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**Financial Engineering and  
Economic Development**

Pedro S. Amaral, Dean Corbae, and  
Erwan Quintin



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**Financial Engineering and Economic Development**

Pedro S. Amaral, Dean Corbae, and Erwan Quintin

The vast literature on financial development focuses mostly on the causal impact of the quantity of financial intermediation on economic development and productivity. This paper, instead, focuses on the role of the financial sector in creating securities that cater to the needs of heterogeneous investors. We describe a dynamic extension of Allen and Gale (1989)'s optimal security design model in which producers can tranche the stochastic cash flows they generate at a cost. Lowering security creation costs in that environment leads to more financial investment, but it has ambiguous effects on capital formation, output, and aggregate productivity. Much of the investment boom caused by increased securitization activities can, in fact, be spent on securitization costs and intermediation rents, with little or even negative effects on development and productivity.

Keywords: Endogenous security markets, financial development, economic development.

JEL classification: E44, E30.

Suggested citation: Amaral, Pedro, Dean Corbae, and Erwan Quintin, "Financial Engineering and Economic Development," Federal Reserve Bank of Cleveland, Working Paper no. 16-29R.

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\*First posted December 2016 with the title "A New Perspective on the Finance-Development Nexus."

# 1 Introduction

A vast literature studies the two-way connection between financial intermediation and economic development. [Goldsmith \(1969\)](#), [McKinnon \(1973\)](#) and [Shaw \(1973\)](#) document the correlation between economic and financial development within and across countries. [King and Levine \(1993\)](#) confirm this strong correlation with detailed cross-country data and find some support for the hypothesis that financial development causes economic development.<sup>1</sup> Furthermore, they make the case, and present some evidence, that financial development raises aggregate output both by fostering the accumulation of resources and by helping direct these resources to their best use.

A related literature quantifies the importance of financial development for aggregate productivity and output using structural models where the connection between finance, investment and resource allocation is made explicit. Those models take an explicit stand on what frictions cause the quantity of intermediation to vary across economies and propose various methods to measure the importance of those frictions. For instance, [Amaral and Quintin \(2010\)](#) describe a span-of-control model in the spirit of [Lucas \(1978\)](#) where producers' ability to borrow is limited by imperfect contract enforcement.<sup>2</sup> They argue that this type of frictions alone could account for much of the development gap between middle-income nations such as Mexico and Argentina and the United States.<sup>3</sup>

More recently, however, a number of papers have argued, on empirical and theoretical grounds, that the effect of financial intermediation on growth and productivity becomes weaker, if not negative, at high levels of financial development. [Arcand, Berkes, and Panizza](#)

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<sup>1</sup>[Rajan and Zingales \(1998\)](#) use industry-level data to provide more evidence that causation runs, at least in part, from financial development to economic development.

<sup>2</sup>For similar exercises, see e.g. [Erosa \(2001\)](#), [Jeong and Townsend \(2007\)](#), [Erosa and Cabrillana \(2008\)](#), [Quintin \(2008\)](#), [Buera, Kaboski, and Shin \(2011\)](#), [Buera and Shin \(2013\)](#), [Caselli and Gennaioli \(2013\)](#). Papers that study the finance-development nexus qualitatively include [Greenwood and Jovanovic \(1990\)](#), [Bencivenga and Smith \(1991\)](#), [Banerjee and Newman \(1993\)](#), [Khan \(2001\)](#) and [Amaral and Quintin \(2006\)](#). See also [Hopenhayn \(2014\)](#) for a detailed review of the literature on finance and misallocation.

<sup>3</sup>[Midrigan and Xu \(2014\)](#) find that these frictions have a lower impact once agents are given more time to self-finance to mitigate the impact of the borrowing constraints they face, but [Moll \(2014\)](#) argues that the mitigating effects of self-financing depend critically on the nature of the idiosyncratic shocks producers face.

(2015), for instance, make the empirical case that once private credit reaches 100% of GDP, additional increases in private intermediation have a negative impact on growth. As they discuss, the leading explanation for eventually decreasing returns is that once the allocative benefits of better credit markets are exhausted, the nature of financial activity expansion changes. Whereas at early stages of development, credit expansion caused, say, by institutional improvements, leads to the funding of new and highly productive projects, eventually financial development results mostly in “repackaging” and securitization activities, which increase financial fragility without significant allocation gains.<sup>4</sup> Our goal in this paper is to make precise and quantify the link between financial engineering activities and development and aggregate productivity.

To that end, we focus on the role the financial sector plays in creating financial products that cater to the needs of heterogeneous investors. To understand the idea, consider an economy that contains agents who, by taste or by constraint, only want to invest in safe securities. Without some financial engineering, the capital these agents are able to provide cannot be tapped to finance risky investment projects. By creating new securities that transform risky cash flows into securities with different characteristics, financial intermediaries allow heterogeneous agents to combine their resources and fund projects whose fundamental characteristics may not meet the particular needs of any specific type of investor. Financial engineering makes it possible to activate projects that could not be funded otherwise.

It follows that, all else equal, a fall in security creation costs leads to more spending on the securities created by the risky production sector and hence to an investment boom. But this boom in financial investment may not lead to an increase in productive capital formation, output or TFP. In fact, we argue analytically, and show via simulations, that a large share of the investment boom may be dissipated into securitization costs and producer/intermediation rents rather than spent on actual capital formation.

As for aggregate TFP, securitization booms tend to cause productivity declines. In our model, all active projects operate at their optimal scale. A reduction in security creation costs

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<sup>4</sup>See [Gennaioli, Shleifer, and Vishny \(2012\)](#) for one formalization of this idea.

leads to the entry of producers whose projects were not profitable until it became cheaper to sell different parts of the associated cash-flows to different savers. There is no reason to expect that those new producers are high TFP-producers. Indeed, in an environment where all projects are operated at, or near, their optimal scale, high-TFP producers tend to be profitable whether or not the cash-flows they generate can be repackaged. This aspect of our environment is in sharp contrast to what emanates from traditional models of missallocation, as described for instance by [Hopenhayn \(2014\)](#). In those models, mitigating financial disruptions allows producers to operate closer to their optimal scale, which drives wage rates up and causes low productivity managers to exit. Both aspects – projects operating closer to their optimal scale and the exit of less productive managers – result in higher TFP, as it is conventionally measured. In our model, lowering securitization costs allows previously infra-marginal producers to become profitable, which can lower TFP. Securitization booms, that is, can be bad for aggregate productivity even when they cause investment booms.

We formalize these ideas in a dynamic extension of [Allen and Gale \(1989\)](#)'s optimal security design model. Our overlapping generation environment contains agents who are risk-neutral and other agents who are highly risk-averse and have a high willingness to pay for safe securities. Absent transaction costs, it would be optimal for producers to sell the safe part of the stochastic cash-flows they generate to risk-averse agents and the residual claims to risk-neutral ones. But tranching cash-flows in this fashion is costly. As a result of these costs, some potentially profitable projects are left inactive, which results in less capital formation, output and dynamic wealth accumulation. The result of these considerations is an aggregate production function which, we show, assumes a standard form and where the connection between project selection and TFP, as it is conventionally-measured, is transparent.

While the implications of varying security creation costs for investment broadly defined are clear, the impact on output, or average productivity, of making the securitization of risky cash-flows cheaper is fundamentally ambiguous, as we illustrate via numerical simulations. In short, when financial development takes primarily the form of repackaging, there is no reason to expect a positive correlation between the quantity of intermediation, development

and growth.

## 2 The environment

Consider an economy in which time is discrete and infinite and with a unique consumption good. Each period, a mass one of two-period lived households is born. For simplicity, we will assume that these households only value consumption at the end of the second, and final, period of their life. Each household is endowed with a unit of labor which they deliver inelastically in the first period of their life for a competitively determined wage. Since they do not value consumption in that first period, they invest all their labor earnings at the beginning of the second period of their life and consume the proceeds from this investment at the end of the period.

Fraction  $\theta \in (0, 1)$  of these households – type 1 households – are risk-neutral. The remainder – type 2 households – are infinitely risk-averse, in the sense that they seek to maximize the lowest possible realization of their investment return.<sup>5</sup> That is, risk-averse agents have Leontieff preferences over contingent consumption plans when old, with equal weights on each state.

The economy also contains a large mass of one-period-lived producers. A unit mass of those producers operate a safe technology that transforms capital  $k$  into the consumption good according to  $Ak^\omega$  where  $A > 0$  and  $\omega < 1$ . These producers rent capital at gross rate  $R_t$  from households. From the point of view of a given (atomistic) household then, and in any equilibrium, this technology offers a safe gross return  $R_t$ .

In what follows, selling securities to risk-averse agents only makes sense if their willingness to pay for safe securities is higher than that of risk-neutral agents. To deliver this feature in a tractable way, assume that risk-averse agents incur transaction or time costs that erode their gross payoff from the safe technology by a ratio  $\delta \in (0, 1)$ . Letting  $r_{1,t}$  and  $r_{2,t}$  denote

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<sup>5</sup>One way to formalize this is that they have CRRA preferences with infinite curvature. See [Epstein and Zin \(1989\)](#).

the net payoffs for the two agent types at date  $t$  we have

$$1 + r_{1,t} = R_t > (1 - \delta)R_t = 1 + r_{2,t}.$$

This assumption makes the opportunity cost of capital lower, hence the willingness to pay for securities higher, for risk-averse households than for risk-neutral households.

The remaining producers can each operate a project whose activation requires an investment of one unit of the consumption good at the start of any period. Project production, unlike the safe technology, is risky. Specifically, an active project operated by a producer of skill  $z_t > 0$  yields gross output

$$z_t^{1-\alpha} n_t^\alpha$$

at the end of period  $t$ , where  $\alpha \in (0, 1)$  and  $n_t$  is the quantity of labor employed by the project. The skill level,  $z_t$ , of a particular producer is subject to aggregate uncertainty. Producers must decide whether to activate their project before knowing whether aggregate conditions  $\eta \in \{B, G\}$  are good ( $G$ ) or bad ( $B$ ). This aggregate shock follows a first-order Markov process with known transition function  $T : \{B, G\} \rightarrow \{B, G\}$ . Producer types are a pair,  $z = (z_B, z_G) \in \mathbb{R}_+^2$  of skill levels given the realization of the aggregate shock. What we mean here is that if a producer is of type  $(z_B, z_G)$ , then their idiosyncratic productivity is  $z_B$  during bad times and  $z_G$  during good times.

The mass of producers in a given Borel set  $Z \subset \mathbb{R}_+^2$  is  $\mu(Z)$  in each period. To make existence arguments quicker we will assume that  $z_G \geq z_B$  almost surely and that  $\mu$  has continuous derivatives.<sup>6</sup> Producer types are public information.

After the aggregate shock is realized, conditional on having activated a project, and taking

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<sup>6</sup>The assumption that all producers are more productive during good times is not essential but makes the exposition quicker by implying that producer profits are higher in good times than in bad times for all types. Assuming continuous density functions makes all mappings from prices to excess demands continuous in our existence proof. The case where  $\mu$  features positive mass points can be handled by introducing lotteries, as in [Halket \(2014\)](#).



the wage rate,  $w_t$ , as given, a producer of talent  $z$  solves

$$\Pi(w_t; z) \equiv \max_{n>0} z^{1-\alpha} n^\alpha - nw_t,$$

where  $\Pi$  denotes net operating income. Let

$$n^*(w_t; z) \equiv \arg \max_{n>0} z^{1-\alpha} n^\alpha - nw_t$$

denote the profit-maximizing labor used, given values of the aggregate shock and the wage.

We note, for future reference, that  $n^*$  is linear in the realized level  $z$  of skill.

Investments in projects are intermediated. Specifically, a stand-in intermediary can buy any given project for a project-type-specific price  $\kappa(z_B, z_G)$  that is determined in equilibrium. Producers become active when  $\kappa(z_B, z_G) \geq 1$ , since they must fund the unit of capital they need but can consume any amount in excess of that (this abstracts from potential limited commitment and other moral hazard issues by assuming that active producers must, in fact, invest the capital.)

The intermediary finances its investment by issuing securities, i.e. claims to the project's output. A security is a mapping from the aggregate state to a non-negative dividend. We require that dividends be non-negative for the same reasons as in [Allen and Gale \(1989\)](#). Allowing negative dividends is formally similar to allowing households to short-sell securities. As is well known, doing so can lead to non-existence, even in static versions of the environment we describe. More importantly perhaps, securitization could not generate private profits if short-sales were unlimited, since any value created by splitting cash-flows could be arbitrated away in the traditional Modigliani-Miller sense.<sup>7</sup> As a result, no costly securitization would take place in equilibrium.

Selling securities to risk-neutral agents is free (this is a mere normalization.) Selling securities to risk-averse agents, on the other hand, requires bearing a cost  $c > 0$ . One formal

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<sup>7</sup>See [Allen and Gale \(1989\)](#) for the formal version of this argument.

way to justify this cost is to assume that risk-averse agents only discover the type of project used to back the securities they purchase if effort cost  $c$  is borne by the issuer. Paying this cost enables managers (or the intermediaries representing them) to distinguish themselves from managers with worthless projects in a manner that is visible for risk-averse agents. We think of  $c$  as standing in for additional guarantees and rating requirements certain investors – institutional investors, say – require. More broadly, the main comparative statics we carry out looks at the effect of varying that cost from zero to a value such that no securitization takes place. Variations in that cost parameter, in that sense, stand in for institutional or technological changes that make securitization easier or more difficult.

Given these assumptions, the intermediary can pay  $c$  to create two securities – one for each household type – or avoid that cost by creating only one security that she then sells to risk-neutral agents. In the one-security case, profits are:

$$q_t^1(B)\Pi(w_t(B); z_B) + q_t^1(G)\Pi(w_t(G); z_G) - \kappa(z_B, z_G), \quad (2.1)$$

where  $q_t^1(\cdot)$  is the willingness-to-pay vector for households of type 1 for each possible realization of the aggregate shock.

If the intermediary decides to create two securities, profits are:

$$q_t^1(G) \left[ \Pi(w_t(G); z_G) - b \right] + q_t^2 b - \kappa(z_B, z_G) - c, \quad (2.2)$$

where

$$b \leq \Pi(w_t(B); z_B),$$

is the payment promised to risk-averse agents. This expression anticipates on a key equilibrium fact we will formally establish in section 3.2: it only makes sense for intermediaries to sell risk-free securities to risk-averse agents. Intuitively – although this requires a subtle argument as we will explain – excess returns have no value for risk neutral investors and the intermediary can sell any excess return to risk neutral agents. Since  $\Pi(w_t(B); z_B)$  is the lowest possible

realization of profits, this is the highest risk-free cash flow the intermediary can sell. It is profitable for the intermediary to purchase projects of type  $(z_B, z_G)$  provided a feasible menu of securities exists such that profits are non-negative.

Old households of type  $i \in \{1, 2\}$  enter date 0 with assets  $a_0^i > 0$ . The aggregate state of the economy in that initial period is summarized by  $\Theta_0 = \{a_0^1, a_0^2, \eta_{-1}\}$  where  $\eta_{-1} \in \{B, G\}$  is the aggregate shock at date  $t = -1$ . An equilibrium, then, is an amount  $k_t$  invested in the safe technology by households, a rental rate  $R_t$ , state-contingent project prices  $\{\kappa_t(z_B, z_G)\}_{t=0}^{+\infty}$  for each producer type, wage rates  $\{w_t(\eta)\}_{t=0}^{+\infty}$  for each  $\eta \in \{B, G\}$ , security menus for each project and household types, consumption plans  $\{c_t^i\}_{t=0}^{+\infty}$  for each household type and, finally, pricing kernels  $\{q_t^1, q_t^2\}$  such that, at all dates  $t$ :

1. Old agents consume the payoff of their security holdings at each date, while young agents save their entire labor income;
2. Security menus solve the intermediary's problem;
3. Profits are exactly zero for the intermediary (i.e.  $\kappa$  equals gross security creation profits);
4. Producers endowed with the safe technology behave competitively and consume their rents so that, in particular

$$R_t = A\omega k_t^{\omega-1};$$

5. Producers of type  $z$  are active if, and only if,  $\kappa_t(z_B, z_G) \geq 1$ ;
6. The market for labor clears:

$$\int_{Z_t} n^*(w_t(\eta); z) d\mu = 1 \text{ for all } \eta \in \{B, G\},$$

where  $Z_t$  denotes the set of active projects at date  $t$ ;

7. Pricing kernels satisfy:

$$(a) \quad q_t^1(\eta) = \frac{T(\eta|\eta_{t-1})}{1+r_{1,t}} \text{ for each } \eta \in \{B, G\};$$

$$(b) \quad q_t^2 = \frac{1}{1+r_{2,t}}.$$

Note that we do not state a capital market clearing condition. Because pricing kernels vanish as investment in the safe technology falls to zero, aggregate spending on securities cannot exceed aggregate wealth, so that the capital market trivially clears in the aggregate. But it is possible that spending on securities by one of the two agent types exceeds their wealth. To make sure that each type is able to fund the required spending on their respective portfolio, it is enough to assume that they can hold a negative position in the safe technology at the start of any given period. One way to implement this is to assume that the intermediary can facilitate the necessary borrowing at  $R_t$  by borrowing from one agent type and lending to the other as needed, an activity that carries zero expected return.<sup>8</sup>

### 3 Properties of equilibria

#### 3.1 Aggregation and measured TFP

The aggregate production function that results from adding up the individual projects' production plans takes a familiar neoclassical form. In order to derive it, let  $Z_\Theta \subseteq \mathbb{R}_2^+$  denote the set of types that operate projects (an equilibrium set to be established later) given the aggregate state,  $\Theta$ , of the economy. Let  $K$  denote the aggregate quantity of capital used to operate active projects in a given period. In equilibrium this has to equal the measure of projects activated:

$$K = \int_{Z_\Theta} d\mu.$$

It will be useful to define the average productivity among active project when the (new)

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<sup>8</sup>For risk-averse agents, we assume that borrowing carries the same transaction cost as storing does, so that they can only be expected to repay  $(1 - \delta)R$ , implying there is no kink in their budget set at zero borrowing. In addition, we continue to assume that households cannot hold negative positions in the securities created by the intermediary so that they cannot arbitrage away gross securitization profits. Another, simpler way to guarantee there is no excess supply of security is to specify the fraction of each agent type so that their wealth always exceeds the volume of security of each type created. Given the preferences we assume, that fraction has no effect on equilibrium paths.

realization of the aggregate state is  $\eta \in \{B, G\}$ :

$$\bar{z}(\eta) \equiv \frac{\int_{Z_\Theta} z_\eta d\mu}{\int_{Z_\Theta} d\mu},$$

and to note that this implies  $K\bar{z}(\eta) = \int_{Z_\Theta} z_\eta d\mu$ .

In our case, the measure of labor supplied is one, but generalizing, let  $N$  denote the total mass of employment. Then, for the labor market to clear, and using the solution to the projects' labor choice problem, we must have that for each  $\eta$ :

$$\begin{aligned} N &= \int_{Z_\Theta} n^*(z_\eta, w(\eta)) d\mu \\ &= n^*(1, w(\eta)) \int_{Z_\Theta} z_\eta d\mu \\ &= n^*(1, w(\eta)) K\bar{z}(\eta). \end{aligned}$$

We can now write the aggregate production function given aggregate capital, aggregate labor and the aggregate productivity shock:

$$\begin{aligned} F(\eta, K, N) &= \int_{Z_\Theta} z_\eta^{1-\alpha} n^*(z_\eta, w)^\alpha d\mu \\ &= \int_{Z_\Theta} z_\eta n^*(1, w(\eta))^\alpha d\mu \\ &= \int_{Z_\Theta} z_\eta \left( \frac{N}{K\bar{z}(\eta)} \right)^\alpha d\mu \\ &= \left( \frac{N}{K\bar{z}(\eta)} \right)^\alpha \int_{Z_\Theta} z_\eta d\mu \\ &= \bar{z}(\eta)^{1-\alpha} N^\alpha K^{1-\alpha}. \end{aligned} \tag{3.1}$$

This is a standard-looking neoclassical production function, where the term  $\bar{z}(\eta)^{1-\alpha}$  plays the role of measured TFP, which in this environment is a function of the efficiency of activated projects.

As we will discuss in more depth in section 5.2, this expression immediately implies that the effects of making security creation cheaper on TFP must be ambiguous. Unlike in traditional models of financial development, there are no untapped efficiency gains at the project level. The net impact of any change in the environment on TFP boils down to whether new entrants are more or less productive than already active and exiting producers. If anything, new entrants following a drop in security creation costs are more likely to be relatively low-productivity producers. Simply put, highly productive producers are active regardless of whether security creation is cheap or expensive.

The set of equilibrium conditions defined above implies an aggregate feasibility constraint that must hold every period. Letting

$$K_t^E = \theta a_{t-1}^1 + (1 - \theta) a_{t-1}^2$$

denote economy-wide wealth at the start of the period, we can write the part of the capital stock devoted to the safe technology as  $K_t^S = K_t^E - I_t$ , where  $I_t$ , investment devoted to risky activities is defined below. Output is the sum of risky project output and safe technology returns:

$$Y_t = F(A_t, K_t, N_t) + A (K_t^S)^\omega .$$

On the expenditure side and starting with consumption, recall that agents only consume when old. Define aggregate consumption as the sum of each type's consumption,

$$C_t \equiv \theta c_{1t} + (1 - \theta) c_{2t} + c_{Et} + c_{St},$$

where  $c_{Et}$  is the consumption of (project) producers that has to equal the proceeds  $\int_{Z_\Theta} \kappa(z) d\mu$  from selling projects, while  $c_{St}$  is the consumption of storage producers, that has to equal their profits,  $(1 - \omega) A (K_t^S)^\omega$ . Aggregate investment is the sum of next period's capital and

the expenditures intermediaries incur in creating new securities:

$$I_t = K_{t+1} + \int_{Z_\Theta} c 1_{b(z)>0} d\mu.$$

The result is that we can express the aggregate feasibility constraint in a familiar form,

$$C_t + I_t = Y_t.$$

That is, aggregate output equals the sum of aggregate consumption and investment.

### 3.2 Financial policies

This section solves the stand-in intermediary's problem given pricing kernels  $(q^1, q^2) \in \mathbb{R}_+^2 \times \mathbb{R}_+$ , and the wage  $w(\eta)$  for each possible realization of the aggregate shock  $\eta \in \{B, G\}$ . It is important to observe, first, that we can treat each project type separately. There is no role in our model for combining claims from different project types to create a new pool and a new set of securities.<sup>9</sup> Next, we formally establish that, in equilibrium, it only makes sense for intermediaries to sell safe securities to risk-averse agents, a fact we have already used in the description of the environment.

**Lemma 1.** *In any equilibrium, the consumption of risk-averse agents is risk-free and they only purchase risk-free securities.*

*Proof.* Assume, by way of contradiction, that an equilibrium exists in which, in a given period, the consumption bundle  $(c_B, c_G)$  of risk-averse agents is such that  $c_B > c_G$ . Then, given their preferences, risk-averse agents pay nothing for the bad-realization payoff on any security, as their marginal valuation of consumption in bad times is zero. Moreover, in order for  $c_B > c_G$

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<sup>9</sup>Our agents can extract the risk-free portion of any combination of assets in one step. In practice, this process often involves the re-securitization of securities from different projects. Our specification encompasses any and all benefits these activities could yield. Indeed, given the assets that are used for the creation of securities, the intermediary can choose to directly reach the overall bound on the supply of risk-free assets. Our specification thus fully encompasses any value CDO-type practices could create.

to hold, a positive mass of securities with higher payoffs in the bad state than in the good state must be issued to risk-averse agents. But those managers and intermediaries would be better off selling the bad state payoff to risk-neutral agents and this would strictly raise their profits. The case in which  $c_B < c_G$  can be similarly ruled out.  $\square$

In short, selling risky securities to risk-averse agents would imply that managers and intermediaries are leaving money on the table. Consider then a particular project type  $z \equiv (z_B, z_G)$  and rewrite the maximum profit the intermediary can generate as:

$$q^2 b + q^1(G) \left( \Pi(w(G); z_G) - b \right) + q^1(B) \left( \Pi(w(B); z_B) - b \right) - \kappa(z_B, z_G) - c1_{\{b>0\}},$$

where the non-negativity restriction on payoffs imposes:

$$b \leq \Pi(w(B); z_B).$$

The following remark will help us fully characterize the intermediary's optimal policy:

**Lemma 2.** *In any equilibrium,  $\kappa$  is monotonic among active projects.*

*Proof.* Assume by way of contradiction that, for a given  $(z_B, z_G)$ , there exist  $(z'_B, z'_G) \geq (z_B, z_G)$  such that  $\kappa(z'_B, z'_G) < \kappa(z_B, z_G)$ . Then, if profits are zero at  $(z_B, z_G)$ , as must be true given the free-entry condition, they have to be strictly positive at  $(z'_B, z'_G)$ , which cannot happen in equilibrium.  $\square$

Given this monotonicity of project prices, the binary decision of whether or not to operate a project is monotonic in  $z$ . Given activation, it also turns out that the financial policy of intermediaries satisfies a simple bang-bang property, recorded in the following proposition:

**Proposition 3.** *If the intermediary activates projects of type  $z \equiv (z_B, z_G)$ , then it also activates all projects of type  $z' > z$ . Furthermore, among active projects and  $\mu$ -almost surely:*

1. *Either  $b(z) = 0$  or  $b(z) = \Pi(w(B); z_B)$*



2.  $b(z_B, z_G)$  is monotonic in  $z_B$  in the sense that given  $z_G$ ,  $b(z'_B, z_G) \geq b(z_B, z_G)$  whenever  $z'_B > z_B$ , strictly so when  $b(z_B, z_G) > 0$ .

*Proof.* That participation is monotonic in  $(z_B, z_G)$  follows from the monotonicity of  $\kappa$  in productivity. As for financial policies, note that gross gains from issuing two securities rather than one are

$$[q^2 - (q^1(G) + q^1(B))]b,$$

since risk-neutral agents are willing to pay  $q^1(G) + q^1(B)$  per unit of risk-free promise. These gains must exceed  $c$  to justify creating two securities. Since

$$q^2 = \frac{1}{R(1-\delta)} > \frac{1}{R} = q^1(G) + q^1(B),$$

gross gains are maximized at  $b = \Pi(w(B); z_B)$ . Obviously then, if it is profitable for a manager of productivity level  $z_B$  to tranche, it is also profitable to do so for managers whose worst-case productivity is  $z'_B$ .  $\square$

These results follow from a fundamental feature of environments in the spirit of [Allen and Gale \(1989\)](#) such as ours: producers take state prices as given, hence have a linear objective which, in turn, leads to bang-bang financial policies. One key consequence is that when producers choose to create some risk-free debt, they max out the production of such debt.

## 4 Existence

Existence of an equilibrium given initial conditions  $\Theta_0 = \{a_0^1, a_0^2, \eta_{-1}\}$  requires, first, that an interest rate and wages exist that clear capital and labor markets in the first period. Since both types save their entire wages when young and those savings become the new starting assets, conditions that guarantee existence in each period also guarantee that a well-defined path of wealth exists. It is easy to show, using standard arguments, that decreasing returns imply that all those paths live in a set that is bounded away from zero and bounded above.

Take starting conditions  $\Theta_0$  as given. Capital available to be deployed is  $K^E = \theta a_0^1 + (1 - \theta)a_0^2$ . Some of this capital – call it  $K^S$  – is invested in the safe technology, and this pins down the gross safe return  $R$ , as well as the two willingnesses to pay  $(q^1, q^2)$  for securities. A pair of wages, then, yields a mass  $K$  of producers that choose to be active and a set  $Z_{\Theta_0}$  of active producer types.

For equilibrium, we need a pair of wages that clears markets. This, in turn, implies a level of securitization costs and an overall demand for capital. We have an equilibrium if, and only if, that overall demand for capital by the production sector, i.e. spending on securities, equals  $K^E - K^S$ .<sup>10</sup> We will now establish that the associated fixed point problem always has a solution.

**Proposition 4.** *An equilibrium exists. Furthermore, all equilibria feature strictly positive investment in the safe technology.*

*Proof.* Start with an arbitrary guess  $K^S \leq \theta a_0^1 + (1 - \theta)a_0^2$  for safe technology capital and let  $R$  be the associated safe return, while  $(q^1, q^2)$  are the corresponding state prices. Given these, we will first find market clearing wages  $(w_G, w_B)$ . Find  $w > 0$  such that when  $(w_G, w_B) = (w, w)$  the labor market clears in the bad aggregate state. Such a  $w$  must exist, since demand for labor in both aggregate states diverges to infinity as  $w \mapsto 0$  while it goes to zero as  $w \mapsto +\infty$ , and since the underlying mapping is continuous.

At the resulting  $(w, w)$  there is (at least weakly and typically strictly) excess demand for labor in the good aggregate state, since  $z_B \leq z_G$   $\mu$ -almost surely. Starting from the pair  $(w_G, w_B) = (w, w)$  so constructed, start lowering the wage  $w_B$  in the bad state while increasing the wage in the high state to a level  $w_G(w_B)$  such that markets continue to clear in the bad state. The mapping  $w_G(w_B)$  is continuous and must diverge to  $+\infty$  as  $w_B$  becomes small. At some point then, demand for labor in the good state must equal one, as needed, which gives us the market clearing pair of wages we needed. By construction of  $w_G(w_B)$ , the

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<sup>10</sup>Equivalently, the requirement is that  $I$ , as defined in section 3.1, equals starting aggregate wealth minus the safe technology capital,  $K^S$  and minus producer rents.

labor market still clears in the bad state. We now have a pair of wages which, given,  $K^S$  (hence  $R$ ) clears both labor markets. Moreover, the resulting mapping from the guess for  $K^S$  to market clearing wages is continuous.

Given  $(R, w_B, w_G)$ , we can now compute (uniquely) spending on securities. In particular, we can compute total demand for capital and, for equilibrium, we need it to equal  $\theta a_0^1 + (1 - \theta)a_0^2 - K^S$ . The full mapping from the initial guess to this demand for capital by the production sector is continuous. It is enough, therefore, to show that for small enough initial guesses there must be an excess supply of investment funds, while for guesses large enough there is an excess demand for capital by producers. Take  $K^S = K^E$ , the largest possible initial guess. At that level of safe capital, the supply of capital to the production sector is zero. The arguments above show that a pair of wages exists that clears markets given the corresponding  $R$ . But this means, in particular, that some producers are active so that there is positive demand for capital by the production sector.

At the other end of the domain of definition of the mapping, assume  $K^S$  converges to zero so that  $R$  diverges to infinity. Labor market clearing requires that wages converge to zero as  $K^S$  does.<sup>11</sup> So do, therefore, aggregate profits, since those are linear in wages at any optimal solution to the producer problem. Aggregate producer rents, since they are bounded above by the present value of expected profits, must then converge to zero as well. With vanishing wages, the mass of active producers must fall since the labor demand of each producer type diverges to infinity. This implies that demand for capital falls to zero, so that, eventually, there must be excess supply. This completes the proof.  $\square$

As discussed by [Allen and Gale \(1989\)](#), it would be difficult to provide general conditions that guarantee uniqueness in this environment with endogenous security design. Here, for instance, there may co-exist equilibria that feature tranching and equilibria that do not. While

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<sup>11</sup>To elaborate, this part of the argument requires two steps. First, one of the two wages must go to zero for there to be any participation by producers, since pricing kernels vanish and producers must fund at least one unit of capital. But since the set  $Z_{\Theta_0}$  of active producer types is common across realizations of the aggregate state, if labor markets clear with vanishing wages in the bad state, vanishing wages are also required for market clearing in the good state. It follows that if one of the two wages vanish, both must.

this complicates comparative statics considerations, our model does yield clear predictions for the impact of making security creation cheaper, as we will now show.

## 5 Comparative statics

### 5.1 Security creation costs and investment

Take a particular economy and assume that security creation costs fall in a particular period. Obviously, holding wages and safe investment levels the same, more producers find it profitable to operate and it follows that lower costs should cause more spending on securities. This section formalizes this intuition.

One complication is that the economy's evolution is affected not just by fundamental parameters, but also by the realization of aggregate shocks. To deal with this issue, we will compare economies that experience identical aggregate shock draws and show that, given these draws, lowering security creation costs implies higher spending on securities on impact. To simplify the analysis, but with little impact on the economic ideas formalized in this section, we concentrate our attention on a parametric case where the two wages must always co-move. Section 5.3 illustrates the general nature of our comparative statics results via numerical simulations.

To simplify the analysis then, assume that producers are scaled up versions of one another in the sense that  $\frac{z_G}{z_B}$  is  $\mu$ -almost surely a constant. Put another way, almost surely,  $z_G = zA_G$  while  $z_B = zA_B$ , where  $z > 0$  is the producer's idiosyncratic skill level and  $A_G > A_B > 0$  are aggregate shocks common to all producers. Under those assumptions, the search for market clearing wages becomes one dimensional. The fact that  $Z_\Theta$  is set prior to the realization of the aggregate shock, and hence is the same regardless of that realization, means that if we know what bad time wages  $w(B)$  are, only one value of  $w(G)$  can also clear wages during good times. Furthermore, the Cobb-Douglas functional forms we have assumed for production functions imply that  $\frac{w(G)}{w(B)}$  is a constant greater than one.

**Proposition 5.** *Assume that  $\frac{z_G}{z_B}$  is  $\mu$ -almost surely a constant. Assume that in a given economy and in a particular period, security creation costs suddenly fall. An equilibrium path exists where spending on securities rises on impact.*

*Proof.* When  $\frac{z_G}{z_B}$  is  $\mu$ -almost surely a constant, producer skills are summarized by a one dimensional level  $z$ . In turn, producer participation in any given period is associated with a skill threshold  $\underline{z}$ , while the security design decision is governed by an upper threshold  $\bar{z}$ . Holding wages the same in a given period, a marginal decrease in security creation costs lowers  $\bar{z}$ . It may lower  $\underline{z}$  as well, but only if  $\underline{z} = \bar{z}$  to begin with, i.e. only if all producers tranche prior to the decrease in security creation costs.

If  $\underline{z}$  does not change following the decrease in security creation costs, labor markets continue to clear at the original wages. In that case, the only consequence of the decrease in security creation costs is an increase in spending on securities since the mass of producers that sell the safe part of their profits at a low discount rate has increased. This creates an excess demand for capital at the original safe capital level. If  $\underline{z} = \bar{z}$  before the decrease in security creation costs then both thresholds move to the left. Bringing labor markets back to equilibrium now requires an increase in wages, hence a further increase in spending on securities, also implying an excess demand for capital.<sup>12</sup>

In either case, there is an excess demand for capital at the original level  $K^S$  hence, using the same arguments as in our existence proof, there is an equilibrium with a safe capital level in  $[0, K^S]$  hence a new equilibrium with a higher investment level.  $\square$

Falling security creation costs, in other words and not surprisingly, cause investment booms. It would seem intuitive that this boom in investment should lead to output gains and more wealth accumulation over time. Our simulations below reveal that this intuition can fail to hold. Before turning to those however, we will first discuss why the connection between

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<sup>12</sup>This specific part of the argument – as we discussed in the existence proof – follows from the fact that aggregate profits are linear in wages. The safe capital level pins down state prices. Holding the safe capital level constant, as we do in this paragraph, keeps state prices constant. Security spending – higher aggregate profits discounted at constant state prices, with possibly more cash-flow splitting – must go up.

security creation costs and output may not be monotonic in our environment.

## 5.2 Security creation costs, output and TFP

The previous section has shown that lower security creation costs lead to more spending on securities. It would seem natural to expect then that the total expected payoff on that investment should be higher. In turn, since that total payoff at the end of each period has to be gross output, it would follow that the risky project output must be higher in expected terms. Under the parametric assumption we made in the previous section (to wit, the assumption that  $\frac{z_G}{z_B}$  is  $\mu$ -almost surely a constant) and since wages are linear in GDP, both wages would then have to rise. It would then follow from these arguments that for a given path of aggregate shocks, wealth, investment, output and wages are uniformly higher following falls in security creation costs.

Where does this simple logic fail? A fall in security creation costs leads to an increase in the participation of risk-averse investors into the risky production sector. These investors require less return on their investment. While total spending on securities must rise, it is not the case that the total payoff on this investment (i.e. gross output) must also rise. In fact, our simulations below will show that much of the investment boom caused by falling security creation costs is spent on greater securitization expenditures and manager rents, and that capital formation in the risky project sector can in fact fall.

As for aggregate productivity, the connection between financial spending and TFP is embodied in the aggregate expression (3.1) we derived in section 3.1. Financial development leads to a rise in TFP if, and only if, the average quality of active projects rises. Intuitively, and as we will confirm quantitatively in the next section, a fall in security creation costs leads to the entry of producers who, comparatively speaking, can produce higher amounts of perfectly safe output. The effect of security creation costs on TFP, then, depends on whether those safe producers tend to be productive producers. In most models (take Greenwood and Jovanovic, 1989, e.g.) risky projects are assumed to be more productive. This accords well

with basic economic intuition. It only make sense to take on riskier projects if average payoffs are higher. So it seems natural to expect that, if anything, a greater share of safe projects will lead to lower TFP.

To make this stark, a comparison of our model with traditional models of financial development is useful. In standard models, TFP differences across economies stem from resource misallocation across projects.<sup>13</sup> In our framework, individual projects are always operated at their optimal level. More finance means more repackaging of fundamental cash flows but does not address any fundamental friction. In particular, project-level TFP is independent of the particular security structure used to finance production. Therefore, as security creation costs decrease and capital deepening occurs, TFP increases if, and only if, the average TFP of new entrants is higher than that of incumbent projects.

In traditional models of misallocation, mitigating financial disruptions allows producers to operate closer to their optimal scale, which drives wage rates up and causes low productivity managers to exit. Both effects result in higher TFP as it is conventionally measured. In our model, lowering securitization costs allows previously infra-marginal producers to become profitable, which can, and typically does, lower TFP. More finance does not mean more output, wealth or higher TFP, as we will now confirm via numerical simulations.

## 5.3 Numerical simulations

### 5.3.1 Parameters

To illustrate the mechanisms described above, we will now compare economies that differ only in security creation costs via numerical simulations. Starting with an economy with no security creation costs that serves as a benchmark, we increase these costs until no tranching takes place in equilibrium.

We will think of one period to be 25 years. Starting with the safe technology, we normalize  $A$  to 1. We then set the parameter governing returns to scale on safe production to  $\omega = 0.37$

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<sup>13</sup>See Restuccia and Rogerson (2008) or Amaral and Quintin (2010).

which, in our upcoming simulations, implies a yearly rate of return of about 4% for risk-neutral households. We set  $\delta$ , the transaction costs infinitely risk-averse agents face to 0.22 so that the difference in yearly interest rate returns between risk-neutral and risk-averse households is about 100 basis points, a value comparable to estimates of the Treasury convenience yield produced for example by [Krishnamurthy and Vissing-Jorgensen \(2012\)](#). The most standard interpretation of this convenience yield is as a premium the most risk-averse investors are willing to pay for default-free and perfectly liquid assets, which corresponds to the purpose of  $\delta$  in our model.

We specify the transition matrix  $T$  for aggregate shocks so that the probability of remaining in the bad state is  $T_{BB} = 0.2$  and the probability of remaining in the good state is  $T_{GG} = 0.9$ . This implies that the economy spends close to 90 percent of the time in the good state. We then make

$$\mathcal{Z} = \{(z_B, z_G) : z_G \geq z_B \text{ and } (z_B, z_G) \in [0, \bar{z}] \times [0, \bar{z}]\},$$

with  $\bar{z} = 5.3$ . This implies a fraction of savings devoted to securities of two-thirds, while a third goes to the safe technology.

The skill distribution function  $\mu(Z)$  is a truncated bivariate normal with mean set to  $(0.01, 0.02)$  which implies a (project) output difference of 1% a year between good times and bad times (28% for a 25 year period). The variance-covariance matrix is symmetric with off-diagonal elements of 0.02 and diagonal elements of 0.08. The resulting distribution of aggregate shocks is shown in [figure 1](#). This skill distribution also implies a ratio of producer rents to value added by the risky production sector of around 10% throughout our simulations which is reasonable given the approximation for this moment in the US obtained by [Corbae and Quintin \(2016\)](#).

Below, we will want to make sure that our main points are not sensitive to particular aspects of the distribution of talent. To that end, we will also produce results for distributions of talent with higher dispersion of talent (twice the benchmark marginal variances) and less



dispersion (half the variance). Because of the truncation at the 45 degree line, changing the dispersion also changes the mean of the distribution. We will show results with and without adjustments to keep the mean constant.<sup>14</sup>

### 5.3.2 Algorithm

Standard arguments show that our economies eventually converge to a stochastic steady-state, i.e. a long term invariant distribution of all endogenous variables in our model.<sup>15</sup> To obtain statistics for all endogenous variables in this stochastic steady-state, we adopt a traditional Markov chain Monte Carlo approach.<sup>16</sup> Specifically, our algorithm is as follows:

1. Given parameters, solve for household and intermediary policy functions for every possible aggregate state of the economy;
2. Draw a 1000-period sequence of aggregate shocks  $\{\eta_t\}_{t=1}^{1000}$  using the Markov transition matrix  $T$  and record the value of all endogenous variables starting from an arbitrary value of aggregate wealth;
3. After dropping the first 100 periods, so that assumed initial conditions have at most a negligible effect on the value of endogenous variables, compute average values for all endogenous variables.

To facilitate comparisons across economies with different costs, we use the same draw of random aggregate shocks throughout our simulations. Figure 3 displays sample paths for our economy.

### 5.3.3 Optimal Financial policies

Figure 2 shows the intermediary's optimal policy decisions for an economy with an intermediate level of security creation costs. A significant mass of projects is left inactive because

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<sup>14</sup>Experimenting with even more extreme distributions – such as uniform distributions – likewise, did not change the basic nature of our results.

<sup>15</sup>See Brock and Mirman (1972).

<sup>16</sup>See Tierney (1994).

they are unprofitable in expected value terms, regardless of the security structures used to finance them – this is the darker area in the figure, labeled  $\Pi < 0$ . Among activated projects, a subset is productive enough to be more profitable after issuing risk-free debt. This is the tranching set, identified by the label  $\Pi^T \geq \Pi^{NT}$ . For these projects, the price that the risk-averse households are willing to pay is enough to compensate the intermediary for security creation costs. For projects that do not pay enough in bad times, but pay enough in good times, the intermediary simply issues one type of security. This is the non-tranching region, identified by the label  $\Pi^T < \Pi^{NT}$ .

The slope of the line separating the activated projects from those that remain dormant is different in the two operating regions: it is steeper in the tranching region than in the non-tranching one. Intuitively, productivity in bad times is more valuable under tranching, given the higher willingness to pay of risk-averse households. As a consequence, a marginal decrease in  $z_B$  in that region needs to be compensated with a larger rise in  $z_G$  in order to keep profits constant, when compared to the non-tranching region. A vertical line separates the tranching from non-tranching regions. That is because once a project is active, whether or not it is more profitable to tranche does not depend on  $z_G$ . Only  $z_B$  matters in this case, as can be seen by subtracting equation (2.2) from equation (2.1).

Figure 4 shows how the intermediary's policies change when security creation costs increase from  $c_0 = 0$  to  $c_4 = 1$ . When there are no security creation costs, all active producers tranche because  $q^2 > q^1(B) + q^1(B)$ , which is guaranteed by the fact that  $r_2 < r_1$ . As costs become strictly positive and we move from  $c_0$  to  $c_1 = 0.1$ , holding wages and the amount devoted to the safe technology fixed, profits from tranching fall. This means some projects that were hitherto tranching stop doing so but continue to operate, while others stop operating altogether (those labeled *Active only for  $c_0$  (tranch.)* in panel A). This releases capital and labor and puts downward pressure on wages, allowing projects that were dormant (because they had a relatively low  $z_B$ ) to become profitable under the lower wage and to come online as non-tranching projects (those labeled *Active only for  $c_1$  (non-tranch.)* in panel A) and re-equilibrate the capital and labor markets at a lower level of wages and capital.

This process continues as security creation costs grow further from  $c_1$  to  $c_2 = 0.34$  (panel B of Figure 4). At this point, the measure of exiting projects is still larger than that of entering ones, resulting in a net decrease in active projects, as can be seen in panel A of Figure 5. However, as security creation costs continue to grow further, from  $c_2$  to  $c_3 = 0.44$ , the mass of tranching projects that stop operating dwindles (panel C of Figure 4) and is surpassed by the mass of entering projects resulting in net entry, and resulting in the non-monotonic relationship between security creation costs and active projects seen in panel A of Figure 5. Eventually, there are no exiting projects and there are only entering (non-tranching) projects (panel D) .

#### 5.3.4 Security creation costs, output, and TFP

One of the main points we make in this paper is that the relationship between security creation costs, output and TFP is non-monotonic. This occurs despite the fact that spending on securities, i.e. investments in risky projects, do decrease monotonically as security creation costs rise (panel B of Figure 5). As a matter of accounting, capital formation (i.e. the mass of active projects) equals security purchases minus the sum of tranching expenditures and intermediary/manager rents. Panels A, B, E, and F of Figure 5 show these four variables. The behavior of tranching expenditures is the dominant cause of non-monotonicity. Initially, the overall mass of tranching projects falls monotonically with security creation costs (the darker area in panel A of Figure 5). At the same time, spending on security creation also rises, as tranching expenditures go from zero to strictly positive. Both effects lead to less capital formation i.e. a decreasing mass of active projects. But eventually, the fact that ever fewer projects choose to tranche leads to a sharp decrease in security creation expenditures, which more than offsets the fall in gross investment, and allows the mass of active projects to rise.

To understand the stark inverse relationship between output and average TFP as security creation costs rise that is shown in panels A and C of Figure 7, it is instructive to think of

output as the product of the measure of active projects and average TFP, or in terms of the relationship between  $\bar{z}$  and  $K$  in equation (3.1). The set of entering (non-tranching) projects have higher productivity in good times and lower productivity in bad times compared to the exiting (tranching) ones and to the average operating project. Because good times are more frequent than bad times under our parameterization of  $T$ , this means that, initially, average TFP is increasing as security creation costs rise, as shown in panel C of Figure 7. Nonetheless, project output is falling in this range (panel A of Figure 7), because the fall in the measure of projects outweighs the average TFP increase. As security creation costs continue to rise, average TFP eventually starts falling as the net entering project becomes less productive than average. Nonetheless, because net entrance is positive and the measure of operating projects increases enough, output also increases, as the extensive margin once again dominates.

Panels B and D of Figure 7 show overall GDP (defined as project output plus safe output) and the measured productivity of capital as defined by overall GDP divided by total wealth which in our model equals investment. Both measures exhibit a non-monotonic relationship with security creation costs. The non-monotonicity in GDP is driven by the non-monotonicity in project output we covered above.

These qualitative findings are not sensitive to even drastic changes in the shape of the producer talent distribution, as figure 6 shows. The main quantitative effect of making talent dispersion higher is that rents and security creation expenditures become higher, but the overall relationship between security creation costs and endogenous variables is robust.

### 5.3.5 Financial engineering and economic development: a new perspective

Figure 8 summarizes the quantitative connection between financial activities, as we have modeled them in this paper, and economic development, for three sets of economies that differ in terms of the dispersion of producer talent, after adjusting the mean so that the average level of talent is the same across economies.

As the ratio of spending on securities to project output rises, output measures (whether

project output or GDP broadly defined) initially fall. At high levels of securitization – once securitization becomes essentially free – output does begin rising. In addition to being non-monotonic, the impact of even large increases in securitization activities is also small. Productivity is, likewise, relatively flat across economies with varying levels of securitization. As we have discussed above, it also shows a negative relationship with output. This is because when greater securitization does lead to more capital formation, it also tends to lead to the activation of relatively low productivity projects.

On the other hand, variations in financial development caused by fundamental differences in average plant TFP levels across economies are associated with potentially big output effects in our model, like in traditional models. Figure 9 illustrates this by considering the same three levels of dispersion in talent as before, but without adjusting the mean so that, as a result of the truncation, more dispersion now implies more talented producers on average. Now, the high dispersion, high talent, economies do display more intermediation and higher output and TFP. This experiment corresponds to the traditional “Enterprise leads, finance follows” view of financial development associated with [Robinson \(1952\)](#). Richer economies have more activity, and hence more intermediation. Across subgroups of economies a strong positive correlation between finance and development emerges. But within homogenous economies – among economies with similar real fundamentals – securitization booms do not result in big output effects. In fact, they may very well lower output.

### 5.3.6 Welfare

Our economy contains five categories of agents: households of two distinct types, safe producers, risky producers, and intermediaries. Assume we give each of these types of agents a choice of which economy to be born in, knowing only that they will be born in stochastic steady-state. Would they select an economy with high or low security creation costs?

Taking each agent category in turn, the welfare of risk-averse agents is monotonic on wages times the net return on the safe technology. The consumption of risk-neutral agents

is subject to aggregate risk but, in expected terms, the return on their investment must also be the return on the safe technology in equilibrium. It follows that, in welfare terms, both household types order distinct economies in exactly the same way. Both types of producers, for their part, simply consume their rents. The intermediary always makes zero profits hence is indifferent across economies with different security creation costs.

Figure 10 shows how stochastic steady state welfare relates to security creation costs for these various agent types. Since wages are linear in project output, household welfare essentially tracks project output and hence looks very similar to panel A in figure 7. In particular, households want to be born in an economy with zero security creation costs. However, just like project output and for the exact same reasons, household welfare is not monotonic in security creation costs. There are regions where lowering security creation costs lowers household welfare.

Safe producers prefer economies with higher securitization costs because such economies exhibit higher safe technology rents. The effect of security creation costs is not fully monotonic, however, because raising those costs also lowers wealth. That effect dominates initially, as panel C of figure 10 shows. Risky producers, as a group and for obvious reasons, rank economies in essentially the opposite order.

## 6 Some evidence on the correlation between financial engineering and development

In this section we show that the predictions of our model are largely borne out by basic correlations between measures of financial complexity and economic development for a cross-section of countries. In particular, we argue that in the data there is a positive, unconditional, association between measures of financial complexity and development, largely consistent with panels B and C in Figure 9. Crucially though, once one conditions for income levels, this positive correlation largely vanishes, consistently with the lack of correlation one sees by

picking out just one type of economy in these two panels.

Our measures of development are real GDP per capita in 2011 and measured TFP in the same year, as given by  $\frac{Y}{K^{0.35}H^{0.65}}$ , where  $Y$  is GDP,  $K$  is the capital stock and  $H$  is the product of employed workers and average hours worked. All measures were taken from the Penn World Table (Feenstra, Inklaar, and Timmer, 2015). The degree of financial complexity an economy exhibits is something harder to measure. In this section we consider two proxies for which data are available for a sufficiently large number of countries.

## 6.1 Asset-backed securitization

Our first proxy is asset-backed securitization in the traditional sense. In this context, the intermediary in the model plays the traditional role of channeling savings from households to borrowers and originates securities that are collateralized by the revenue streams the acquired projects produce. These securities may have multiple tranches, offering dividends with different risk profiles.

The global securitized debt market is growing fast. According to data from the Securities Industry and Financial Markets Association (SIFMA), the global amount of consolidated securitized debt outstanding went from \$4.8 trillion in 2000 to \$13.6 trillion in 2010. The United States accounts for over three quarters of all securitization volume, but several emerging countries such as China, South Africa, India and Malaysia have budding debt securitization markets growing at a fast pace.

We have data on outstanding securitized debt for a set composed mostly of developed countries.<sup>17</sup> A large fraction of total securitized debt is backed by residential mortgages. In our model, the collateral backing securities is better interpreted as some form of commercial or business investment. With that in mind, we subtract the amount of outstanding residential mortgage-backed securities (RMBS) from our measure of outstanding securitization, although

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<sup>17</sup>Our data for Australia and New Zealand, Canada, Japan, Malaysia, South Africa, South Korea and the U.S., comes from SIFMA, while data for European countries (Belgium, France, Greece, Ireland, Italy, The Netherlands, Portugal, Russia, Spain and the United Kingdom) comes from the Association for Financial Markets in Europe (AFME).

our results change little when all securitization activities are included.

## 6.2 Corporate bonds

The second measure of financial complexity we consider is the relative importance of private bond market capitalization across countries. Fundamentally, firms issue bonds in order to raise funds from investors who require more guarantees than equity investors and more liquidity than direct lenders might, and are willing to pay premia for those features. Participating in bond markets is costly however, since it requires becoming listed on the corresponding exchanges, the production of issuer and issue ratings, not to mention compliance with accounting and disclosure standards. Participation in bond markets is profitable only when these costs are outweighed by the benefits of raising funds from heterogenous investors, just like in our model. One should expect bond market participation costs to vary a lot across countries. Nations such as the United States, with a long history of bond trading, high competition between exchanges, and established benchmarks for pricing (a well defined yield curve with high liquidity at all maturities) have low participation costs compared to nations with shorter bond trading histories and weaker institutions.

We have data on the market capitalization of private corporate debt (for both financial and non-financial corporations) as a fraction of GDP for 49 (developed and developing) countries compiled in the Financial Development and Structure Dataset, from [Beck, Demirguc-Kunt, and Levine \(1999\)](#), that uses the corporate debt data from the Bank for International Settlements.

## 6.3 Cross-country correlations

Panels A and C of figure 11 show how our cross-country measure of securitization correlates with GDP per capita and measured TFP.<sup>18</sup> The correlation coefficients are positive at 0.27

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<sup>18</sup>The economic development measures are for 2011 and are presented relative to U.S. values. The private bond market as a share of GDP is also for 2011. We found similar results to the ones we report below for 2009 and 2010, while 2012 leaves us with a much smaller sample for the private bond market data (26 countries



and 0.17, respectively. The magnitudes are small because, as far as income is concerned, but for a few exceptions, our sample consists mostly of industrialized countries.

Looking instead at bond market capitalization allows us to enlarge our sample to include a larger number of developing countries. Panels B and D plot the results. The correlation coefficients rise to 0.36 and 0.39, for GDP per capita and measured TFP. One can now reject the null that these correlations are zero at the 2% level. These positive associations are in line with what simulated data from the model would deliver for a set of economies that differ in how productive their potential projects (e.g. human capital) are, just like panels B and C in Figure 9 imply.

However, when we restrict our attention to industrialized countries only, which we will take to be the economies whose GDP per capita is at least half that of the U.S., these correlation coefficients all drop, and even become slightly negative. To wit, the correlation between securitization and GDP per capita drops from 0.27 to -0.13; the correlation between securitization and TFP drops from 0.18 to -0.11; the correlation between private bonds and GDP per capita drops from 0.36 to -0.05; and the correlation between private bonds and TFP drops from 0.39 to 0.2. Moreover, the standard errors on all these restricted correlations are such that one can no longer reject the null that they are all zero. These flat, if not slightly negative, relationships are precisely what the model predicts once one conditions on an economy's underlying production possibilities, akin to focusing on a single economy type in panels B and C of Figure 9.

## 7 Conclusion

This paper shows that by allowing producers (or intermediaries) to create securities that appeal to investors with heterogenous tastes, financial engineering leads to more investment, which accords well with intuition. Less intuitive however is the fact that the resulting securi-

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instead of 49). The securitization values for the U.S. and the European countries are averages between 2007 and 2015. For the remaining countries the averages are for 2007 to 2010 because of data availability.

tization boom may not lead to increases in output, capital formation and TFP. Much of the spending on engineered securities may be dissipated into securitization costs and producer or intermediary rents. We view this as a natural explanation for the fact that the impact of financial development on economic development is weak, at best, in economies with already well-developed financial markets.

In this sense, it seems appropriate to think of financial development as consisting of two phases.<sup>19</sup> In low-income economies, institutional gains and the resulting gains in financial activity enable productive, but previously constrained, producers to become active and/or operate more effectively. This results in economic development gains, as has been emphasized by the traditional literature on financial development. While the size of those gains may be a matter of debate,<sup>20</sup> there is no disagreement on the direction of the effect during this initial phase of financial development.

Once higher levels of financial development are reached and markets function well, financial innovation tends to take the form of repackaging of fundamental cash-flows to create securities that appeal to the tastes of heterogenous investors. Not only do we find the output and productivity effects of this second phase to be small, they may very well turn out to be negative.

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<sup>19</sup>This dichotomous view of financial development has a counterpart in the model of [Acemoglu, Aghion, and Zilibotti \(2006\)](#) in which, in a nutshell, economic development consists first of harvesting low-hanging fruit but becomes tougher to sustain once obvious growth opportunities have been implemented.

<sup>20</sup>See the contrasting views of [Midrigan and Xu \(2014\)](#) on one side and [Moll \(2014\)](#) and [Amaral and Quintin \(2006\)](#), on the other.

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Figure 1: Productivity distribution

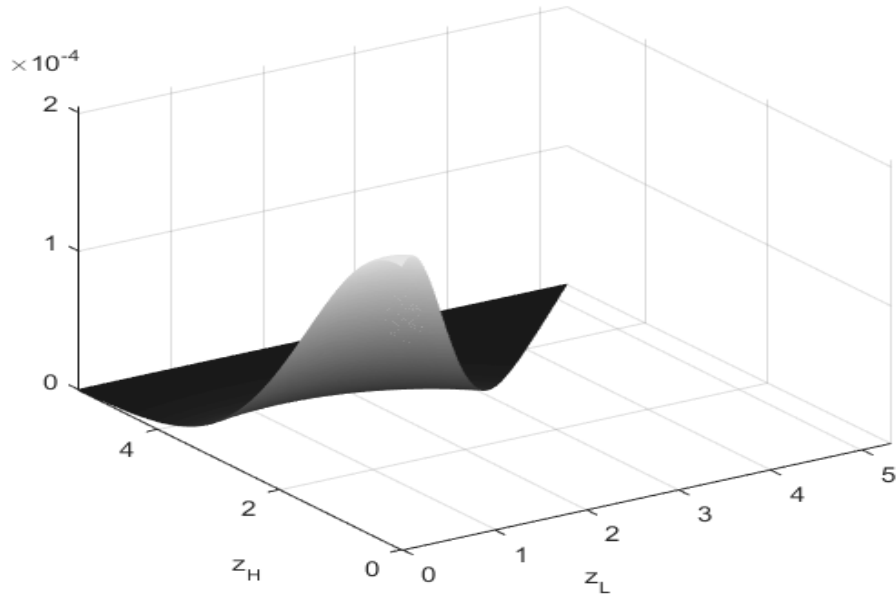


Figure 2: Intermediary's policies

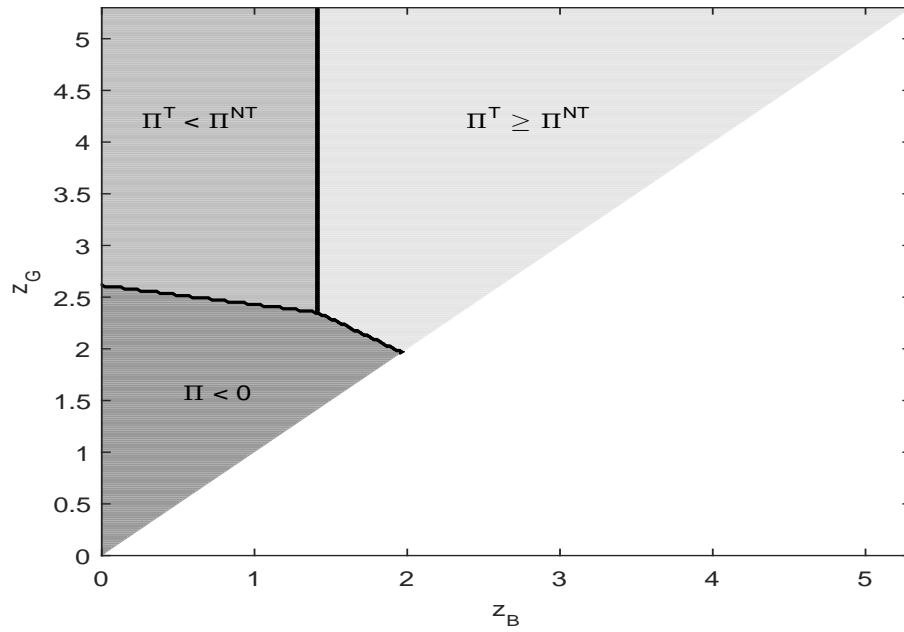


Figure 3: Simulating illustrative example economies

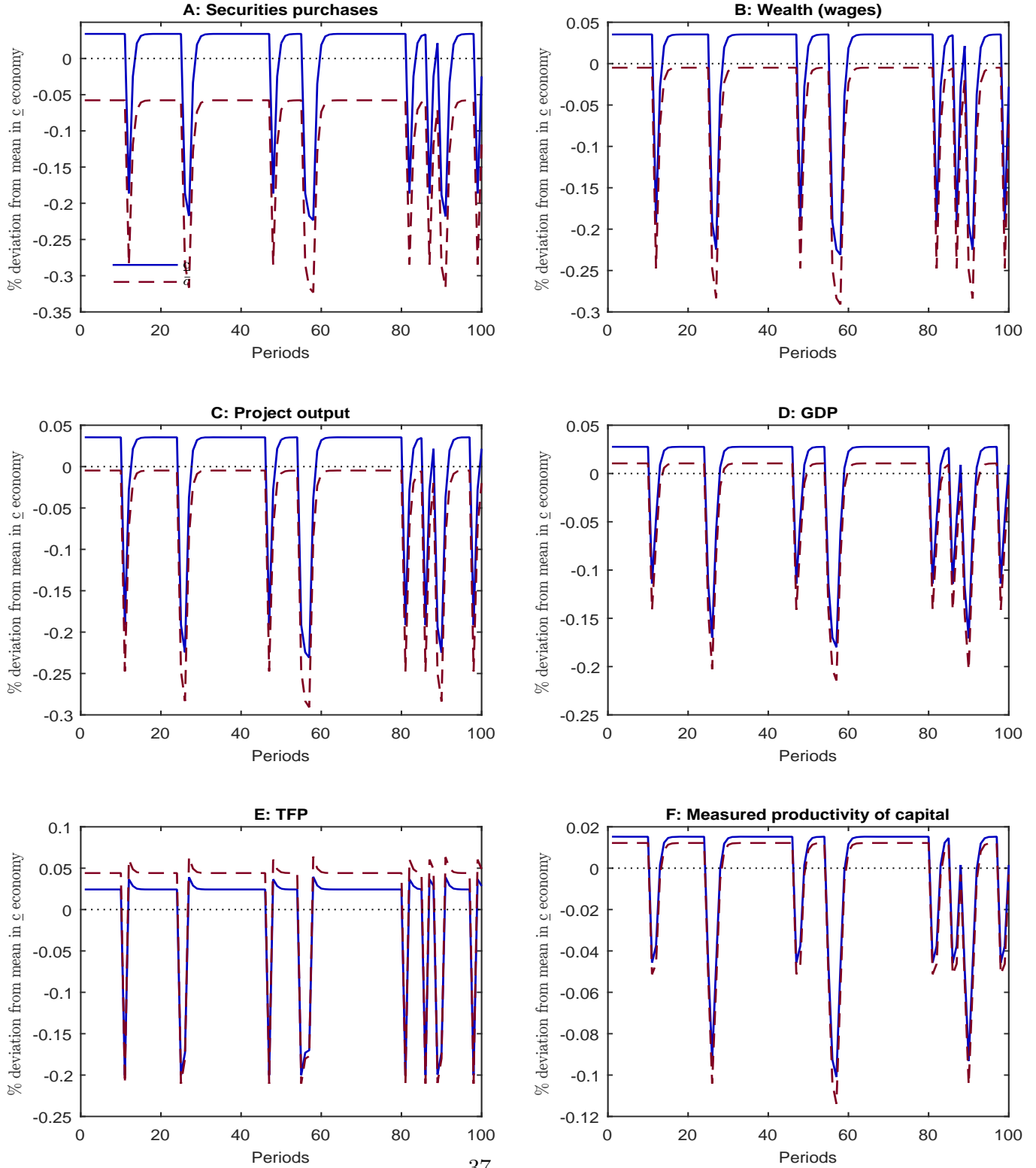


Figure 4: Changing security creation costs

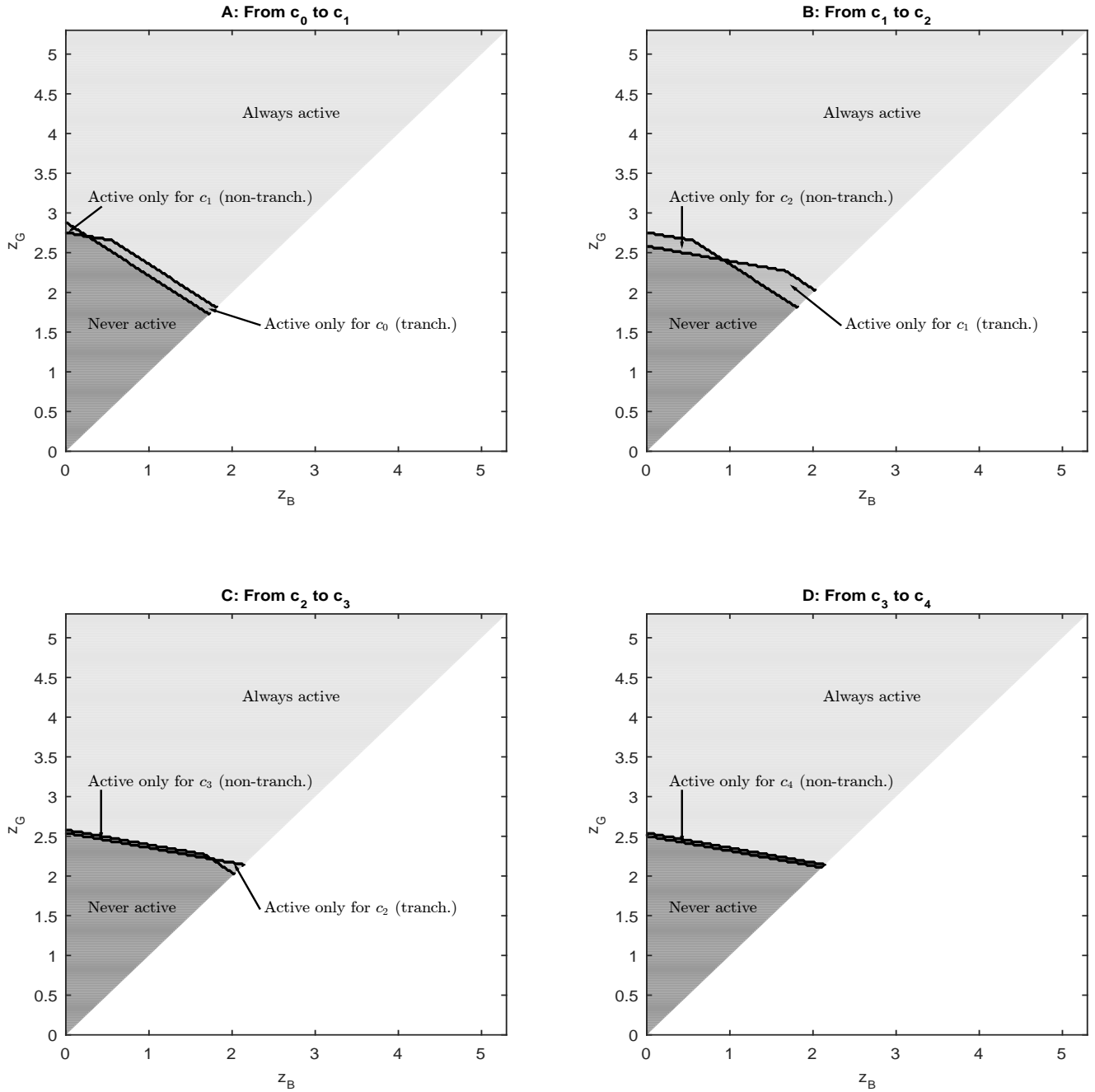




Figure 5: Varying security creation costs: outcomes I

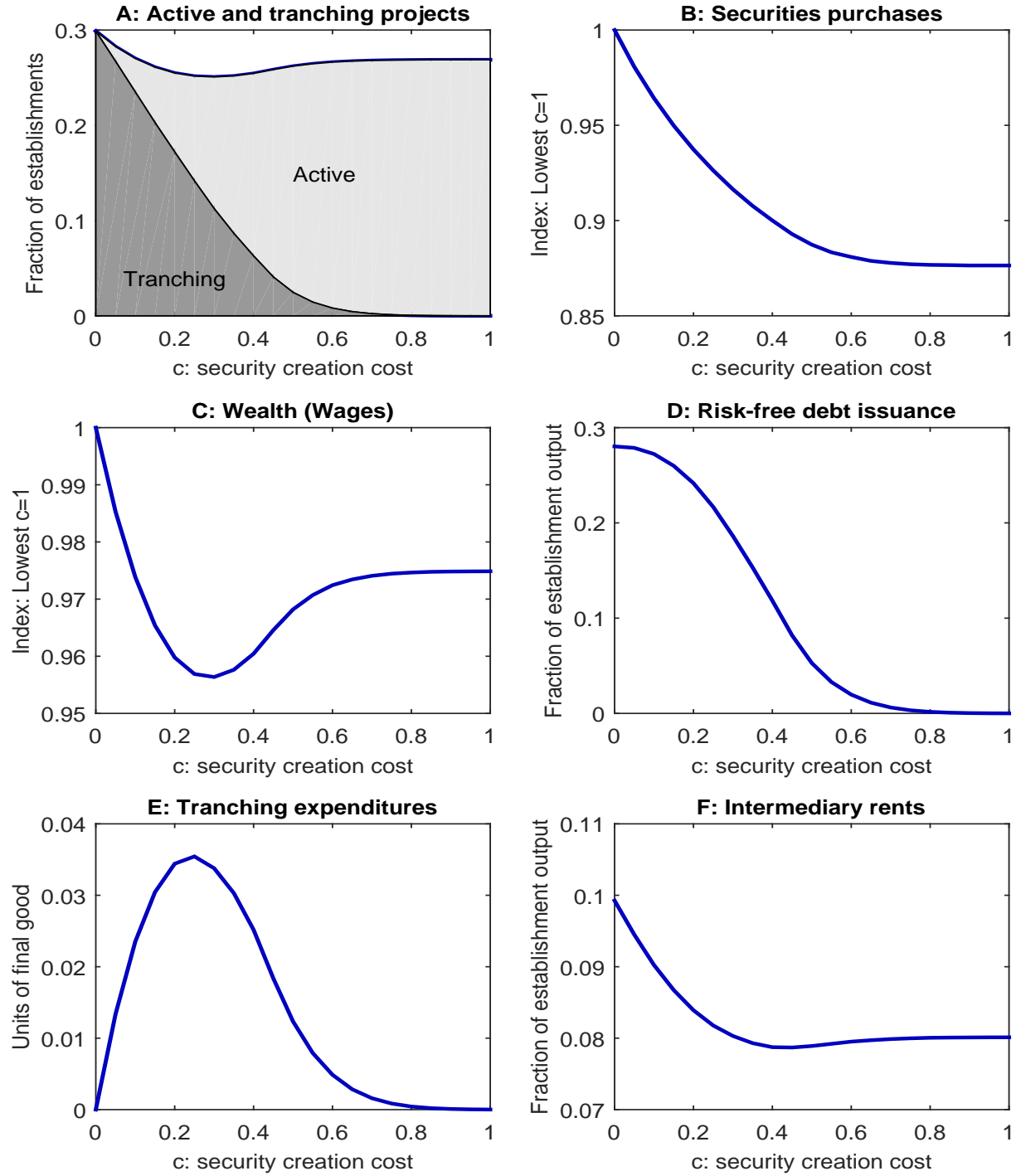


Figure 6: Varying security creation costs: outcomes I, different talent dispersion

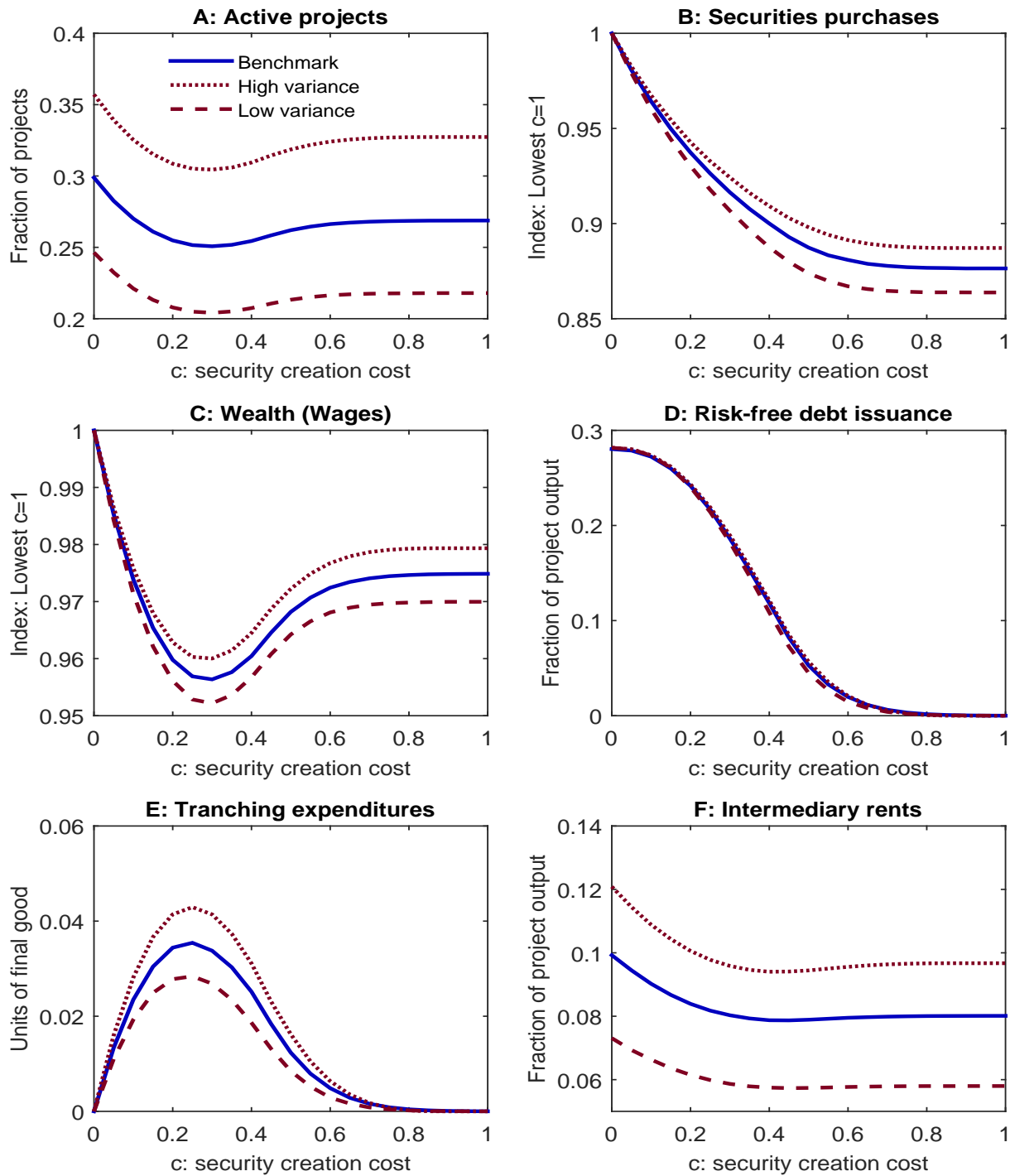


Figure 7: Varying security creation costs: outcomes II

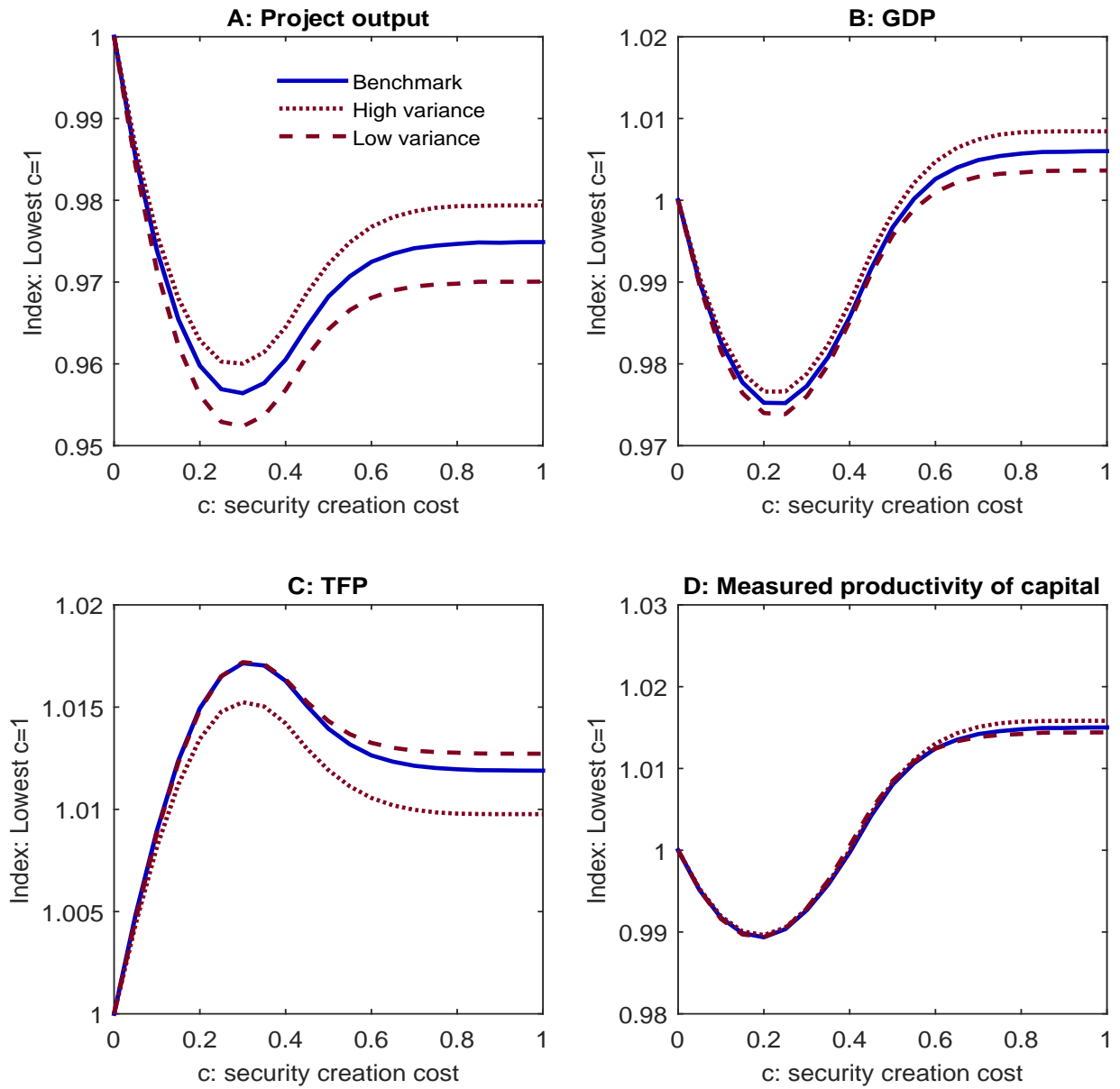


Figure 8: Spending on securities and economic development

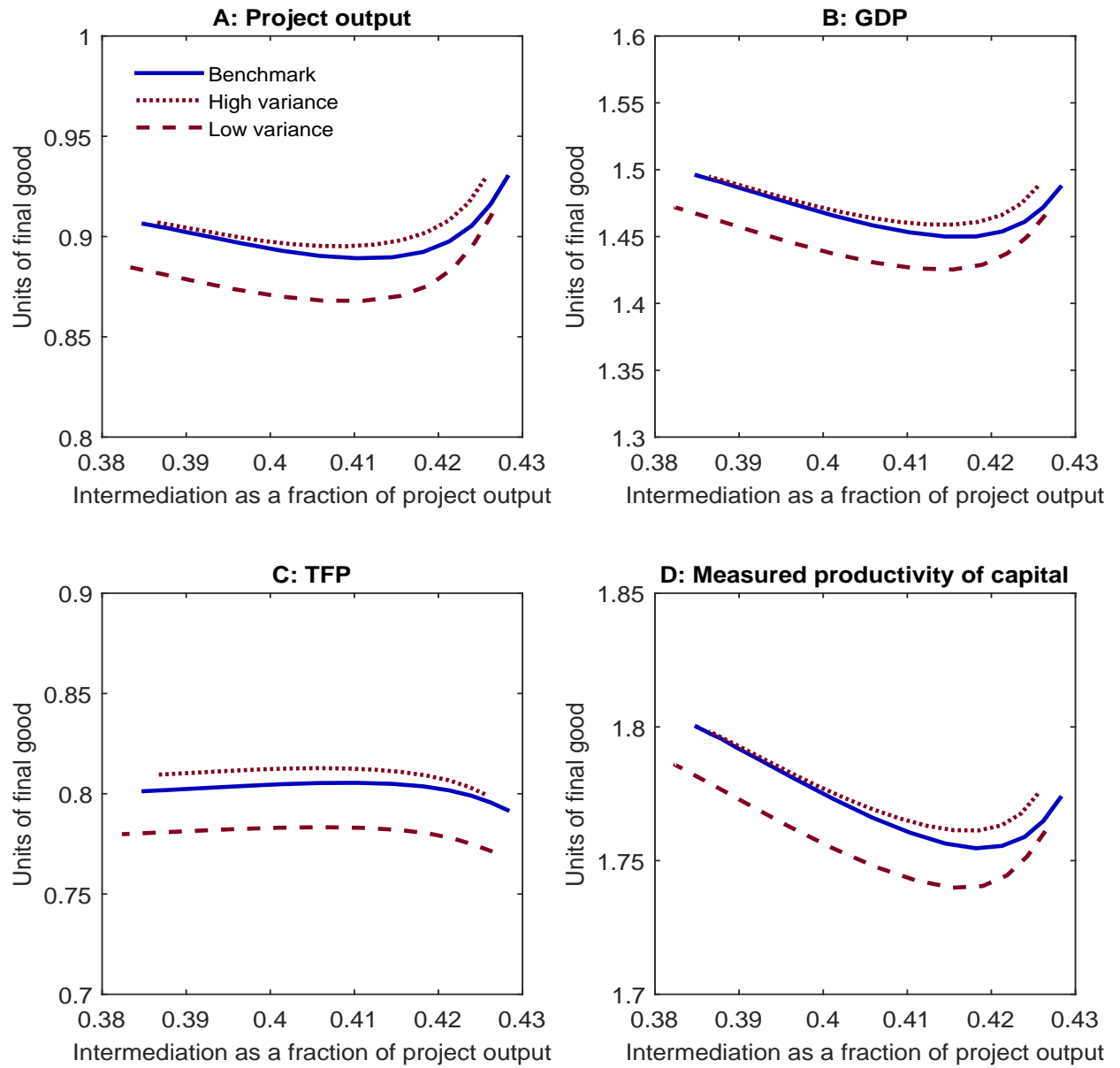


Figure 9: Enterprise leads, finance follows

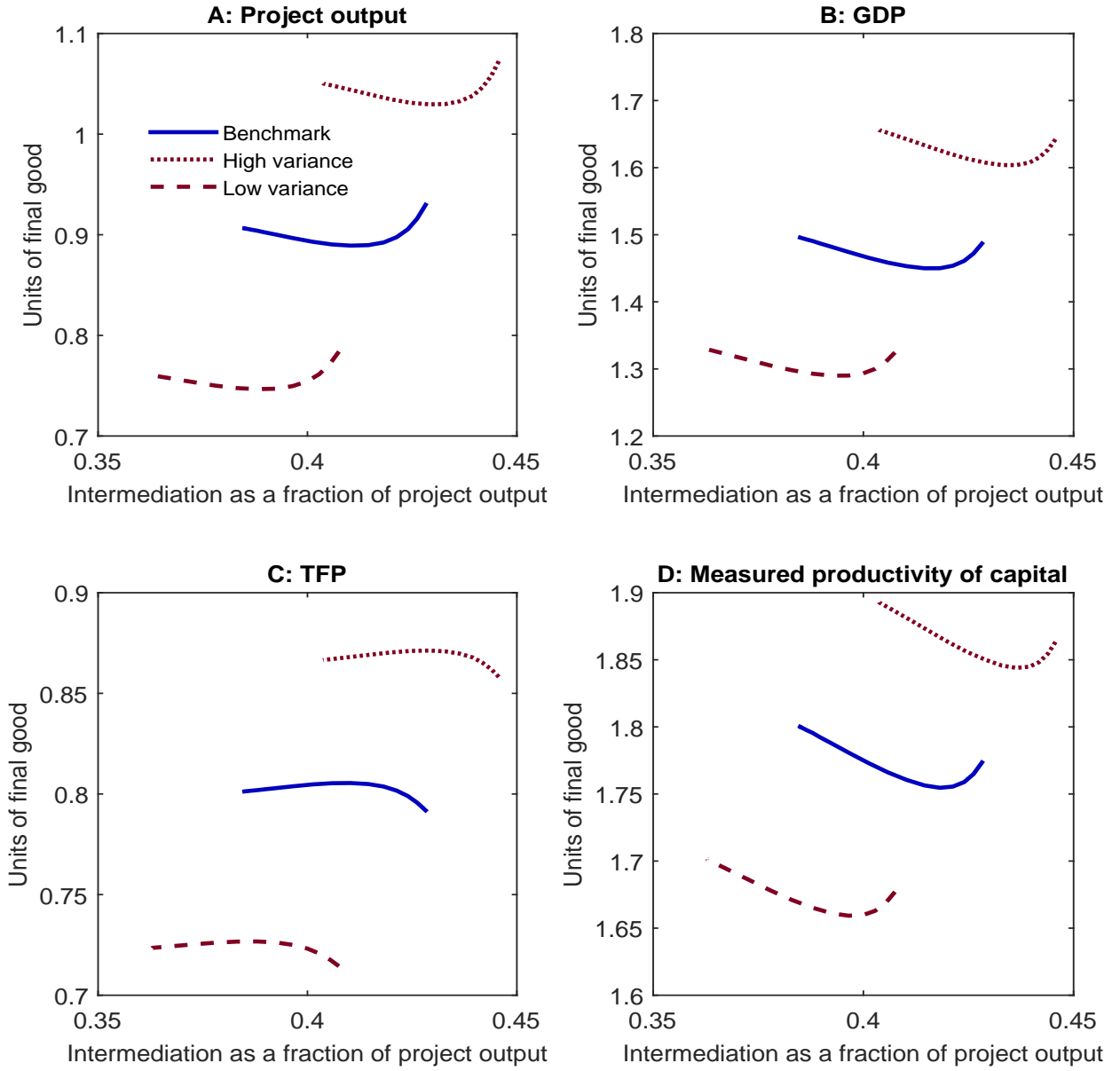


Figure 10: Welfare consequences of varying security creation costs

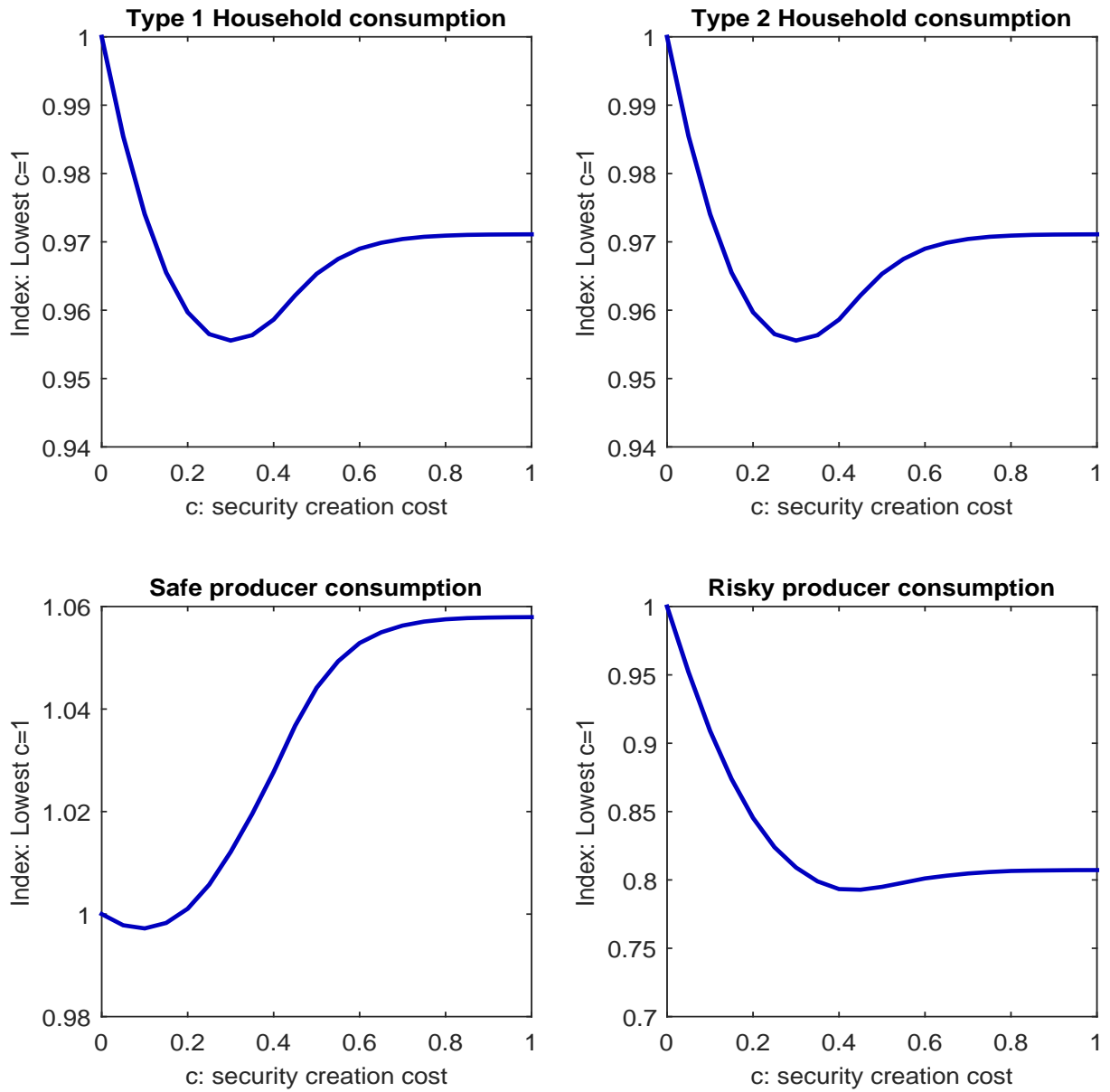


Figure 11: Measures of financial engineering and economic development

