

Liquidity, Innovation, and Endogenous Growth^{*}

Semyon Malamud and Francesca Zucchi[†]

April 26, 2015

Abstract

We characterize optimal liquidity management, innovation, and production decisions for a continuum of firms facing financing frictions and the threat of creative destruction. We show that liquidity constraints lead firms to cut production and increase markups, which are then countercyclical with respect to firm-specific shocks. We also illustrate that liquidity constraints may spur firms' investment in innovation and give rise to a non-monotonic cash-investment relation. We embed our single-firm dynamics in a Schumpeterian model of endogenous growth and demonstrate that financing frictions have a non-monotonic effect on economic growth and may increase aggregate consumption. When the corporate sector is constrained, liquidity injections by the government have real effects and can increase investment in innovation.

Keywords: Innovation; Cash management; Financial constraints; Endogenous growth; Creative destruction

JEL Classification Numbers: D21; G31; G32; G35; L11

^{*}We would like to thank Michael Fishman, Mikhail Golosov, Luigi Guiso, Barney Hartman-Glaser, Zhiguo He, Dalida Kadyrzhanova, Leonid Kogan, Arvind Krishnamurthy, Erwan Morellec, and Paola Sapienza for helpful comments. Any remaining error is our own.

[†]Swiss Finance Institute and EPFL. E-mail: semyon.malamud@epfl.ch and francesca.zucchi@epfl.ch

1 Introduction

*“Yes, I mean that. Less money raised leads to more success. That is the data I stare at all the time.” (Fred Wilson, co-founder of Union Square Ventures)*¹

Innovation is pivotal to economic growth. The emergence of new goods and improvements in the quality of existing goods shape the world we live in and drive the dynamics of the global economy. Investment in innovation, however, is costly and hard to finance, because the outcome is uncertain and it may require a long gestation period before becoming productive. Firms respond to these financing frictions by hoarding liquidity.² While financing frictions naturally limit the set of viable corporate decisions, they can spur investment in innovation because the resulting breakthroughs can alleviate these constraints. As a result, the relations among liquidity hoarding, investment in innovation, and economic growth are a priori ambiguous. The goal of this paper is to develop a model to study these relations.

To this end, we introduce financing frictions and liquidity hoarding into a Schumpeterian model of endogenous growth. We consider a setting in which the technological frontier is advanced by the innovations of financially constrained incumbents as well as of entrepreneurs that pose the threat of creative destruction. Financially constrained firms hoard liquidity (cash reserves) to maintain financial flexibility, cover operating losses, and finance investment in research and development (in the following, R&D or innovation).³ Optimal production and innovation decisions are functions of liquidity, and the cross-sectional distribution of liquidity affects the rate of economic growth. In turn, the rate of economic growth feeds back into firms’ production and innovation decisions through the market interest rate, which is pinned down by the households’ intertemporal problem.

The contribution of the paper is twofold. First, we investigate the relation between liquidity constraints, investment in innovation, and production decisions at the firm level, and link these policies to various firm characteristics. Second, we embed the single-firm’s problem into a general equilibrium setting, which allows us to study the effects of financing frictions and liquidity hoarding on economic growth.

¹<http://avc.com/2013/09/maximizing-runway-can-minimize-success/>

²See, for instance, Hall (2005) and Hall and Lerner (2010).

³Recent empirical evidence (see, e.g., Lyandres and Palazzo (2014), Ma, Mello, and Wu (2013), Falato, Kadyrzhanova, and Sim (2013)) suggests that R&D activity is a (if not the) major driving factor of corporate cash holdings.

We start by solving the optimization problem of an incumbent firm facing the threat of creative destruction—that is, the threat of going out of business because a new firm is marketing higher quality products in the same product line. Costly access to outside funds creates incentives for the firm to retain earnings in a cash reserve. Financial constraints make the firm effectively risk-averse even if shareholders are risk-neutral.⁴ In response to negative operating shocks, the effectively risk-averse firm manages the risk-return trade-off by adjusting both the scale of production and the investment in innovation. Cash flow volatility is then endogenous and depends on the firm’s financial strength. After a sequence of negative shocks, the price-setting incumbent optimally reduces cash-flow risk by scaling down production and increasing markups. As a result, liquidity constraints lead to endogenous markups that are countercyclical to firm-specific shocks. We show that this relation is monotonic: the tighter the liquidity constraints (i.e., the smaller a firm’s cash reserves), the more a firm scales down production as a cost-cutting device to avert costly refinancing.

The dynamics of investment in innovation are more complex. We highlight that financially constrained firms might be more R&D-intensive than unconstrained peers. As we quote at the beginning, “*Less money [...] leads to more success.*” Specifically, we show that severely constrained firms may invest more in innovation in order to increase the chances of attaining technological breakthroughs, in line with a “*gamble for resurrection*” mechanism. Such breakthroughs allow firms to extract monopoly rents from the brand-new technology and to raise funds on the capital market through a success (the achievement of technological improvements) rather than a failure (running out of funds after negative operating shocks). Although it is inherently uncertain, investment in innovation is potentially highly rewarding. When liquidity constraints tighten, we show that firms with more efficient innovation technologies (i.e., firms that innovate more frequently) cut production and invest more in innovation.

While “gamble for resurrection” has been studied in relation to conflicts of interest between equityholders and debtholders, we show that it can also arise for all-equity firms. We demonstrate that firms with lower operating margins and more volatile profits are

⁴See, e.g., Décamps, Mariotti, Rochet, and Villeneuve (2011), Bolton, Chen, and Wang (2011, 2013), and Hugonnier, Malamud, and Morellec (2015). In these models, as in our model, the marginal value of cash decreases with the level of cash reserves, and eventually reaches one at the target cash-to-assets ratio, at which point the firm optimally decides to distribute dividends.

more likely to gamble for resurrection. This is consistent with the evidence that young firms (which match these characteristics) actively and substantially contribute to bring path-breaking innovations to the market despite their tighter financial constraints (see, e.g., Akcigit and Kerr, 2015 and Acemoglu et al., 2013). Our finding can also rationalize the observation that, although the recent crisis has exacerbated corporate constraints, investment in innovation has not decreased uniformly.⁵

We also show how liquidity constraints lead to endogenous dynamics of the volatility of cash flows and the idiosyncratic volatility of stock returns. In stark contrast with extant cash management models (see, e.g., Décamps et al., 2011), we find that idiosyncratic return volatility can be a hump-shaped function of cash reserves. While we do observe the leverage effect for relatively unconstrained firms, the relation between changes in firm value and the volatility of stock returns can become positive when liquidity constraints are tight. In particular, the sign of the covariance between average returns and idiosyncratic volatility varies with the cash-to-assets ratio. Thus, accounting for liquidity frictions offers a new perspective to the idiosyncratic volatility puzzle.

In the second part of our analysis, we embed the dynamics of a single firm into a general equilibrium setting and study a “balanced growth path” equilibrium in which the economy grows at a constant rate. In equilibrium, incumbents take the market interest rate as given and solve for their optimal production, innovation, and cash management decisions. In each industry, the incumbents’ value and the rate of creative destruction are jointly determined by the free-entry condition. The investments in R&D of incumbents and entrants aggregate and determine the growth rate of aggregate consumption, which affects the market interest rate through the representative consumer’s Euler equation.

We find that financing frictions deter entry and decrease creative destruction. This effect leads incumbents to spend more on innovation because they expect their profits to last for longer before a new firm seizes their market share.⁶ The frictions faced by entrants then have contrasting effects on growth. On the one hand, they deter innovation by new firms (which decreases growth); on the other hand, they prompt innovation by incumbents (which increases growth). The latter (respectively, former) effect dominates

⁵For example, Archibugi, Filippetti, and Frenz (2013) report that some firms have actually increased their R&D investment despite the toughening constraints. In a related study, Kanerva and Hollanders (2009) find no relation between firm size and decline in investment in 2008.

⁶This effect is similar to Aghion and Howitt (1992).

when the entry cost is high (low). In the presence of financing frictions, therefore, the rate of economic growth can be larger than that of an identical but unconstrained economy. Even when the growth rate of the constrained economy is smaller, financing frictions may lead to an increase in consumption vis-à-vis the unconstrained benchmark. Indeed, financing frictions increase incumbents' expected monopoly rents by curbing the threat of creative destruction. At the same time, the resulting lower growth rate decreases the interest rate that is used to discount future cash flows. These mechanisms all imply that constrained firms can be more valuable and promise more dividends, which in turn increases aggregate consumption. Our analysis reveals that financing frictions may be not welfare-decreasing.

Throughout most of the analysis, we follow extant cash holdings models and assume that the wedge between the market interest rate and the return on cash, the so-called liquidity premium, is exogenous. To endogenize the liquidity premium, we add more structure to the model and introduce the government as the liquidity provider. Specifically, we follow Woodford (1990) and assume that cash can only be stored by holding government bonds. Firms are net demanders of liquidity, and the return on cash (i.e., the return on government bonds) is determined by market clearing. In turn, the equilibrium tax rate is uniquely pinned down by the government's budget constraint.

In this richer environment, government debt policies have real effects because they impact the liquidity premium. When the government increases liquidity in the economy by issuing more public debt, the liquidity premium decreases, as documented by Krishnamurthy and Vissing-Jorgensen (2012). Firms are then more willing to hoard money-like securities and increase their target cash reserves; i.e., they increase the resources that are naturally meant for the financing of innovation. As a result, liquidity injections crowd in investment in innovation by incumbents and creative destruction by entrants. These effects increase economic growth. From the government's perspective, a larger supply of liquidity means that it will cost more to maintain a target debt-to-GDP ratio, which calls for a contemporaneous increase in the equilibrium tax rate. Despite such a fiscal adjustment, an increase in government debt can increase aggregate consumption and welfare via the positive effect on firms' slack, innovation, and economic growth.

Related literature Our paper relates to different strands of literature. First, the paper contributes to the literature studying dynamic cash management models. The tremendous increase in the cash-to-asset ratios of U.S. firms over the last few decades, as documented by Bates, Kahle, and Stulz (2009), has spurred the development of a new generation of cash management models; see, for instance Riddick and Whited (2009), Décamps, Mariotti, Rochet, and Villeneuve (2011), Bolton, Chen, and Wang (2011, 2013), and Hugonnier, Malamud, and Morellec (2015). Our explicit solution to the dynamic problem of optimal liquidity, innovation, and production decisions for a price-setting firm links our paper to this literature. Within this strand, the papers that analyze the relation between cash holdings and investment do so by considering neoclassical models of investment and capital accumulation, either incremental (as in Bolton, Chen, and Wang 2011, 2013) or lumpy (as in Hugonnier, Malamud and Morellec, 2015). To the best of our knowledge, our paper is the first to study the cash management problem of a firm engaged in production and R&D investment in a Schumpeterian framework.⁷ This problem is economically important given the documented relations between cash holdings and R&D investment and between R&D investment and economic growth (see e.g. Caballero and Jaffe, 1993, Akcigit and Kerr, 2015, or Kogan, Papanikolaou, Seru, and Stoffman, 2014), although it is non-trivial because it involves solving a problem with an infinite number of (sequentially arriving) growth options.

The paper also contributes to the literature studying the financing of innovation. Lyandres and Palazzo (2014) and Ma, Mello, and Wu (2014) investigate, both theoretically and empirically, the relation between competition, R&D investment, and cash holdings. In the same vein, Falato, Kadyrzhanova, and Sim (2013) study and test the strong relation between investment in intangible capital and cash holdings in a neoclassical model with no growth. While we abstract from strategic competition within an industry, we contribute to this strand by studying the joint dynamics of cash accumulation, production, and innovation. We also study implications of these dynamics for economic growth and welfare, and investigate the role of government as a liquidity provider.

Modeling the joint dynamics of R&D investment and liquidity constraints is motivated by vast empirical evidence. Among others, Hall (2005) and Hall and Lerner (2010)

⁷The key difference in neoclassical capital accumulation models and Schumpeterian innovation models is that, in the former models, investment implies an immediate increase in the output, whereas the payoff from investment in R&D arrives at uncertain (Poisson) times.

document that innovation is best financed through internal savings because this type of investment is subject to asymmetric information, it is not pledgeable, and its return is highly uncertain. Brown, Fazzari, and Petersen (2009) report a strong impact of financing constraints on innovation at both the firm level and the aggregate level, and document that innovation decisions are related to the *supply* of internal and external equity finance.⁸ Consistent with this evidence, Hall (2005), Hall and Lerner (2010), Rajan (2012), and Acharya and Xu (2014) emphasize the relative importance of equity with respect to debt for the financing of innovation, as we do in our theoretical model.

On the macroeconomic side, Schumpeter (1942) was the first to emphasize the importance of innovation for economic growth by introducing the concept of “creative destruction.” The work of Schumpeter has led to the development of a subfield of macroeconomics, known as “Schumpeterian models of endogenous growth;” see Aghion, Akcigit, and Howitt (2014) for an overview. Our model belongs to this literature. In particular, we build on the endogenous technological change literature (see also Romer, 1990, Grossman and Helpman, 1991, or Klette and Kortum, 2004) and assume that investment in innovation is pursued both by incumbent firms and by a continuum of potential entrants, as in the recent contributions of Acemoglu and Cao (2015), Akcigit and Kerr (2015), or Acemoglu, Akcigit, Bloom, and Kerr (2013).

Our paper also relates to the literature studying the effects of financial constraints on long-term growth; see Levine (2005) and Beck (2012) for two surveys. Thus far, however, relatively little attention has been paid to the role of corporate liquidity in providing flexibility to constrained firms. Our model seeks to fill this gap. Our focus on liquidity allows to study the interaction between the demand and supply of money-like securities; see also Woodford (1990), Holmstrom and Tirole (1998), Saint-Paul (2005), Kiyotaki and Moore (2012), Kocherlakota (2009), or Farhi and Tirole (2012) for related work. In particular, our results confirm the result of Woodford (1990) who shows that, contrary to the standard neoclassical crowding-out effect, government debt can crowd in

⁸Brown, Fazzari, and Petersen (2009) report that, in the US, young publicly traded firms in high-tech industries finance R&D investment almost entirely with internal and external equity as debt financing is difficult due to non-pledgeability. Citing from their paper, “*While the large literature on finance and economic growth has good reasons to focus on debt and credit constraints, our results suggest that more attention should be given to equity finance [...] for models that emphasize innovation. [...] External equity is the more relevant substitute for internal cash flow for young high-tech firms.*”

investment.⁹ In our framework, as in Woodford (1990) and Kocherlakota (2009), firms are net demanders of liquidity, and liquidity is scarce because firms cannot supply liquidity by issuing debt—which is the case for R&D-intensive firms. In our model, government debt policy has a *novel redistributive effect* because it changes the cross-sectional distribution of liquidity in the economy, thereby affecting production and innovation decisions in the corporate sector.

The paper is organized as follows. Section 2 describes the model. Section 3 solves the model in the benchmark unconstrained economy. Section 4 solves the model in the economy featuring financing frictions. Section 5 provides a quantitative assessment of the model’s predictions. Section 6 concludes. All proofs are in the Appendix.

2 The Model

Throughout the paper, time is continuous and uncertainty is modeled by a probability space $(\Omega, \mathcal{F}, P)$, equipped with a filtration $(\mathcal{F}_t)_{t \geq 0}$ that represents the information available at time t . We consider an economy in which the representative household maximizes constant relative risk aversion (CRRA) preferences:

$$\int_0^\infty e^{-\rho t} \frac{\mathcal{C}_t^{1-\theta} - 1}{1-\theta} dt. \quad (1)$$

In this equation, $\mathcal{C}_t$ is the consumption rate at time t . The parameters ρ and θ represent the discount rate and the inverse of the elasticity of intertemporal substitution, respectively. Population is constant at L . Agents supply labor inelastically, for which they receive labor wage denoted by W_t .

Final good sector. There is one multipurpose final good $\mathcal{Y}_t$ serving as the numeraire of the economy. The final good is produced competitively using labor and a continuum of specialized intermediate goods indexed by $j \in [0, 1]$, according to the production function

⁹See also Saint-Paul (2005), who argues that government debt can boost growth as its collateral value makes it easier for entrepreneurs to borrow; and Kiyotaki and Moore (2008) who argue that the circulation of fiat money and government debt “lubricates” the economy and helps boost aggregate activity.

$$\mathcal{Y}_t = \frac{1}{1-\beta} \int_0^1 L^\beta \bar{X}_t(j)^{1-\beta} q_t(j)^\beta dj, \quad \beta \in [0, 1]. \quad (2)$$

In this equation, $\bar{X}_t(j)$ is the input quantity of the intermediate good j and $q_t(j)$ is the “quality” associated with it. We normalize the initial quality level to one: $q_0(j) = 1$ for all $j \in [0, 1]$. We assume that only the highest quality version of each intermediate good j is used in the production of the final good. Improvements in the quality of each intermediate good j occur via two channels: innovation by incumbent firms and *creative destruction* by entrants.

Intermediate goods sector. As is common in Schumpeterian models, we assume that each intermediate good j is produced by the latest innovator in the industry j . The latest innovator enforces a patent on the highest quality version of the intermediate good j and becomes the incumbent monopolist in the production of that good. The patent is assumed to last forever but does not prevent other firms from improving further the quality of that good. Whenever a new firm launches a higher quality version of the intermediate good j , it enforces a new patent on it and becomes the new monopolist of the industry j .

Each incumbent firm invests in innovation to further improve the quality of the intermediate good it produces. We denote by z_t an incumbent’s innovation intensity (or innovation rate). Innovation is costly, and its outcome is uncertain. Specifically, we assume that an incumbent firm paying the flow cost

$$\Phi(z_t, q_t) = \zeta \frac{z_t^2}{2} q_t, \quad \zeta > 0,$$

succeeds in increasing the quality of its intermediate good at a Poisson rate of ϕz_t . These Poisson events represent technological breakthroughs, whose occurrence is more likely when the innovation rate z_t is larger. When a technological breakthrough occurs, the quality of the intermediate good j jumps from $q_{t-}(j)$ to

$$q_t(j) = \lambda q_{t-}(j).$$

The parameter $\lambda > 1$ measures the incremental improvement in quality due to the in-

cumbent's technological breakthrough.¹⁰

The operating revenues of each incumbent firm are primarily driven by the scale of production. In the following, we denote by $\bar{X}_t(j)$ the production quantity of the product line j and by $\Pi_t(j)$ the corresponding revenues. The dynamics of revenues are given by:

$$d\Pi_t(j) = [\bar{X}_t(j)(p_t(j) - m(j)) - \Phi(z_t, q_t)] dt + \sigma \bar{X}_t(j) dZ_t(j). \quad (3)$$

In this equation, p_t represents the price of the intermediate good j , whereas m represents the marginal cost of production. $Z_t(j)$ is a standard Brownian motion that represents random operating shocks.¹¹ Operating shocks are firm-specific and independent across firms. $\bar{X}_t(j)$ and $p_t(j)$ are endogenously determined in the following.

The cash flow process in equation (3) implies that incumbents are exposed to operating losses. If access to outside financing was frictionless, as in previous Schumpeterian models of growth, losses could be covered by raising fresh funds whenever needed. We depart from this assumption and assume that firms face refinancing costs, as in Bolton, Chen, and Wang (2011, 2013).¹² We model financing frictions to capture features that are common among R&D-intensive firms (see, e.g., Lerner et al., 2012). These firms tend to delay refinancing events until technological breakthroughs occur (or when in the extreme need of funds). When breakthroughs occur, it is easier to attract financiers.

We assume that incumbents can refinance current operations at a cost $\epsilon > 0$ for any dollar raised. When technological breakthroughs occur, current production is “upgraded” and incumbents can raise fresh funds by sharing the surplus created with the financiers. We model the surplus sharing between the firm's shareholders and the financiers via Nash bargaining (see, e.g., Duffie, Garleanu, and Pedersen, 2007). Denoting the bargaining power of financiers by $\alpha \in [0, 1]$ and the surplus created by S , the rents extracted by

¹⁰See also Acemoglu and Cao (2015) or Acemoglu et al. (2013). We do not allow incumbent firms to operate multiple product lines (as in Klette and Kortum, 2004); that is, each firm innovates only on one product line. As in Aghion, Howitt, and Mayer-Foulkes (2005), Acemoglu, Aghion, and Zilibotti (2006), or Acemoglu and Cao (2015), we do not consider skilled labor in the intermediate-good sector and assume that firms are run by entrepreneurs.

¹¹The assumption of Brownian shocks is similar to the neoclassical AK-technology used in the model of Bolton, Chen, and Wang (2011, 2013) and DeMarzo, Fishman, He, and Wang (2012).

¹²As in Bolton, Chen, and Wang (2011, 2013), financing costs are exogenous. Financing costs could be microfounded through limited enforcement (Albuquerque and Hopenhayn, 2002), asymmetric information (Clementi and Hopenhayn, 2002), or limited pledgeability (Holmstrom and Tirole, 2011).

financiers satisfy

$$\Gamma^* = \arg \max_{\Gamma \geq 0} \Gamma^\alpha [S - \Gamma]^{1-\alpha} = \alpha S.$$

As a result, incumbent firms retain a fraction $1 - \alpha$ of the total surplus S .

To maintain financial flexibility, incumbent firms may find it optimal to retain earnings in a cash reserve. We denote by $\bar{C}_t$ the firm's cash reserves at time t . Cash reserves earn a rate δ that is lower than the market interest rate r , so holding cash entails an opportunity cost. The opportunity cost of cash can stem from agency costs of free cash flows (as in Décamps, Mariotti, Rochet, and Villeneuve, 2011) or from tax disadvantages (as in Riddick and Whited, 2009). As we show in Section 4.5, this opportunity cost may also arise when the supply of liquidity in the economy is scarce. Notwithstanding its microfoundation, the wedge between r and δ leads to a dynamic trade-off between dividend payout and liquidity hoarding. Under the model assumptions, the dynamics of the cash holdings process $(\bar{C})_{t \geq 0}$ are given by

$$d\bar{C}_t = \left[\delta \bar{C}_t + \bar{X}_t(j)(p_t(j) - m(j)) - \Phi(z_t, q_t) \right] dt + \sigma \bar{X}_t(j) dZ_{jt} - dD_t + dF_t + dF_t^I. \quad (4)$$

The first term in the square brackets represents the instantaneous return on the stock of cash, whereas the second and third terms represent the expected net operating profit. $dF_t \geq 0$ is the instantaneous net inflow from refinancing current operations, $dF_t^I \geq 0$ is the instantaneous net inflow when marketing a technological breakthrough, and $dD_t \geq 0$ is the instantaneous flow of payouts at time t .

Incumbent firms choose production $\{\bar{X}_t\}$, innovation $\{z_t\}$, financing $\{F_t\}, \{F_t^I\}$, and payout $\{D_t\}$ policies to maximize the present value of future dividends subject to the budget constraint (4) and the non-negativity constraint on cash holdings. We denote by $V(t, \bar{C}, q)$ the time- t value of the firm with cash reserves $\bar{C}$ and producing its intermediate good at quality level q , given by

$$V(t, \bar{C}, q) = \max_{\{\bar{X}_s\}, \{z_s\}, \{F_s\}, \{F_s^I\}, \{D_s\}} E \left[\int_t^{\mathcal{T}_d} e^{-r(s-t)} (dD_s - (1 + \epsilon) dF_s - (1 + \alpha S_s) dF_s^I) \right].$$

In this equation, $\alpha S dF^I$ is the surplus extracted by financiers upon a technological breakthrough, and $\mathcal{T}_d$ is the time of liquidation due to creative destruction. When creative destruction hits, the incumbent loses its market position, and shareholders receive a lumpy

liquidation dividend equal to the firm's cash holdings; that is, $dD_{\tau_d} = \bar{C}_{\tau_d}$. As is common in Schumpeterian models, we assume that obsolescence drives the liquidation value of other assets to zero.

Entrants. An incumbent firm is replaced in the production of the intermediate good j when an entrepreneur markets a higher quality version of this good. Specifically, we assume that there is a mass of entrepreneurs on the sideline, who develop blueprints to improve the quality of the intermediate goods. Once successfully developed, a blueprint has the potential to improve the current quality of a good j by a factor $\Lambda > 1$, i.e. quality may jump from $q_{t-}(j)$ to

$$q_t(j) = \Lambda q_{t-}(j).$$

We do not impose a priori restrictions on the relation between λ and Λ .¹³

We assume that entrepreneurs do not collaborate with incumbent firms due to frictions in the sale of ideas (see also Kondo and Papanikolaou, 2013 and Silveira and Wright, 2010). To exploit a successful blueprint, an entrepreneur needs to set up a firm. Creating a firm at a quality level q_t requires a technological cost equal to $\kappa_T q_t L$. To finance this cost, an entrepreneur contacts financiers. In turn, financiers charge a financing cost to the entrepreneur. We denote this financing cost by $\kappa_I q_t L$, so the total entry cost is given by

$$K_t(j) = q_t(j)L(\kappa_T + \kappa_I) = \Lambda q_{t-}(j)L(\kappa_T + \kappa_I). \quad (5)$$

The ratio $\frac{\kappa_I}{\kappa_T + \kappa_I}$ is a measure of the financiers' ability to extract rents from entrants.¹⁴

Balanced growth path. We consider symmetric balanced growth path equilibria in which, for any industry j , the entry rate is given by x_d , and the equilibrium output $\mathcal{Y}_t$ in (2) grows at a constant rate g (endogenously determined in the following). We will

¹³We allow for different sizes of quality jumps for incumbents and entrants; see Acemoglu and Cao (2015) or Akcigit and Kerr (2015). These contributions assume that $\Lambda > \lambda$ to model the difference between “incremental” innovations by incumbents and “radical” innovations by entrants. The difference between λ and Λ is not essential to our analysis. However, we set $\Lambda > \lambda$ in the numerical analysis.

¹⁴Due to the free-entry condition (6), this is the fraction of firm value (net of the cash provided) that financiers extract from entrants. In the real world, adverse selection reduces entrants' bargaining power relative to that of an incumbent. To capture this effect, we assume that $\frac{\kappa_I}{\kappa_T + \kappa_I} > \alpha$.

frequently refer to the entry rate x_d as the rate of creative destruction, which is determined by the free-entry condition

$$V(t, \bar{C}_t^*, \Lambda q(j)) - \bar{C}_t^* = K_t(j). \quad (6)$$

In this equation, we assume that entrants start operations endowed with their target level of cash reserves, denoted by $\bar{C}_t^*$.¹⁵ As we show below, this target level always exists and can be characterized explicitly.

To solve the model, we first derive the incumbents' optimal policies and then aggregate in general equilibrium. An equilibrium is an allocation characterized as follows: (i) Incumbent firms set production, innovation, payout, and financing policies to maximize the expected present value of net dividends; (ii) New firms enter at a rate that makes the free-entry condition binding; (iii) The final good producer maximizes profits; (iv) The representative household maximizes utility from consumption; (v) The final-good market and the intermediate-good market clear. In Section 4.5, we endogenize the opportunity cost of cash, $r - \delta$, by introducing the government acting as liquidity provider.

3 Benchmark unconstrained economy

We first solve the model by assuming that incumbents and entrants do not face financing frictions, meaning that the parameters ϵ , α , and κ_I are zero.¹⁶ In this setting, idiosyncratic operating shocks do not matter in the definition of corporate policies, because losses can be covered by raising external funds immediately and costlessly. Under these assumptions, firms have no incentive to keep cash.

We begin the analysis by solving the optimization problem of the final-good producer,

$$\max_{\bar{X}(j)} \frac{1}{1-\beta} \int_0^1 L^\beta \bar{X}_t(j)^{1-\beta} q_t(j)^\beta dj - \int_0^1 p_t(j) \bar{X}_t(j) dj, \quad (7)$$

which delivers the standard demand curve for the highest quality version of any interme-

¹⁵One can argue that financiers may be reluctant to provide the amount of liquidity that is optimal from the firms' perspective, due to adverse selection problems. We have solved a version of the model in which some of the entrants start with less cash than is optimal, and our main results do not change.

¹⁶In this unconstrained setting, our model follows Acemoglu and Cao (2015).

diate good $j \in [0, 1]$, given by

$$\bar{X}_t(j) = L \left(\frac{q_t^\beta(j)}{p_t(j)} \right)^{\frac{1}{\beta}}. \quad (8)$$

Taking the demand schedule of the final-good producer as given, an incumbent firm maximizes its profits by setting the monopoly price¹⁷

$$p_t = p^* = \frac{1}{1 - \beta}.$$

In this equation, and everywhere in the following, the marginal cost of production m is normalized to one. This price implies a constant markup above the marginal cost, equal to $\frac{\beta}{1 - \beta}$. It follows that the optimal production quantity is $\bar{X}_t^*(j) = q_t(j) L X^*$, where

$$X^* = (1 - \beta)^{\frac{1}{\beta}}$$

denotes the time-independent production quantity scaled by quality (as we explain below, we will often refer to scaled quantities). Substituting the expressions for X^* and p^* into (2), we derive the aggregate output,

$$\mathcal{Y}_t^* = L(1 - \beta)^{\frac{1}{\beta} - 2} \int_0^1 q_t(j) dj, \quad (9)$$

and the competitive wage,

$$W_t^* = L\beta(1 - \beta)^{\frac{1}{\beta} - 2} \int_0^1 q_t(j) dj. \quad (10)$$

We next derive the value of an incumbent firm, denoted by $V(t, q)$. Incumbents always produce the value-maximizing quantity $\bar{X}_t^*$ of their intermediate good and any net operating profit is immediately paid out as a dividend. Following standard arguments,

¹⁷As in other contributions, we rule out the case of limit pricing to keep the analysis tractable. For instance, Aghion and Howitt (1992) assume that innovations are always drastic so that a monopolist is unconstrained by potential competition from the previous patents. Akcigit and Kerr (2015) assume that the current incumbent and the former incumbents in a given product line enter a two-stage price-bidding game whereby each firm pays a fee to announce its price. Under this assumption, only the new leader pays the fee and announces its price. We adopt similar assumptions in our setup.

$V(t, q)$ satisfies the following Hamilton-Jacobi-Bellman (HJB) equation

$$rV(t, q) - V_t(t, q) = \max_z \left\{ \beta L q (1 - \beta)^{\frac{1}{\beta}-1} - \frac{z^2}{2} \zeta q + \phi z [V(t, \lambda q) - V(t, q)] - x_d V(t, q) \right\}. \quad (11)$$

The first two terms on the right-hand side represent the incumbent's operating profit net of production and innovation expenditures. The third term is the expected change in value when the incumbent markets a higher quality version of its intermediate good weighted by the probability of this occurrence. The fourth term is the value discount due to creative destruction. The terms on the left-hand side represent, respectively, the return required by investors and the change in firm value as time elapses. To solve the incumbent's maximization problem, we conjecture that firm value is linear in the quality q_t ,

$$V(t, q) = V(q_t) = q_t L v, \quad (12)$$

for some $v > 0$. In the following, we will refer to v as the scaled value of an incumbent. Substituting (12) into (11), we obtain

$$\max_z \left\{ \mu^* - \frac{z^2}{2} \frac{\zeta}{L} + \phi z (\lambda v - v) - x_d v \right\} = r v, \quad (13)$$

where we have defined the auxiliary quantity $\mu^* \equiv \beta (1 - \beta)^{\frac{1}{\beta}-1}$. Differentiating (13), it follows that the value-maximizing innovation rate z^* is given by

$$z^* = \phi \frac{L}{\zeta} (\lambda - 1) v. \quad (14)$$

The optimal innovation rate z^* is increasing in firm value v , in the rate of technological breakthroughs ϕ , as well as in the quality improvement λ . Substituting (14) into (13), we derive a closed-form expression for the value of an incumbent firm v^* , as reported in Proposition 1. Finally, the free-entry condition

$$v^* = \kappa_T. \quad (15)$$

determines the entry rate x_d^* (i.e., the rate of creative destruction) for all the product lines j .

The expected increase in the quality of a given intermediate good j is given, per unit

of time dt , by

$$E_{t-}[dq_t(j)] = q_{t-}(j) [(\lambda - 1)\phi z^* + (\Lambda - 1)x_d^*] dt.$$

In this expression, the first (respectively, second) term in the square brackets is the incumbents' (entrants') contribution to the improvement in quality of the intermediate good j . Innovations in different product lines $j \in [0, 1]$ occur at independent Poisson times. By the law of large numbers, we obtain

$$\int_0^1 q_t(j) dj = e^{g^* t}, \quad (16)$$

where g^* denotes the rate of economic growth and is given by

$$g^* = (\lambda - 1)\phi z^* + (\Lambda - 1)x_d^*. \quad (17)$$

Notably, equation (16) implies that the aggregate output in (9) grows at the rate g^* . Finally, the Euler equation of the representative household determines the equilibrium interest rate r^* , which satisfies the following relation:

$$r^* = \rho + \theta g^*. \quad (18)$$

We summarize our findings in the following proposition.

Proposition 1 *In the unconstrained economy, the optimal innovation rate and the scaled value of an incumbent firm are respectively given by*

$$z^* = \phi \frac{L}{\zeta} (\lambda - 1) \kappa_T,$$

$$v^* = \frac{2\mu^*}{(x_d + r) + \sqrt{(x_d + r)^2 - 2\mu^* \phi^2 \frac{L}{\zeta} (\lambda - 1)^2}}.$$

Moreover, the equilibrium rate of creative destruction x_d^* , the rate of economic growth g^* ,

and the market interest rate r^* respectively satisfy

$$\begin{aligned} x_d^* &= \frac{1}{1 + \theta (\Lambda - 1)} \left[\frac{\mu^*}{\kappa_T} - \rho + \kappa_T \phi^2 \frac{L}{\zeta} (\lambda - 1)^2 \left(\frac{1}{2} - \theta \right) \right] \\ g^* &= \frac{1}{1 + \theta (\Lambda - 1)} \left([\Lambda - 1] \left(\frac{\mu^*}{\kappa_T} - \rho \right) + \kappa_T \frac{\Lambda + 1}{2} \phi^2 \frac{L}{\zeta} (\lambda - 1)^2 \right) \\ r^* &= \frac{1}{1 + \theta (\Lambda - 1)} \left[\rho + \theta (\Lambda - 1) \frac{\mu^*}{\kappa_T} + \kappa_T \theta \frac{\Lambda + 1}{2} \phi^2 \frac{L}{\zeta} (\lambda - 1)^2 \right]. \end{aligned}$$

Two remarks are worth a mention. First, the equilibrium growth rate g^* is non-monotonic in the entry cost. On the one hand, a low κ_T allows more entry; on the other hand, greater entry renders incumbent firms subject to more creative destruction and decreases their innovation rate. Second, it may appear surprising that the innovation rate z^* does not depend on the firm's monopoly rents, whose magnitude is determined by the parameter β . Indeed, the extant literature places a strong accent on the link between the incentives to innovate and the monopolistic rents a firm can extract (among others, see the seminal contributions of Arrow, 1962, Romer, 1990, or Aghion and Howitt, 1992). The reason is that, in the economy with no liquidity frictions, this link is fully offset by the free entry condition: an increase in monopoly rents stimulates entry and increases creative destruction, thereby exactly offsetting the positive effect of β on z^* . As we show in Section 4.2, liquidity frictions help restore the link between rents and innovation decisions.

We finally compute aggregate consumption, denoted by $\mathcal{C}_t^*$ in the unconstrained economy. By the household budget constraint, aggregate consumption is the sum of labor wage and net dividends:

$$\mathcal{C}_t^* = W_t^* + d_t^* - f_t^*.$$

The aggregate dividend paid by incumbent firms represents an inflow to the representative household and is given by

$$d_t^* \equiv \int_0^1 \left(\beta L q_t(j) (1 - \beta)^{\frac{1}{\beta} - 1} - \frac{(z^*)^2}{2} \zeta q_t(j) \right) dj = \left(\mu^* - \frac{(z^*)^2}{2} \frac{\zeta}{L} \right) L e^{g^* t}. \quad (19)$$

Moreover, the representative household needs to finance entry of the new firms, which

amounts to a loss of consumption at a flow rate

$$f_t^* \equiv \int_0^1 x_d^* K_t(j) dj = x_d^* \Lambda L \kappa_T e^{g^* t}. \quad (20)$$

As aggregate consumption grows at the balanced growth path rate, it follows that $\mathcal{C}_t^*$ is given by

$$\mathcal{C}_t^* = \mathcal{C}_0^* e^{g^* t}, \quad \text{with} \quad \mathcal{C}_0^* = W_0^* + \mu^* L - \frac{(z^*)^2}{2} \zeta - x_d^* \Lambda L \kappa_T.$$

The equilibrium labor wage also grows at the rate g^* . Thus, the relation $W_t^* = W_0^* e^{g^* t}$ holds, where we define

$$W_0^* = L \beta (1 - \beta)^{\frac{1}{\beta} - 2}$$

by (10). We analyze in detail the properties of these aggregate quantities in Section 4.4 and Section 5.2, where we compare the constrained and unconstrained economies.

4 The liquidity constrained economy

We now analyze the economy featuring financing frictions. In this setting, firms retain precautionary cash reserves to hedge against these frictions. We start by deriving the optimal production, innovation, financing, and dividend decisions of incumbent firms. We then derive the stationary distribution of liquidity in the economy. Finally, we integrate single-firm quantities with respect to the stationary distribution to obtain the aggregate equilibrium quantities.

4.1 Deriving the value of incumbent firms

Recall that $V(t, \bar{C}, q)$ represents the time- t value of an incumbent with cash reserves $\bar{C}$ and producing an intermediate good at the quality level q . Since the benefit from an additional dollar saved is decreasing in the cash reserves and the marginal cost is constant, we conjecture that there exists some target level of cash reserves $\bar{C}^*(q)$ where the marginal cost and benefit of cash are equalized. Above this target, it is optimal to pay out excess cash as dividends to shareholders.

By assumption, an incumbent firm can always raise external funds by incurring the

proportional cost ϵ . Raising the amount $dF > 0$ changes firm value from $V(t, \bar{C}, q)$ to $V(t, \bar{C} + dF, q) - (1 + \epsilon)dF$. The exercise of this financing option is optimal if and only if the marginal gain, $V_c(t, \bar{C} + dF, q)$, is larger than the marginal cost, $1 + \epsilon$, for some levels of cash reserves. We conjecture and verify that the marginal value of cash is decreasing in the level of the cash reserves. As a result, an incumbent firm raises new funds only when the cash buffer is completely depleted, in which case the marginal gain from external financing equals the marginal cost, i.e., the condition $V_c(t, 0, q) = 1 + \epsilon$ holds.

In addition to this “routine financing,” an incumbent firm can raise funds when marketing a successful innovation (i.e., after a technological breakthrough). While this financing channel is not subject to the proportional fee ϵ , we assume that financiers are able to extract a fraction α of the surplus created. In this case, it is optimal for the firm to raise an amount that replenishes the cash reserves at the target level $\bar{C}^*(\lambda q)$. Thus, the total surplus generated by this transaction is given by $S(t, \bar{C}, q) = V(t, \bar{C}^*(\lambda q), \lambda q) - (\bar{C}^*(\lambda q) - \bar{C}) - V(t, \bar{C}, q)$. Because of bargaining with the financiers, firm value increases by $(1 - \alpha)S(t, \bar{C}, q)$ upon this transaction.¹⁸

As in the unconstrained economy, incumbents take the demand schedule of the final-good sector as given and choose their value-maximizing level of output. Differently, liquidity constraints may force firms to produce below the benchmark quantity X^* linked to the constant price p^* derived in Section 3. In the constrained economy, the optimal production decision $\bar{X}_t$ and the optimal innovation rate z_t depend on the level of the cash buffer and can be characterized by solving the HJB equation for the firm value:

$$\begin{aligned} rV(t, \bar{C}, q) - V_t(t, \bar{C}, q) = \max_{z, \bar{X}} \left\{ \frac{\sigma^2}{2} \bar{X}^2 V_{cc}(t, \bar{C}, q) + \left[\delta \bar{C} + (p - 1)\bar{X} - \frac{z^2}{2} q \zeta \right] V_c(t, \bar{C}, q) \right. \\ \left. + \phi z (1 - \alpha) (V(t, \bar{C}^*(\lambda q), \lambda q) - (\bar{C}^*(\lambda q) - \bar{C}) - V(t, \bar{C}, q)) + x_d (\bar{C} - V(t, \bar{C}, q)) \right\}. \end{aligned} \quad (21)$$

¹⁸If an incumbent firm does not accept the financiers’ surplus sharing offer, its value jumps from $V(t, \bar{C}, q)$ to $V(t, \bar{C}, \lambda q)$ after a successful innovation. Since firm value is concave in $\bar{C}$, marginal value of cash satisfies $V_c(t, \bar{C}, \lambda q) < V_c(t, 0, \lambda q) = 1 + \epsilon$. Thus, raising external funds through the “routine” procedure is never optimal, whereas moving from $V(t, \bar{C}, \lambda q)$ to $V(t, \bar{C}^*(\lambda q), \lambda q) - (\bar{C}^*(\lambda q) - \bar{C})$ is optimal, because the marginal value of cash is always above one. Hence, it is always optimal for the firm to take the financiers’ offer to share the surplus $\tilde{S}(t, \bar{C}, q) = V(t, \bar{C}^*(\lambda q), \lambda q) - (\bar{C}^*(\lambda q) - \bar{C}) - V(t, \bar{C}, \lambda q)$, independent of the fraction of the surplus they would like to extract. Note, however, that in our model we assume that financiers are extracting the fraction α of $S = \tilde{S} + (V(t, \bar{C}, \lambda q) - V(t, \bar{C}, q))$. While this assumption is made for analytical tractability, one can interpret the term $\alpha(V(t, \bar{C}, \lambda q) - V(t, \bar{C}, q))$ either as an additional fixed cost of intermediation or as the cost of marketing the technological breakthrough.

The right-hand side of this equation is the expected change in the value of the firm on a time interval. The first and the second terms capture the effect of cash flow volatility and cash savings, respectively. The third term captures the change in firm value when marketing a technological breakthrough. In these cases, financiers provide new funds to the firm to raise the cash buffer up to the target cash level $\bar{C}^*$ and extract a fraction α of the surplus created. Finally, the fourth term represents sudden exit due to creative destruction. When this happens, shareholders only recover the firm's cash reserves. The left-hand side of this equation admits an interpretation analogous to (11).

To solve for the optimal policies, we conjecture and verify that firm value can be written as

$$V(t, \bar{C}, q) = q_t L v\left(\frac{\bar{C}_t}{q_t L}\right) \equiv Q_t v(c), \quad Q_t = q_t L, \quad (22)$$

for some function $v(c)$. In analogy to the unconstrained economy, $v(c)$ represents the value of an incumbent firm scaled by the quality of the intermediate production good. In the constrained economy, this value depends on the firm's cash reserves. We define scaled cash reserves c as

$$c \equiv \bar{C}_t / Q_t,$$

and we conjecture that the target cash level satisfies

$$\bar{C}^*(q_t) = Q_t C^*$$

for some constant $C^* > 0$. Scaled cash reserves represent the most important state variable for the firm in our model: optimal policies can be expressed as functions of c and are determined by solving the HJB equation for $v(c)$.

Defining the scaled production quantity as $X(c) \equiv \bar{X}_t / Q_t$ and substituting (22) into (21), we obtain the following equation for $v(c)$,

$$\begin{aligned} \max_{z, X} \left\{ \frac{\sigma^2}{2} X^2 v''(c) + v'(c) \left[\delta c + X^{1-\beta} - X - \frac{z^2}{2} \frac{\zeta}{L} \right] \right. \\ \left. + (1 - \alpha) \phi z [\lambda(v(C^*) - C^*) - (v(c) - c)] + x_d(c - v(c)) - r v(c) \right\} = 0. \end{aligned} \quad (23)$$

We define the curvature (i.e., the “risk aversion”) of the value function as

$$\gamma(c) = -\sigma^2 \frac{v''(c)}{v'(c)}, \quad (24)$$

and we let $F(\gamma)$ be the unique solution to

$$-\gamma F + (1 - \beta)F^{-\beta} = 1. \quad (25)$$

Conjecturing that the marginal value of cash $v'(c)$ is monotone decreasing in c (that is, $v''(c) \leq 0$), the maximization problem in (23) has an interior solution for any level of c , and the value-maximizing production quantity $X(c)$ and the optimal innovation rate $z(c)$ are, respectively, given by

$$X(c) = F(\gamma(c)), \quad (26)$$

$$z(c) = \phi(1 - \alpha) \frac{L}{\zeta} \frac{(\lambda w^* - v(c) + c)}{v'(c)}. \quad (27)$$

In this equation, the quantity

$$w^* \equiv w^*(C^*) = v(C^*) - C^*$$

represents the scaled firm value at the target cash level, net of cash reserves. Substituting these expressions into (23), we obtain the following differential equation:

$$\begin{aligned} & -\frac{\sigma^2}{2} X(c)^2 v''(c) + v'(c) \beta X(c)^{1-\beta} + v'(c) c \delta \\ & + \frac{\varphi^2}{2} \frac{(\lambda w^* - v(c) + c)^2}{v'(c)} + x_d (c - v(c)) - r v(c) = 0, \end{aligned} \quad (28)$$

where we have defined the auxiliary quantity

$$\varphi \equiv \phi(1 - \alpha) \left(\frac{L}{\zeta} \right)^{1/2}. \quad (29)$$

In order to pin down the value of an incumbent firm, we solve (28) subject to the

following boundary conditions

$$v'(0) = 1 + \epsilon, \quad v'(C^*) = 1, \quad v''(C^*) = 0. \quad (30)$$

The first boundary condition means that when the cash reserves are depleted, the marginal value of cash equals the marginal cost of raising funds (i.e., $1 + \epsilon$). That is, an incumbent firm refinances current operations every time the cash reserves are depleted, by issuing an infinitesimal amount that reflects the cash process back into the retention region. The second boundary condition means that the marginal value of cash at the target level C^* is equal to one. Above this target level, excess cash is paid out to shareholders and firm value is linear and given by

$$v(c) = v(C^*) + c - C^*.$$

Finally, the third boundary condition is the super-contact condition at C^* , which guarantees that the dividend threshold C^* is optimally chosen to maximize firm value. As c approaches the target level C^* , the firm's effective risk-aversion γ goes to zero, and the firm starts behaving as if it were unconstrained.

Substituting the boundary conditions $v'(C^*) = 1$ and $v''(C^*) = 0$ into (28), we derive the scaled value of an incumbent at the target cash level $v(C^*)$. By straightforward calculations, the scaled value net of cash reserves is given by

$$w(C^*) = v(C^*) - C^* = \frac{2[\mu^* - (r - \delta)C^*]}{x_d + r + [(x_d + r)^2 - 2\varphi^2(\lambda - 1)^2(\mu^* - (r - \delta)C^*)]^{1/2}}, \quad (31)$$

where $\mu^* \equiv \beta(1 - \beta)^{\frac{1}{\beta}-1}$ as in Section 3. We summarize our findings in the following proposition.¹⁹

Proposition 2 *The value of an incumbent firm is given by (22), where $v(c)$ is the unique solution to (28) satisfying the boundary conditions (30). The scaled value of an incumbent firm holding its target level of cash reserves is given by $w(C^*) + C^*$ as from (31). By the*

¹⁹While our analytical proof only holds for small ϵ , numerical results indicate that firm value exists and is concave for all reasonable values of ϵ .

free-entry condition, the following equality holds,

$$w^*(C^*) = \kappa_T + \kappa_I.$$

Using these results, we analyze in detail the policies of incumbent firms.

4.2 Characterizing corporate policies

We now investigate corporate decisions and firm value in relation to various firm characteristics. Throughout this section, we will refer to scaled quantities without an explicit mention.

Firm value and liquidity hoarding. We start by investigating the value of an incumbent firm as a function of its cash holdings. Firm value in the unconstrained economy is given by $c + w^*(0)$ ²⁰ whereas, by concavity, firm value in the constrained economy satisfies $v(c) \leq c + w^*(C^*) = c + \kappa_T + \kappa_I$ due to the free-entry condition. In order to gain a deeper understanding of the impact of liquidity frictions on firm value, we compute a Taylor approximation for $v(c)$ in a neighborhood of C^* , as shown in the next Proposition.

Proposition 3 *Suppose that ϵ is sufficiently small. For c in a left neighborhood of C^* , firm value is given by*

$$v(c) \approx v(C^*) - (C^* - c) - \frac{1}{6}v_3(C^* - c)^3 + \frac{1}{24}v_4(C^*)(c - C^*)^4$$

where

$$v_3 = \frac{2(r - \delta)}{\sigma^2 X_0^2},$$

$$v_4(C^*) = -\frac{v_3}{X_0} \left[4 \frac{r - \delta}{\beta} + \frac{2\beta}{\sigma^2(1 - \beta)} + \frac{1}{\sigma^2 X_0} (2\delta C^* - \varphi^2(\lambda - 1)^2(\kappa_T + \kappa_I)^2) \right].$$

In these expressions, $X_0 = X^* = (1 - \beta)^{1/\beta}$ is the firm's production choice at C^* .

Proposition 3 shows that the magnitude of the loss in firm value is determined (to the highest order) by the opportunity cost of cash $r - \delta$, the cash flow volatility coefficient

²⁰Recall, however, that in the constrained economy, there is the friction α in the expression of φ .

σ , and the production quantity associated with the frictionless economy X_0 (which is a function of β only). The cost $r - \delta$ has an unambiguous negative effect on firm value. Differently, cash flow volatility σ increases firm value when the cash reserves are close to the target C^* . Since the curvature of the value function tends to zero when σ does, it follows that firm value is non-monotonic in σ , conditional on a value of C^* . This effect raises the question of the dependence of C^* on σ . The following proposition addresses this question.

Proposition 4 *Suppose that ϵ is sufficiently small. The target cash level C^* is given by*

$$C^* \approx C_1^* \sqrt{\epsilon} + C_2^* \epsilon$$

$$C_1 = \left(\frac{2}{v_3} \right)^{\frac{1}{2}}, \quad C_2 = \frac{v_4(0)}{3 v_3^2}$$

The first crucial observation is that, to the highest order, the target level C^* is proportional to the square root of the refinancing cost, $\epsilon^{1/2}$. This means that a small financing friction ϵ can have a large effect on firm value. To the highest order, the target level of cash reserves is proportional to the quotient $\frac{\sigma X_0(\beta)}{(r-\delta)^{1/2}}$. Hence, it is largely driven by cash flow volatility and the opportunity cost of holding cash, as in previous cash holdings models. The target level also depends on the elasticity β . A larger β means that a firm sets a higher markup and produces less (X_0 is decreasing in β). Proposition 4 then suggests that firms with larger monopolistic rents should hold less cash.²¹

Innovation decisions. For a given innovation rate z , the expected gain from investing in innovation is proportional to the expected change in firm value upon a quality breakthrough, given by $\lambda w^* - v(c) + c$. Gains from innovation are decreasing in cash holdings: the less constrained the firm is, the smaller the incentives to succeed are. At the same time, the marginal cost of innovation is proportional to the marginal value of cash $v'(c)$. Since $v'(c)$ is decreasing in c , this cost is smaller for firms that are less constrained. By (27), the optimal innovation rate is the quotient of the marginal gain and the marginal cost and therefore balances these two contrasting forces. Depending on whether the rate

²¹In this context, see also Morellec, Nikolov, and Zucchi (2014), who analyze the relation between corporate cash holdings and product market competition.

of decrease in the marginal value of cash is higher than the rate at which the gains decrease, the optimal innovation rate $z(c)$ can be increasing or decreasing in c . Using the Taylor expansion of $z(c)$ around C^* allows to gain detailed information about this pattern, as follows.

Proposition 5 *Suppose that ϵ is sufficiently small. The optimal innovation rate is*

$$z(c) \approx z_0 + \frac{1}{2}(C^* - c)^2 z_2 - \frac{1}{6}(C^* - c)^3 z_3$$

for c in a left neighborhood of C^* . In this expression, we have defined $z_0 = \phi(1 - \alpha) \frac{L}{\xi} (\lambda - 1)(\kappa_T + \kappa_I)$, $z_2 = -\phi(1 - \alpha) \frac{L}{\xi} v_3 (\lambda - 1)(\kappa_T + \kappa_I)$, and $z_3 = -\phi(1 - \alpha) \frac{L}{\xi} (v_3 + v_4(\lambda - 1)(\kappa_T + \kappa_I))$, whereas v_3 and v_4 are defined as in Proposition 3.

Using the approximation in Proposition 5 and the monotonicity properties of the following auxiliary quantity:

$$\mathcal{Z} \equiv \frac{2(\lambda - 1)(\kappa_T + \kappa_I)}{1 - \frac{1}{X_0} \left[4 \frac{r - \delta}{\beta} + \frac{2\beta}{\sigma^2(1 - \beta)} + \frac{1}{\sigma^2 X_0} (2\delta C^* - \varphi^2(\lambda - 1)^2(\kappa_T + \kappa_I)^2) \right] (\lambda - 1)(\kappa_T + \kappa_I)},$$

the next corollary shows that the optimal innovation rate may be non-monotonic in the firm's cash reserves.

Corollary 6 (Liquidity and Innovation) *Suppose that $\mathcal{Z} > 0$. Then,*

- if $\mathcal{Z} > C^*$, $z(c)$ is monotone increasing;
- if $\mathcal{Z} < C^*$, $z(c)$ is decreasing for $c < C^* - \mathcal{Z}$. This pattern is more likely to arise for firms operating with: (1) larger cash flow volatility σ , (2) more severe financing constraints ϵ , (3) more frequent technological breakthroughs, i.e. larger φ , (4) smaller opportunity cost of cash holdings $r - \delta$,

Smaller cash reserves imply fewer resources available to invest in R&D. Nonetheless, Corollary 6 shows that the optimal innovation rate might increase when cash reserves decrease. This pattern resembles a “gamble for resurrection” decision and is largely driven by financial constraints. Given two firms with the same fundamental characteristics but different cash reserves, gamble for resurrection implies that the firm with smaller cash

reserves chooses a larger innovation rate. So doing, the firm increases the probability of achieving a technological breakthrough. When a breakthrough occurs, the firm accesses the monopoly rents of marketing the brand-new technology and can raise outside funds because of a “success” rather than a “failure” (running out of funds due to operating losses). All else being equal, less cash may lead to more success. Since larger financing costs ϵ make the firm more constrained, they make the firm more willing to gamble. Corollary 6 also suggests that firms with more efficient R&D technologies (larger φ , meaning that technological breakthroughs come more often) are more likely to gamble.

Interestingly, financing frictions make the innovation rate $z(c)$ dependent on firm’s characteristics that do not affect z^* in the unconstrained economy (besides, obviously, the opportunity cost of cash). First, the optimal innovation rate in the constrained economy *does* depend on β whereas it *does not* in the unconstrained economy. In particular, firms are more willing to gamble for resurrection when β is lower. In this case, the markup set by the firm is smaller and, hence, the firm has a greater incentive to decrease production and increase the innovation rate. Second, the volatility coefficient σ has a major impact on a firm’s innovation rate in the constrained economy. Specifically, gambling for resurrection arises in environments in which σ is sufficiently large.

Production and markups. We next analyze the firm’s optimal scale of production, $X(c)$. By (26), the pattern of $X(c)$ is fully determined by the firm’s effective risk aversion $\gamma(c)$ defined in (24) and the function F in equation (25). Since the function $F(\gamma)$ is monotone decreasing in γ , so is $X(c)$. The intuition is as follows. As liquidity constraints tighten, effective risk aversion increases. The firm is then reluctant to take on idiosyncratic risk and, hence, scales down production. Since liquidity constraints become negligible at the target cash level in that $v''(C^*) = 0$, the scale of production at the target level C^* equals the (constant) scale of production $X_0 = X^* = (1 - \beta)^{1/\beta}$ of the unconstrained economy. As a result, $X(c) < X_0$ for all $c < C^*$.

Since the firm acts as a price-setting monopolist facing the demand schedule (8), selecting a scale of production $X(c)$ is equivalent to setting the following price

$$p(c) = X(c)^{-\beta} \geq X_0^{-\beta} = \frac{1}{1 - \beta}.$$

Thus, liquidity frictions lead to deviate from the constant price p^* . That is, financial constraints lead firms to *produce less* and *increase markups*. In the constrained economy, markups are given by $p(c) - 1$ and they are always larger than in the unconstrained economy. In addition, markups are *countercyclical* with respect to idiosyncratic shocks, as the next result shows.

Proposition 7 (Liquidity and Markups) *The optimal production rate $X(c)$ is monotone increasing in c whereas markups $p(c) - 1$ are decreasing. Now, suppose that ϵ is sufficiently small. For c in a left neighborhood of C^* , the optimal scale of production can be approximated by*

$$X(c) \approx X_0 + X_1(c - C^*) + \frac{X_2}{2}(c - C^*)^2,$$

where X_0 is defined as in Proposition 3, $X_1 = \frac{2(r-\delta)}{\beta}$ and

$$X_2 = \frac{X_1}{X_0} \left[X_1(\beta + 5) + \frac{2\beta}{\sigma^2(1 - \beta)} + \frac{1}{\sigma^2 X_0} (2\delta C^* - \varphi^2(\lambda - 1)^2(\kappa_T + \kappa_I)^2) \right].$$

This approximation implies that (1) A larger β leads to a lower sensitivity of markups to liquidity shocks; (2) Firms that face a lower rate of creative destruction (smaller x_d) or that have more efficient innovation technology (larger φ or larger λ) decrease their scale of production (lower $X(c)$) and set higher markups.

An important implication of Proposition 7 is that liquidity frictions create a link between markups and firm characteristics, which is absent in the unconstrained economy. Ceteris paribus, if technological breakthroughs occur more often (larger φ) or are more path-breaking (larger λ), a firm invests more in innovation. As a result, such a firm depletes cash reserves faster, it has a higher risk-aversion, and it scales down production by a larger amount when cash reserves decrease. While previous Schumpeterian models highlight that higher monopoly rents imply higher incentives to innovate,²² Proposition 7 warns that liquidity frictions may reverse the causality of this relation. Namely, firms with more efficient innovation technologies are more R&D-intensive, which makes them

²²See, e.g., Aghion and Howitt (1992) and Aghion, Akcigit, and Howitt (2014). Similarly, in Romer's (1990) variety model, lower rents for innovators lead to lower R&D incentives. Note, however, that Arrow (1962) argues that the incentive to invest in innovations is lower under monopolistic than under competitive conditions, due to "organizational inertia."

more financially constrained and leads them to charge higher markups. This result is consistent with the empirically observed positive link between innovation and markups (see, e.g., Cassiman and Vanormelingen, 2013).

Idiosyncratic volatility of returns and cash flows. The optimal production decision $X(c)$ affects the volatility of cash flows, given by $\sigma X(c)$. The monotonicity of $X(c)$ in c implies that cash flow volatility is monotone increasing in the level of cash reserves. That is, a firm scales down operating risk when liquidity constraints are tight. This result has interesting implications for the empirically observed relation between cash flow volatility and cash reserves (e.g., Bates, Khale, and Stulz, 2009). Our model suggests not only that σ affects C^* , but also that the level of cash reserves (i.e., a firm's financial stance) determines cash flow volatility through the optimal production decision. After positive operating shocks, cash reserves increase, the curvature of the value function decreases, and firms are willing to take on more risk. Conversely, negative operating shocks lead firms to reduce production, and, as a result, cash flow volatility decreases.

We relate endogenous cash flow volatility to the idiosyncratic volatility of stock returns. By (4), the realized volatility of stock returns $dR(c) = \frac{dv(c)}{v(c)}$ is given by

$$\sigma_R(c) = \sigma X(c) \frac{v'(c)}{v(c)}.$$

Since all cash flow shocks are idiosyncratic in our model, $\sigma_R(c)$ coincides with the idiosyncratic return volatility. A direct calculation implies that $\sigma_R(c)$ is locally monotone increasing in c if and only if

$$\frac{X'(c)}{X(c)} \frac{v'(c)}{v(c)} > -\frac{d}{dc} \frac{v'(c)}{v(c)}.$$

Since $v(c)$ is concave and increasing in c , the ratio $v'(c)/v(c)$ is decreasing. Thus, if the rate of change in production is higher than the rate of change in the value function, idiosyncratic volatility will be locally increasing.

The monotonicity of $\sigma_R(c)$ is closely related to the leverage effect identified by Black (1976), according to which the volatility of stock returns increases after a negative shock to stock prices. In this context, Décamps et al. (2011) develop a cash management model

with constant cash flow volatility to show that liquidity frictions may generate the leverage effect as $\sigma_R(c)$ is monotone decreasing (and stock price increasing) in c . Nevertheless, the empirical evidence on the co-movement between stock returns and idiosyncratic volatility appears ambiguous. Early studies report a positive relation (e.g. Duffee, 1995, or Malkiel and Xu, 2002), whereas more recent works (Ang, Hodrick, Xing, and Zhang, 2006, 2009) report a negative relation—which has been labeled as the idiosyncratic volatility puzzle. Our model is capable of capturing both the positive and the negative relation. In fact, the instantaneous covariation of returns and idiosyncratic volatility is given by

$$\langle v(c)^{-1}dv(c), d\sigma_R(c) \rangle = v(c)^{-1}\sigma_C(c)^2v'(c)\sigma'_R(c)dt,$$

so the hump-shaped pattern for $\sigma_R(c)$ leads to a negative (positive) co-movement for firms with high (low) cash reserves. This result calls for a thorough empirical investigation of the role of corporate liquidity in the idiosyncratic volatility puzzle.

4.3 The stationary cross-sectional distribution of liquidity

Using the results in the previous sections, we now determine the cross-sectional stationary distribution of liquidity in the economy, which we denote by $\eta(c)$. For each individual incumbent (omitting the subscript j), the dynamics of scaled cash reserves satisfy

$$dC_t = \mu(C_t)dt + \sigma(C_t)dZ_t + dF_t + dF_t^I - dD_t + (\lambda C^* - C_t)dN_t. \quad (32)$$

In this equation, N_t is a Cox process with stochastic intensity $\phi z(C_t)$, representing the occurrence of a technological breakthrough. Moreover, the quantities

$$\mu(c) = \delta c + X^{1-\beta}(c) - X(c) - \frac{z^2(c)}{2} \frac{\zeta}{L}, \quad \text{and} \quad \sigma(c) = \sigma X(c),$$

denote, respectively, the net operating profits and cash flow volatility, as from Section 4.1. Since liquidity shocks are independent and identically distributed (i.i.d.) across firms, the cross-sectional distribution of liquidity satisfies the following Kolmogorov forward equation

$$\frac{1}{2} (\sigma^2(c)\eta(c))'' - (\mu(c)\eta(c))' - x_d\eta(c) - z(c)\phi\eta(c) = 0,$$

as we show in the appendix. To solve for the cross-sectional density, we impose the following boundary conditions

$$\begin{aligned} 0.5(\sigma^2\eta)'(0) - (\mu(0)\eta(0)) &= 0 \\ 0.5(\sigma^2\eta)'(C^*) - (\mu(C^*)\eta(C^*)) &= \int_0^{C^*} \phi z(c)\eta(c)dc + x_d. \end{aligned} \tag{33}$$

For any level of cash reserves c , the quantity $0.5(\sigma^2\eta)'(c) - (\mu(c)\eta(c))$ represents the infinitesimal change in the mass of firms due to retained earnings and profitability (as captured by the drift $\mu(c)$) and due to idiosyncratic cash flow shocks (as captured by the volatility $\sigma(c)$). The first equation in (33) is the mass conservation condition at zero: it guarantees that there is no loss of mass for firms that run out of liquidity and use external financing to remain solvent. The second equation is the mass conservation at C^* : it ensures that the loss of mass on the left-hand side is offset by the inflow of successful innovators whose cash reserves jump to C^* . In the next sections, we use this stationary distribution to derive the equilibrium quantities of the model.

4.4 Equilibrium quantities

We now embed the preceding analysis into a general equilibrium setting. Along a balanced growth path, output and aggregate consumption grow at the constant (endogenous) rate g , which satisfies the following relation:

$$g = (\lambda - 1)\phi \int_0^{C^*} z(c)\eta(c)dc + (\Lambda - 1)x_d. \tag{34}$$

The interpretation of this expression is as follows. Since innovation decisions are i.i.d. across firms, the law of large numbers implies that the contribution of incumbent firms to economic growth is given by the probability-weighted size of their quality improvements multiplied by the average innovation intensity in the population of incumbent firms (the first term in (34)). Similarly, the contribution of entrants is given by the size of their quality improvements times the entry rate (the second term). In equilibrium, the entry rate (i.e., the rate of creative destruction) is pinned down by the free-entry condition

$$v(C^*(x_d); x_d) - C^*(x_d) = \kappa_T + \kappa_I.$$

We solve for x_d by using (31) and the approximation for C^* in Proposition 4.

Proposition 8 *The equilibrium rate of creative destruction satisfies*

$$x_d = \frac{\mu^* - (r - \delta)C^*}{\kappa_T + \kappa_I} + \varphi^2(\lambda - 1)^2 \frac{\kappa_T + \kappa_I}{2} - r.$$

In particular, when ϵ is sufficiently small, we get

$$x_d \approx \frac{\mu^* - (r - \delta)^{1/2} \sigma X_0 \epsilon^{1/2}}{\kappa_T + \kappa_I} + \varphi^2(\lambda - 1)^2 \frac{\kappa_T + \kappa_I}{2} - r.$$

To single out the various effects at play, we begin by studying the predictions of Proposition 8 while holding r fixed (in equilibrium, the interest rate r is obviously endogenous and depends on all of the model parameters). This is akin a semi-partial equilibrium setting, for instance within a single industry whose impact on the interest rate is sufficiently small. Proposition 8 shows that the financial constraints of incumbents discourage fresh entry, and this effect is stronger when cash flow volatility σ , the opportunity cost of cash $r - \delta$, and the refinancing cost ϵ are larger. Moreover, the entry rate is monotone increasing in the elasticity β since X_0 is monotone decreasing in β .

Along the balanced growth path, consumption grows at the rate g . The equilibrium interest rate is pinned down by the Euler equation of the representative household and given by

$$r = \rho + \theta \left[(\lambda - 1) \phi \int_0^{C^*} z(c; r) \eta(c; r) dc + (\Lambda - 1) x_d(r) \right]. \quad (35)$$

This equation represents the fixed point equation for $r > \delta$, which we solve numerically by focusing on parameter sets for which the solution is unique.

We turn to analyze consumption and welfare. As in the unconstrained economy, consumption is the sum of labor wage and aggregate dividends net of financing. In particular, the wage paid by the competitive final-good producer is given by

$$W_t = \frac{1}{1 - \beta} \int_0^1 L^\beta \bar{X}_t(j)^{1 - \beta} q_t(j)^\alpha dj - \int_0^1 p_t(j) \bar{X}_t(j) dj.$$

Along the balanced growth path, the equilibrium wage grows at g : $W_t = W_0 \int q_t(j) dj$ with $\int q_t(j) dj = e^{gt}$. By a direct calculation, it follows that

$$W_0 = \frac{\beta L}{1 - \beta} \int \eta(c) X(c)^{1-\beta} dc.$$

In our continuous time model, calculating the dividend rate is a non-trivial exercise. Even though the dividend process of every firm is singular, aggregate dividends are smooth and grow at the rate g . At every instant of time, firms with cash reserves close to C^* may move to C^* according to the endogenous dynamics in (32), and eventually pay out dividends. Thus, computing the dividend rate requires keeping track of the whole cross-sectional distribution of liquidity in the economy. To address this issue, we proceed as follows.

We denote by d_t the aggregate dividend rate and by f_t the total financing rate to the incumbent and entrant firms of the economy. In order to compute the rate $d_t - f_t$, we define $Y(q_t(j), c)$ to be the present value of a virtual “production unit” that we name *dynasty*. Namely, a dynasty represents the expected present value of dividends net of financing of all firms that will ever operate in the future in the product line j . As for the other quantities in a balanced growth path equilibrium, $Y(q_t(j), c)$ is homogeneous in the quality of the intermediate good j . Hence, the relation

$$Y(q_t(j), c) = L q_t(j) y(c)$$

holds for some function $y(c)$. As shown in the Appendix, $y(c)$ solves the following equation:

$$\begin{aligned} \frac{1}{2} \sigma^2(c) y''(c) + \mu(c) y'(c) + \phi z(c) [\lambda(y(C^*) - C^*) - y(c) + c] \\ + x_d [\Lambda y(C^*) - y(c) + c - \Lambda (C^* + \kappa_T)] = r y(c). \end{aligned}$$

The first two terms on the left-hand side represent the effect of cash flow volatility and profitability. The third term represents the change in value after a technological breakthrough by the current incumbent, weighted by the probability of this occurrence. In this case, investors provide an amount $\lambda C^* - c$ to the dynasty. The fourth term represents the probability-weighted change in value after a technological breakthrough by an entrant. Upon fresh entry, investors provide the amount $\Lambda (C^* + \kappa_T)$ to the entrant and collect the cash holdings of the exiting incumbent. It is important to note that the financing

fees ϵ , κ_I , and α have no direct impact on the cash flows to the representative household: by assumption, these costs are paid in equity shares and not in cash.²³ As a result, the marginal value of cash for the dynasty, $y'(c)$, is equal to one at $c = 0$ and $c = C^*$:

$$y'(C^*) = 1 = y'(0) .$$

Solving for $y(c)$ allows to determine the aggregate net dividend rate of the economy. Since net dividends grow at g on a balanced growth path, it follows that

$$d_0 - f_0 = (r - g)L \int_0^{C^*} \eta(c)y(c)dc ,$$

as $q_0(j) = 1$ for any j . Because aggregate consumption grows at g , the relation $\mathcal{C}_t = \mathcal{C}_0 e^{gt}$ holds, with $\mathcal{C}_0 = W_0 + d_0 - f_0$.

The analysis highlights that the effect of financial constraints on the equilibrium wage is unambiguous. Since $X(c) < X_0$ for any $c < C^*$, it follows that $W_0 \leq W_0^*$. That is, the equilibrium wage of the constrained economy is lower than that of an identical but unconstrained economy. W_0^* only depends on β in the unconstrained economy, whereas liquidity frictions imply that W_0 depends on the other model parameters through their impact on production decisions $X(c)$ and the distribution of liquidity in the economy $\eta(c)$. The analytical comparison of the net dividend rate in the constrained and unconstrained economies is less trivial. On the one hand, the entry rate is lower in the constrained economy (as from Proposition 8), meaning that investors provide financing to new firms less often. On the other hand, the amount provided is larger in this economy, because investors finance not only the entry cost but also provide entrants with cash reserves. We provide a numerical analysis of consumption and welfare in the constrained/unconstrained economies in Section 5.2.

4.5 Government debt and the liquidity premium

The wedge between the market interest rate and the return on cash reserves (i.e., the opportunity cost $r - \delta$) plays a major role in determining the impact of financing frictions

²³When a firm runs out of cash and raises an amount f , the cost to incumbent shareholders is ϵf . This cost is paid in shares of the company and has no impact on the wealth of the representative household.

on firms' decisions. Indeed, it affects the target level of cash reserves and, thus, the firms' financial resilience. In the extant cash management literature, this wedge is typically attributed to agency frictions (the free cash flow problem) or to tax disadvantages.²⁴ In this section, we propose a general equilibrium channel to endogenize the wedge $r - \delta$, which is based on the interplay between the demand (from the corporate sector) and the supply (from the government) of liquidity. We follow Woodford (1990) and assume that liquidity can only be stored by holding government bonds.²⁵ When the supply by the government is scarce, bonds trade at a premium that results in a positive wedge $r - \delta$.

As in previous contributions, we assume that the government faces an exogenous expenditure stream. We denote this expenditure stream by $\mathcal{G}_t$ and assume that it constitutes a fixed fraction $\mathcal{G} \in [0, 1]$ of the final-good output, i.e. $\mathcal{G}_t = \mathcal{G}\mathcal{Y}_t$. To finance these expenditures, the government levies income taxes and issues public debt. We denote the amount of taxes collected at time t by T_t . We assume that taxes represent a fraction τ of wages, i.e. $T_t = \tau W_t L$. Moreover, we denote the public debt outstanding at time t by B_t . We assume that public debt promises a return of δ , which is endogenously determined in equilibrium. Under these assumptions, the budget constraint of the government is given by

$$\mathcal{G}_t + \delta B_{t-1} = \tau W_t + B_t \quad (36)$$

at any time t . The left-hand side of this equation denotes the government outflow, i.e., the expenditure stream plus the repayment of the maturing debt. The right-hand side denotes the government inflow, i.e., the tax inflow plus the newly issued debt.

We assume that public debt grows at the equilibrium rate g : $B_t = gB_{t-1}$, so the debt-to-output ratio is constant. Under this assumption, if the budget constraint of the government holds at time zero,

$$\mathcal{G}\mathcal{Y}_0 + \delta B_0 = \tau W_0 + gB_0,$$

it does hold at any t . In this equation, $\mathcal{Y}_0$ denotes the final-good output at time zero,

²⁴See also Zucchi (2014), who shows how this wedge may arise endogenously due to market illiquidity.

²⁵See also Holmstrom and Tirole (1998), Bansal, Coleman, and Lundblad (2011), Krishnamurthy and Vissing-Jorgensen (2012, 2013), Greenwood, Hanson, and Stein (2015), and Nagel (2014).

which is given by

$$\mathcal{Y}_0 = \frac{L^\beta}{1-\beta} \int_0^{C^*} \bar{X}(c)^{1-\beta} \eta(c) dc = \frac{L}{1-\beta} \int_0^{C^*} X(c)^{1-\beta} \eta(c) dc.$$

The equilibrium return δ^* makes the government debt market clear, i.e.,

$$L \int_0^{C^*(\delta)} c \eta(\delta, c) dc = B_0.$$

That is, the demand for liquidity in the economy equals the supply of bonds issued by the government.²⁶ Fixing the supply B_0 amounts to determining the equilibrium tax rate $\tau(B_0)$ from the government budget constraint, which is then given by

$$\tau(B_0) = \frac{\mathcal{G}\mathcal{Y}_0(\delta^*) - B_0(g(\delta^*) - \delta^*)}{W_0(\delta^*)}.$$

In the absence of liquidity frictions, government bonds trade at the market rate r and have no impact on the dynamics of the economy. By contrast, the supply of government bonds has real effects in the presence of liquidity frictions. By affecting the liquidity premium, debt supply influences corporate policies. In particular, as B_0 increases, liquidity frictions vanish, and the economy converges with the frictionless one. We numerically analyze the interplay between liquidity demand and supply in the next section.

5 Model analysis

In this section, we provide a quantitative assessment of the model implications. Table 1 reports the baseline parametrization. Refinancing current operations entails a cost of $\epsilon = 8\%$ for any dollar raised, consistent with the range of values reported by Hennessy and Whited (2007). Financiers extract a share $\alpha = 6\%$ of the surplus when incumbents market a higher quality product. The financing component of the entry cost κ_I is 10% of the technological component, which means that financiers extract more rents from entrants than from incumbents. Moreover, we capture in a simple fashion that innovation

²⁶Note that in our model, the representative agent does not want to hold government bonds because they pay a rate of return below r .

by entrants tends to be path-breaking while innovation by incumbents tends to be incremental by setting λ and Λ equal to 1.04 and 1.10 respectively; see, e.g., Akcigit and Kerr (2015), and Acemoglu et al. (2013). We set the coefficient σ equal to 0.4, which implies that cash flow volatility (given by $\sigma X(c)$) varies between 9.9% and 12.7% under the baseline parametrization. We start by taking the return on cash δ as exogenous and equal to 4.9%, which implies an opportunity cost of cash $r - \delta$ around 0.5%. We endogenize δ in Section 5.2.

5.1 Corporate outcomes

We start our analysis by comparing the value-maximizing corporate policies in the constrained and unconstrained economies. Confirming the analytical results, Figure 1 shows that firms downsize production when cash reserves are low. As a result, the production rate $X(c)$ in the constrained economy is always below that of the unconstrained economy. While intuition may suggest that financial constraints lead firms to reduce their investment in innovation, our analysis reveals that this may not be the case. Under the baseline parametrization, $z(c)$ is always higher than z^* , being roughly 7.14% higher for c close to zero. The innovation rate is decreasing when cash reserves are small and is almost flat when cash holdings are large, in line with a gamble for resurrection behavior.

Figure 2 investigates further the patterns of the optimal innovation rate. An increase in the refinancing cost ϵ up to 14% makes the optimal innovation rate steeper around zero. That is, tighter financial constraints make firms more willing to gamble. Conversely, an increase in the cost of financing a technological breakthrough α up to 12% decreases the innovation rate very sharply. An increase in this parameter erodes the surplus from innovation accruing to incumbents; as a result, $z(c)$ lies below z^* when c is large enough. Note, however, that firms again find it optimal to increase their innovation rate when cash reserves are small. An increase in κ_I up to 0.1 (implying that the financing component of the entry cost is about 14.3% of the technological component) spurs innovation: e.g., $z(0)$ is 10.7% larger than in the unconstrained benchmark z^* . A larger κ_I deters entry and renders incumbents less threatened by creative destruction. This leads to an increase in their innovation rate.

We also explore the impact of cash flow volatility and profitability on the optimal

innovation rate. Notably, the parameters σ and β *do not* affect z^* in the unconstrained economy, but they *do* affect $z(c)$ in the constrained economy. Figure 2 shows that a decrease in β leads to a decrease in markups and prompts gamble for resurrection. When liquidity constraints are tight and profitability is low, it is relatively more convenient to cut core production and invest more in innovation. Moreover, a decrease in σ leads to a sharp drop in the optimal innovation rate and dampens gamble for resurrection.

Our analysis reveals that $z(c)$ can be higher or lower than z^* , and it can be non-monotonic in c . These results suggest that liquidity frictions may boost investment in innovation and may help explain the innovation patterns of young entrepreneurial firms in comparison to mature firms. Young firms are more financially constrained (larger ϵ), they operate with lower margins (lower β), and their cash flows are very volatile (larger σ). Despite these constraints, small firms appear very R&D-intensive, as discussed in the Introduction. Our model can rationalize these patterns.

Moreover, Figure 1 shows that firms can be more valuable in the constrained economy than in the unconstrained economy. In the latter, entry is less costly as it does not involve any financing cost. The entry rate is then larger, which implies that incumbent firms are more likely to exit the industry. We investigate the general equilibrium effects of this result in the next section.

5.2 Aggregate quantities

The cross-sectional distribution of liquidity. We now study the cross-sectional distribution of liquidity in the economy, as derived in Section 4.3. Figure 3 displays the distribution $\eta(c)$ on $c \in [0, C^*]$ under several parametrizations. The distribution is monotone increasing as in the model of Bolton, Chen, and Wang (2011). That is, incumbents' cash reserves are relatively large most of the time. Variations in the parameter values affect not only the shape of the distribution, but also its interval of definition. For instance, a decrease in the return on cash from 4.9% to 1% or in the coefficient of cash flow volatility from 0.4 to 0.2 leads to a decrease in the target level of cash reserves. In both cases, the distribution is defined over a tighter interval, and it becomes steeper. Conversely, a decrease in the elasticity β reinforces firms' precautionary policies. Firms

enlarge their target level of cash holdings, and the distribution of liquidity becomes flatter around zero. That is, firms with smaller monopolistic rents hold more cash.

Financing frictions, growth, and welfare. We next investigate the effects of financing frictions and corporate liquidity hoarding on economic growth and welfare. Under the baseline parametrization, economic growth is 1.916% in the constrained economy, whereas it is 2.013% in the identical but unconstrained economy.

Figure 4 shows creative destruction and growth as a function of the technological and financing components of the entry cost, κ_T and κ_I . It shows that creative destruction is decreasing in κ_T whereas growth displays a U-shaped pattern.²⁷ Departing from the baseline Schumpeterian paradigm (where growth is spurred by creative destruction only), our model takes into account the incumbents' contribution to economic growth. It highlights that an increase in κ_T deters fresh entry but boosts the incumbents' innovation rate. When κ_T is low enough, an increase in κ_T leads to lower growth. In this case, the reduction in the entrants' contribution to growth overtakes the increase in the incumbents' innovation rate. When κ_T is large enough, conversely, a further increase in κ_T increases growth. In this case, the increase in the incumbents' contribution to growth more than offsets the decrease in creative destruction.

In our model, the entry cost includes a financing component on top of the technological component. By imposing barriers on entrants, financiers slow down creative destruction (i.e., the entry rate is lower). Indeed, Figure 4 shows that x_d decreases in κ_I . If creative destruction occurs less often, incumbents expect to enjoy monopoly rents for longer periods and thus increase their innovation rate (as illustrated in Section 5.1). Since the growth rate is non-monotonic in the entry cost, g can be larger than g^* if κ_T and κ_I are large enough. Notably, our analysis shows that financing frictions are not necessarily detrimental to economic growth.

An interesting question is how financing frictions affect aggregate consumption and welfare. To address this question, we make the following thought experiment. Suppose that the planner intervenes to relax the financing frictions in the economy.²⁸ After this

²⁷This may not be the case when risk aversion θ is less than (or equal to) 0.5. We do not consider these parametrizations, as they may bring along an interest rate greater than the rate of economic growth.

²⁸In our thought experiment, we assume that the planner can remove the financing friction and switch the economy from constrained to unconstrained (i.e., as in Section 3).

intervention, the equilibrium quantities become those described in Section 3. Importantly, firms stop retaining earnings. Corporate cash reserves, amounting to

$$\tilde{C} \equiv L \int_0^{C^*} c\eta(c)dc,$$

are distributed to the representative household. The resulting intertemporal wealth of the household is the sum of consumption (in the unconstrained economy, C_0^*) and corporate cash reserves. If the planner does not intervene, conversely, corporate cash reserves remain “trapped” in the corporate sector.

Recall that the dynasty represents the expected present value of dividends net of financing in a given product line j . In the unconstrained economy, the scaled value of a dynasty j equals the scaled value of the incumbent that currently produces the intermediate good j , which in turn is equal to κ_T due to the free-entry condition. In the constrained economy, in contrast, the scaled value of the dynasty is larger than the value of the corresponding incumbent; in particular, the following relations $y(C^*) - C^* > v(C^*) - C^* = \kappa_T + \kappa_I \geq \kappa_T = v^* = y^*$ hold (see the results of Section 4.4). This implies that if the planner does not intervene and the economy remains constrained, agents enjoy larger net dividends. If the planner does intervene, agents enjoy larger wages and receive cash holdings of the corporate sector.

Figure 5 shows consumption and welfare as a function of κ_T and of κ_I if the planner does or does not intervene. The figure shows that welfare is non-monotonic in κ_T and follows a U-shaped pattern as the rate of economic growth. Importantly, the figure shows that financing frictions may *be not* welfare-decreasing. When κ_I is large enough, a firm operating in the constrained economy is more valuable than an identical firm operating in the unconstrained economy.²⁹ As explained, the former is less threatened by creative destruction. The constrained dynasty promises greater net dividends. In the constrained economy, aggregate consumption is larger than in the unconstrained economy if the increase in dividends more than offsets the decrease in wages.

²⁹Recall that the financing cost κ_I is paid in shares of the company’s stock and therefore has no direct impact on aggregate consumption. Of course, κ_I has an indirect effect through the rate of creative destruction.

Endogenizing the liquidity premium. We finally endogenize the return on cash δ by linking it to the supply of government debt.³⁰ Consistent with Bansal, Coleman, and Lundblad (2011) and Krishnamurthy and Vissing-Jorgensen (2012), Figure 6 shows that an increase in government debt B_0 leads to an increase in δ . When the supply of liquidity is large, the liquidity premium $r - \delta$ narrows. At the same time, a larger δ makes debt more costly for the government, which results in a higher tax rate τ . As a result, higher levels of government debt imply higher taxes, as in Woodford (1990).

Figure 6 also shows that a larger B_0 is associated to a larger rate of economic growth (and to a larger rate of creative destruction, not displayed in the figure). That is, when firms are financially constrained, policies that increase liquidity in the economy might effectively enhance growth by stimulating the incumbents' and entrants' innovation rate. The mechanism is the following. An increase in B_0 decreases the cost of holding cash and thus leads to an increase in the target level of cash C^* (Figure 7, right panel). As cash is the resource used to finance R&D investment, the incumbents' innovation rate also increases in B_0 (see Figure 7, left panel). The value of incumbent firms then increases, which makes it more attractive for new firms to enter the industry. As a result, the rate of creative destruction increases. Although larger liquidity supply leads to a larger tax rate, in unreported results we find that an increase in B_0 can increase aggregate consumption and welfare via the positive effect on firms' innovation and on economic growth.

6 Conclusions

Several empirical studies document strong relations between corporate cash reserves and investment in innovation, and between innovation and growth. In this paper, we develop a theoretical model that studies the micro and macro implications of financing frictions and liquidity hoarding for investment in innovation and economic growth. To this end, we embed liquidity frictions into a Schumpeterian model that features innovations by incumbents and entrants. Our modeling of financial frictions accounts for several major features that characterize innovation-intensive industries. In particular, firms prefer internal funds and delay external (equity) financing until technological milestones are attained or when

³⁰We use again the benchmark parametrization, and in addition we set $\mathcal{G} = 10\%$. Note that the equilibrium tax rate τ is then uniquely pinned down by the government's budget constraint.

in extreme need of funds. The model generates rich joint dynamics of cash holdings, production, and R&D investment decisions, which capture documented stylized facts and deliver new testable predictions. One of our main findings is that liquidity frictions can spur investment in innovation. We also find that, in the presence of financial constraints, firms can be more valuable and pay out more dividends, which can lead to an increase in equilibrium consumption and welfare.

We believe that the interactions between liquidity frictions, innovations, and growth are important for the dynamics of the global economy and policy-making. Our paper makes only the first step in this direction. First of all, we abstract from aggregate shocks. Nonetheless, it would be interesting to investigate the impact of government liquidity policies on production, innovation, and long-run growth over the business cycle (see also Aghion, Farhi, and Kharroubi, 2012). Second, we take the costs of external financing as exogenous and do not microfound them. Such microfoundations based on asymmetric information and limited pledgeability of assets could also allow one to investigate full-fledged dynamic capital structure choices and study their micro and macro implications. We leave these aspects for future research.

A Appendix

A.1 Deriving incumbents' policies and value

In the presence of liquidity frictions, the incumbents' HJB equation is

$$0 = V_t + \max_{z, \bar{X}} \left\{ \frac{\sigma^2}{2} \bar{X}^2 V_{cc} + V_c \left(\delta \bar{C} + X(p-1) - \frac{z^2}{2} q \zeta \right) + \phi(1-\alpha)z(\lambda(V - \bar{C}^*) - (V - \bar{C})) + x_d(\bar{c} - V) - rV \right\}. \quad (37)$$

We conjecture

$$V(t, \bar{C}, q) = qL v\left(\frac{\bar{C}}{qL}\right) \equiv Q v(c) \quad Q = qL.$$

We also define

$$X \equiv \bar{X}/Q, \quad c \equiv \bar{C}/Q$$

so the expression for the price of input becomes

$$p = (\bar{X}^{-1}Q)^\beta = X^{-\beta}.$$

Substituting

$$V_t = 0, \quad V_c = v'(c), \quad V_{cc} = \frac{1}{Q} v''(c)$$

into (37), we get³¹

$$\max_{z, \bar{X}} \left\{ \frac{\sigma^2}{2} X^2 v''(c) + v'(c) \left(\delta c + X^{1-\beta} - X - \frac{z^2}{2} \frac{\zeta}{L} \right) + \phi(1-\alpha)z(\lambda(v(C^*) - C^*) - (v(c) - c)) + x_d(c - v(c)) - rv(c) \right\} = 0. \quad (38)$$

Let

$$A(c) = -\sigma^2 \frac{v''(c)}{v'(c)}. \quad (39)$$

The first order condition for X takes the form

$$-A(c)X + (1-\beta)(X)^{-\beta} = 1. \quad (40)$$

Define $F(a)$ to be the unique solution to

$$-aF(a) + (1-\beta)(F(a))^{-\beta} = 1. \quad (41)$$

³¹The true surplus created upon raising funds when a technological breakthrough occurs is given by $\tilde{S}(c) = \lambda(v(C^*) - C^*) + c - \lambda v(c/\lambda)$. To ease the analysis, we take a slightly modified version of this surplus, i.e. $S(c) = \lambda(v(C^*) - C^*) + c - v(c)$. This is without loss of generality. In fact, we can show that $0 < \tilde{S}(c) < S(c)$. Indeed, we have $\lambda(v(C^*) - v(c/\lambda)) > \lambda(C^* - c/\lambda) = \lambda C^* - c$ since $v'(c) \geq 1$. Hence, it is always optimal for the firm to bargain with the financiers and raise new funds when technological breakthroughs occur.

Then, $X(c) = F(A(c))$. Denote $w^* \equiv v(C^*) - C^*$. By the first order condition, we have that the optimal innovation rate solves

$$z = \phi(1 - \alpha) \frac{L}{\zeta} \frac{(\lambda w^* - v(c) + c)}{v'(c)}$$

and the corresponding term in the HJB is

$$\frac{\phi^2(1 - \alpha)^2}{2} \frac{L}{\zeta} \frac{(\lambda w^* - v(c) + c)^2}{v'(c)}$$

and we define $\varphi \equiv \phi(1 - \alpha) \left(\frac{L}{\zeta}\right)^{1/2}$. Now, by (40), it follows that

$$F^{1-\beta} - F = \beta F^{1-\beta} - \sigma^2 \frac{v''(c)}{v'(c)} F^2$$

and hence we get

$$0.5\sigma^2 F(A(c))^2 v''(c) + v'(c)(F^{1-\beta} - F) = -0.5\sigma^2 F(A(c))^2 v''(c) + v'(c)\beta F^{1-\beta}.$$

Thus, the HJB equation can be written as follows:

$$\begin{aligned} & -\frac{\sigma^2}{2} F(A(c))^2 v''(c) + v'(c) \beta F(A(c))^{1-\beta} + v'(c) c \delta \\ & + \frac{\varphi^2 (\lambda w^* - v(c) + c)^2}{2 v'(c)} + x_d (c - v(c)) - r v(c) = 0, \end{aligned} \tag{42}$$

subject to the following set of boundary conditions

$$\begin{aligned} v'(0) &= 1 + \epsilon, \\ v'(C^*) &= 1, \\ v''(C^*) &= 0. \end{aligned}$$

It follows that $A(C^*) = 0$ and $X(C^*) = X_0$. Then, at C^* , the following equation

$$\mu + \delta C^* + 0.5(\varphi(\lambda - 1)w^*)^2 - x_d w^* - r(w^* + C^*) = 0 \tag{43}$$

holds, where we have defined $\mu = \mu^* = \beta(X_0)^{1-\beta}$ and $X_0 = X(C^*) = (1-\beta)^{\frac{1}{\beta}}$. This reveals that the solution to w^* is given by³²

$$w^* = w(C^*) = \frac{x_d + r - \left((x_d + r)^2 - 2(\varphi(\lambda - 1))^2(\mu - (r - \delta)C^*) \right)^{1/2}}{\varphi^2(\lambda - 1)^2}.$$

A.2 Approximations

In this section, we derive $F^i(c)$, $A^i(c)$, $v_i = v^{(i)}$, where F, A, v are the functions derived in the previous section. We start with the function $A(c)$. By simple calculations, it follows that

$$A'(c) = -\sigma^2 \left(\frac{v'''(c)}{v'(c)} - \frac{(v''(c))^2}{(v'(c))^2} \right), \quad \Rightarrow \quad A'(C^*) = -\sigma^2 v'''(C^*),$$

and

$$A''(c) = -\sigma^2 \left(\frac{v''''(c)}{v'(c)} - 3 \frac{v''(c)v'''(c)}{(v'(c))^2} + 2 \frac{(v''(c))^3}{(v'(c))^3} \right), \quad \Rightarrow \quad A''(C^*) = -\sigma^2 v''''(C^*).$$

We turn to F . By differentiating (41), we have

$$-F - aF' - \beta(1-\beta)F^{-\beta-1}F' = 0$$

so

$$F'(A(c)) = -\frac{F(A(c))}{A(c) + \beta(1-\beta)F(A(c))^{-\beta-1}} \quad \Rightarrow \quad F'(A(C^*)) = -\frac{X_0^{\beta+2}}{\beta(1-\beta)}. \quad (44)$$

To arrive at F'' , we differentiate again the equation above

$$\begin{aligned} -2F' - aF'' - \beta(-\beta-1)(1-\beta)F^{-\beta-2}(F')^2 - \beta(1-\beta)F^{-\beta-1}F'' &= 0 \\ \Rightarrow F''(A(C^*)) &= \frac{X_0^{2\beta+3}}{\beta^2(1-\beta)^2}(\beta+3) \end{aligned} \quad (45)$$

Summarizing, the following relations hold at C^*

$$\begin{aligned} A'(C^*) &= -\sigma^2 v_3 \\ A''(C^*) &= -\sigma^2 v_4 \end{aligned}$$

³²The choice of the solution to pick is motivated as follows. Consider the frictionless case $C^* = 0$. In the limit when $\phi \rightarrow 0$, $w^* = \frac{\mu}{r+x_d}$, where $\mu = \beta(X_0)^{1-\beta}$. Our solution can be rewritten as

$$w^* = \frac{2\mu}{x_d + r \mp \left((x_d + r)^2 - 2(\varphi(\lambda - 1))^2(\mu - (r - \delta)C^*) \right)^{1/2}}.$$

Obviously, to get the continuous solution in the limit, we need to pick the plus sign, as the other solution blows up. Thus, by continuity, we pick that with the plus sign.

and

$$F'(A(C^*)) = -\frac{X_0^{\beta+2}}{\beta(1-\beta)} = -\left((1-\beta)^{1/\beta}\right)^{\beta/2}$$

$$F''(A(C^*)) = (\beta+3) \frac{X_0^{2\beta+3}}{\beta^2(1-\beta)^2}.$$

By simple calculations, we also obtain

$$X(C^*) = X_0 = F(A(C^*)) = (1-\beta)^{\frac{1}{\beta}},$$

$$X'(C^*) = X_1 = F'(A(C^*))A'(C^*) = \frac{2(r-\delta)X_0^\beta}{\beta(1-\beta)} = \frac{2(r-\delta)}{\beta},$$

$$X''(C^*) = X_2 = F''(A(C^*))(A'(C^*))^2 + F'(A(C^*))A''(C^*)$$

$$= \frac{X_0^{2\beta-1}(2(r-\delta))^2}{\beta^2(1-\beta)^2}(\beta+3) - \frac{X_0^{\beta+2}}{\beta(1-\beta)}(\sigma^2 v_4),$$

where we omit the arguments of the functions to ease the notation. We will provide an expression for the term $v_4 = v^{(4)}(c)$ in the following.

We now differentiate equation (42), obtaining

$$-\frac{\sigma^2}{2}v'''(c)F(A(c))^2 - \sigma^2 v''(c)F(A(c))F'(A(c))A'(c) + v''(c)\beta(F(A(c)))^{1-\beta}$$

$$+ v'(c)\beta(1-\beta)F^{-\beta}(A(c))F'(A(c))A'(c) + v''(c)c\delta + v'(c)\delta$$

$$+ \varphi^2(\lambda w^* - v(c) + c)\left(\frac{1}{v'(c)} - 1\right) - \frac{\varphi^2(\lambda w^* - v(c) + c)^2 v''(c)}{(v'(c))^2}$$

$$+ x_d(1 - v'(c)) - rv'(c) = 0.$$

Using the boundary conditions, we obtain an expression for the third derivative of v at the target cash level

$$v'''(C^*) \equiv v_3 = \frac{2(r-\delta)}{\sigma^2}X_0^{-2}.$$

Differentiating again the ODE, we obtain

$$\begin{aligned}
& -\frac{\sigma^2}{2}v''''(c)F^2 - 2\sigma^2v'''(c)FF'A' \\
& -\sigma^2v''(c)(F')^2(A')^2 - \sigma^2v''(c)FF''(A')^2 - \sigma^2v''(c)FF'A'' \\
& + v'''(c)\beta F^{1-\beta} + 2v''(c)\beta(1-\beta)F^{-\beta}F'A' \\
& - v'(c)\beta^2(1-\beta)F^{-\beta-1}(F')^2(A')^2 + v'(c)\beta(1-\beta)F^{-\beta}F''(A')^2 \\
& + v'(c)\beta(1-\beta)F^{-\beta}F'A'' + v'''(c)c\delta + 2v''(c)\delta \\
& + \varphi^2 \frac{(-v'(c)+1)^2}{v'(c)} - \varphi^2 \frac{(\lambda w^* - v(c) + c)v''(c)}{(v'(c))^2} (2 - v'(c)) \\
& + \varphi^2 \frac{(\lambda w^* - v(c) + c)^2(v''(c))^2}{(v'(c))^3} \\
& - \frac{\varphi^2}{2} \frac{(\lambda w^* - v(c) + c)^2v'''(c)}{(v'(c))^2} - (r + x_d)v''(c) = 0.
\end{aligned}$$

At C^* , the above equation becomes:

$$\begin{aligned}
& -\frac{\sigma^2}{2}v''''(C^*)X_0^2 - 2\sigma^2v'''(C^*)XF'A' + v'''(C^*)\beta X^{1-\beta} \\
& - \beta^2(1-\beta)X^{-\beta-1}(F')^2(A')^2 + \beta(1-\beta)X^{-\beta}F''(A')^2 + \beta(1-\beta)X^{-\beta}F'A'' \\
& + v'''(C^*)C^*\delta - \frac{\varphi^2}{2}(\lambda w^* - v(C^*) + C^*)^2v'''(C^*) = 0.
\end{aligned}$$

Therefore, we also obtain an expression for the fourth derivative of v at C^* ,

$$v^{(4)}(C^*) \equiv v_4 = \frac{2v_3}{\sigma^2 X_0^2} \left(\frac{\varphi^2}{2} (\lambda - 1)^2 (w^*)^2 - \beta X_0^{1-\beta} - \delta C^* - v_3(\sigma^2)^2 \frac{X_0^{\beta+3}}{\beta(1-\beta)} \right).$$

Suppose that ϵ is sufficiently small. For c close to C^* , firm value can be approximated by the following expression

$$\begin{aligned}
v(c) & \approx v(C^*) + v'(C^*)(c - C^*) + \frac{v''(C^*)}{2}(c - C^*)^2 + \frac{v'''(C^*)}{6}(c - C^*)^3 \\
& + \frac{v''''(C^*)}{24}(c - C^*)^4 + O((c - C^*)^5) \approx \\
w^* + c & + \frac{v_3}{6}(c - C^*)^3 + \frac{v_4}{24}(c - C^*)^4 + O((c - C^*)^5)
\end{aligned} \tag{46}$$

while the first and the second derivative of v satisfy

$$\begin{aligned} v'(c) \approx & 1 + v''(C^*)(c - C^*) + \frac{v'''(C^*)}{2}(c - C^*)^2 + \frac{v''''(C^*)}{6}(c - C^*)^3 = \\ & 1 + \frac{v_3}{2}(c - C^*)^2 + \frac{v_4}{6}(c - C^*)^3 \end{aligned} \quad (47)$$

$$\begin{aligned} v''(c) \approx & v''(C^*) + v'''(C^*)(c - C^*) + \frac{v''''(C^*)}{2}(c - C^*)^2 = \\ & v_3(c - C^*) + \frac{v_4}{2}(c - C^*)^2. \end{aligned} \quad (48)$$

Using these approximations, it follows that

$$\begin{aligned} v'(0) &= 1 + \frac{v_3}{2}(C^*)^2 - \frac{v_4}{6}(C^*)^3, \\ v''(0) &= -v_3 C^* + \frac{v_4}{2}(C^*)^2. \end{aligned} \quad (49)$$

The threshold C^* is then obtained by exploiting the boundary condition at zero, i.e.

$$C^* : 1 + \frac{v_3}{2}(C^*)^2 - \frac{v_4}{6}(C^*)^3 = 1 + \epsilon.$$

We use

$$C^* \approx \left(\frac{2}{v_3} \right)^{\frac{1}{2}} \epsilon^{\frac{1}{2}} + a\epsilon$$

where a can be found by solving the following equation

$$\frac{v_3}{2}\epsilon \left(\left(\frac{2}{v_3} \right)^{\frac{1}{2}} + a\epsilon^{\frac{1}{2}} \right)^2 - \frac{v_4}{6}\epsilon^{\frac{3}{2}} \left(\left(\frac{2}{v_3} \right)^{\frac{1}{2}} + a\epsilon^{\frac{1}{2}} \right)^3 = \epsilon.$$

Ignoring the terms of order higher than $\frac{1}{2}$, we obtain

$$a = \frac{v_4}{3 v_3^2}.$$

Then, the approximation for the target level of cash holdings is given by

$$\begin{aligned} C^* &\approx C_1 \sqrt{\epsilon} + C_2^* \epsilon, \\ C_1 &= \left(\frac{2}{v_3} \right)^{\frac{1}{2}}, \\ C_2 &= \frac{v_4}{3 v_3^2}. \end{aligned}$$

We also calculate the approximation for $z(c)$, as follows:

$$z(c) \approx z(C^*) + z'(C^*)(c - C^*) + \frac{z''(C^*)}{2}(c - C^*)^2 + \frac{z'''(C^*)}{6}(c - C^*)^3.$$

To ease the notation, we define the auxiliary quantity $\phi^* \equiv \phi(1 - \alpha)^{\frac{L}{\zeta}}$. The derivatives of $z(c)$

at C^* are given by

$$\begin{aligned}
z'(c) &= \phi^* \left(-1 + \frac{1}{v'(c)} \right) - \frac{\phi^* v''(c) (\lambda w^* - v(c) + c)}{(v'(c))^2}, \\
z''(c) &= \frac{\phi^* v''(c)}{v'(c)} - \frac{\phi^* (2v''(c) + v'''(c) (\lambda w^* - v(c) + c))}{(v'(c))^2} + \frac{2\phi^* (v''(c))^2 (\lambda w^* - v(c) + c)}{(v'(c))^3}, \\
z'''(c) &= \frac{2\phi^* v'''(c)}{v'(c)} - \frac{\phi^*}{(v'(c))^2} \left(3v''(c)^2 + 3v'''(c) + v^{(4)}(c) (\lambda w^* - v(c) + c) \right) + \\
&\quad + \frac{6\phi^*}{(v'(c))^3} (v''(c)^2 + v''(c)v'''(c) (\lambda w^* - v(c) + c)) - \frac{6\phi^*}{(v'(c))^4} v''(c)^3 (\lambda w^* - v(c) + c).
\end{aligned}$$

So,

$$\begin{aligned}
z(C^*) &= z_0 = \phi^* (\lambda - 1) w^*, & z'(C^*) &= z_1 = 0, \\
z''(C^*) &= z_2 = -\phi^* v_3 (\lambda - 1) w^*, & z'''(C^*) &= z_3 = -\phi^* (v_3 + v_4 (\lambda - 1) w^*),
\end{aligned}$$

and the resulting approximation for $z(c)$ is therefore

$$z(c) \approx z_0 + \frac{z_2}{2} (c - C^*)^2 + \frac{z_3}{6} (c - C^*)^3. \quad (50)$$

Finally, the approximation for $X(c)$ is

$$X(c) \approx X(C^*) + X'(C^*)(c - C^*) + \frac{X''(C^*)}{2} (c - C^*)^2,$$

where $X^{(i)}(C^*)$ are calculated as above. Then, we have

$$X(c) \approx X_0 + X_1(c - C^*) + \frac{X_2}{2} (c - C^*)^2.$$

A.3 The cross-sectional distribution of liquidity

For any incumbent firm, the dynamics of scaled cash holdings satisfy

$$dC_t = \mu(C_t)dt + \sigma(C_t)dZ_t + dF_t + dF_t^I - dD_t + (\lambda C^* - c)dN_t$$

where N_t is a Cox process with stochastic intensity $\phi z(C_t)$. Since cash is i.i.d. across firms, the cross-sectional distribution of firms will satisfy the Kolmogorov Forward equation

$$\frac{1}{2} (\sigma^2(c)\eta(c))'' - (\mu(c)\eta(c))' - x_d\eta(c) - z(c)\phi\eta(c) = 0.$$

By calculations, it follows:

$$\begin{aligned}(\mu(c)\eta(c))' &= \mu'(c)\eta(c) + \mu(c)\eta'(c) \\ (\sigma^2(c)\eta(c))' &= 2\sigma(c)\sigma'(c)\eta(c) + \sigma^2(c)\eta'(c) \\ (\sigma^2(c)\eta(c))'' &= 2(\sigma'(c))^2\eta(c) + 2\sigma(c)\sigma''(c)\eta(c) + 4\sigma(c)\sigma'(c)\eta'(c) + \sigma^2(c)\eta''(c).\end{aligned}$$

Now, we need to determine the boundary conditions. By assumption, firms never vanish and are only replaced by new entrants. So the mass always stays constant, equal to 1. At zero, the reflection boundary condition implies that the equality

$$0.5(\sigma^2(c)\eta(c))'(0) - (\mu(0)\eta(0)) = 0$$

holds. With reflection at C^* , and with innovating firms jumping to C^* , we will also have an additional term

$$\frac{1}{2}(\sigma^2(c)\eta(c))'' - (\mu(c)\eta(c))' - x_d\eta(c) - z(c)\phi\eta(c) = 0.$$

By integrating, it follows that

$$\begin{aligned}0 &= \int_0^{C^*} \left(\frac{1}{2}(\sigma^2(c)\eta(c))'' - (\mu(c)\eta(c))' - x_d\eta(c) \right) dc - \int_0^{C^*} \phi z(c)\eta(c) dc \\ &= \left(\frac{1}{2}(\sigma^2\eta)'(C^*) - (\mu(C^*)\eta(C^*)) \right) - \left(\frac{1}{2}(\sigma^2\eta)'(0) - (\mu(0)\eta(0)) \right) \\ &\quad - x_d \int_0^{C^*} \eta(c) dc - \int_0^{C^*} \phi z(c)\eta(c) dc.\end{aligned}\tag{51}$$

Thus, mass conservation

$$\int_0^{C^*} \eta(c) dc = 1$$

is equivalent to

$$\frac{1}{2}(\sigma^2\eta)'(C^*) - (\mu(C^*)\eta(C^*)) - \int_0^{C^*} \phi z(c)\eta(c) dc - x_d = 0,$$

or equivalently,

$$\left(\sigma'(C^*)\sigma(C^*) - \mu(C^*) \right) \eta(C^*) + 0.5\sigma^2(C^*)\eta'(C^*) = \Psi(\epsilon).\tag{52}$$

In this equation, we have defined

$$\Psi(\epsilon) \equiv \int_0^{C^*} \phi z(c; \epsilon) \eta(c; \epsilon) dc + x_d$$

Having derived the cross-sectional distribution of liquidity, which we solve numerically, we turn to analyze the general equilibrium properties of the model.

A.4 General equilibrium analysis

Using the notation introduced in Section 4.4, we derive the scaled value of the dynasty $y(c)$, the equilibrium net dividends, labor wage, and aggregate consumption. After a technological breakthrough at time t , outside investors inject the amount $q_{t-}(j)(\lambda C^* - c)$ of liquidity into the firm. As compensation, they receive a fraction of the surplus, $\alpha q_{t-}(j)(\lambda v(C^*) - v(c))$ in shares of the firm. Note that compensation cannot be in cash because this would mean they had to inject more than C^* and would then receive their own cash back immediately. Thus, after this transaction, the cash buffer rises to $q_{t-}(j)\lambda C^*$ whereas the value of the firm changes from $q_{t-}(j)v(c)$ to $q_{t-}(j)(v(c) + (1 - \alpha)(\lambda v(C^*) - v(c)))$. However, the effect of bargaining is a pure share dilution, and has no effect on the outside liquidity in the economy.

The scaled value of the dynasty is given by the difference between the expected present value of the dividends paid (denoted by the function $D(c)$) and the expected present value of the financing received by all of the firms that will ever operate in the dynasty j . That is, $y(c) = D(c) - F(c)$. In particular, the function $D(c)$ satisfies

$$\begin{aligned} \frac{1}{2}\sigma^2(c)D''(c) + \mu(c)D'(c) + \phi z(c)\left(\lambda D(C^*) - D(c)\right) + \\ + x_d\left(c + \Lambda D(C^*) - D(c)\right) = rD(c), \quad D'(0) = 0, \quad D'(C^*) = 1, \end{aligned}$$

whereas the function $F(c)$ satisfies

$$\begin{aligned} \frac{1}{2}\sigma^2(c)F''(c) + \mu(c)F'(c) + \phi z(c)\left(\lambda F(C^*) - F(c) + (\lambda C^* - c)\right) + \\ + x_d\left(\Lambda F(C^*) - F(c) + \Lambda(C^* + \kappa_T)\right) = rF(c), \quad F'(0) = -1, \quad F'(C^*) = 0. \end{aligned}$$

Taking the difference, it follows that $y(c)$ satisfies³³

$$\begin{aligned} \frac{1}{2}\sigma^2(c)y''(c) + \mu(c)y'(c) + \phi z(c)\left(\lambda(y(C^*) - C^*) - y(c) + c\right) + \\ + x_d\left(\Lambda y(C^*) - y(c) + c - \Lambda(C^* + \kappa_T)\right) = ry(c) \end{aligned}$$

³³For completeness, we also define the dynasty in the frictionless benchmark, denoted by y^* and satisfying the following relation

$$\mu - \frac{(z^*)^2}{2} \frac{\zeta}{L} - x_d^* \kappa_T \Lambda = \left(r^* - x_d^*(\Lambda - 1) - \phi z^*(\lambda - 1)\right) y^*$$

Therefore, it follows that

$$d_0^* - f_0^* = L \left(\mu - \frac{(z^*)^2}{2} \frac{\zeta}{L} - x_d^* \kappa_T \Lambda \right) = L(r^* - g^*)y^*.$$

with

$$y'(C^*) = 1 = y'(0).$$

The present value of dividends net of financing is then given by

$$\int_0^\infty e^{-rt}(d_t - f_t)dt = \int_0^\infty e^{-rt}(d_0 - f_0)e^{gt}dt$$

Since we normalize $q_0(j) = 1$ for all j , it follows:

$$\frac{d_0 - f_0}{r - g} = \int_0^\infty e^{-rt}(d_t - f_t)dt = \int Y(q_0(i), c(i))di = L \int \eta(c)y(c)dc.$$

Turning to the wage, straightforward calculations deliver

$$W_t = \frac{1}{1 - \beta} \int_0^1 L^\beta \bar{X}_t(j)^{1-\beta} q_t(j)^\beta dj - \int_0^1 p_t(j) \bar{X}_t(j) dj.$$

By the results in Section 4, the term $\bar{X}_t(j)^{1-\beta}$ in the above equation is given by

$$\bar{X}_t(j)^{1-\beta} = q_t(j) (p(c(j)))^{-1/\beta} L^{1-\beta}, \quad \bar{X}_t(j) = (p(c(j)))^{-1/\beta} q_t L.$$

Moreover, as discussed in the main text, the following relation

$$W_t = W_0 \int q_t(j) dj$$

holds. In this equation, the expression for W_0 is given by

$$W_0 = \frac{L}{1 - \beta} \int \eta(c) p(c)^{-(1-\beta)/\beta} dc - L \int \eta(c) p(c)^{1-1/\beta} dc,$$

that is equivalent to

$$W_0 = \frac{\beta L}{1 - \beta} \int \eta(c) X(c)^{1-\beta} dc.$$

Furthermore,

$$\int q_t(j) dj = e^{gt}.$$

Then, $\mathcal{C}_t = \mathcal{C}_0 e^{gt}$, with

$$\mathcal{C}_0 = W_0 + (d_0 - f_0).$$

Finally, total welfare is given by the utility of the representative consumer, i.e.

$$\int_0^\infty e^{-\rho t} \frac{\mathcal{C}_t^{1-\theta} - 1}{1 - \theta} dt = \frac{1}{\theta - 1} \left(\frac{1}{\rho} - \frac{\mathcal{C}_0^{1-\theta}}{\rho + g(\theta - 1)} \right).$$

References

- Acemoglu, D., P. Aghion, and F. Zilibotti. 2006. "Distance to Frontier, Selection, and Economic Growth." *Journal of the European Economic Association* 4:37–74.
- Acemoglu, D., U. Akcigit, N. Bloom, and W. Kerr. 2013. "Innovation, reallocation, and growth." Working paper.
- Acemoglu, D., and D. Cao. 2015. "Innovation by Entrants and Incumbents." *Journal of Economic Theory* 157:255–294.
- Acharya, V., and Z. Xu. 2014. "Financial dependence and innovation: The case of public versus private firms." Working paper.
- Aghion, P., U. Akcigit, and P. Howitt. 2014. "What Do We Learn From Schumpeterian Growth Theory?" in *Handbook of Economic Growth*, ed. by P. Aghion and S.N. Durlauf, Vol.2:515–563.
- Aghion, P., E. Farhi, and E. Kharroubi. 2012. "Monetary policy, liquidity, and growth." NBER Working paper.
- Aghion, P., P. Howitt, and D. Mayer-Foulkes. 2005. "The effect of financial development on convergence: Theory and evidence." *Quarterly Journal of Economics* 120:173–222.
- Akcigit, U., and W. Kerr. 2015. "Growth through Heterogenous Innovation." Working paper.
- Albuquerque, R., and H. Hopenhayn. 2004. "Optimal Lending Contracts and Firm Dynamics." *The Review of Economic Studies* 71:285–315.
- Ang, A., R. Hodrick, Y. Xing, and X. Zhang. 2006. "The cross-sectional volatility and expected returns." *Journal of Finance* 51:259–299.
- . 2009. "High idiosyncratic volatility and low returns: International and further U.S. evidence." *Journal of Finance* 91:1–23.
- Archibugi, D., A. Filippetti, and M. Frenz. 2013. "Economic crisis and innovation: Is destruction prevailing over accumulation?" *Research Policy* 42:303–314.
- Arrow, K. 1962. "The economic implications of learning by doing." *Review of Economic Studies* 29:155–173.
- Bansal, R., W. Coleman, and C. Lundblad. 2011. "Endogenous liquidity supply." Working paper.
- Bates, T., K. Kahle, and R. Stulz. 2009. "Why Do U.S. Firms Hold So Much More Cash Than They Used To?" *Journal of Finance* 64:1985–2021.
- Beck, T. 2012. "Finance and growth: lessons from the literature and the recent crisis." LSE Growth Commission.
- Bekaert, G., C. Harvey, and C. Lundblad. 2005. "Does financial liberalization spur growth?" *Journal of Financial Economics* 77:3–55.

- Black, F. 1976. "Studies of stock market volatility changes." Proceedings of the 1976 Meetings of the American Statistical Association, Business and Economic Statistics Section.
- Bolton, P., H. Chen, and N. Wang. 2013. "Market Timing, Investment, and Risk Management." *Journal of Financial Economics* 109:4062.
- . 2011. "A Unified Theory of Tobin's q , Corporate Investment, Financing and Risk Management." *Journal of Finance* 66:1545–1578.
- Brown, J., S. Fazzari, and B. Petersen. 2009. "Financing Innovation and Growth: Cash Flow, External Equity, and the 1990s R&D Boom." *Journal of Finance* 64:151–184.
- Caballero, R., and A. Jaffe. 1993. "How high are the giants' shoulders: An empirical assessment of knowledge spillovers and creative destruction in a model of economic growth." In *NBER Macroeconomics Annual 1993* Volume 8:15–86.
- Cassiman, B., and S. Vanormelingen. 2013. "Profiting from innovation: Firm level evidence and markups." Working Paper.
- Cheng, I.H., and K. Milbradt. 2012. "The hazards of debt: Rollover freezes, incentives, and bailouts." *Review of Financial Studies* 25:1070–1110.
- Chiu, J., C. Meh, and R. Wright. 2011. "Innovation and growth with financial, and other, frictions." NBER Working Paper.
- Clementi, G., and H. Hopenhayn. 2006. "A Theory of Financing Constraints and Firm Dynamics." *Quarterly Journal of Economics* 121:229–265.
- Décamps, J.P., T. Mariotti, J.C. Rochet, and S. Villeneuve. 2011. "Free Cash Flows, Issuance Costs and Stock Prices." *Journal of Finance* 66:1501–1544.
- DeMarzo, P., M. Fishman, Z. He, and N. Wang. 2012. "Dynamic Agency and the q Theory of Investment." *Journal of Finance* 11:2295–2341.
- Dixit, A., and R. Pindyck. 1994. *Investment Under Uncertainty*. Princeton, New Jersey: Princeton University Press.
- Duffee, G. 1995. "Stock returns and volatility: A firm level analysis." *Journal of Financial Economics* 37:399–420.
- Duffie, D., N. Garleanu, and L. Pedersen. 2007. "Valuation in over-the-counter markets." *Review of Financial Studies* 20:1865–1900.
- Eisfeldt, A., and T. Muir. 2014. "Aggregate Insurance and Savings Waves." Working Paper.
- Falato, A., D. Kadyrzhanova, and J. Sim. 2013. "Rising Intangible Capital, Shrinking Debt Capacity, and the US Corporate Savings Glut." Working Paper.
- Farhi, E., and J. Tirole. 2012. "Bubbly Liquidity." *Review of Economic Studies* 79:678–706.
- Graham, J. 2000. "How big are the tax benefits of debt?" *Journal of finance* 55:1901–1941.

- Greenwood, R., S. Hanson, and J. Stein. 2015. "A comparative-advantage approach to government debt maturity." *Journal of finance*, Forthcoming.
- Grossman, G., and E. Helpman. 1991. "Quality Ladders in the Theory of Growth." *The Review of Economic Studies* 58:43–61.
- Gupta, N., and K. Yuan. 2009. "On the growth effect of stock market liberalizations." *Review of Financial Studies* 22:4715–4752.
- Hall, B. 2005. "The Financing of Innovation." *The Handbook of Technology and Innovation Management*.
- Hall, B., and J. Lerner. 2010. "The Financing of R&D and Innovation." *Handbook of the Economics of Innovation*.
- Hennessy, C., and T. Whited. 2007. "How Costly is External Financing? Evidence from a Structural Estimation." *Journal of Finance* 62:1705–1745.
- Holmstrom, B., and J. Tirole. 2011. *Inside and Outside Liquidity*. MIT Press.
- . 1998. "Private and Public Supply of Liquidity." *Journal of Political Economy* 106:1–40.
- Hugonnier, J., S. Malamud, and E. Morellec. 2015. "Capital Supply Uncertainty, Cash Holdings, and Investment." *Review of Financial Studies* 28:391–445.
- Jensen, M. 1986. "Agency Costs of Free Cash Flow, Corporate Governance, and Takeovers." *American Economic Review* 76:323–329.
- Kanerva, M., and H. Hollanders. 2009. "The Impact of the Economic Crisis on Innovation." INNO Metrics Thematic Paper. European Commission, DG Enterprise, Brussels.
- Kiyotaki, N., and J. Moore. 2012. "Liquidity, Business Cycles, and Monetary Policy." NBER Working paper.
- Klette, T.J., and S. Kortum. 2004. "Innovating Firms and Aggregate Innovation." *Journal of Political Economy* 112:986–1018.
- Kocherlakota, N. 2009. "Bursting Bubbles: Consequences and Cures." Unpublished manuscript, FDB of Minneapolis.
- Kogan, L., D. Papanikolaou, A. Seru, and N. Stoffman. 2014. "Technological innovation, resource allocation, and growth." Working paper.
- Kondo, J., and D. Papanikolaou. 2013. "Innovation Cycles." Working paper.
- Krishnamurthy, A., and A. Vissing-Jorgensen. 2012. "The Aggregate Demand for Treasury Debt." *Journal of Political Economy* 120:717–738.
- . 2013. "Short-term Debt and Financial Crises: What we can learn from U.S. Treasury Supply." Working paper.

- Lerner, J., A. Leamon, and F. Hardymon. 2012. *Venture capital, private equity, and the financing of entrepreneurship*. Wiley.
- Levine, R. 2005. "Finance and Growth: Theory and Evidence." "Handbook of Economic Growth," Vol.1 of Handbook in Economics, P. Aghion and S. Durlauf, Elsevier.
- Lyandres, E., and B. Palazzo. 2014. "Cash holdings, competition, and innovation." Working paper, Boston University.
- Ma, L., A. Mello, and Y. Wu. 2014. "Industry Competition, Winner's Advantage, and Cash Holdings." Working Paper.
- Malkiel, B., and Y. Xu. 2002. "Idiosyncratic risk and security returns." Working Paper, University of Texas.
- Nagel, S. 2014. "The liquidity premium of near-money assets." Working Paper.
- Rajan, R. 2012. "Presidential address: The corporation in finance." *Journal of Finance* 67:1173–1217.
- Riddick, L., and T. Whited. 2009. "The Corporate Propensity to Save." *Journal of Finance* 64:1729–1766.
- Romer, P. 1990. "Endogenous technical change." *Journal of Political Economy* 98:71–102.
- Saint-Paul, G. 2005. "Fiscal Policy and Economic Growth: The Role of Financial Intermediation." *Review of International Economics* 13:612–629.
- Schumpeter, J. 1942. *Capitalism, Socialism, and Democracy*. New York: Harper & Row.
- Silveira, R., and R. Wright. 2010. "Search and the market for ideas." *Journal of Economic Theory* 145:1550–1573.
- Woodford, M. 1990. "Public debt as private liquidity." *American Economic Review* 80:382–388.
- Zucchi, F. 2014. "Internal-External liquidity feedbacks." Working Paper.

Table 1: BASELINE PARAMETRIZATION.

Symbol	Description	Value
ρ	Discount rate	1.5%
θ	Risk aversion	2.00
σ	Cash-flow volatility coefficient	0.40
ϕ	Innovation rate coefficient	3.00
ζ	Innovation cost coefficient	1.00
β	Elasticity of substitution	0.25
ϵ	Proportional refinancing cost	0.08
α	Surplus haircut	0.06
λ	Quality improvement (incumbents)	1.04
Λ	Quality improvement (entrants)	1.10
κ_T	Entry cost (technological component)	0.70
κ_I	Entry cost (financing component)	0.07
L	Labor supply	1.00

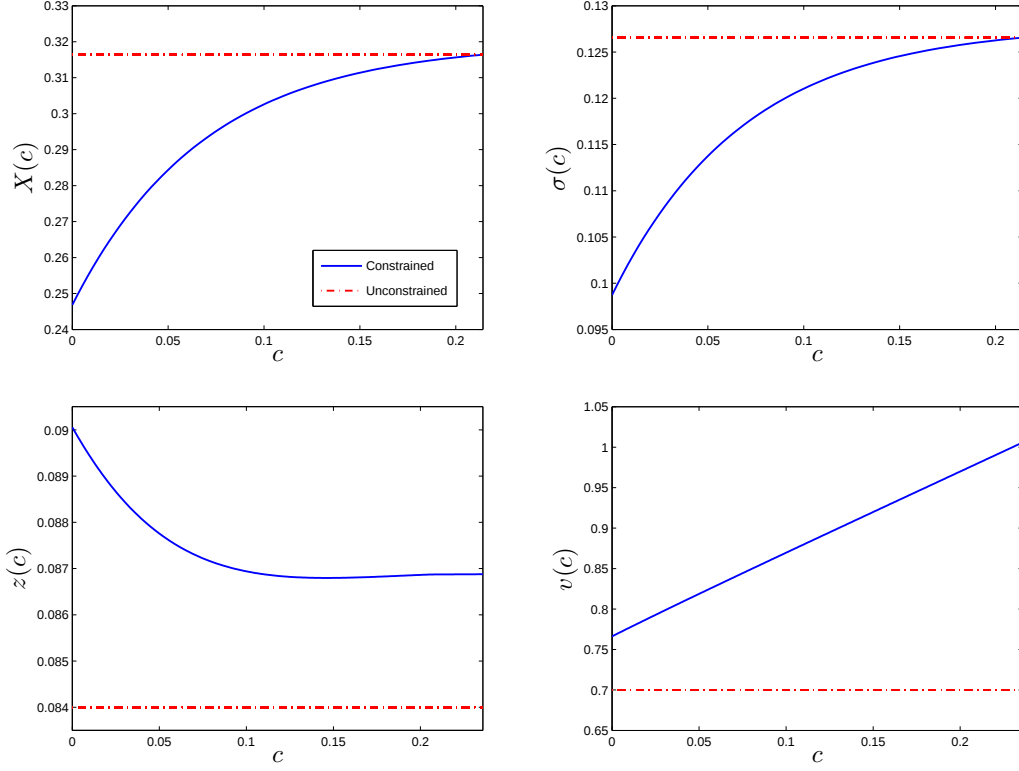


Figure 1: CORPORATE POLICIES.

The figure illustrates the optimal production quantity $X(c)$, the volatility of cash flows $\sigma(c)$, the innovation rate $z(c)$, and the scaled value of an incumbent firm $v(c)$ as a function of the cash reserves $c \in [0, C^*]$, under the baseline parametrization. The red line represents the benchmark unconstrained economy, whereas the blue line represents the constrained economy.

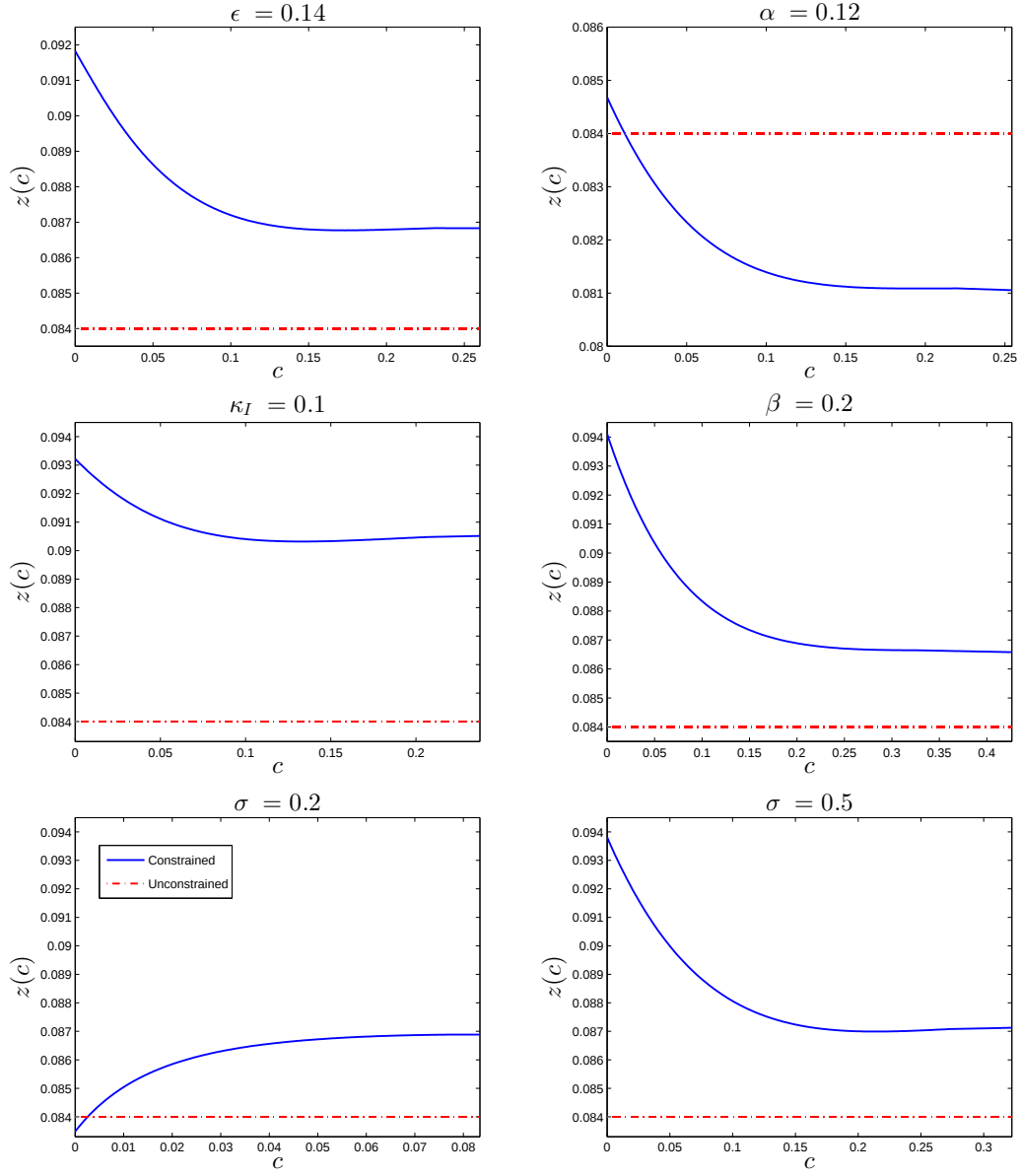


Figure 2: INNOVATION, FINANCING FRICTIONS, AND FIRM CHARACTERISTICS.

The figure illustrates the endogenous innovation rate $z(c)$ as a function of the cash reserves $c \in [0, C^*]$ when varying the financing costs ϵ , α , and κ_I , the elasticity β , and the coefficient of cash flow volatility σ . The red line represents the benchmark unconstrained economy, whereas the blue line represents the constrained economy.

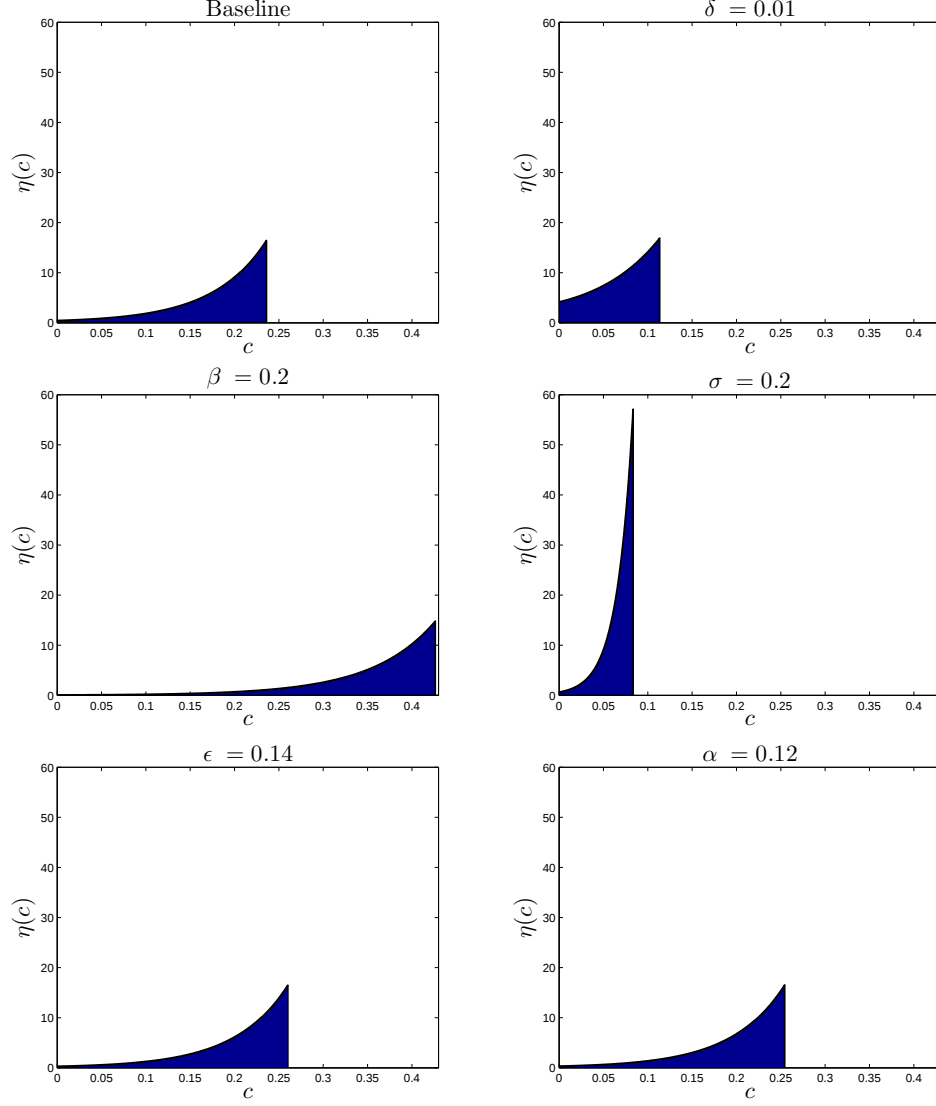


Figure 3: STATIONARY DISTRIBUTION OF LIQUIDITY.

The figure illustrates the stationary cross-sectional distribution of liquidity $\eta(c)$ as a function of $c \in [0, C^*]$ in the baseline parametrization and when varying the return on cash δ , the elasticity β , the coefficient of cash flow volatility σ , and the financing cost ϵ and α .

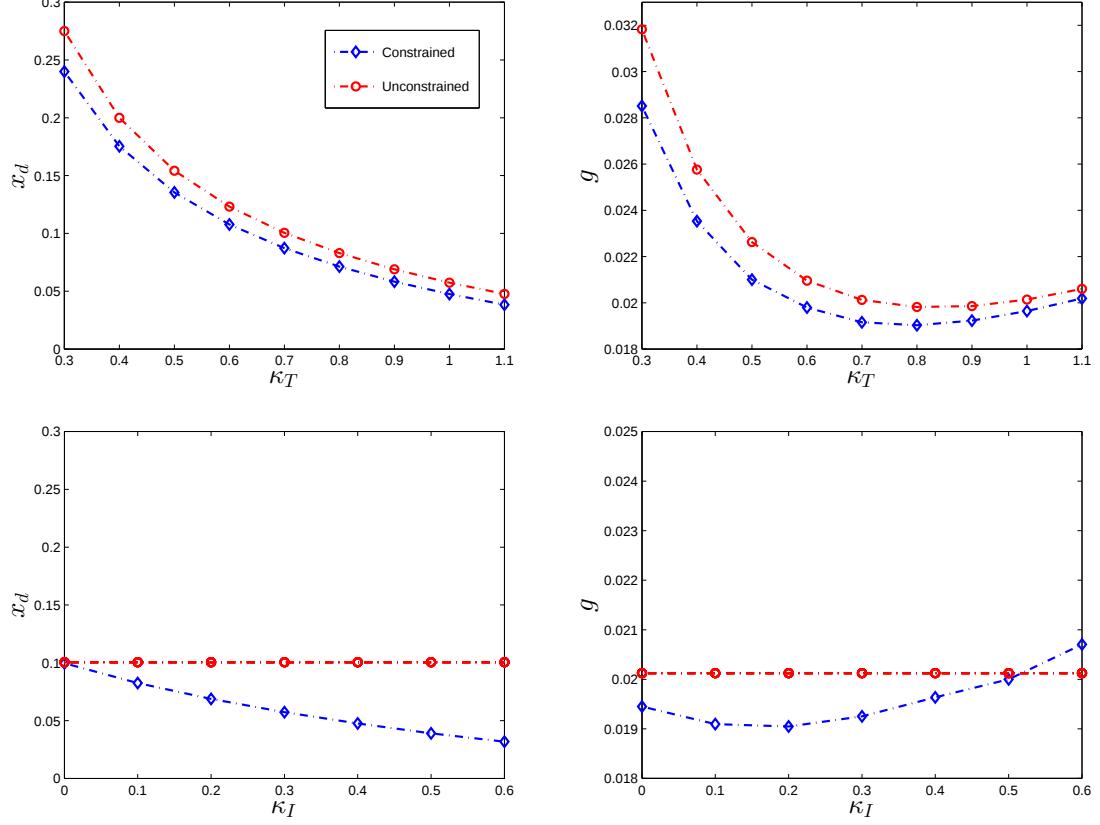


Figure 4: CREATIVE DESTRUCTION AND GROWTH.

The figure shows the equilibrium rate of creative destruction x_d and the equilibrium growth rate g as a function of the technological κ_T (top panel) and financing κ_I (bottom panel) components of the entry cost. In the top panels, we vary κ_T while setting κ_I to be 10% of κ_T . In the bottom panels, we vary κ_I while keeping κ_T as in the baseline. The red line represents the benchmark unconstrained economy, while the blue line represents the constrained economy.

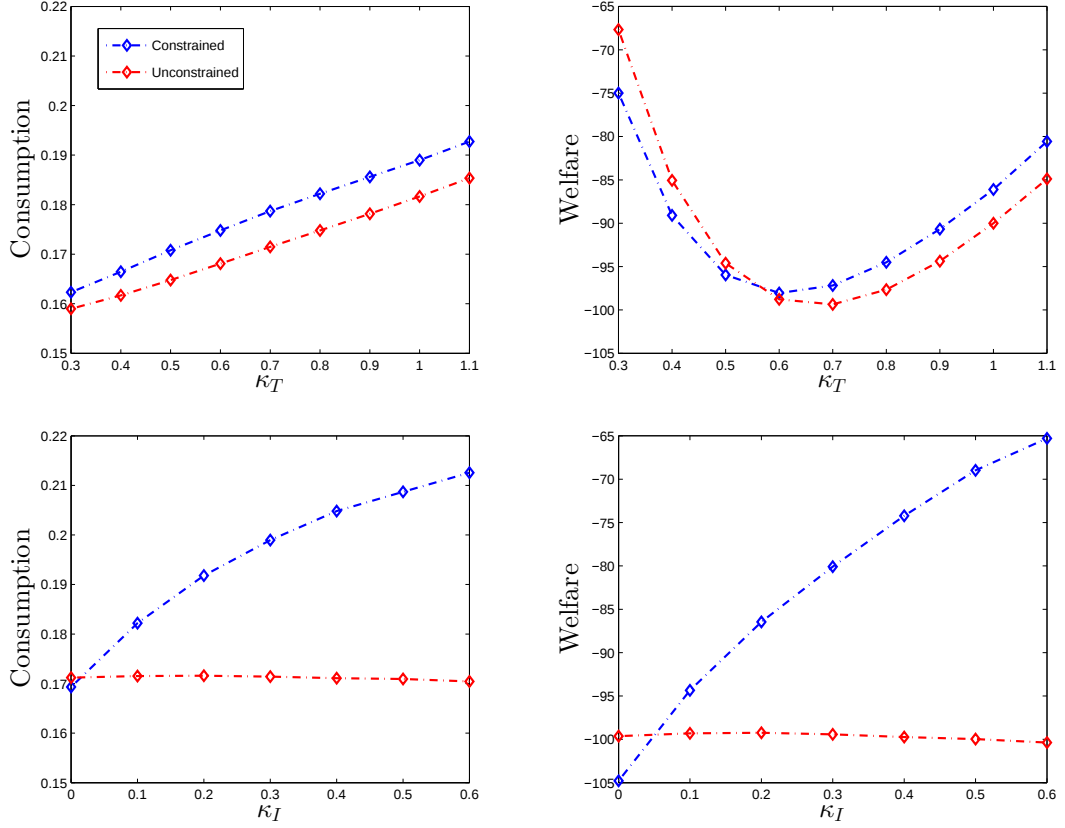


Figure 5: AGGREGATE CONSUMPTION AND WELFARE.

The figure shows aggregate consumption and welfare as a function of the technological κ_T (top panel) and financing κ_I (bottom panel) components of the entry cost. In the top panels, we vary κ_T while setting κ_I to be 10% of κ_T . In the bottom panels, we vary κ_I while keeping κ_T as in the baseline. The red line represents the benchmark unconstrained economy, while the blue line represents the constrained economy.

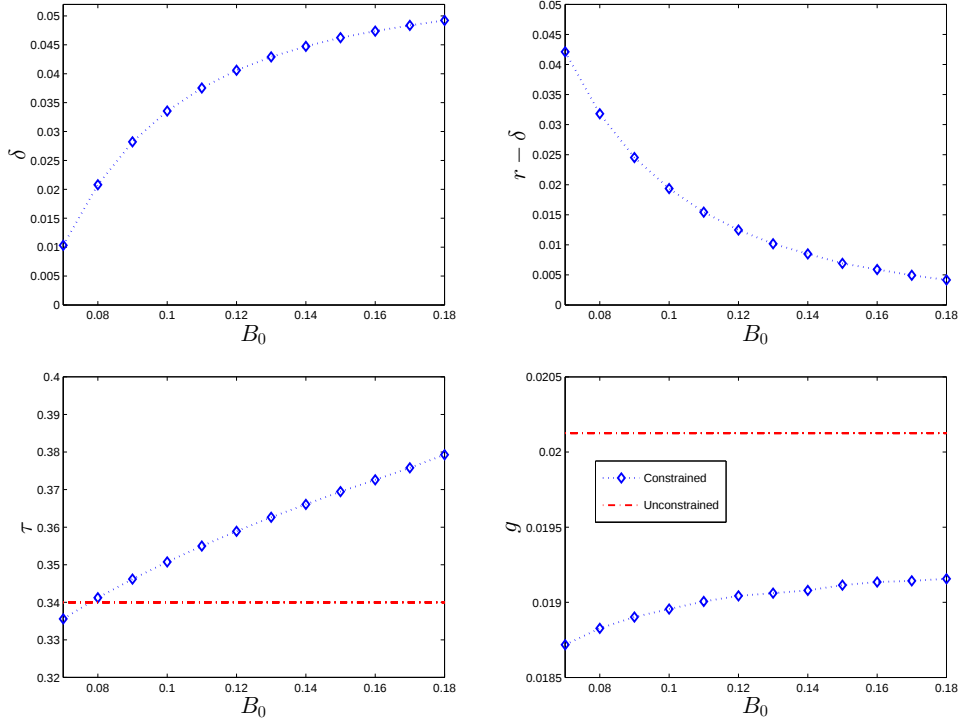


Figure 6: LIQUIDITY SUPPLY AND EQUILIBRIUM QUANTITIES.

The figure shows the equilibrium return on government debt δ , the liquidity premium $r - \delta$, the tax rate τ , and the economic growth rate g as a function of liquidity supply B_0 . The red line represents the benchmark unconstrained economy, while the blue line represents the constrained economy.

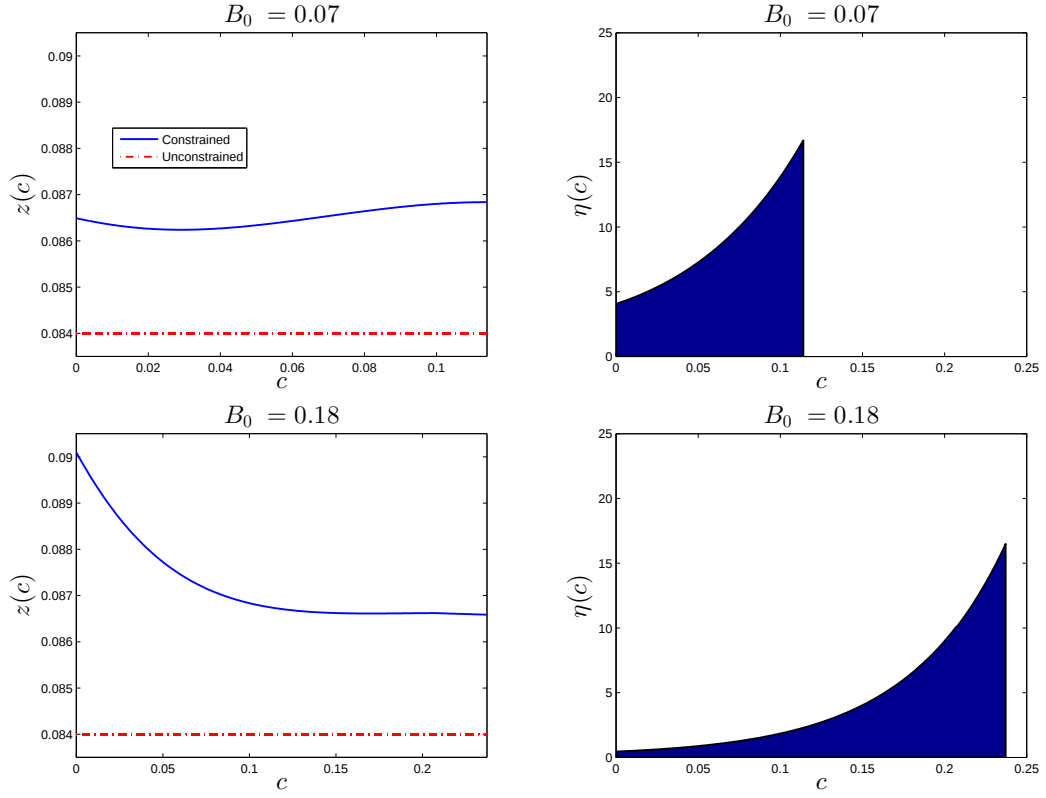


Figure 7: LIQUIDITY SUPPLY AND INNOVATION.

The figure illustrates the innovation rate $z(c)$ (left panel) and the stationary cross-sectional distribution of liquidity $\eta(c)$ (right panel) as a function of $c \in [0, C^*]$ for low supply of liquidity ($B_0 = 0.07$, top panel) and high supply of liquidity ($B_0 = 0.18$, bottom panel). The red line represents the benchmark unconstrained economy, whereas the blue line represents the constrained economy.