Asset Bubbles, Financial Market Frictions, and Endogenous Cycles

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Abstract

We present a simple model of endogenous cycle with asset bubbles. The presence of asset bubbles corrects allocative ineciency regarding production resources, relocating investment resources from low-productivity agents to high-productivity agents. Accordingly, the presence of asset bubbles can promote capital accumulation. When the elasticity of marginal product increases in the level of capital accumulation, capital income can be described as inverted-U shape on the level of capital. Then, we show that the economic fluctuation occurs in the range of higher capital accumulation. Therefore, the occurrence of asset bubbles and the development of the financial markets, through the relaxation of credit constraints, brings the possibility of causing an unstable behavior of the economy from the stable behavior, and GDP and asset bubbles can fluctuate.

Key Words: asset bubbles, financial market frictions, endogenous cycle
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