Financial Frictions and the Persistence of History

Francisco J. Buera* Yongseok Shin†

February 2006

Abstract

How do movements in the distribution of income and wealth affect the macroeconomy? We create two economies where the only difference between them lies in the initial distribution of economic resources and the degree of frictions in financial markets. Generally, these economies eventually reach the same (or very similar) stationary equilibria in terms of aggregate variables—e.g. capital stock and output. In this sense, financial frictions and wealth distribution have little macroeconomic impact on the stationary equilibria. Here we map out the entire transition dynamics and answer the following questions: (i) Do financial frictions slow down the economy's progression toward the stationary equilibria? (ii) Does inequality affect the speed of convergence to the stationary equilibria? and (iii) If economic resources are initially misallocated (e.g. entrepreneurs not having any resources), is the speed of convergence to the stationary equilibria significantly lower? We find that financial frictions and initial wealth distribution have significant and persistent effects on the transitional dynamics of the aggregate variables.

*Department of Economics, Northwestern University, 2001 Sheridan Road, Evanston, IL 60208, USA (e-mail: `f-buera@northwestern.edu`).

†Department of Economics, University of Wisconsin, 1180 Observatory Drive, Madison, WI 53706, USA (e-mail: `yshin@ssc.wisc.edu`).