Asset Price Bubbles and the Distribution of Firms[*]

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Abstract

This paper studies the macroeconomic effects of asset bubbles from the perspective of firms. I introduce bubbles into a model with firm heterogeneity and firm entry and exit: in a bubbly equilibrium, the price of a firm contains a fundamental component, which represents the net present value of profits, and a bubble component. I show that bubbles act as subsidies to new firms and have the following implications: i) bubbles lower the average productivity and profitability of new firms; ii) bubbles increase the number of firms, wages, and aggregate output; iii) along transition dynamics, bubbles subsidize new firms rather than incumbents, aggravating misallocation and therefore depressing aggregate productivity. The model can be used to discriminate the alternative explanations of business cycles, like shocks to productivity, and shocks to financial frictions. Firm-level evidence suggests that the Spanish economic expansion before the global financial crisis can be well interpreted as a consequence of a bubble boom, and the recession as an outcome of a bubble crash.

JEL Codes: E32, E44, O40
Keywords: bubbles, subsidy, the distribution of firms, misallocation

1 Introduction

In the past two decades, most developed economies witnessed spectacular oscillations of asset prices. Notably, the asset price booms and busts generally coincided with fluctuations in credit, investment, and output, and they usually prove difficult to be explained by changes of fundamentals.[1] The speculative and procyclical nature of asset prices has renewed the interest in understanding the macroeconomic implications of asset bubbles. Indeed, it has been argued that asset bubbles may have expansionary effects on aggregate economic activity as they can relax financial constraints.[2] However, it remains unclear what implications bubbles may have at the firm-level. This paper is an attempt to fill this gap in the literature.

I develop a model with bubbles, firm heterogeneity, and firm entry and exit. In equilibrium, the price of a firm may contain a bubble component in addition to the fundamental component, i.e. the net present value of profits. I show that bubbles act as subsidies to firm entry because they raise the return on the establishment and investment of new firms. Within this framework, bubbles have the following implications: i) by subsidizing entry, bubbles lower the average productivity and profitability of new firms; ii) at the aggregate-level, the subsidy on firm entry leads to an expansion in the number of firms, wages, and aggregate output, even in the absence of financial frictions; iii) along transition dynamics, since they subsidize new firms but not incumbent firms, bubbles aggravate misallocation and therefore depress aggregate productivity.

These theoretical insights are important for us to differentiate among the various explanations of business cycles. Besides characterizing the effects of bubbles, I use the model to study shocks to productivity and financial intermediation. I find that, at the aggregate-level, the effects of bubbles are analogous to the effects of positive shocks to productivity and financial intermediation, given that these shocks may also boost the number of firms, wages, credit, and aggregate output. Nonetheless, one distinction stands out when we consider the distribution of firms. Expansionary shocks to productivity and financial intermediation increase the average productivity or profitability of new firms, whereas bubbles lower the average productivity and profitability of new firms by subsidizing the entry of the less productive firms.

The model can shed light on the recent Spanish experience. Spanish GDP grew significantly between early 1990s and the Great Recession, and this expansion was accompanied by

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[1]See LeRoy (2004), Shiller (2005, 2014), Fernández-Villaverde and Ohanian (2009) and Fernandez-Villaverde, Garicano, and Santos (2013).

[2]See Asriyan et al. (2016), Farhi and Tirole (2011), Martin and Ventura (2011,2012), and Miao and Wang (2015).

a dramatic boom in asset prices.[3] In principle, the output expansion can be interpreted as an outcome of high productivity and an improvement in financial intermediation. However, using firm-level AMADEUS data for Spain, I find that the new firms entering the market at the peak of the economic expansion were less productive and profitable than the entrants after the outbreak of the financial crisis. It is difficult for fundamental factors such as productivity or financial frictions to reconcile these facts, but they arise naturally as an outcome of bubbles. When an economic expansion is fueled by a bubble, less productive firms find it optimal to enter the market even if the net present value (NPV) of their profits is lower than the entry cost, and the entry of these firms lowers the average productivity and profit of entrants. When a bubble crashes, however, less productive firms no longer find it optimal to enter the market; consequently, the average productivity and profit of new firms increase during the recession.

The model is developed in the spirit of Lucas (1978) and Hopenhayn (1992): firms are heterogeneous in productivity, and the production function exhibits decreasing returns to scale (DRS); incumbents are price takers, and prospective entrants make entry decisions. The novel feature of this model is that the prices of firms contain two components: a fundamental component, which equals the NPV of profits, and a bubble component. Bubbles can subsidize firms along both the extensive and the intensive margins. Along the extensive margin, bubbles subsidize firm entry and increase the number of firms. Because of decreasing returns to scale, the subsidy along the extensive margin leads to an expansion of aggregate output, even in the absence of financial frictions. Along the intensive margin, bubbles subsidize the size of a given firm if the size of the bubble component is increasing in the firm size. The subsidy along the intensive margin encourages entrepreneurs to start their firms with more capital.

To help build intuition, I study stationary equilibria in the absence of aggregate uncertainty. I characterize the existence conditions for bubbly equilibria, in which the aggregate bubble is stable over time, even though the bubble component of an individual firm is always explosive. These stationary equlibria feature a closed-form solution. I perform comparative statics analysis on these equilibria and show that the effects of bubbles are very distinct from those of increasing productivity and alleviating financial frictions. However, interestingly, the effects of bubbles are similar to those of an interest rate reduction. A decrease in interest rates has two effects. Firstly, it lowers the cost of capital. Secondly, it increases discount factor and therefore lowers the break-even profit required to compensate the entry cost. I show that the two subsidy effects of bubbles are respectively analogous to the two effects of a declining interest rate.

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[3]See Fernández-Villaverde and Ohanian (2009) and Fernandez-Villaverde, Garicano, and Santos (2013).

Moreover, I analyze net output in a stationary bubbly equilibrium. Net output is the amount of consumption good produced in every period, which equals the difference between aggregate output and investment. It can be shown that bubbles have ambiguous effects on net output. On the one hand, because of the subsidy effects, a bubble always increases investment and therefore increases aggregate output. On the other hand, since capital is subject to diminishing returns, the increase in investment may exceed the increase in output. Therefore a bubble does not necessarily improve net output. In fact, a bubble is more likely to boost net output when capital is scarce, or when the size of the bubble is small. Similarly, a financial reform does not necessarily increase net output, especially when the size of the bubble (subsidy) is large. When the size of the bubble is large, investment is heavily subsidized, and financial frictions can restrain entrepreneurs from excessive investment. Hence alleviating financial frictions may reduce net output.

Furthermore, I illustrate how bubbles can give rise to misallocation. I study stochastic bubbles using a dynamic example with parsimonious parameters: in response to a bubble shock, the simulated aggregate output growth increases, wheras the simulated aggregate productivity growth decreases. Intuitively, along transition dynamics, stochastic bubbles generate dispersion in capital intensity across firms, as some cohorts of firms get bubble subsidy but other cohorts do not; thereby bubble shocks aggravate misallocation and dampen aggregate productivity. I also show that bubble shocks can significantly contribute to the magnitude of output fluctuations.

The recent literature on rational bubbles focuses mainly on the macroeconomic implications. Bubbles can serve as either collateral or liquidity, in the presence of financial constraints. Martin and Ventura (2011, 2012, 2016) study an economy with collateral constraints. Bubbles can supplement collateral and thus relax credit constraints and boost investment and output. They also point out that sentiment shocks, the shocks reflected by the stochastic size of bubbles, are important sources of aggregate fluctuations. Miao and Wang (2015) analyze real effect of bubbly collateral in an infinite-horizon framework. They (2014) also investigate how bubbles reallocate resources between productive and non-productive sectors, and how the reallocation affect economic growth. Farhi and Tirole (2011) study how bubbles relax liquidity constraints: if fundamental liquidity is scarce, bubbles can be used as a substitute to be devoted to projects. Ventura (2012) explores the interaction between bubbles and capital cost: bubbles crowd out (inefficient) investment in capital-abundant economies and increase (efficient) investment in capital-scarce economies. My paper is perhaps closest to the one by Olivier (2000), which is the first paper, as far as I know, to study subsidy effect of bubbles. Olivier (2000) extends the horizontal innovation model by assuming that bubbles are attached to different "blue prints", so that bubbles serve as a subsidy

to R&D. A common feature of the paper by Olivier (2000) and this paper is that in both papers bubbles can only be achieved after making specific sorts of investment: R&D in the paper by Olivier (2000), and firm entry in the current paper. However, my paper focuses mainly on the implications on the distribution of firms, and studies the aggregate impact of bubbles through the lens of firms.

This paper is also closely related to the wide body of research on firm and industry dynamics. My work is to some extent inspired by Lee and Mukoyama (2015), and Clementi and Palazzo (2015). Lee and Mukoyama (2015) focus on the cyclical pattern of firm entry and exit. Clementi and Palazzo (2015) emphasize the amplifying mechanism of procyclical firm entry and exit. Both works introduce aggregate productivity shocks as the source of fluctuation. My paper is also related to the vast literature incorporating credit constraints to heterogeneous-firm framework. Midrigan and Xu (2014) build up a quantitative Hopenhayn model where new entrepreneurs have no initial assets, nor external financing but can overcome the financial constraint by accumulating funds over time. Calibrating the model with Korean data, they argue that the productivity loss from a low level of firm entry can be very large. Jermann and Quadrini (2007) explain the comovement of stock prices, credit and output growth rate in 1990s as a result of expected increase of growth rate. They argue that the stock market boom in 1990s was induced by the expectation of higher future growth rate; the increased asset prices relaxed the credit constraint and increased the initial investment and capital intensity, and thus increased output and labor productivity.

The recent debt crisis in Eurozone has motivated a literature exploring the credit boom and misallocation in southern Europe. Gopinath et al. (2015) document a significant increase in misallocation of capital in Spain. They argue that adjustment costs and financial constraints play critical roles in generating the dispersion of the marginal product of capital. Garcia-Santana et al. (2016) study misallocation across firms in Spain. They find that deterioration of allocative efficiency in Spain is mainly driven by misallocation across firms rather than across industries. They also find that the measure of misallocation significantly exacerbated using an unbalanced panel with the full sample of firms, compared with the same measure using a balanced panel with permanent sample of firms: the result seems to support that the entry of firms is at the root of the TFP decline in Spain. In my model, bubbles relax financial constraints and subsidize capital inputs for new entrants, so that fluctuations in bubbles generate dispersion in the marginal product of capital across different cohorts of firms, therefore deteriorate allocative efficiency and lower aggregate productivity.

The paper proceeds as follows. Section 2 presents the facts which motivate this paper. Section 3 develops the baseline model. Section 4 delivers the stationary equilibria, as in Hopenhayn (1992) and Melitz (2003), without aggregate shocks. The comparative statics

is studied in Section 5. Section 6 studies the dynamic model with aggregate uncertainties. Section 7 concludes with a discussion of future research.

2 Motivating Facts

2.1 Firm Entry

Figure 1 plots the number of newly registered companies and the total number of companies in Spain since 1999. The data is from the DIRCE, a database provided by Spanish National Statistics Institute and containing statistical information for the population of Spanish companies. The number of entrants experienced an expansion, reaching the height in year 2007, before a rapid downturn during the financial crisis. The accelerating firm entry increased the total number of companies by about one half from 1999 to 2008. However, following the financial crisis and the housing bubble crash, the number of entrants experienced a drastic decline and thereafter stagnated during the prolonged recession. The slowdown of firm entry coincided with a contraction in the number of companies: by 2014 the total number of companies dropped by 10 percent.
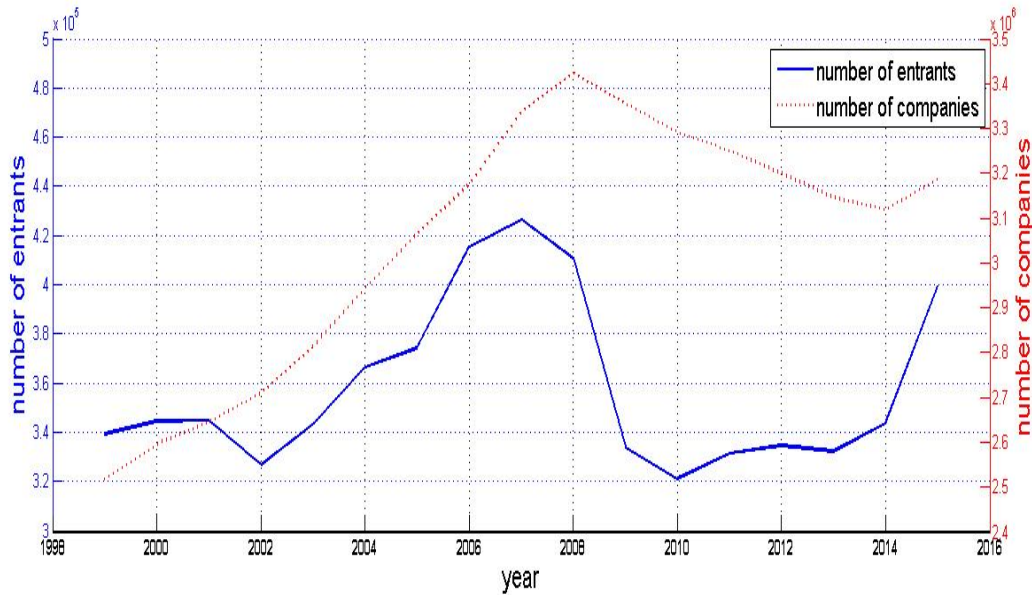

Figure 1: The Number of Newly Registered Companies and the Total number of Companies in Spain, 1999 to 2015

The procyclicality of firm entry shown in Figure 1 is in line with various explanations of business cycles. Lee and Mukoyama (2015) find that the entry rate of the U.S. manufacturing plants is procyclical, and they develop a model with productivity shocks to explain this

pattern. Clementi and Palazzo (2015) reproduce the same cyclical pattern of firm entry, using a different quantitative model with productivity shocks. Intuitively, an increase in productivity improves profitability and thus incentivizes firms to enter the market. Gopinath et al. (2015) argue that the decrease in interest rate in early 2000s can potentially explain the increasing number of firms in Spain before the Great Recession, as the low interest rate could enhance the profitability of firms. I show in Section 5 that a financial reform has an ambiguous effect on the equilibrium firm entry, and that investor optimism increases the number of firm entry by subsidizing entrants with bubbles.

2.2   Aggregate Productivity and Misallocation

Probably the most salient feature of the Spanish economy is the protracted decline of aggregate productivity. Figure 2 plots the Total Factor Productivity (TFP) in Spain, using Spanish TFP data from Penn World Table 9.0. The TFP declined not only in the recession (after 2008), but also at the time of output expansion (1994-2007).
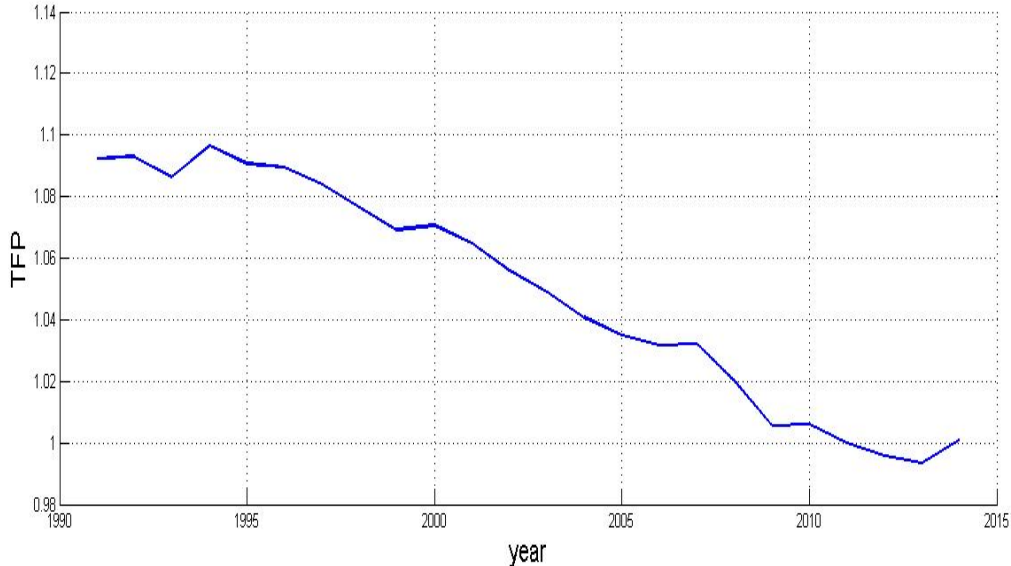
Figure 2: Total Factor Productivity in Spain, 1991-2014

The declining TFP is associated with exacerbating allocative efficiency. The recent literature has documented aggravating misallocation underlying the Spanish boom. Garcia-Santana et al. (2016) find that the TFP in Spain would otherwise grow 0.8% per year on average between 1994 and 2007, if there was no deterioration in allocative efficiency. Gopinath et al. (2015) propose the decrease in interest rate as a source of exacerbating misallocation. While Gopinath et al. (2015) focus on the misallocation among incumbent

7

firms, in my model misallocation arises as bubbles subsidize the capital inputs of new firms and increase their capital intensity: I show in Section 6 that bubble shocks can give rise to the decline of aggregate productivity.

2.3 Firm-level Productivity and Profit

I estimate the firm-level revenue-based total factor productivity (TFPR) using the AMADEUS data for Spain during 2003-2009. Assume that firms in a given industry produce identical product according to a Cobb-Douglas production function. For a given industry j, the output of firm i is:

$$y_{it} = \beta_0^j + \beta_l^j l_{it} + \beta_k^j k_{it} + \beta_\iota^j \iota_{it} + \epsilon_{it} \tag{1}$$

Where y_{it} is the log of output, for firm i at time t; l_{it}, k_{it}, ι_{it} are respectively the logs of labor input, capital input, and intermediate inputs. The firm-level productivity is measured by Solow residual: $\beta_0^j + \epsilon_{it}$. However, it is well known that OLS estimation of equation (1) yields biased estimation because of the simultaneity problem.[4] I address the estimation problem by implementing the program developed by Levinsohn, Petrin, and Poi (2003), which is based on the approach proposed by Levinsohn and Petrin (2003).[5] In my estimation, y_{it} is measured by annual operation revenue; l_{it} input is measured by the number of employees; k_{it} is measured by total asset; ι_{it} is measured by materials expenditure. The estimation is run at industry-level: the estimation relies on the assumption that the firms in a given industry produce according to homogeneous production function and the function does not vary in the sample period.[6] Since the output is measured by operation revenue, the estimated log productivity $\beta_0^j + \epsilon_{it}$ is the log of revenue productivity, or TFPR, so that changes in the estimated productivity also capture changes in prices.[7] I also calculate the firm-level net profit using the data of profit margin and operating revenue.

Permanent Sample	2006	2009	Boom	Recesssion
Average log TFPR	5.41	5.30	5.38	5.32
Average normalized log TFPR	-8.00	-8.19	-7.92	-8.17
Average net profit (unit: euros)	6870225	3792534	6450195	4507961
Average profit margin	4.03	-0.81	3.91	0.40

Table 1: Average log Productivity and Profit of Permanent Sample

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[4]See Olley and Pakes (1996) and Levinsohn and Petrin (2003) for more details.

[5]Levinsohn and Petrin (2003) use intermediate input as a proxy for unobserved productivity in a two-stage estimation.

[6]The industries are identified by a 3-digit SIC code.

[7]Foster, Haltiwanger, and Syverson (2008) study the difference between revenue productivity (TFPR) and quantity productivity (TFPQ).

Table 1 lists the averages of: i) log TFPR $\beta_0^j + \epsilon_{it}$, ii) log TFPR normalized by capital stock $\beta_0^j + \epsilon_{it} - k_{it}$,[8] iii) net profit, and iv) profit margin[9] for the permanent sample which consists of the firms existing throughout the sample period. The two columns in the middle compare year 2006, when the economy was at the peak of economic expansion, and the year 2009, when the economy was deeply trapped in the recession. The firms from the permanent sample had on average higher productivity and net profit in 2006 than in 2009. Besides, the normalized log TFPR, and profit margin, which measure the productivity and profitability in relative terms, were also lower on average in 2009 than in 2006. The last two coulumns represent a comparison between the boom years 2003-2007, and the recession years 2008-2009. Again, the average productivity and profitability were lower after the outbreak of the Great Recession. The results suggest that the revenue productivity and profitability of existing firms were dampened in the recession, which is consistent with the conventional wisdom that there was a negative productivity shock in the recession.

Entrants	2006	2009	Boom	Recesssion
Average log TFPR	4.99	5.01	4.96	5.00
Average normalized log TFPR	-6.53	-6.50	-6.56	-6.47
Average net profit (unit: euros)	223225	247293	244636	247901
Average profit margin	-2.55	-2.33	-2.49	-2.18

Table 2: Average log Productivity and Profit of Entrants[10]

In contrast, Table 2 reports the opposite pattern for entering firms. The two columns in the middle show that the entrants in 2006 had on average lower productivity and profitability, in both absolute and relative terms, than the entrants in 2009. The comparison suggests, perhaps surprisingly, that the average productivity and profitability of entrants were lower in the boom than in the recession. The pattern still prevails even if we consider more sample years. The last two columns show that the new firms entering the market in 2003-2007 were on average less productive and profitable than the new firms in 2008-2009. In Section 5 I show that this pattern would be possible only if the Great Recession features a bubble crash or an increase in interest rate. If the crisis is merely a consequence of dropping productivity, or exacerbating financial frictions, the average productivity and profit of entrants would become otherwise lower in the recession compared with that in the boom.

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[8]The normalized log TFPR equals to $\ln\left(\frac{\exp(\beta_0^j + \epsilon_{it})}{k_{it}}\right)$.

[9]The profit margin can be interpreted as the net profit normalized by revenue.

[10]Gopinath et al. (2015) document that before the Great Recession, the average log productivity over their full sample of firms declined significantly relative to the permanent sample. They argue this implies the entry of less productive firms over time.

To sum up, in the past two decades, the Spanish economy was characterized by: i) procyclical firm entry, ii) a persistent decline in aggregate productivity, and iii) an increase in the average productivity and profitability of entrants during the Great Recession. In the rest of this paper, I propose a theory that can rationalize these 3 facts.

3 Model Setup

In this section, I set up a model in the spirit of Lucas (1978) and Hopenhayn (1992). The model is a simplified version of the standard Hopenhayn model. I assume exogenous firm exit, time-invariant firm-level productivity, and a fixed number of potential new firms.[11] I incorporate credit constraints for new firms when they make intial investment in capital. The model describes a small open economy where the interest rate is determined exogenously.

3.1 Production

There is a mass of atomistic firms, heterogeneous in productivity, producing a single product. Time t runs from zero to infinity. I assume that at time t, firms produce good according to:

$$y_t = (A\varphi)^{1-\alpha-\gamma} \cdot n_t^\alpha k^\gamma, \alpha + \gamma < 1 \tag{2}$$

The production displays decreasing return to scale (DRS). A is the common productivity component, which is identical across all firms. φ is the idiosyncratic productivity component, which is firm-specific. Capital k is chosen when the firm is created.[12] Capital input k and productivity components A and φ are time-invariant. n_t is the labor input the firm employs at period t.

Firms take wage as given. The wage is determined in a frictionless market, in which the labor supply is given by a monotonically increasing function of wage w_t:

$$L_{s,t} = w_t^\varepsilon$$

where $\varepsilon > 0$.

Let λ_t denote the vector of aggregate state variables at time t. Given the aggregate state λ_t, capital k, and productivity $A \cdot \varphi$, incumbent firms maximize their profit by choosing labor

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[11]The assumptions regarding firm entry and labor supply resemble those used by Clementi and Palazzo (2015) and Carvalho and Grassi (2015).

[12]The assumption enables a closed-form solution of stationary equiliria and greatly simplifies the analysis of aggregate dynamics in Section 6. It also captures the fact that the difference between cohorts of firms are persistent and that the performance of a firm depends heavily on when it was created, a fact documented and studied by Sedlacek and Stern (2016).

input n_t:

$$\pi\left(\lambda_t, \varphi, k\right) = \max_{n_t} \left\{ (A\varphi)^{1-\alpha-\gamma} \cdot n_t^\alpha k^\gamma - w_t n_t \right\} \tag{3}$$

3.2 Firm Exit and the Value of Incumbents

Every period after producing, there are idiosyncratic exit shocks which are i.i.d. to firms with a constant probability $1-p$. If a firm draws the exit shock, it would exit the market permanently. Firms are traded in equity market at the begining of each period by a group of risk-neutral investors, who have free access to international credit market and take the interest rate as given. The investors discount future profit by interest rate, $\frac{1}{R_t}$. A firm is only tradable if it produces: the firm value becomes zero forever if the firm is forced to exit. The value of any incumbent firm thus satisfies:

$$v_t\left(\lambda_t, \varphi, k\right) = \pi\left(\lambda_t, \varphi, k\right) + \frac{p}{R_t}\widehat{E}_t v_{t+1}\left(\lambda_{t+1}, \varphi, k\right) \tag{4}$$

where the operator $\widehat{E}_t$ denotes the conditional expectation at t given that the firm would survive at $t+1$. Equation (4) implies that the value equals the sum of current profit and the discounted expected value, which equals the product of discount factor $\frac{1}{R_t}$, survival probability p, and expected continuation value $\widehat{E}_t v_{t+1}\left(\lambda_{t+1}, \varphi, k\right)$.[13] I show in the subsequent section that under certain circumstances, the value of a firm can be decomposed into a "stationary" fundamental component which equals to the NPV of the future profit, and an "explosive" bubble component which is a pyramid scheme that can be rolled over if the firm survives. The solutions nest the standard solution in Hopenhayn (1992) or in Melitz (2003) where bubble components equal zero.

3.3 Firm Entry and the Credit Constraint

There is a constant mass $\bar{M}$ of potential entrants every period. The potential entrants draw their idiosyncratic productivity φ according to the Pareto distribution function $F\left(\varphi\right)$[14]:

$$F\left(\varphi\right) = 1 - \varphi^{-\zeta}$$

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[13]The expected value equals to the product of survival probability and the expected continuation value:

$$E_t v_{t+1}\left(\lambda_{t+1}, \varphi, k\right) = (1-p) \cdot 0 + p\widehat{E}_t v_{t+1}\left(\lambda_{t+1}, \varphi, k\right) = p\widehat{E}_t v_{t+1}\left(\lambda_{t+1}, \varphi, k\right)$$

[14]The assumption is based on the fact that the firm size distribution is well approximated by the Pareto distribution.

11

where $\zeta > 1$[15]. Both the common productivity component A and the idiosyncratic productivity component φ are publicly observable: each potential entrant knows her own productivity level $A\varphi$ before deciding whether or not to enter the market and start production in the subsequent period.

At time t, the entrants issue one-period debt to raise the capital stock k in the international credit market, where the interest rate is given by R_t: the firms become tradable in the equity market once they start production at $t+1$. After getting the credit, entrepreneurs can either flee with a fraction $1 - \delta$ of the credit or invest the credit into their firms. The credit contract is incentive-compatible if and oly if:

$$(1 - \delta) k \leq \frac{1}{R_t} \left(E_t v_{t+1} \left(\lambda_{t+1}, \varphi, k \right) - R_t k \right) \tag{5}$$

Throughout the paper, I limit the analysis to the incentive-compatible contracts satisfying inequality (5). Inequality (5) ensures that the payoff from defaulting does not exceed the present value of investing the credit into the firm. δ can be motivated by the fraction of credit which entrepreneurs have to spend to evade the enforcement. The size of δ is a proxy for institutional quality: better institution (higher δ) would increase the expenditure of defaulting and prohibit entrepreneurs from stealing the credit; in fact, if $\delta = 1$, the credit constraint is never binding, as the entrepreneurs are unable to steal any credit. Thereafter I refer the "financial reform" to an exogenous increase in δ. Furthermore, inequality (5) implicitly implies that $R_t k \leq E_t v_{t+1} \left(\lambda_{t+1}, \varphi, k \right)$, so that the default can not take place once the firm is initiated: the entrepreneurs would lose the firms if they default, and the loss would always outweigh the gains from default.

As for the prospective entrants, the value of entering the market, v^e, is:

$$v_t^e \left(\lambda_t, \varphi \right) = \frac{1}{R_t} \max_k E_t \left(v_{t+1} \left(\lambda_{t+1}, \varphi, k \right) - R_t k \right) \tag{6}$$

$$s.t. \ (1 - \delta) R_t k \leq E_t v_{t+1} \left(\lambda_{t+1}, \varphi, k \right) - R_t k$$

Entering the market incurs two sunk costs: 1) the cost of physical capital $R_t k$, and 2) entry cost c_e, which measures the utility loss from setting up a firm in the market. The prospective entrant will enter the market if and only if the value of entering is no less than the entry cost c_e:

$$v_t^e \left(\lambda_t, \varphi \right) \geq c_e \tag{7}$$

where $c_e \geq 0$.

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[15]If $\zeta \leq 1$, the mean value of φ would be infinite. The literature has found ζ close to but slightly above 1.

4 Stationary Equilibria

The model I develop in the previous section is essentially a simplified Hopenhayn model with credit market frictions. In a dynamic equilibrium: the labor market and the equity market clear over time; incumbents and entrants maximize their payoff. To help build intuition, in this section I investigate the stationary equilibria as studied by Hopenhayn (1992) and Melitz (2003). Throughout this and the next section, aggregate state variables are stable over time: $\lambda_t = \lambda$[16]. In Section 6 I study instead the equilibria with time-varying λ_t.

In the literature of firm dynamics, the value of a firm equals the NPV of profits. At the begining of this section, I show that under certain circumstances, the functional equation (4) features multiple solutions, in which the value of a firm contains a positive bubble component in addition to the NPV of profits, and each solution corresponds to a unique stationary equilibrium.[17]In Section 4.2 I study the input choices, and the subsidy effect of bubbles on capital input (the intensive margin). The equilibria are characterized in Section 4.3, where I investigate the subsidy effect of bubbles on firm entry (the extensive margin). The aggregate variables and other variables of interest are explored in Section 4.4.

4.1 Value Function Decomposition

The solution to the functional equation (4) can be decomposed into a fundamental component which equals the NPV of future profits, and a bubble component which is a pyramid scheme:

$$v_t (\lambda, \varphi, k) = b_t (\lambda, \varphi, k) + f (\lambda, \varphi, k)$$

where $f (\lambda, \varphi, k)$ denotes the fundamental component, which equals the NPV of the firm's future profits, and $b_t (\lambda, \varphi, k)$ denotes the bubble component, which is a pyramid scheme. Notably, I keep the time subscript for the bubble component rather than the fundamental component. The reason is that in a stationary equilibrium, the fundamental component is pinned down by the time-invariant variables λ, φ, and k, which determine the size of profit π. However, the bubble component arises as an outcome of investor sentiments, and can change independently with respect to λ, φ, and k, so that the time subscript is indispensable.[18] We

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[16]Unless otherwise specified, letters without time subscript denote the variables in stationary equilibria.

[17]The model is similar to the one used by Gali (2014) in the sense that bubble component coexist with positive profit (or rent). Unlike in Gali (2014), bubbles in my model are assumed to be destroyed when firms stop production. This property implies a different necessary condition under which the bubble and fundamental components can coexist.

[18]Moreover, as discussed below, the process of bubble component is non-stationary.

have:

$$f\left(\lambda,\varphi,k\right) = \pi\left(\lambda,\varphi,k\right) + \frac{p}{R}f\left(\lambda,\varphi,k\right) = \frac{R}{R-p}\pi\left(\lambda,\varphi,k\right) \tag{8}$$

The necessary and sufficient condition for the fundamental component to exist is that $p < R$, otherwise the NPV of profits is equal to infinity. Meanwhile we have the recursive formula for bubble component $b_t\left(\lambda,\varphi,k\right)$:

$$b_t\left(\lambda,\varphi,k\right) = \frac{p}{R}\widehat{E}_t b_{t+1}\left(\lambda,\varphi,k\right) \tag{9}$$

$\hat{b}_t\left(\lambda,\varphi,k\right)$ is a Ponzi game component and has to be rolled over every period. Equation (9) implies that, given that $p < R$, the expected future size (upon continuation) is strictly larger than the current size of bubble component. In other words, the bubble component is expected to grow over time insofar as the firm stays in the market.

The size of the bubble component depends on the investor sentiment, so it has multiple possible processes. Throughout the paper, I limit the analysis to the special case that, for any new firm at time t:

$$b_t^N\left(\lambda,\varphi,k\right) = \hat{b}_t f\left(\lambda,\varphi,k\right) \tag{10}$$

where $b_t^N\left(\lambda,\varphi,k\right)$ denotes the size of bubble components for new firms at t. In stationary equilibria: $\hat{b}_t = \hat{b}$. The assumption underlying equation (10) is that every new firm is created with a bubble component proportional to the fundamental component, and the proportion is constant across the entrant cohort.[19]

The standard solution to functional equation (4) features a zero bubble component, and the value of incumbent firms equals their fundamental component. In a bubbly equilibrium, the solution to equation (4) features a positive bubble component. It is of our interest to know whether a positive bubble component is sustainable in a stationary equilibrium. We have the following proposition:[20]

PROPOSITION 1: *There exist multiple bubbly stationary equilibria in which functional equation (4) has multiple solutions with a positive bubble component $\left(\hat{b} > 0\right)$, if and only if $p < R < 1$. In a bubbly equilibrium, the size of the bubble component is not stationary, while the aggregate value of bubbles is stable over time.*

The intuition is that, even though at the firm-level, the bubble component upon con-

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tinuation is non-stationary and can grow to infinity, at the aggregate level, $1 - p$ fraction of bubbles disappear as a consequence of firm exit, ensuring a stable size of aggregate bubbles.[21] Throughout the rest of Section 4 and 5, I assume that $p < R < 1$, so that there exist sustainable stationary bubbly equilibria.

4.2 Choice of Inputs

The demand for labor can be derived from the F.O.C. of incumbents:

$$\alpha \left(A\varphi \right)^{1-\alpha-\gamma} n^{\alpha-1} k^{\gamma} = w \tag{11}$$

Since incumbents recruit labor in a frictionless market, they choose the optimal size of labor which equates the marginal product of labor to market wage.

The demand for capital can be derived analogously from the F.O.C. of entrants, which are however exposed to the credit constraint. If the collateral constraint is not binding, the demand for capital is given by:

$$\frac{R \left(1 + \hat{b} \right) \gamma}{R - p} \left(1 - \alpha \right) \left(A\varphi \right)^{1-\alpha-\gamma} n^{\alpha} k^{\gamma-1} = R \tag{12}$$

Entrants equate the marginal incumbent value of a new firm to the interest rate, whenever the credit constraint is not binding. Equation (12) suggests that bubbles serve as a subsidy on capital input: the demand for capital is strictly increasing in the size of bubble creation ratio $\hat{b}$. In fact, the ratio $\hat{b}$ is mathematically equivalent to a rate of subsidy on capital. Intuitively, the size of the bubble component is proportional to the fundamental component, which is increasing in the size of capital input, so the entrants in a bubbly economy ($\hat{b} > 0$) are encouraged to invest more in physical capital to create a larger bubble component.

If the collateral constraint is binding, the demand for capital is given by:

$$\frac{R \left(1 + \hat{b} \right)}{\left(R - p \right) \left(2 - \delta \right)} \left(1 - \alpha \right) \left(A\varphi \right)^{1-\alpha-\gamma} \left(n^{*} \right)^{\alpha} \left(k^{*} \right)^{\gamma-1} = R \tag{13}$$

The size of capital input is bounded by the pledgeable value of firm. An increase in $\hat{b}$ increases the constrained optimal capital input as well as the unconstrained optimal capital input. In a bubbly economy, bubbles serve as a subsidy on capital regardless of whether the financial constraint is binding; moreover, when the collateral constraint is binding, bubbles also serve

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[21]There is no bubbly equilibrium if the aggregate bubbles also grows to infinity, since there is not sufficient resource to purchase the bubbles. For more discussions of sustainable bubbly equilibrium, see Tirole (1985), Martin and Ventura (2012), and Gali (2014).

as additional collateral to entrepreneurs, so the increase in capital demand is an outcome of both a subsidy effect and a collateral effect.

It is crucial for our analysis to verify whether the credit constraint is binding. We have the following proposition:

PROPOSITION 2: *In a stationary equilibrium, the collateral constraint for entrants is binding if and only if*

$$\gamma > \frac{1}{2 - \delta}$$

The proposition is immediate given by equations (12) and (13). The underlying intuition is straightforward: larger δ implies higher pledgeability, while higher γ implies a higher need for capital. Firms are more likely to be financially constrained if the need for capital is large or if the pledgeability is small; apparently, the constraint is never binding if $\delta = 1$. Most importantly, the proposition holds irrespective of whether there exist bubbles. Although the existence of bubbles increases the value of pledgeable assets, it propotionally increases the demand of capital, and the two effects cancel out: if the inequality holds, bubbles still increase the size of pledgeable value and thus the constrained optimal capital input, but increase even more the unconstrained optimal size of capital.

4.3 Free Entry Condition and Labor Market Clearing Condition

I prove in Appendix 2 that there always exists a cutoff productivity φ^*: a firm enters the market as long as it draws a productivity $\varphi > \varphi^*$, otherwise it does not enter the market since the entry value $v^e(\lambda, \varphi)$ is not high enough to cover the entry cost c_e. An equilibrium can be represented by a pair: (φ^*, π^*), where φ^* denotes the cutoff productivity for prospective entrants, and π^* denotes the cutoff level profit. Notably, φ^* is interchangable with m, the amount of firm entry, since m is a bijective (and decreasing) function of φ^*.[22]

Two conditions are necessary to characterize the equilibrium (φ^*, π^*): free entry condition (henceforth FE) and factor markets clearing condition (henceforth LMC). Free entry condition establishes the relationship between φ^* (or m) and π^* when the entry value for marginal entrants equals to the entry cost c_e. Labor market clearing condition establishes the link between φ^* (or m) and π^* when the labor market clears. Both conditions are contingent on whether credit constraint are binding, and on the investor sentiment, or more

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[22]Given the law of large numbers, we have:

$$m(\varphi^*) = (1 - F(\varphi^*)) \cdot \bar{M}$$

16

specifically, the size of the bubble creation ratio $\hat{b}$:[23]

PROPOSITION 3: *The FE and LMC in a stationary equilibrium are given by (respectively)*

$$FE: \ \pi^* = \frac{R-p}{\left(1+\hat{b}\right)\left(1-\min\left(\frac{1}{2-\delta},\gamma\right)\right)}c_e \tag{14}$$

$$LMC: \ \pi^* = \left[(1-\alpha)(A\varphi^*)^{1-\alpha-\gamma}\left(\frac{\left(1+\hat{b}\right)\min\left(\frac{1}{2-\delta},\gamma\right)}{R-p}\right)^{\gamma}n\left(\lambda,\varphi^*\right)^{\alpha}\right]^{\frac{1}{1-\gamma}} \tag{15}$$

where $n\left(\lambda,\varphi*\right)$ denotes the size of labor input for cutoff entrants:

$$n\left(\lambda,\varphi^*\right) = \left(\frac{(1-p)\left(\alpha\left(\frac{\left(1+\hat{b}\right)(1-\alpha)\min\left(\frac{1}{2-\delta},\gamma\right)}{\alpha(R-p)}\right)^{\gamma}(A\varphi^*)^{1-\alpha-\gamma}\right)^{\frac{\varepsilon}{1-\gamma}}}{\bar{M}\int_{\varphi\geq\varphi*}\left(\frac{\varphi}{\varphi^*}\right)dF\left(\varphi\right)}\right)^{\frac{1}{1-\frac{\varepsilon}{1-\gamma}(\alpha+\gamma-1)}} \tag{16}$$

The FE and LMC conditions simultaneously pin down the stationary equilibrium, which is illustrated in Figure 3. The horizontal line represents the FE condition. The profit π^* given in equation (14) can be interpreted as the "reservation profit" for prospective entrants: a break-even level of profit for prospective entrants to compensate the entry cost. Free entry condition implies that a prospective entrant would not enter the market if her profit after entry is lower than π^* (lower than the break-even FE line). The "reservation profit" for a prospective entrant is independent from her own productivity, so that the FE line is horizontal.

The upward sloping curve represents the LMC condition. The profit π^* given in equation (15) denotes the profit of cutoff entrants when the labor market clears. Mathematically, equations (15) and (16) imply that the cutoff profit π^* is increasing in the cutoff productivity φ^*, or alternatively, decreasing in the number of entrants.[24] Intuitively, moving leftward along the LMC curve (reducing φ^*) corresponds to: 1) a decline in the productivity of cutoff entrants, and 2) an increase in the number of firms which bids up the equilibrium wage.[25] Consequently, the cutoff profit decreases as we move leftward along the LMC curve. Therefore LMC implies an increasing cutoff profit if φ^* increases. In the equilibrium, the labor market clears, and the profit of cutoff entrants equals the "reservation profit".

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[23]The proof of Proposition 3 can be found in Appendix 3.
[24]See the proof in Appendix 4.
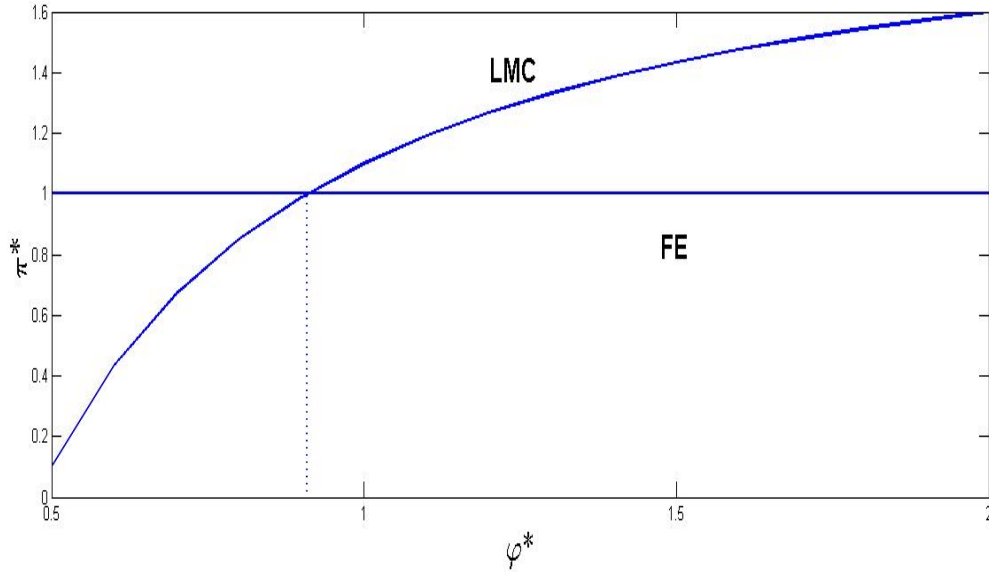[25]See discussions with more details in Section 4.4.

Figure 3: Free Entry Condition (FE) and Labor Market Clearing Condition (LMC)

Notably, equation (14) suggests that the cutoff profit is monotonically decreasing in the size of the bubble creation ratio $\hat{b}$. In a bubbly equilibrium, entrants get a bubble component in addition to the fundamental component, so the existence of bubbles lowers the "reservation profit" requested by entrepreneurs to compensate their entry cost c_e. Again, bubbles serve as a subsidy, but what equation (14) captures is the subsidy effect of bubbles on firm entry, or the subsidy at the extensive margin, rather than the subsidy effect on capital as studied in 4.2.

The subsidy effect on capital, or the subsidy at the intensive margin, is captured by equation (15), the LMC condition. This subsidy effect, on the contrary, tends to increase the cutoff profit: in a bubbly equilibrium, the entrants are encouraged to invest more in capital to increase their profits (and therefore the NPV of profits), so as to raise the size of bubble components. This subsidy effect raises the profitability of entrants in general.

4.4 Analysis of the Stationary Equilibrium

Before investigating the comparative statics, I complete characterizing the stationary equilibrium by studying the equilibrium aggregate variables and average productivity and profitability of entrants. The results established here are for the reference of Section 5.

4.4.1 Aggregate Variables

Construct the aggregate production function Y:

$$Y \equiv \int y^j dj = \Phi^{1-\alpha-\gamma} N^\alpha K^\gamma$$

where j denotes the index for firms, $N = \int n^j dj$, $K = \int k^j dj$ denote the aggregate amounts of inputs. The aggregate productivity Φ [26]is given by the following formula:[27]

$$\Phi = A\left(\frac{\bar{M}}{1-p}\right)\left(\int_{\varphi \geq \varphi^*} \varphi dF(\varphi)\right) \tag{17}$$

Firm level productivity $A\varphi$ can be viewed as a type of input, intangible asset, and the aggregate productivity Φ equals to the aggregate amount of intangible asset. It is easy to prove that $\frac{d\Phi}{d\varphi^*} < 0$. In this model, an increase of firm entry is equivalent to a decrease in the cutoff φ^*, so equation (17) implies that the stationary equlibria level of aggregate productivity is increasing in the amount of firm entry: an increase in the firm entry raises the supply of intangible asset, and consequently improves the aggregate productivity Φ.

The aggregate amount of labor and capital are respectively:

$$(labor) \ \ \alpha\Phi^{1-\alpha-\gamma} N^{\alpha-1} K^\gamma = w = N^{\frac{1}{\varepsilon}} \tag{18}$$

$$(capital) \ \ \frac{R(1+b)}{R-p}(1-\alpha)\min\left(\frac{1}{2-\delta},\gamma\right)\Phi^{1-\alpha-\gamma} N^\alpha K^{\gamma-1} = R \tag{19}$$

Equations (18) and (19) are simply aggregate counterparts of Equations (11)-(13). We know from Equation (18) and (19) that, an increase in the firm entry raising the aggregate productivity Φ raises the marginal product of labor and capital, and hence increases the equilibrium level of aggregate inputs. To be more specific, since the production function exhibits DRS, an increase in the number of firms lowers the size of firms, and therefore increases the marginal product of inputs across firms.

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[26]The definition of aggregate productivity depends on how we set up the aggregate production function. If we consider the number of firms as an input, as in Hopenhayn (2014), the aggregate productivity would equal the average productivity of all firms.

[27]See the derivation in Appendix 5

4.4.2 Average Productivity

The average productivity of entrants, $\widetilde{\varphi}$, is given by:

$$\widetilde{\varphi} \equiv \frac{\int_{\varphi \geq \varphi*} A\varphi dF(\varphi)}{\int_{\varphi \geq \varphi*} dF(\varphi)} = \frac{-\zeta A \varphi^*}{1-\zeta} \tag{20}$$

where $\zeta > 1$. Equation (20) implies that average productivity $\widetilde{\varphi}$ is increasing in the cutoff φ^*. Intuitively, a reduction in the cutoff productivity φ^* corresponds to the entry of the less productive firms, which lowers the average productivity of entrants.

4.4.3 Average Net Profit

Notably, the profit π in the previous analysis does not take into consideration of capital cost, and is not comparable with the data of net profits. I define net profit in my model as:

$$\pi_{net} \equiv \pi - rk = y - wl - rk$$

where $r \equiv R - 1$[28]. The alternative measure of profits takes into account the capital cost. Furthermore, the average net profit of entrants $\widetilde{\pi}_{net}$ equals

$$\widetilde{\pi}_{net} = \frac{\int_{\varphi \geq \varphi^*} \pi_{net}^* \left(\frac{\varphi}{\varphi^*}\right) dF(\varphi)}{\int_{\varphi \geq \varphi^*} dF(\varphi)} = \frac{-\zeta \pi_{net}^*}{1-\zeta} \tag{21}$$

[29]where π_{net}^* denotes the net profit of cutoff firms. Equation (21) implies that the average net profit of entrants (and firms) decreases insofar as the the cutoff net profit π_{net}^* decreases: the entry of the less profitable firms dampens the average net profit of entrants.

Importantly, whenever FE condition is satisfied, the cutoff net profit π_{net}^* takes the following form:

$$\pi_{net}^* = \left(r + \frac{1 - p - r\hat{b}}{\left(1+\hat{b}\right)\left(1 - \min\left(\gamma, \frac{1}{2-\delta}\right)\right)}\right) c_e \tag{22}$$

Equation (22) is indeed a counterpart of the FE condition given by equation (14) [30]. The cutoff net profit π_{net}^* is not only the profit level of cutoff entrants, but also the "reservation net profit" for prospective entrants: an entrepreneur enters the market so long as the net

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[28]It can be easily proven that the NPV of net profits π_{net} equals the entry value v^e if $p = 1$ and $b = 0$.

[29]Use that:

$$\frac{\pi_{net}^i}{\pi_{net}^j} = \frac{\pi^i}{\pi^j} = \frac{k^i}{k^j} = \frac{\varphi^i}{\varphi^j}$$

[30]The derivation of Equation (22) can be found in Appendix 6.

profit is no less than π^*_{net}. Clearly, the "reservation net profit" in equation (22), akin to the "reservation profit" in the FE condition, is decreasing in the size of the bubble creation ratio $\hat{b}$: the bubble subsidy lowers the break-even net profit for firm entry. Equations (21) and (22) lead us to conclude that bubbles subsidize the entry of the less profitable firms and thereby reduce the average net profit of entrants.

5 Comparative Statics

Armed with the results in Section 4, in this section I study the comparative statics. To begin with, I investigate investor optimism (bubbles) in Section 5.1. Then in Section 5.2 and 5.3 I review shocks to productivity and to financial frictions, which have been two orthodox explanations for business cycles. I argue that both explanations cannot fully rationalize the Spanish experience. The implications of a declining interest rate is studied in Section 5.4. Finally, in Section 5.5 I present several results regarding net output in bubbly stationary equilibria.

5.1 Bubbles

Figure 4 displays the comparative statics from the bubbleless equilibrium ($\hat{b} = 0$) to a bubbly equilibrium ($\hat{b} > 0$), irrespective of whether credit constraint is binding. The solid lines characterize the bubbleless equilibrium; the dashed lines characterize the bubbly equilibrium. The movement of FE captures the subsidy at the extensive margin: when bubbles emerge, the FE line shifts downward, as the bubble component subsidizes the entry decision, making prospective entrants accept a lower "reservation profit". Bubbles also shift the LMC upwards. The movement of the LMC captures the subsidy at the intensive margin: even in the absence of financial frictions, bubbles subsidize the capital and thus increase the profitability of firms.[31] When the financial constraint is binding, the shift of the LMC is driven by the combination of bubble subsidy and bubbly collateral: the emergence of bubbles (or increase in $\hat{b}$) encourages entrants to increase capital, and the increase in capital is collateralized by the additional bubble component.

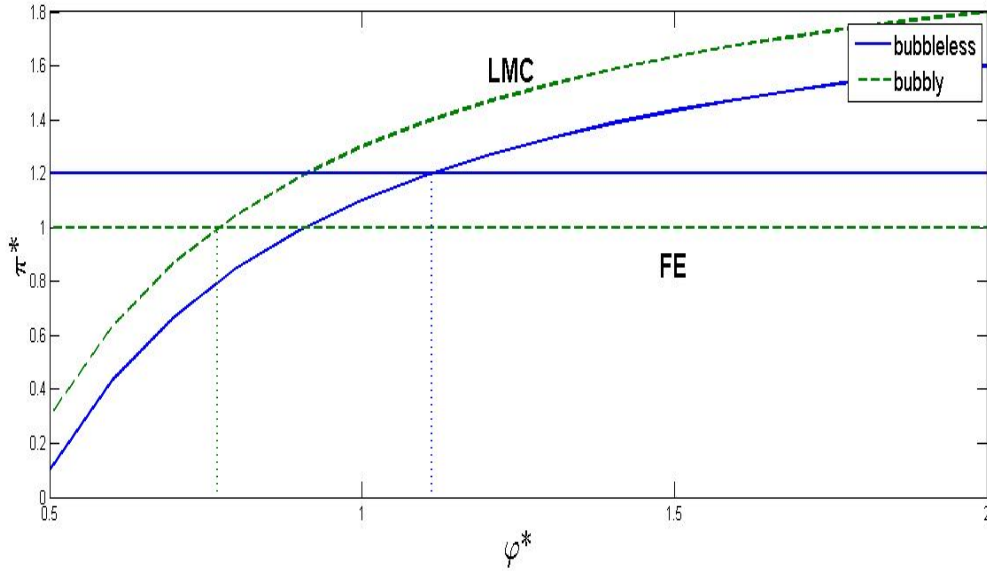[31]Notably, the profit here takes into account only the labor cost, rather than the capital cost.

Figure 4: Equlibrium Effects of Bubbles

Figure 4 illustrates how bubbles increase firm entry in equilibrium. Bubbles lower the "reservation profit" required by entrepreneurs. The less productive firms which would enter the market in bubbly episodes would not necessarily enter the market in bubbleless episodes, because the profit is too low compared with the entry cost. In bubbly episodes, however, the entrepreneurs get the bubble component in addition to the fundamental component, they are willing to set up firms even if the profit (or NPV) is very low compared with the entry cost. Besides, the prospective entrants are also encouraged by higher profitability as bubbles subsidize the capital input.

An increase in the bubble creation ratio b increases the stationary equilibrium level of the aggregate output Y, the aggregate productivity Φ, the equilibrium wage w, and the aggregate inputs K and N.[32] The sentiment optimism exerts expansionary effects on the aggregate input and output, even in the absence of financial frictions. Equations (17)-(19) characterize the aggregate demand for inputs, given w and R. The emergence of bubbles lowers the cutoff φ^*, and increases Φ. N and K increase in response to an increase in b, not only because that aggregate productivity Φ increases, or firm entry increases (extensive margin), but also because that bubbles subsidize (and collateralize, if the credit constraint is binding) capital for all entrants (the intensive margin). When markets clear, N and K increase, so does the aggregate output Y.

Mathematically, it is easy to conclude from Equation (20) that the average productivity $\widetilde{\varphi}$ decreases as bubbles lower the cutoff φ^* (thus more firm entry). From equations (21)

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[32]See the proof in Appendix 7.

and (22) we can see that bubbles lower the average net profit.[33] Intuitively, if an economy expansion is fueled by bubbles, the less productive and profitable firms enter the market to acquire bubbles, and the entry of these firms lowers the average productivity and net profit. Therefore the documented rise of average revenue productivity and average net profit in the recession is a natural outcome if the recession features a bubble bust, as the less productive and profitable firms would not enter the market after the bubble crash.

5.2 Productivity Shocks

In this sub-section, I revisit real business cycles. An increase in the common productivity component A boosts the firm entry. Figure 5 displays the comparative statics following an increase in A. Equations (14)-(16) imply that, regardless of whether collateral constraint is binding, an increase in A shifts the LMC upwards but it has no impact on the FE. The firm entry is higher in the new stationary equilibrium, as φ^* is lower. A universal increase in the productivity does not change the "reservation profit" that entrepreneurs require, but it does increase the profitability of operating firms unanimously. Entrants in the new equilibrium include firms which would not enter without the productivity increase: those firms become entrants in the new equilibrium because of the higher productivity (and profit). Importantly, I have assumed in my setup that the price of product is given; however, an increase in prices is mathematically equivalent to an increase in A. An increase in A therefore can capture not only a universal increase in productivity, but also a general increase in demand.

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[33]Equation (22) can be rewritten as:

$$\pi^*_{net} = \left(\frac{R - p}{\left(1 + \hat{b}\right)\left(1 - \tilde{\delta}\right)} - \frac{r\tilde{\delta}}{1 - \tilde{\delta}} \right) c_e$$

where $\tilde{\delta} \equiv \min\left(\gamma, \frac{1}{2 - \delta}\right)$.
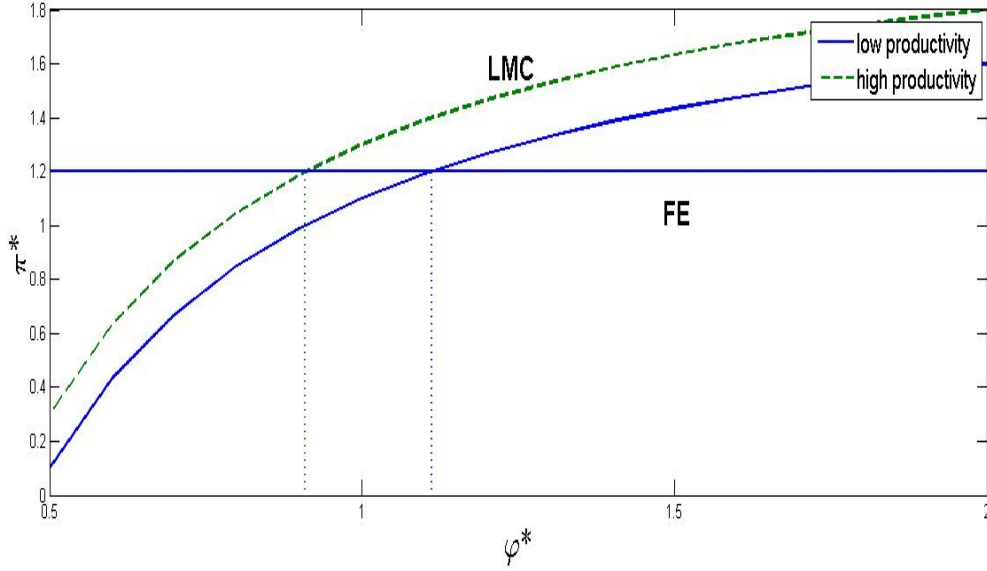
Figure 5: Equlibrium Effects of an Increase in A (Increasing Productivity)

We can further verify that an increase in A undoubtedly raises the aggregate inputs and output. We know from equation (17) that the aggregate productivity Φ raises in response to an improvement in A. In addition, according to equations (18)-(19), the equilibrium level of inputs increases as the marginal products of inputs are boosted by rising Φ. The aggregate output expands, as long as Φ, K, and L all increase.

The change of average productivity $\widetilde{\varphi}$ can be derived using equation (20). The change of $\widetilde{\varphi}$ depends on the change of $A\varphi^*$, which equals the productivity level of cutoff entrants. The increase in A raises the aggregate output Y, and the equilibrium wage w. However, the cutoff profit level π^* remains unchanged in the new equilibrium, so that the productivity of marginal entrants has to increase to maintain the profit level (given the higher w).[34] Therefore, in response to an increasing A, the average productivity $\widetilde{\varphi}$ increases. If the economic downturn in the Great Recession is exclusively a consequence of declining A, we would have observed lower average TFPR of entrants in the recession than in the boom.

Moreover, according to equation (22), changes in A have no impact on the average net profit. The average net profit is solely determined by the level of "reservation net profit". An increase in A enhances the profitability of entrants in general, meanwhile it raises the number of entrants: the increase in the number of entrants lowers the relative fraction of more productive and more profitable entrants. As a result, the average net profit of entrants remains invariant.

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[34]It is easy to check that the capital stock of the cutoff entrant remains invariant.
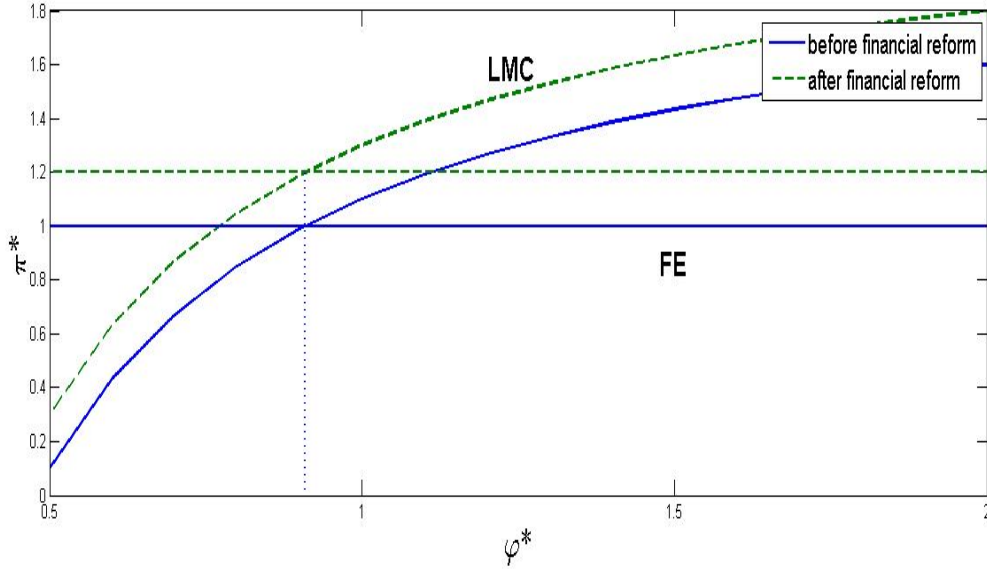
24

5.3 Shocks to Financial Frictions

Figure 6: Equlibrium Effects of an Increase in δ (Financial Reform)

Equations (14) to (16) tell us how an increase in δ affects the equilibrium. The financial shock has no impact if the credit constraint is never binding ($\gamma < \frac{1}{2-\delta}$). Figure 6 above graphically illustrates the comparative statics of an increase in δ, if $\gamma > \frac{1}{2-\delta}$. The solid lines denote the equilibrium before the increase in δ; the dashed lines denote the equilibrium after the increase in δ. According to equation (14), an increase in δ increases π^*, shifting the FE line upwards. More specifically, the shift of FE line captures the selection effect: the relaxing of the financial constraint increases the expenditure on capital, hence prohibitting the entry of the less productive firms. Meanwhile, equations (15) and (16) suggest that conditional on φ^*, an increase in δ increases the cutoff profit π^* if the labor market clears. Therefore the LMC curve shifts to the right in reaction to an increasing δ. The shift of LMC curve captures that the less productive firms are more lucrative (i.e. they are encouraged to enter the market) because of higher pledgeability. The overall effect of an increasing δ on the number of firm entry is ambiguous.

Since an increasing δ has ambiguous effect on the equilibrium firm entry, or equivalently, the cutoff productivity φ^*, it is not conclusive how it affects the aggregate productivity Φ and the average productivity $\widetilde{\varphi}$. Moreover, a financial reform lowering the firm entry and thus depressing the aggregate productivity Φ, does not necessarily reduce the aggregate output Y, as it raises pledgeability and possibly increase the aggregate capital K according to equation (19). If a financial reform boosts the firm entry, it would unambiguously expand

the output as it does not only increase the aggregate productivity Φ, but also, as implied by equations (18)-(19), increases the aggregate inputs K and L.

Equation (21) implies that the average net profit of entrants $\widetilde{\pi}_{net}$ increases insofar as the cutoff net profit π^*_{net} raises. Equation (22) shows that a financial reform raises the cutoff net profit π^*_{net} (as well as π^* in Figure 6), so it is expected that a financial reform would also raise the average net profit of entrants. If an economic expansion is solely driven by an increasing δ, the average net profit of entrants would be higher in the boom than in the recesssion. However, as shown in Section 2, the opposite is found in the data: compared with the entrants in the recession, the entrants in the boom were on average less profitable.

If the Spanish economic expansion before the financial crisis is jointly explained by high levels of A and δ, we would expect the average net profit of entrants to fall in the recession: a result which is at odds with the facts. To sum up, changes in A and δ can not fully rationalize aforementioned empirical facts.

5.4   Interest Rate

In this small open economy, another alternative explanation for economic expansions is a declining interest rate. An important implication of equations (14)-(16) is that: an increase in b is mathematically equivalent to a decrease in the interest rate R. Therefore, like an increase in b, a decrease in interest rate lowers the cutoff profit π^* and increases the firm entry. Intuitively, a decrease in R has two effects: it lowers the cost of capital, encourages capital investment, and therefore raises profitability of firms; meanwhile, it reduces the "reservation profit" as the discount factor $\frac{1}{R}$ increases. The two effects are analogous to the subsidy effects of bubbles on capital input and on firm entry. The comparative statics is shown in Figure 7.
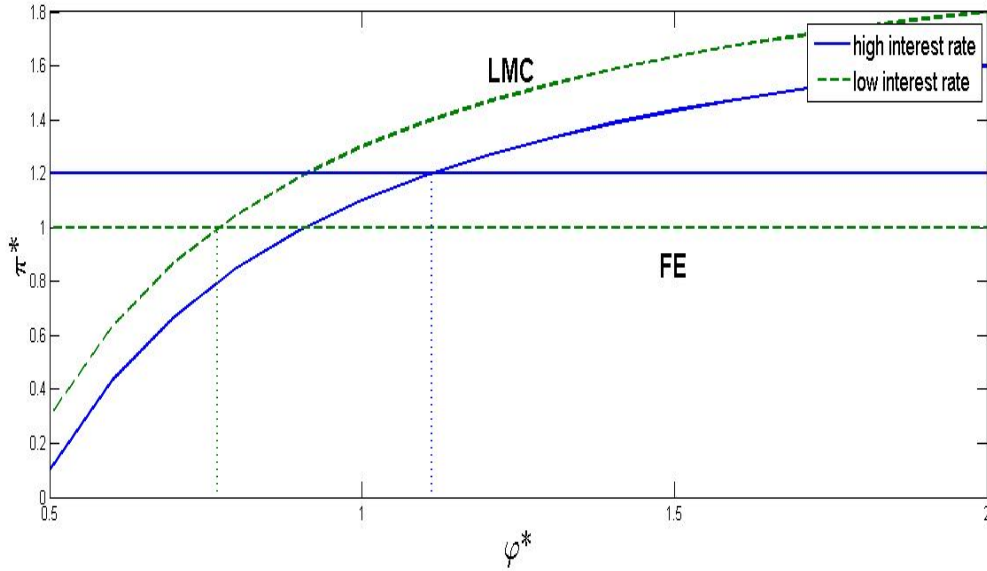
Figure 7: Equlibrium Effects of a Decrease in R

Moreover, lowering the interest rate R improves the aggregate productivity as it expands the firm entry. Besides, lowering R reduces the cost for capital. One can see from equations (18)-(19) that, at the aggregate level, lowering interest rate increases the aggregate output, and boosts the aggregate inputs K and L.

At the firm level, since lowering interest rate decreases the cutoff productivity, Equation (20) implies that it also dampens the average productivity. However, lowering interest rate has ambiguous effect on the average net profit. Recall the equation (22):

$$\pi_{net}^* = \left(r + \frac{1 - p - r\hat{b}}{\left(1 + \hat{b}\right)\left(1 - \min\left(\gamma, \frac{1}{2-\delta}\right)\right)} \right) c_e$$

In fact, the equations above suggests that the change in the cutoff (and thus the average) net profit due to a decline in the interest rate depends on the size of $\hat{b}$: if $\hat{b}$ is close to zero, lowering interest rate would lower the cutoff net profit; if $\hat{b}$ is very large, lowering interest rate would improve the cutoff net profit. Intuitively, lowering interest rate, on the one hand, increases the discount factor $\frac{1}{R}$, and hence lowers the "reservation net profit". On the other hand, lowering interest rate unambiguously dampens the cutoff profit π^* and thus dampens the size of the bubble subsidy for cutoff entrants: if the size of bubble creation ratio $\hat{b}$ is large enough, this channel is going to be overwhelming, and thus lowering the interest rate increases the "reservation net profit", as well as the average net profit of entrants.

Notably, the analogy between bubbles and declining interest rates might be an artifact of the assumption that firms only borrow and invest when they enter the market. If incumbent

firms can adjust their size of capital, they may respond to an interest rate reduction by increasing their capital stock, in order to take advantage of a lower investment cost. However, a shock to the bubble creation ratio only affects entrants directly, rather than incumbents. Moreover, changes in interest rates are exogenous in this small open economy. It is important to be aware that in a more general model, interest rates can be determined by fundamental factors (like productivity and fiancial frictions) and bubbles. [35]

5.5 Net Output

At the end of Section 5, I study the net output in stationary bubbly equilibria. Net output is the amount of consumption good produced in every period:

$$\widehat{Y} \equiv Y - (1-p)\,K$$

$\hat{Y}$ equals to the difference between aggregate output Y and the "depreciation" of physical capital, $(1-p)\,K$, which equals to the amount of capital destroyed with firm exit in every period.[36] As shown in Section 4.3, an increase in $\hat{b}$ decreases φ^*, and increases the aggregate capital stock K in the new stationary equilibrium; consequently, investment cost raise as well in the new stationary equilibrium. An increase in $\hat{b}$ thereby has an ambiguous effect on $\hat{Y}$.

The size of $\hat{b}$ maximizing $\hat{Y}$ in stationary equilibria is analogous to the "Golden Rule Savings rate" in the Solow model. The aggregate capital stock K and productivity Φ are both increasing in $\hat{b}$, and subject to diminishing returns: when $\hat{b}$ raises above a certain level, the increases in the capital depreciation are destined to override the increase in output, and any further increase in $\hat{b}$ deteriorates the net output. Notably, the reasoning above also implies that there always exists an optimal level of $\hat{b}$ (which can equal zero) maximizing the net output $\hat{Y}$.

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[35]For more discussions about the interplay between interest rates and bubbles, see Farhi and Tirole (2011), and Asriyan et al. (2016).

[36]It has been implicitly assumed that capital cannot be reallocated once the firm exit, otherwise the aggregate amount of capital would grow unboundedly.
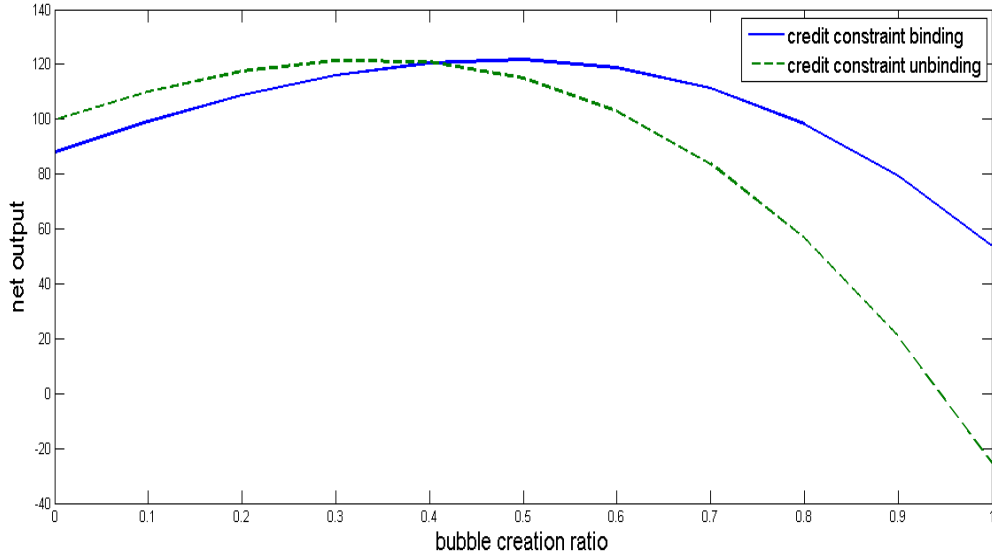
Figure 8: Bubble Creation Ratio and Net Output

Not surprisingly, the size of $\hat{b}$ maximizing $\hat{Y}$ depends on how financially constrained the economy is. Figure 8 shows a comparison between two economies which are only different in pledgeability δ: the solid line denotes an economy with low pledgeability δ and the credit constraint is binding, while the dashed line denotes an economy with high pledgeability δ and the credit constraint is not binding. Despite the fact that in both economies bubbles improve net output when they are small, the size of $\hat{b}$ maximizing $\hat{Y}$ is higher in the economy with lower pledgeability. An alternative interpretation is that bubbles are more likely to improve net output when pledgeability δ is low. Intuitively, bubbles relax the financial constraint and raise the capital stock, and the output expansion from increasing capital stock is more pronounced when there is fewer capital stock: low level of pledgeability depressing the size of capital stock makes bubbles more likely to improve net output.

Perhaps the most astounding feature of Figure 8 is that: when the bubble creation ratio is small, the net output is increasing in pledgeability δ; however, the relationship is reversed when the bubble creation ratio is large. This is again because that the aggregate capital stock K is increasing in $\hat{b}$. When the bubble creation ratio is small, capital is scarce and increasing pledgeability improves the net output as it raises the output greatly. When the size of bubble creation is large, there is abundant capital, and increasing pledgeability deteriorates the net output since the corresponding increase in capital stocks raises depreciation cost but has very limited impact on output.

The mechanism discussed above can be studied mathematically through a special case of economy, where the entry cost $c_e = 0$. When there is no entry cost, an increase in $\hat{b}$ or δ

increases the aggregate capital K, rather than the aggregate productivity Φ, which always equals to its maximum level. According to Equation (19), when the financial constraint is binding, the "aggregate" marginal product of capital is given by:

$$\frac{\partial Y}{\partial K} = \gamma \Phi^{1-\alpha-\gamma} N^\alpha K^{\gamma-1} = \frac{\gamma (R - p) (2 - \delta)}{\left(1 + \hat{b}\right)(1 - \alpha)}$$

The marginal product $\frac{\partial Y}{\partial K}$ is strictly decreasing in $\hat{b}$ and δ, while a financial reform or an increase in $\hat{b}$ is welfare improving if and only if $\frac{\partial Y}{\partial K} > 1 - p$. In an economy with very high level of $\hat{b}$ (to the extent that $\frac{\partial Y}{\partial K} < 1 - p$), capital is heavily subsidized, and the credit constraint restricts entrepreneurs from excessive investment: a financial reform in such an economy would aggravate the loss in net output.

6   Aggregate Fluctuations

In this section I study aggregate fluctuations. Although the model features heterogeneous firms and firm entry and exit, it can be solved without implementing approximation techniques a la Krusell and Smith (1998). In Section 6.1 I lay down the basic idea of my solution method. The stochastic dynamic model can be illustrated through an easy example in Section 6.2.

The main purpose of this section is to study misalloaction. As I show in the previous section, bubbles and an interest rate reduction both increase the aggregate productivity in stationary equilibria. However, misallocation arises in transition dynamics as capital intensity fluctuates across cohorts. Using the example economy I set up in Section 6.2, in Section 6.3 I plot the impulse response functions. I show that the aggregate productivity decreases in response to bubble shocks or negative interest rate shocks, while the aggregate output expands. The results are in line with the stylized fact that the Spanish TFP declined during the output expansion.

I close this section by running counterfactual experiments about bubbles. In Section 6.4 I compare the experiment result with a bubble crash and the result without a bubble crash. The comparison result suggests that bubble shocks can significantly contribute to the magnitude of aggregate fluctuations.

6.1   The Model with Aggregate Uncertainties

With aggregate uncertainties included, the model is only solvable with computational tools. A common feature of the stochastic dynamic model with heterogeneous agents is that the

aggregate states consist of the entire distribution of heterogeneous agents. A standard approach, developed by Krusell and Smith (1998), is to approximate infinite-dimension states with a finite number of variables. In my model, the assumptions that labor market is frictionless and that there are no idiosyncratic productivity shocks enable me to collapse the information of the entire distribution of firms into one single state variable without approximation.

Recall that the production function is:

$$y_t = (A\varphi)^{1-\alpha-\gamma} \cdot n_t^\alpha k^\gamma, \alpha + \gamma < 1$$

Define the term "efficient capital" as: $\hat{k} :\equiv \left((A\varphi)^{1-\alpha-\gamma} (k)^\gamma\right)^{\frac{1}{1-\alpha}}$, so the production function can be rewritten as:

$$y_t = n_t^\alpha \hat{k}^{1-\alpha}$$

Since the production function is CRS in labor and efficient capital, and the labor market is frictionless, it is immediate that the aggregate output takes the following form:

$$Y_t = N_t^\alpha \hat{K}_t^{1-\alpha}$$

where N_t, $\hat{K}_t$ are respectively the aggregate amount of labor and efficient capital at period t. For any given firm j, the profit π_t^j is pinned down by the wage w_t, the capital input k^j, and the productivity φ^j. The wage w_t is determined by the aggregate efficient capital $\hat{K}_t$, so in order to determine the fundamental component of a firm, we only need to keep track of the process of the aggregate efficient capital $\hat{K}_t$, rather than the evolution of the entire distribution of firms. The aggregate efficient capital $\hat{K}_t$, follows the following process:

$$\hat{K}_{t+1} = p\hat{K}_t + \int_{\varphi \geq \varphi_{t+1}^*(\lambda_t)} \left((A\varphi)^{1-\alpha-\gamma} (k(\lambda_t, \varphi)^\gamma)\right)^{\frac{1}{1-\alpha}} dF(\varphi) \tag{23}$$

$\hat{K}_{t+1}$ equals the sum of two terms: the remaineder of efficient capital from period t, which equals $p\hat{K}_t$; and the total amount of efficient capital brought by the entrants, which equals the second term on the RHS of equation (23). In our setup, the exit probability of firm j is independent from the level of $\hat{k}^j$, so the LLN imples that $(1-p)\hat{K}_t$ is destroyed at the end of the period t and $p\hat{K}_t$ remains. The cutoff level at period $t+1$, φ_{t+1}^*, and the capital input of the entrants at period $t+1$, are both determined at the end of period t, so that they are both functions of aggregate states λ_t, which includes not only $\hat{K}_t$, but also the bubble creation shock $\hat{b}_t$, and the interest rate R_t. The process of $\hat{K}_{t+1}$ can therefore be pinned down recursively. I use Value Function Iteration (VFI) to solve for the fundamental component,

the algorithm is described in the Appendix 8.

An important difference between the transition dynamics and the stationary equilibria we explore in Section 4 is that, if we write down the aggregate production function as:

$$Y_t = \Phi_t^{1-\alpha-\gamma} N_t^\alpha K_t^\gamma \tag{24}$$

like what I do in Section 4.4, the aggregate productivity Φ_t has no close-form representation in transition dynamics. In order to derive a closed-form Φ_t like in Section 4.4, it is necessary that, for any firm i and j:

$$\frac{n_t^j}{n_t^i} = \frac{k^j}{k^i} = \frac{\varphi^j}{\varphi^i}$$

The equality always holds in a stationary equilibrium; however, with shocks to $\hat{b}_t$ and R_t, the ratio φ^j/k^j fluctuates across different cohorts, entailing misallocation. I show in Section 4.4 that a permanent increase in $\hat{b}_t$ increases aggregate productivity in the long run; however, as shown in Section 6.3, a temporary increase in $\hat{b}_t$ does not necessarily increase aggregate productivity in the short run, because misallocation is exacerbated in bubbly episodes: the capital investment of entrants are subsidized in bubbly episodes, not by the government, but by optimistic investors.

6.2   An Example

In this section I set up an example of a stochastic dynamic model. I include only two types of aggregate shocks: sentiment shocks, which are shocks to $\hat{b}_t$, and interest rate shocks, which are shocks to R_t. It is ideal to include as well the shocks pledgeability δ[37], but that would exceedingly prolong the computation time. In any case, as shown in Section 5, the view that the financial crisis in Spain was essentially a sudden drop in A or δ is at odds with the documented increase of the average profit and productivity of entrants. Thus I limit my analysis to interest rate and sentiment shocks, with A and δ fixed.

The baseline parameters are shown in Table 3. I study the benchmark case where $\delta = 0$. The labor and capital intensity α and γ, the Pareto shape parameter ζ, the wage elasticity of labor supply ε, the survival probability p are taken from the literature.[38] A and $\bar{M}$ are irrelevant for our analysis and do not affect our results, so I set them to one.

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[37]In this model, we can no longer use the law of motion in Equation (23), if we include shocks to A.

[38]The labor and capital intensity α and γ, and the Pareto shape parameter ζ are taken from Garcia-Santana (2014); the survival probability p is taken from Garcia-Macia (2015); the wage elasticity of labor supply ε is a conventional value in the literature. None of the values is eccentric compared with their counterparts in the literature.

α	γ	ζ	ε	p	ρ	σ	$\bar{r}$	p_b	p_f	δ	c_e	$\hat{b}$
0.5185	0.3315	1.08	2	0.96	0.7579	0.035	0.0092	0.93	0.89	0	1.5	0.4

Table 3: Parameters

I assume that the net interest rate $r_t :\equiv R_t - 1$ follows:

$$r_t = \bar{r} + \rho r_{t-1} + \epsilon_t \tag{25}$$

where $\epsilon_t \sim N\left(0, \left(1 - \rho^2\right)\sigma^2\right)$. I estimate ρ, σ, and $\bar{r}$ by regression (25), using Spanish data of annual long-term real interest rate (linearly detrended) from OECD. The choice of ρ, σ, and $\bar{r}$ are based on the estimation results.

The sentiment state $\hat{b}_t$ is assumed to follow a 2-state Markov process $\hat{b}_t \in \left\{0, \hat{b}\right\}$, where $b > 0$: the economy is in a bubbly episode if $\hat{b}_t = \hat{b}$. The transition matrix is given by:

$$\begin{bmatrix} p_f & 1 - p_f \\ 1 - p_b & p_b \end{bmatrix}$$

p_f denotes the probability of staying in a bubbleless episode; p_b denotes the probability of staying in a bubbly episode. It is important for our analysis to identify the bubbly episodes among the sample periods, yet it is difficult to do it using macro data. The conventional view is that Spain experienced a bubbly episode coinciding with the rapid economic expansion, before its economy collapsed in early 2008. In media or academia, the bubble in Spain refers mostly to "housing bubble": while the bubble in the context of this paper refers mostly to the stock market bubble, the housing bubble is a sign of investor optimism which would very likely affect the stock market. In fact, Fernández-Villaverde and Ohanian (2009) show that the Spanish stock market concurrently experienced a dramatic boom, and the size of which was even more exaggerated than those in other developed economies like the U.S. Even if it remains inconclusive whether Spanish economy was bubbly in 1980s, it is plausible to classify the period 1994-2007 as a bubbly episode, and the prolonged recession during 2008-2014 as a bubbleless episode. The calibration of p_f and p_b is based on this classification: p_f and p_b are chosen to maximize the likelihood that the economy was bubbly from 1994 to 2007, and was bubbleless from 2008 to 2014.[39]

The last two parameters: entry cost c_e and the bubble creation ratio, $\hat{b}$, are estimated using Simulated Method of Moments (SMM). Given guesses of c_e, and $\hat{b}$, I simulate the model and calculate the implied target moments: the autocorrelations of GDP growth rate and the TFP growth rate, which is constructed according to Equation (24). c_e and $\hat{b}$ are chosen to

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[39]Year 1993 is assumed to be bubbleless, given the fact that Spain was in recession that year.

minimize the difference between the simulated moments and their empirical counterparts calculated using Spanish data.[40] The fittness of the model is reported in Table 4. The autocorrelations of GDP growth and TFP growth in the simulated data are very close to the moments in the real data. I also compare the standard deviations of simulated TFP and GDP growth with the actual data: despite the exclusion of productivity shocks and financial shocks, the model can explain approximately one half of the volatility in TFP growth and one third in GDP growth.

Statistics	Model	Data
Targeted moments		
Autocorr. GDP growth	0.69	0.70
Autocorr. TFP growth	0.60	0.60
Non-targeted moments		
Std. TFP growth	0.0045	0.0098
Std. GDP growth	0.0071	0.0221

Table 4: Moments Fit

6.3 Impulse Response Functions

I plot the impulse response using the calibrated model in 6.2. I run simulations with 1010 periods: the shocks are drawn stochastically except that a bubble shock arrives at period $t = 1000$. I repeat the same experiment 1000 times and calculate the average impulse responses following the bubble shock at $t = 1000$. The results are plotted in Figure 9: the starting points at time axis correspond to period $t = 1001$, when the lagged effects of the bubble shock appear. The upper-left panel reports the reaction of GDP growth rate. The GDP growth rate increases in response to a bubble shock. The acceleration in output growth is mainly driven by an acceleration in capital growth, which is reported in the upper-right panel: the growth rate of capital increased by about 1.3 percent points. The lower-left panel suggests that the number of firms also increases in reaction to the temporary bubble shock.

Most notably, we can tell from the last panel that the growth of the aggregate productivity is dampened by a bubble shock. The reason is that the allocative efficiency is deteriorated in a bubbly episode: entrants in a bubbly episode receive bubble subsidy on capital input, and invest more in capital than the cohorts from bubbleless episodes, so that bubble shocks can amplify the dispersion of MPK across different cohorts (and firms). The result is consistent with the stylized fact regarding the Spanish aggregate productivity during 1994-2007.

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[40]GDP data is the Constant GDP per capita for Spain, from World Bank; TFP data is Spanish TFP data from Penn World Table 9.0.
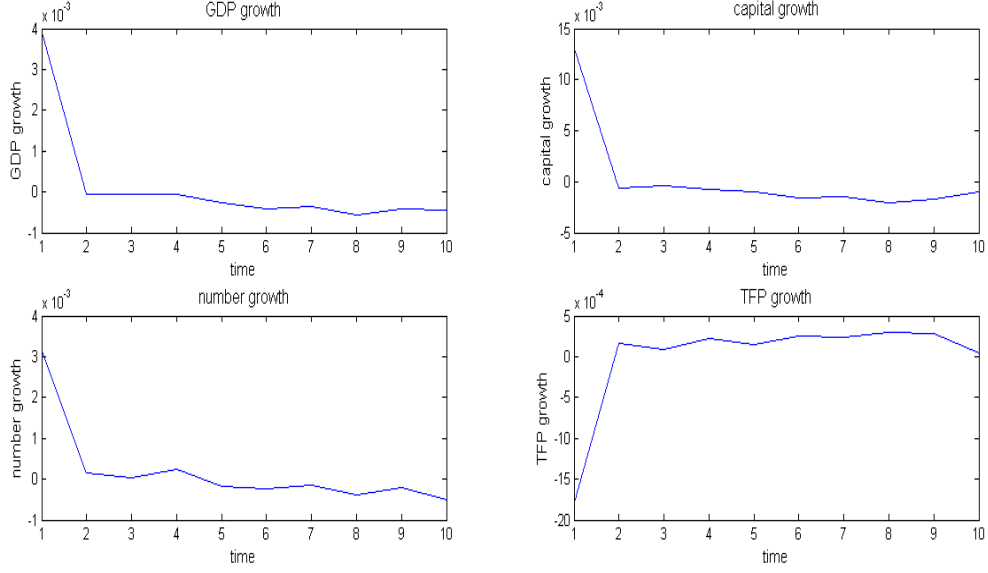
Figure 9: Impulse Response to a Bubble Shock

Like in the stationary equilibria, in the transition dynamics a (temporary) reduction in the interest rate is similar to a bubble shock. Figure 10 plots the impulse responses to a negative shock in interest rate. At time $t = 1000$, the interest rate falls by one standard deviation: the starting points at time axis correspond to period $t = 1001$. The direction of the impulse responses to a negative interest rate shock are the same as to a bubble shock. In particular, as proposed by Gopinath et al. (2015), a negative interest rate shock can worsen the allocative efficiency and trigger a decline in the aggregate productivity.
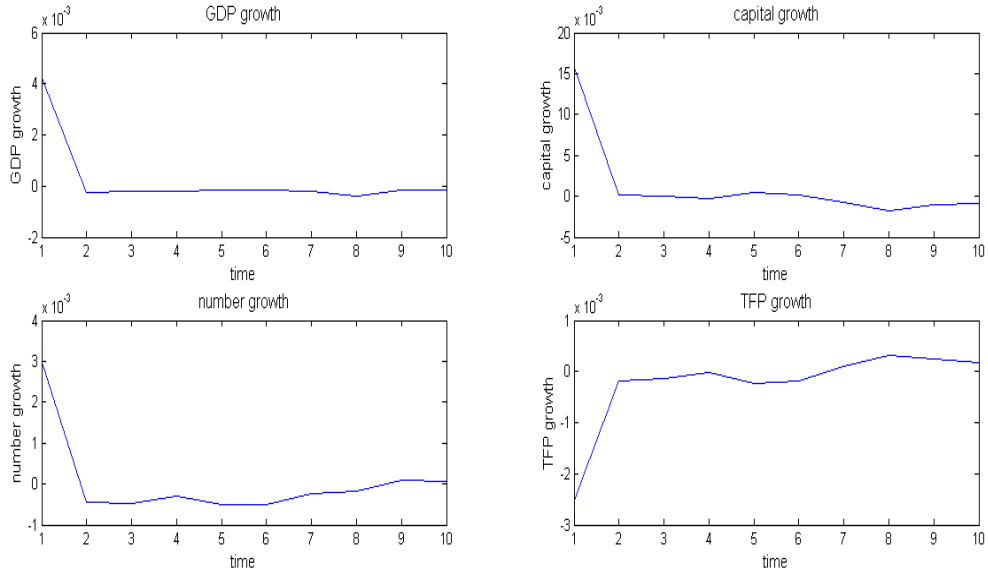

Figure 10: Impulse Response to a Negative Interest Rate Shock

6.4   Bubble Crash and the Great Recession

We can evaluate the importance of bubble shocks by performing counterfactual experiments. I run two experiments: in the first experiment I assume that the period 1994-2007 was bubbly, and that the year 1993 and the period 2008-2014 was bubbleless; in the second experiment the sentiment state in the period 1993-2014 is simulated according to the Markov process in our calibration. In both experiments I use actual realization of interest rates for years 1993-2014, and a simulated history of states before year 1993. Each experiment is repeated 1000 times. I plot the average simulated GDP growth rate from both experiments in the Figure 11: the left panel for the first experiment and the right panel for the second experiment. The simulation result are plotted in dashed lines, compared with the real data (growth rate of GDP per capita) in solid lines.
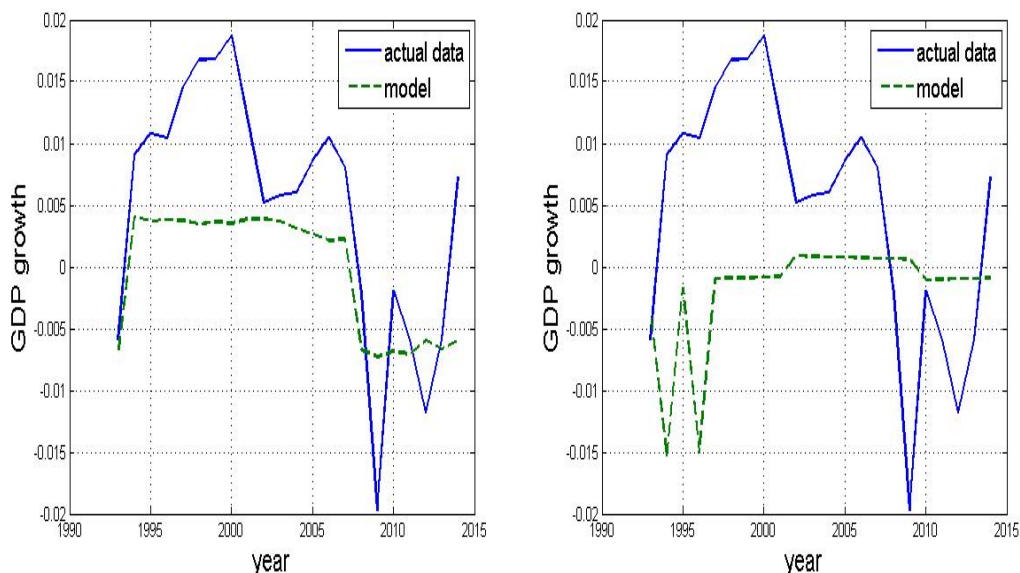

Figure 11: Counter-factual Experiment with Bubble Shocks

In the right panel, our control group, the average effect of bubble shocks is close to zero and the fluctuation of GDP growth is driven solely by the changes in the interest rate. It is clear that the model is unable to reproduce the economic expansion with comparable magnitude. Moreover, without a bubble crash, the model cannot account for the size of the downturn during the Great Recession. In the left panel, our experimental group, bubbles existed during 1993-2007, and did not exist during 2008-2014: with the boom-bust of bubbles, the fluctuations are significantly amplified. It is premature to overstate the importance of bubble shocks in the real world, but the results suggest that bubble shocks are prospective in explaining the dramatic size of aggregate fluctuations.

7 Conclusion

To the utmost of my knowledge, this is the first paper studying the implications of asset price bubbles on the distribution of firms, and the first paper investigating the macroeconomic implication of sentiments through firm entry in an economy. In this paper, I construct a model in the spirit of Lucas (1978) and Hopenhayn (1992). I characterize the bubbly equilibria where the price of a firm equals the sum of a fundamental component and a Ponzi game component. The model can shed light on the distinctions between the various explanations of economic expansions, and can rationalize the recent Spanish experience. Although the theory developed in this paper is motivated by and used to interpret the Spanish empirical facts, it is also applicable to study other economies, like other countries in southern Europe, or China, which is experiencing a dramatic boom in asset prices.

The theoretical insights of this paper may be of interest to policy makers. There is a growing literature studying policy implications of bubbles.[41] In practice, policy makers face the challenge of verifying whether an economic expansion is driven by bubbles or other unobservable factors like productivity or demand. The theory I propose here can facilitate this verification.

In order to derive a closed-form solution of stationary equilibrium and to simplify the numerical analysis, I abstract from capital adjustment, fixed cost of production, and idiosyncratic productivity shocks. The first extension of the baseline model would be to introduce capital adjustment. It is widely documented that compared with younger firms, older firms are less likely to be financially constrained.[42] The literature argues that this pattern is due to the fact that firms can overcome the financial constraint by accumulating capital stocks.[43] As shown in Section 4, a rational bubble component is expected to grow upon continuation. The growth of bubble components can be an engine for firm growth: as bubble components expand over time, firms gradually grow out of financial constraints since bubbles can act as collateral when fundamental collateral is scarce.[44] In the presence of bubbles, firms can grow even if they do not accumulate capital stock (for instance, capital fully depreciates every period). It has not yet been explored to which extent bubbles contribute to the growth of firms. Introducing capital adjustment of incumbent firms would enable us to study the implications of bubbles on firm growth and moreover, how bubbles affect the evolution of firm size distribution.

The second extension would be to incorporate fixed operating cost and idiosyncratic

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[41]See Asriyan et al. (2016), Gali (2014), and Martin and Ventura (2016).

[42]See Cabral and Mata (2003).

[43]See Midrigan and Xu (2014), and Moll (2014).

[44]See Martin and Ventura (2012, 2016)

productivity shocks. A limitation of the baseline model is that there is only exogenous exit rather than endogenous exit: incumbents never choose to exit the market since there is no fixed operating cost and the profit is always non-negative. Firms would possibly choose to exit when facing a positive fixed operating cost and a negative idiosyncratic productivity shock. In the scenario with endogenous exit, bubbles act as a tax on firm exit since exit incurs loss of bubbles. The wave of firm exit in the financial crisis could be well explained as a consequence of a bubble crash. Moreover, through the interaction with firm exit, bubbles amplify misallocation given that bubbles sustain the non-productive firms which would otherwise exit the market. Furthermore, bubbles make older firms less likely to exit, since bubble components are expected to grow upon continuation, and older firms are more likely to have larger bubble components: this is consistent with the empirical evidence.[45] In a word, the interaction between bubbles and endogenous exit would be an interesting avenue for future research.

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[45]See Dunne, Roberts, and Samuelson (1989).

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Appendix 1

This Appendix presents proof for Proposition 1. The aggregate bubbles in stationary equilibria, B, as a result of Law of Large Number, follow the process:

$$B = RB + B(0)$$

or

$$B = \frac{B(0)}{1 - R}$$

where $B(0)$ denotes the total amount of bubbles for the entrant. When $B(0) = 0$, the equilibrium is the fundamental equilibrium studied by Hopenhayn (1992) and Melitz (2003), as well as another papers in the literature of firm/industry dynamics. If $B(0) > 0$, the equilibrium is a bubbly equilibrium, and the aggregate bubbles are not explosive if and only if $R < 1$ and $B(0) < \infty$. Given my setup, $B(0)$ is always bounded: for any given entrant, the size of bubbles is proportional to the fundamental component as well as to its profit and output; since the total output for entrants is always bounded, $B(0)$ is bounded as well. Moreover, A bubbly stationary equilibrium is sustainable if B is not larger than the aggregate output, and there always exists a bubble creation ratio b which makes $B(0)$ and B small enough compared with aggregate output.

Q.E.D.

Appendix 2

The fundamental component, $f(\lambda, \varphi, k)$, is increasing in the idiosyncratic productivity component φ, since the profit is increasing in φ, conditional on λ and k. Equation (6) can be rewritten as:

$$v^e(\lambda, \varphi) = \frac{1}{R} \max_k \{v(\lambda, \varphi, k) - Rk\} = \frac{1}{R} \max_k \{(1 + b) f(\lambda, \varphi, k) - Rk\}$$

The equation above implies that the value function $v^e(\lambda, \varphi)$ is also increasing in φ[46]. Therefore there is a unique cutoff productivity φ^*: an entrant enters the market as long as she

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[46]Use Envelope Theorem.

draws a productivity $\varphi > \varphi^*$, otherwise she does not enter the market since the entry value $v^e(\lambda, \varphi)$ is not high enough to cover the entry cost c_e[47].

Appendix 3

Without loss of generality, I start with the scenario where $\gamma < \frac{1}{2-\delta}$: the collateral constraint is not binding.

Appendix 3.1: Derive FE

Use that:

$$Rk = \frac{R\left(1 + \hat{b}\right)\gamma}{R - p}\pi$$

we can rewrite Equation (6) as:

$$v^e(\lambda, \varphi) = \frac{\left(1 + \hat{b}\right)(1 - \gamma)}{R - p}\pi(\lambda, \varphi, k(\lambda, \varphi)) \tag{26}$$

$k(\lambda, \varphi)$ is the capital input chosen by the entrants. FE holds if and only if as for the marginal entrant with $\varphi = \varphi^*$,

$$v^e(\lambda, \varphi^*) = c_e \tag{27}$$

Equation (27) implies that at the cut-off productivity level $\varphi = \varphi^*$, entrants are indifferent in whether or not to enter the market. If $\hat{b} = 0$, the stationary equilibrium is a bubbleless, or fundamental equilibrium, as studied by Hopenhayn (1992) and Melitz (2003). We can derive the free entry condition (FE) using Equation (26) and (27):

$$\pi^* = \frac{R - p}{\left(1 + \hat{b}\right)(1 - \gamma)}c_e \tag{28}$$

Appendix 3.2: Derive $n(\lambda, \varphi^*)$

We need to derive $n(\lambda, \varphi^*)$ before we derive the LMC. The crucial step is to rewrite the wage w as the marginal product of labor for the marginal entrants. Recall Equation (11) and (12):

$$\alpha(A\varphi)^{1-\alpha-\gamma}n^{\alpha-1}k^\gamma = w \tag{29}$$

$$\frac{R\left(1 + \hat{b}\right)}{R - p}(1 - \alpha)\gamma(A\varphi)^{1-\alpha-\gamma}n^\alpha k^{\gamma-1} = R \tag{30}$$

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[47]Use that $v^e(\lambda, \varphi) \to 0$ if $\varphi \to 0$; $v^e(\lambda, \varphi) \to +\infty$ if $\varphi \to +\infty$.

Using Equation (29) and (30), we can derive that

$$k = \frac{w\left(1+\hat{b}\right)(1-\alpha)\gamma}{\alpha(R-p)}n \tag{31}$$

Plug Equation (31) into Equation (29), we get:

$$w^{1-\gamma} = \alpha(A\varphi)^{1-\alpha-\gamma}\left(\frac{\left(1+\hat{b}\right)(1-\alpha)\gamma}{\alpha(R-p)}\right)^{\gamma}n^{\alpha+\gamma-1}$$

As for the marginal entrant:

$$w^{1-\gamma} = \alpha(A\varphi^*)^{1-\alpha-\gamma}\left(\frac{\left(1+\hat{b}\right)(1-\alpha)\gamma}{\alpha(R-p)}\right)^{\gamma}n(\lambda,\varphi^*)^{\alpha+\gamma-1}$$

Using Equation (29) and (30), we have:

$$\frac{n^i}{n^j} = \frac{\varphi^i}{\varphi^j} \tag{32}$$

where n^j denotes the labor demand of firm j. Labor market clearing implies that:

$$\int_{\varphi\geq\varphi*}\left(\frac{\varphi}{\varphi^*}\right)n(\lambda,\varphi^*)\frac{\bar{M}}{1-p}dF(\varphi) = L_s = w^{\varepsilon} \tag{33}$$

where the left-hand-side is the aggregate labor demand, while the right-hand-side is the aggregate labor supply, conditional on wage; $\frac{M}{1-p}dF(\varphi)$ measures the amount of firms with productivity φ in the stationary equilibria. Equation (33) can thus be rewritten as:

$$\int_{\varphi\geq\varphi*}\left(\frac{\varphi}{\varphi^*}\right)n(\lambda,\varphi^*)\frac{\bar{M}}{1-p}dF(\varphi) = \left[\alpha(A\varphi^*)^{1-\alpha-\gamma}\left(\frac{\left(1+\hat{b}\right)(1-\alpha)\gamma}{\alpha(R-p)}\right)^{\gamma}n(\lambda,\varphi^*)^{\alpha+\gamma-1}\right]^{\frac{\varepsilon}{1-\gamma}}$$
$$\tag{34}$$

Move $n(\lambda,\varphi^*)$ to the left-hand-side:

$$n(\lambda,\varphi^*)^{1-\frac{\varepsilon(\alpha+\gamma-1)}{1-\gamma}} = \frac{(1-p)\left[\alpha(A\varphi^*)^{1-\alpha-\gamma}\left(\frac{(1+\hat{b})(1-\alpha)\gamma}{\alpha(R-p)}\right)^{\gamma}\right]^{\frac{\varepsilon}{1-\gamma}}}{\bar{M}\int_{\varphi\geq\varphi*}\left(\frac{\varphi}{\varphi^*}\right)dF(\varphi)} \tag{35}$$

44

or:

$$n\left(\lambda, \varphi^{*}\right)=\left(\frac{(1-p)\left(\alpha\left(\frac{(1+\hat{b})(1-\alpha)\gamma}{\alpha(R-p)}\right)^{\gamma}(A\varphi^{*})^{1-\alpha-\gamma}\right)^{\frac{\varepsilon}{1-\gamma}}}{\bar{M}\int_{\varphi\geq\varphi*}\left(\frac{\varphi}{\varphi*}\right)dF\left(\varphi\right)}\right)^{\frac{1}{1-\frac{\varepsilon}{1-\gamma}(\alpha+\gamma-1)}} \quad (36)$$

Appendix 3.3: Derive LMC

The relationship between profit and labor demand is given by[48]:

$$\pi\left(\lambda, \varphi\right)=\left[(1-\alpha)(A\varphi)^{1-\alpha-\gamma}\left(\frac{\left(1+\hat{b}\right)\gamma}{R-p}\right)^{\gamma}n\left(\lambda, \varphi\right)^{\alpha}\right]^{\frac{1}{1-\gamma}}$$

We can thus characterize the labor market clearing condition (LMC):

$$\pi^{*}=\left[(1-\alpha)(A\varphi^{*})^{1-\alpha-\gamma}\left(\frac{\left(1+\hat{b}\right)\gamma}{R-p}\right)^{\gamma}n\left(\lambda, \varphi^{*}\right)^{\alpha}\right]^{\frac{1}{1-\gamma}} \quad (37)$$

where $n\left(\lambda, \varphi*\right)$ is given by Equation (36). The LMC establishes another relationship between cutoff productivity φ^{*} and profit π^{*}.

Appendix 3.4: FE and LMC when Credit Constraint is Binding

If $\gamma > \frac{1}{2-\delta}$, we can derive the FE and LMC analogously[49]:

$$FE: \ \pi^{*}=\frac{R-p}{\left(1+\hat{b}\right)\left(1-\frac{1}{2-\delta}\right)}c_{e} \quad (38)$$

$$LMC: \ \pi^{*}=\left[(1-\alpha)(A\varphi^{*})^{1-\alpha-\gamma}\left(\frac{\left(1+\hat{b}\right)}{(R-p)(2-\delta)}\right)^{\gamma}n\left(\lambda, \varphi^{*}\right)^{\alpha}\right]^{\frac{1}{1-\gamma}} \quad (39)$$

---

[48]The equation is immediate if we rewrite capital input as a function of labor input and parameters according to Equation (30), and then use that:

$$\frac{k}{\pi}=\frac{\left(1+\hat{b}\right)\gamma}{R-p}$$

[49]Simply repeat every step but replace γ with δ

where $n(\lambda, \varphi*)$ is given by:

$$n(\lambda, \varphi^*) = \left(\frac{(1-p)\left(\alpha \left(\frac{(1+\hat{b})(1-\alpha)}{\alpha(R-p)(2-\delta)} \right)^{\gamma} (A\varphi^*)^{1-\alpha-\gamma} \right)^{\frac{\varepsilon}{1-\gamma}}}{\bar{M} \int_{\varphi \geq \varphi*} \left(\frac{\varphi}{\varphi*} \right) dF(\varphi)} \right)^{\frac{1}{1 - \frac{\varepsilon}{1-\gamma}(\alpha+\gamma-1)}} \tag{40}$$

Appendix 4

The LMC imples that π^* can be written as a function of φ^*, independent of whether financial constraint is binding:

$$\pi^* = a_0 A^{a_1} (\varphi^*)^{a_2} \left(1+\hat{b} \right)^{a_3}$$

where:

$$a_1 = \frac{1}{1-\gamma} \left(1-\alpha-\gamma + \frac{\alpha}{1+\frac{\varepsilon}{1-\gamma}(1-\alpha-\gamma)} \frac{\varepsilon(1-\alpha-\gamma)}{1-\gamma} \right) > 0$$

$$a_2 = \frac{1}{1-\gamma} \left(1-\alpha-\gamma + \frac{1}{1+\frac{\varepsilon}{1-\gamma}(1-\alpha-\gamma)} \left(\frac{\varepsilon(1-\alpha-\gamma)}{1-\gamma} + \zeta \right) \right) > 0$$

$$a_3 = \frac{1}{1-\gamma} \left(\gamma + \frac{\alpha}{1+\frac{\varepsilon}{1-\gamma}(1-\alpha-\gamma)} \frac{\varepsilon(1-\alpha-\gamma)}{1-\gamma} \right) > 0$$

and a_0 is a constant independent of φ^*, $\hat{b}$, and A. The LMC condition implies that: 1) π^* is increasing in φ^*, or equivalently, decreaing in the amount of firm entry; 2) if $\hat{b}$ increases, π^* increases for every φ^*.

Appendix 5

It is immediate from the definition of aggregate productivity that:

$$\Phi = \frac{\bar{M}}{1-p} \int (A\varphi)^{1-\alpha-\gamma} \left(\frac{n(\lambda, \varphi)}{N} \right)^{\alpha} \left(\frac{k(\lambda, \varphi)}{K} \right)^{\gamma} dF(\varphi)$$

We can use that:[50]

$$\frac{n(\lambda, \varphi)}{N} = \frac{k(\lambda, \varphi)}{K}$$

---

[50]The equality holds if firms are universally financially constrained, or universally unconstrained: which is the case in stationary equilibria.

and

$$\frac{N}{n(\lambda, \varphi)} = \int_{\varphi' \geq \varphi^*} \left(\frac{\varphi'}{\varphi}\right) dF(\varphi')$$

to derive the expression for aggregate productivity:

$$\Phi = A\left(\frac{\bar{M}}{1-p}\right)^{1-\alpha-\gamma} \left(\int_{\varphi \geq \varphi^*} \varphi dF(\varphi)\right)$$

Appendix 6

Use that:

$$k = \frac{\left(1 + \hat{b}\right) \min\left(\frac{1}{2-\delta}, \gamma\right)}{R - p} \pi \tag{41}$$

We can get, from the identity of net profit, that:

$$\pi_{net} = \frac{R - p - r \min\left(\gamma, \frac{1}{2-\delta}\right)\left(1 + \hat{b}\right)}{R - p} \pi \tag{42}$$

It is immediate that:

$$\pi_{net}^* = \frac{R - p - r \min\left(\gamma, \frac{1}{2-\delta}\right)\left(1 + \hat{b}\right)}{R - p} \pi^* \tag{43}$$

Plug in the FE condition from Equation (14) to Equation (43), we have:

$$\pi_{net}^* = \frac{R - p - r \min\left(\gamma, \frac{1}{2-\delta}\right)\left(1 + \hat{b}\right)}{\left(1 + \hat{b}\right)\left(1 - \min\left(\gamma, \frac{1}{2-\delta}\right)\right)} c_e$$

, or:

$$\pi_{net}^* = \left(r + \frac{1 - p - r\hat{b}}{\left(1 + \hat{b}\right)\left(1 - \min\left(\gamma, \frac{1}{2-\delta}\right)\right)}\right) c_e \tag{44}$$

Appendix 7

Equations (18) and (19) can be rewritten respectively as:

$$\alpha Y = N^{1 + \frac{1}{\varepsilon}} \tag{45}$$

$$\frac{R\left(1 + \hat{b}\right)}{R - p} (1 - \alpha) \min\left(\frac{1}{2 - \delta}, \gamma\right) Y = RK \tag{46}$$

Using the definition of aggregate production function, and Equation (46), we can derive that:

$$\Phi^{1-\alpha-\gamma}\left(\alpha Y\right)^{\frac{\varepsilon\alpha}{\varepsilon+1}}\left(\frac{1+\hat{b}}{R-p}\left(1-\alpha\right)\min\left(\frac{1}{2-\delta},\gamma\right)Y\right)^{\gamma}=Y$$

or

$$Y=\left(\Phi^{1-\alpha-\gamma}\alpha^{\frac{\varepsilon\alpha}{\varepsilon+1}}\left(\frac{1+\hat{b}}{R-p}\left(1-\alpha\right)\min\left(\frac{1}{2-\delta},\gamma\right)\right)^{\gamma}\right)^{\frac{1}{1-\gamma-\frac{\varepsilon\alpha}{\varepsilon+1}}} \tag{47}$$

No matter whether financial constraint is binding, we have:

$$\frac{dY}{d\hat{b}}=\frac{\partial Y}{\partial\Phi}\frac{\partial\Phi}{\partial\varphi^*}\frac{\partial\varphi^*}{\partial\hat{b}}+\frac{\partial Y}{\partial\hat{b}}>0$$

since $\frac{\partial Y}{\partial\Phi}>0$, $\frac{\partial\Phi}{\partial\varphi^*}<0$, $\frac{\partial\varphi^*}{\partial\hat{b}}<0$, and $\frac{\partial Y}{\partial\hat{b}}$. Hence an increase in $\hat{b}$ increases the aggregate output Y in a new stationary equilibrium. According to Equations (45) and (46), aggregate inputs K and N increase if Y increases.

Appendix 8

As for fundamental component, we have the functional equation:

$$f\left(\lambda_t,\varphi,k\right)=\pi\left(\lambda_t,\varphi,k\right)+\frac{p}{R_t}\widehat{E}_t f\left(\lambda_{t+1},\varphi,k\right) \tag{48}$$

It is possible to solve functional equation (48) for fundamental component using value function iteration. The aggregate states consist of the intereset rate R_t, the bubble creation ratio $\hat{b}_t$, and the efficient capital $\widehat{K}_t$[51]. While R_t and $\hat{b}_t$ follow exogenous stochastic process, we need to characterize the law of motion for efficient capital $\widehat{K}_t$. The algorithm include the following steps.

Step 1: Given a set of parameters, guess a function for fundamental component $f_1\left(\varphi,k,\widehat{K}_t,R_t,\hat{b}_t\right)$ and law of motion for $\widehat{K}_t$ conditional on $\widehat{K}_{t-1}$, R_t, and $\hat{b}_t$.

Step 2: Solve the following constrained maximization problem to get $v^e\left(\varphi,\widehat{K}_t,R_t,\hat{b}_t\right)$ and $k\left(\varphi,\widehat{K}_t,R_t,\hat{b}_t\right)$:

$$v^e\left(\varphi,\widehat{K}_t,R_t,\hat{b}_t\right)=\frac{1}{R_t}\max_k\widehat{E}_t\left(\left(1+\hat{b}_t\right)f_1\left(\varphi,k,\widehat{K}_{t+1},R_{t+1},\hat{b}_{t+1}\right)-R_t k\right) \tag{49}$$

$$s.t.\quad\left(1+\hat{b}_t\right)\widehat{E}_t f_1\left(\varphi,k,\widehat{K}_{t+1},R_{t+1},\hat{b}_{t+1}\right)\geq\left(R_t+1-\delta\right)k$$

---

[51]The algorithm I describe here is the one I use to solve the example in 6.2. The algorithm is basically identical if we include a stochastic pledgeability δ_t.

Step 3: Find the implied law of motion for $\widehat{K}_t$:

$$\widehat{K}_{t+1} = p\widehat{K}_t + \int_{\varphi \geq \varphi_{t+1}^*\left(\widehat{K}_t, R_t, \hat{b}_t\right)} \left((A\varphi)^{1-\alpha-\gamma} \left(k\left(\varphi, \widehat{K}_t, R_t, \hat{b}_t\right)^\gamma\right)\right)^{\frac{1}{1-\alpha}} dF(\varphi) \qquad (50)$$

where $\varphi_{t+1}^*\left(\widehat{K}_t, R_t, \hat{b}_t\right)$ is pinned down through the following equation:

$$v^e\left(\varphi_{t+1}^*\left(\widehat{K}_t, R_t, \hat{b}_t\right), \widehat{K}_t, R_t, \hat{b}_t\right) = c_e$$

Step 4: Update our guess for fundamental value function:

$$f_2\left(\varphi, k, \widehat{K}_t, R_t, \hat{b}_t\right) = \pi\left(\varphi, k, \widehat{K}_t, R_t, \hat{b}_t\right) + \frac{p}{R_t}\widehat{E}_t f_1\left(\varphi, k, \widehat{K}_t, R_t, \hat{b}_t\right) \qquad (51)$$

Step 5: Go back to Step 2, however, use the updated guesses for fundamental value function from Equation (51), and for law of motion from Equation (50).

Iterate Step 2-5 until the fundamental value function converges.