Finance, Firm Dynamics, and Productivity

This paper analyzes how different financial institutions influence firm dynamics, innovation, and aggregate productivity. We develop a model of endogenous innovation and reallocation and emphasize distinct economic functions of banks, venture capitalists, and private equity at firm creation and destruction margins. New firms start at the technological frontier and become less productive and subject to performance shocks over time. Banks liquidate loans to firms with weak performance and reallocate scarce credit to more productive frontier firms. Venture capitalists foster firm creation by selecting the most promising start-ups and supporting them with managerial advice that magnifies the effects of private R&D investments. Thereby, banks and venture capital importantly affect capital allocation and aggregate productivity. However, frictions in the intermediation process hamper credit reallocation and limit access to venture capital.

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