Cycles of Credit Expansion and Misallocation: The Good, The Bad and The Ugly*

Feng Dong† Zhiwei Xu‡

This Version: February, 2018

Abstract

Burgeoning empirical evidence suggests that credit booms may not only increase misallocation, but also sow seeds for financial crises. However, there is relative under-supply of theory accounting for these facts. To bridge the gap, we develop a unified general equilibrium banking model with heterogeneous firms to analyze the misallocation consequences of credit expansion policy both within and across sectors. The main insight is the trade-off between credit quantity and quality. On the one hand, a moderate credit expansion has a non-monotonic impact on the aggregate output. It raises credit potentially available for production at the cost of more severe productivity distortion. On the other hand, a sufficiently large credit expansion may trigger an interbank market crisis, generating discontinuous effect. The resulting economic recession is exacerbated by the firm-level productivity misallocations. By extending the static model to a dynamic environment, we show that an expansionary credit policy can generate endogenous boom-bust business cycles despite the absence of adverse shocks.

Keywords: Credit Expansion, Credit Misallocations, Financial Risk Capacity, Financial Crisis, Credit Cycles

*Very preliminary and comments are welcome. We thank Jess Benhabib, Xuewen Liu, Cheng Wang, Pengfei Wang, Xiaodong Zhu and participants at PBC School of Finance of Tsinghua University, Fudan University, Shanghai Jiao Tong Univeristy, SAIF, and Shanghai University of Finance and Economics. The usual disclaim applies. First Version: August, 2017.

†Antai College of Economics and Management, Shanghai Jiao Tong University; Email: fengdong@sjtu.edu.cn.

‡Antai College of Economics and Management, Shanghai Jiao Tong University; Email: xuzhiwei09@gmail.com.