k$ is homogeneous with degree $-1$.

(iii) By definition, $q(k, b, z) = (V_k(u'(c) - z\pi)(1 - \delta)^{-1}$. Using (ii), we know that $q(k, b, z)$ can be written as $q(\lambda, z)$ where $
 \lambda = k/(k+b)$.

C.3 Proposition 1 Investment and Disinvestment

C.3.1 When $k = 0$

Notice that

$$V(0, b, z; X) = \max\{W^1(0, b, z; X), W^0(0, b, z; X)\}$$

$$W^1(0, b, z; X) = \max_{k', b'}\{\log(Rb - k' - b') - \eta + \beta\mathbb{E}_{z,X} [V(k', b', z'; X')]\}$$

$$W^0(0, b, z; X) = \max_{b'}\{\log(Rb - b') + \beta\log b' + \beta\mathbb{E}_{z,X} [V(0, 1, z'; X)]\}$$

For $W^1$, one can maximize out $k' + b'$ with optimal solution $k' + b' = \beta R$ and

$$W^1(0, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log Rb}{1 - \beta} - \eta + \max_{\lambda'} \left\{ \frac{\beta \log \lambda'}{1 - \beta} + \beta\mathbb{E}_{z,X} [V(1, \frac{1 - \lambda'}{\lambda'}, z'; X')] \right\}$$

which means that investing entrepreneur will pick a common target leverage $\lambda' = \lambda$ to maximize the expressions in the bracket. Also, the consumption is

$$c = (1 - \beta)Rb$$

For $W^0$, the optimal solution is $b' = \beta R$ and therefore one has

$$W^0(0, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log Rb}{1 - \beta} + \beta\mathbb{E}_{z,X} [V(0, 1, z'; X)]$$

The consumption is again

$$c = (1 - \beta)Rb$$

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C.3.2 When $k > 0$.

(1) If the entrepreneur decides to invest, $W^1(k, b, z; X)$ can be rewritten as

$$W^1(k, b, z; X) = \max_{k', b'} \{ \log(z \pi k + Rb - \psi(k', 1) - b') - \eta + \beta \mathbb{E}_{z, X}[V(k', b', z'; X')] \}$$

$$= \max_{k', b'} \left\{ \log(z \pi k + (1 - \delta)k + Rb - k' - b') - \eta + \frac{\beta \log(k' + b')}{1 - \beta} + \beta \mathbb{E}_{z, X}[V(\lambda', 1 - \lambda', z'; X')] \right\}$$

One can maximize out $k' + b'$ with optimal solution $k' + b' = \beta [z \pi k + (1 - \delta)k + Rb]$ and

$$W^1(k, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log(z \pi k + (1 - \delta)k + Rb)}{1 - \beta} - \eta + \max_{\lambda'} \left\{ \frac{\beta \log \lambda'}{1 - \beta} + \beta \mathbb{E}_{z, X} \left[ V\left(1 - \frac{\lambda'}{\lambda''}, z'; X'\right) \right] \right\}$$

which means again that investing entrepreneur will pick a common target leverage $\lambda' = \bar{\lambda}$ and is the same as those investing entrepreneurs without firms. The consumption function is

$$c = (1 - \beta)(z \pi k + (1 - \delta)k + Rb)$$

(2) If the entrepreneur decides to sell.

$$W^0(k, b, a; X) = \max_{b'} \{ \log(z \pi k + (1 - \delta)(1 - d)k + Rb - b') + \beta \mathbb{E}_{z, X}[V(0, b', z'; X')] \}$$

$$= \max_{b'} \left\{ \log(z \pi k + (1 - \delta)(1 - d)k + Rb - b') + \beta \mathbb{E}_{z, X}[V(0, 1, z'; X')] + \frac{\beta \log(b')}{1 - \beta} \right\} .$$

Notice that $\mathbb{E}_{z, X}[V(0, 1, z; X)]$ does not depend on the choice of $b'$. Therefore, given $b$ and $k$ the optimal solution $b'$ is $b' = \beta [z \pi k + (1 - \delta)(1 - d)k + Rb]$ and we have

$$W^0(k, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log(z \pi k + (1 - \delta)(1 - d)k + Rb)}{1 - \beta} + \beta \mathbb{E}_{z, X} \left[ V(0, 1, z'; X') \right] .$$

The consumption function is thus

$$c = (1 - \beta)(z \pi k + (1 - \delta)(1 - d)k + Rb)$$

(3) If the entrepreneur decides to be inactive, $W^1(k, b, z; X)$ can be rewritten as

$$W^1(k, b, z; X) = \max_{k', b'} \{ \log(z \pi k + Rb - \psi(k', 1) - b') - \eta + \beta \mathbb{E}_{z, X}[V(k', b', z'; X')] \}$$

$$= \max_{k', b'} \left\{ \log(z \pi k + q(1 - \delta)k + Rb - qk' - b') - \eta + \frac{\beta \log(qk' + b')}{1 - \beta} + \beta \mathbb{E}_{z, X} \left[ V\left(\frac{1}{q + \frac{1 - \lambda'}{\lambda'}, \frac{1}{q + \frac{\lambda'}{\lambda'}, z'; X'}\right) \right] \right\} .$$
One can maximize out \( qk' + b' \) with optimal solution and \( k' + b' = \beta [z\pi k + (1 - \delta)qk + Rb] \)

\[
W^1(k, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log(z\pi k + (1 - \delta)qk + Rb)}{1 - \beta} - \eta
\]

\[
+ \max_{\lambda'} \left\{ \frac{\beta \log \left( \frac{\lambda'}{\lambda' + 1 - \lambda'} \right)}{1 - \beta} + \beta \mathbb{E}_{z, X} \left[ V(1, \frac{1 - \lambda'}{\lambda'}, z'; X') \right] \right\}
\]

which means again that investing entrepreneur will pick a common target leverage \( \lambda' = \bar{\lambda}' \) and is the same as those investing entrepreneurs without firms. The consumption function is

\[
c = (1 - \beta) [z\pi k + (1 - \delta)qk + Rb]
\]

Thus far, we know that consumption function has the above algebraic form, regardless of whether the entrepreneur needs to invest, sell or be inactive. One can replace \( q = 1 \) and \( q = 1 - d \) for those who invest and who sell. The remaining question is to solve

\[
\max_{\lambda'} \left\{ \frac{\beta \log \left( \frac{\lambda'}{\lambda' + 1 - \lambda'} \right)}{1 - \beta} + \beta \mathbb{E}_{z, X} \left[ V(1, \frac{1 - \lambda'}{\lambda'}, z'; X') \right] \right\}
\]

where the first-order condition is

\[
\frac{1}{(1 - \beta) \left( q + \frac{1 - \lambda'}{\lambda'} \right)} = \mathbb{E}_{z, X} V_b(1, \frac{1 - \lambda'}{\lambda'})
\]

Using the envelop condition and using \( c = (1 - \beta) [z\pi k + (1 - \delta)qk + Rb] \), one has

\[
\frac{1}{q + \frac{1 - \lambda'}{\lambda'}} = \mathbb{E}_{z, X} \left[ \frac{R'}{z'\pi' + (1 - \delta)q' + R'\frac{1 - \lambda'}{\lambda'}} \right]
\]

For convenience, denote \( \phi \) such that \( qk' = \phi \beta [z\pi k + (1 - \delta)qk + Rb] \) and \( b' = (1 - \phi)\beta [z\pi k + (1 - \delta)qk + Rb] \), then the above equation can be simplified to

\[
\mathbb{E}_{z, X} \left[ \frac{R'}{\phi \frac{z'\pi' + (1 - \delta)q'}{q} + (1 - \phi)R'} \right] = 1
\]

Notice that \( \frac{V_b}{R} = \frac{V_b}{z\pi + (1 - \delta)q} \), one also has

\[
\mathbb{E}_{z, X} \left[ \frac{z'\pi' + (1 - \delta)q'}{\phi \frac{z'\pi' + (1 - \delta)q'}{q} + (1 - \phi)R'} \right] = 1
\]

### C.4 Proposition 2 : Leverage and Deleverage

Consider an entrepreneur with leverage \( \lambda \). Normalize capital stock by \( k = 1 \), the state variable is \((1, \frac{1 - \lambda}{\lambda}, z; X)\). Consumption is can be expressed as \( c = (1 - \beta) [z\pi + (1 - \delta) + R\lambda^{-1}(1 - \lambda)] \). In
addition, from the budget constraint
\[ c = z\pi + R\frac{1 - \lambda}{\lambda'} - (1 - \delta)\frac{1 - \lambda'}{\lambda'} \]
such that
\[ z\pi + R\lambda - (1 - \delta)\frac{1 - \lambda'}{\lambda'} = (1 - \beta) \left[ z\pi + (1 - \delta)q + R\frac{1 - \lambda}{\lambda} \right], \]
where both \( q \) and \( \lambda' \) are functions of \((\lambda, z; X)\). Then,
\[
q(\lambda, z; X) = \beta \left[ z\pi + R\frac{1 - \lambda}{\lambda'} - (1 - \delta)\frac{1 - \lambda'}{\lambda'} \right].
\]

For convenience, let me do change of variable \( \tilde{\lambda} = b/k = (1 - \lambda)/\lambda \). Since \( \tilde{\lambda} \) and \( \lambda \) has one to one mapping, I can express
\[
q\left(\tilde{\lambda}, z; X\right) = \beta \left[ z\pi + R\tilde{\lambda} - (1 - \delta)\tilde{\lambda} \right]/(1 - \beta)(1 - \delta).
\]

The goal is to prove that \( q \) is an increasing function of \( \lambda \) or a decreasing function of \( \tilde{\lambda} \). Take derivative w.r.t. \( \tilde{\lambda} \), one has
\[
\frac{\partial q}{\partial \tilde{\lambda}} = \beta R - (1 - \delta)\frac{\partial \tilde{\lambda}}{\partial \lambda}.
\]

Further, if being inactive in investment \( k' = (1 - \delta) \) and \( \psi(k, 1) = 0 \), the envelop condition gives
\[
V_b(1, \tilde{\lambda}, z; X) = \frac{R}{z\pi + R\tilde{\lambda} - \psi(k', 1) - k'\left(\tilde{\lambda}\right)} = \frac{R}{z\pi + R\tilde{\lambda} - (1 - \delta)\tilde{\lambda}}.
\]

Therefore
\[
\frac{\partial V_b(1, \tilde{\lambda}, z; X)}{\partial \lambda} = -\frac{R \left[ R - (1 - \delta)\frac{\partial \tilde{\lambda}'}{\partial \lambda} \right]}{z\pi + R\tilde{\lambda} - (1 - \delta)\tilde{\lambda}}.
\]

In addition, one can use the expression for consumption such that
\[
V_b(1, \tilde{\lambda}, z; X) = \frac{R}{(1 - \beta) \left[ z\pi + (1 - \delta)q\left(\tilde{\lambda}, z; X\right) + R\tilde{\lambda}\right]}
\]
and therefore
\[
\frac{\partial V_b(1, \tilde{\lambda}, z; X)}{\partial \lambda} = -\frac{R \left[ (1 - \delta)\frac{\partial q}{\partial \lambda} + R \right]}{(1 - \beta) \left[ z\pi + (1 - \delta)q\left(\tilde{\lambda}, a; X\right) + R\tilde{\lambda}\right]} = -\frac{R \left[ \beta R - (1 - \delta)\frac{\partial \tilde{\lambda}'}{\partial \lambda} \right]}{(1 - \beta)(1 - \delta) + R}.
\]

I equate the above two expressions for \( \frac{\partial V_b(1, \tilde{\lambda}, z; X)}{\partial \lambda} \) and obtain
\[
\frac{\partial \tilde{\lambda}'}{\partial \lambda} = \frac{\beta R}{\delta(1 - \delta)}.
\]

Using this result, equation (20) then becomes
\[
\frac{\partial q}{\partial \lambda} = -\frac{\beta R}{\delta^2} < 0.
\]
which proves that \( q \) is a decreasing function of \( \tilde{\lambda} \) and thus an increasing function of \( \lambda \).

Notice that \( \delta \) is close to 0, while \( \beta R \) is close to 1. Then, if keeping drawing \( z' = z' \), then \( \tilde{\lambda}' > \tilde{\lambda} \) because \( \frac{\partial \tilde{\lambda}'}{\partial \lambda} > 1 \). The option value \( q(\tilde{\lambda}', z' ; X') < q(\tilde{\lambda}, z' ; X) \), in the neighbourhood around steady state i.e., when \( X' \) is not very different from \( X \)

C.5 Proposition 3: Liquidation Decisions

Consider an entrepreneur with a firm, according to the previous proof, the three values associated with investing, being inactive, and selling are

\[
W^1(k, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log(z\pi k + (1 - \delta)k + Rb)}{1 - \beta} - \eta
\]

\[
+ \max_{\lambda'} \left\{ \beta \log \frac{1}{1 - \beta} + \beta E_{z,X} \left[ V(1, 1 - \frac{X'}{\lambda'}, z'; X') \right] \right\}
\]

\[
W^1(k, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log(z\pi k + (1 - \delta)(1-d)k + Rb)}{1 - \beta} - \eta
\]

\[
+ \max_{x} \left\{ \beta \log \frac{1}{1 - \beta} + \beta E_{z,X} \left[ V(1, x - 1, z'; X') \right] \right\}
\]

\[
W^0(k, b, z; X) = \log(1 - \beta) + \frac{\beta \log \beta}{1 - \beta} + \frac{\log(z\pi k + (1 - \delta)k + Rb)}{1 - \beta} + \beta E_{z,X} \left[ V(0, 1, z'; X') \right]
\]

The algebraic form of being inactive is the same as investing by replacing \( q = 1 \).

\[
W^1 - W^0 = \log \left( 1 + \frac{(1 - \delta)q(\lambda) - (1 - d)}{z\pi + (1 - \delta)(1 - d) + R\lambda^{-1}(1 - \lambda)} \right) + \max_{x} \left\{ \beta \log \frac{1}{1 - \beta} + \beta E_{z,X} \left[ V(1, x - 1, z'; X') \right] \right\}
\]

The last two components are constant while the first two components are increasing function of \( \lambda \). Therefore, \( W^1 - W^0 \) will be a increasing function of \( \lambda \) and there will be single cross with zero if there is crossing such that there exist a \( \lambda \) below which \( W^0 \) dominate and above which \( W^1 \) dominates. That is, \( \lambda \) is the liquidation threshold.

From the above discussion, one knows that the value function can be written as

\[
V(k, b, z; X) = J_b(X) + \frac{\log(z\pi k + (1 - \delta)k + Rb)}{1 - \beta}
\]

if entrepreneurs decide to invest,

\[
V(k, b, z; X) = J(\lambda, z; X) + \frac{\log(z\pi k + (1 - \delta)qk + Rb)}{1 - \beta}
\]

if entrepreneurs decide to being inactive, and

\[
V(k, b, z; X) = J_s(X) + \frac{\log(z\pi k + (1 - \delta)(1-d)k + Rb)}{1 - \beta}
\]

if entrepreneurs decide to sell existing business or keep out of business. Importantly, \( J_b, \ J, \) and \( J_s \) are independent of \( k \) and \( b \) levels. To compute the leverage with which entrepreneurs liquidate
the firms, I use no one-shot deviation strategy. Consider an entrepreneur who is about to liquidate business and who is with leverage $\lambda$ and net-worth $n = z\pi + (1 - \delta)(1 - d) + R\lambda^{-1}(1 - \lambda)$. Again, I normalize capital stock to be 1. If liquidate, the value of doing so is

$$\log((1 - \beta)n) + \rho^h\mathbb{E}_X \left[ J_b(X') + \frac{\log(R\beta n)}{1 - \beta} \right] + \rho^n\mathbb{E}_X \left[ J_a(X') + \frac{\log(R\beta n)}{1 - \beta} \right]$$

If keeping running for one more period but liquidating next period if still drawing $z'$, the value of doing so is

$$\log((1 - \beta)n) - \eta + \rho^h\mathbb{E}_X \left[ J_b(X') + \frac{\log(z'\pi'(1 - \delta) + (1 - \delta)R'}{1 - \beta} \right]$$

$$+ \rho^n\mathbb{E}_X \left[ J_a(X') + \frac{\log(z'\pi'(1 - \delta) + (1 - \delta)R')}{1 - \beta} \right]$$

where $b' = \beta n - (1 - d)(1 - \delta)$. Then, the leverage cut-off $\lambda$ should make this two expression the same i.e.,

$$\tilde{\eta} = \frac{\beta}{1 - \beta} \rho^h\mathbb{E}_X \left[ \log \left( 1 + (1 - \delta) \frac{z'\pi' + (1 - \delta) - (1 - d)R'}{\beta n R'} \right) \right]$$

$$+ \frac{\beta}{1 - \beta} \rho^n\mathbb{E}_X \left[ \log \left( 1 + (1 - \delta) \frac{z'\pi' + (1 - \delta)(1 - d) - (1 - d)R'}{\beta n R'} \right) \right]$$

C.6 Aggregate TFP

We know that aggregate TFP can be measure by

$$TFP = \frac{\pi(\alpha_K z_h' K_h + z_i' K_i)}{(K_h + K_i)\alpha} \left[ \left( \frac{\pi}{\alpha} \right)^{1 - \alpha} (z_h K_h + z_i K_i)/A + l_e \right]^{1 - \alpha}.$$  

(21)

We know information of all variables except $l_e$. To compute $l_e$, we first compute the measure of entrepreneurs $m_i$ in each vintage $i$. For vintage 0 entrepreneurs, the evolution satisfies

$$m'_0 = \rho^h m_0 + \rho^n \sum_{i=1}^{N+2} m_i$$

For vintage $i = 1, 2, ..., N$ entrepreneurs,

$$m'_i = \rho^{i-1} m_{i-1}$$

For vintage $i = N + 1$,

$$m'_{N+1} = \rho^{N+1} f m_N$$

For vintage $i = N + 2$,

$$m'_{N+2} = \rho^{N+2} (1 - f) m_N + \rho^{(N+2)} m_{N+2}$$

Therefore, if we stack the measure as $m = [m_1, m_2, ..., m_{N+1}, m_{N+2}]^T$, we have

$$m' = P m$$

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where
\[
P = \begin{bmatrix}
p_{hh} & p_{hl} \\
p_{lh} & p_{ll} \\
... & ... \\
p_{lh} & (1-f)p_{ll} \\
p_{lh} & p_{ll} \\
\end{bmatrix}_{(N+2) \times (N+2)}
\]

In steady state, once \( f \) is determined, the right eigenvector (after normalization) of \( P^T \) associated with eigenvalue one is the stationary population of entrepreneurs in each vintage. For a detail description, see Ljungqvist and Sargent (2004). Further, we can use the relationship between \( m' \) and \( m \) to compute \( m' \) and then \( l'_e \)

\[
l'_e = 1 - m_{N+2}
\]