Abstract

This paper presents a model of search and matching equilibrium in financial economics by extending some ideas in the search and matching literature, such as Diamond (1982a) in trade, and Shapiro and Stiglitz (1984) and Masters (1998) in labor economics. The basic idea is that a lender owns capital and an entrepreneur owns entrepreneurial skill. Output is produced only when search generates a successful meeting between a lender and an entrepreneur. The autarkic equilibrium under bargaining-without-search and bargaining-with-search has been examined. It is shown that the autarkic investment in capital and skill is sub-optimal and inefficient. The inefficiency in autarky is due to search frictions and externality problems. The outcome under bargaining-with-search is better than that of bargaining-without-search though it is still inefficient. The introduction of competitive financial intermediation, however, removes most of the inefficiencies.

The outcome under asymmetric information – moral hazard on the part of entrepreneurs – is not efficient even in the in presence of financial intermediation. Any attempt that reduces market frictions and eases the search and matching process induces more investment, output and economic growth. Introduction of financial intermediation lowers monitoring cost and raises the probability of detecting shirking, thus creating opportunities for higher investment and output.

Keywords: Financial Intermediation, Entrepreneur, Capital, Search and Matching Equilibrium, Moral Hazard and Economic Growth.

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