Macroeconomics with Financial Frictions: A Survey[*]

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Abstract

This article surveys the macroeconomic implications of financial frictions. Financial frictions lead to persistence and when combined with illiquidity to non-linear amplification effects. Risk is endogenous and liquidity spirals cause financial instability. Increasing margins further restrict leverage and exacerbate the downturn. A demand for liquid assets and a role for money emerges. The market outcome is generically not even constrained efficient and the issuance of government debt can lead to a Pareto improvement. While financial institutions can mitigate frictions, they introduce additional fragility and through their erratic money creation harm price stability.

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