International Capital Flows and Credit Market Imperfections: a Tale of Two Frictions

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Abstract

The financial crisis of 2007-08 has underscored the importance of adverse selection in financial markets. This friction has been mostly neglected by macroeconomic models of financial frictions, however, which have focused almost exclusively on the effects of limited pledgeability. In this paper, we fill this gap by developing a standard growth model with adverse selection. Our main results are that, by fostering unproductive investment, adverse selection: (i) leads to an increase in the economyís equilibrium interest rate, and; (ii) it generates a negative wedge between the marginal return to investment and the equilibrium interest rate. Under financial integration, we show how this translates into excessive capital ináows and endogenous cycles. We also explore how these results change when limited pledgeability is added to the model. We conclude that both frictions complement one another and argue that limited pledgeability exacerbates the effects of adverse selection.