

# Low Interest Rates, Market Power, and Productivity Growth\*

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## Abstract

This study provides a new theoretical result that low interest rates encourage market concentration by raising industry leaders' incentive to gain a strategic advantage over followers, and this effect strengthens as the interest rate approaches zero. The model provides a unified explanation for why the fall in long-term interest rates has been associated with rising market concentration, reduced business dynamism, a widening productivity-gap between industry leaders and followers, and slower productivity growth. Support for the model's key mechanism is established by showing that a decline in the ten year Treasury yield generates positive excess returns for industry leaders, and the magnitude of the excess returns rises as the Treasury yield approaches zero.

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# 1 Introduction

Long term real interest rates have fallen to low levels over the last few decades. For example, the U.S. ten-year real interest rate has steadily declined from around 7 percent in the early 1980s to near-zero in the last decade. The decline in the interest rate is global and expected to persist in the foreseeable future. This study analyzes the impact of persistently low long term interest rates on industry market structure and productivity growth.

This study provides a new theoretical insight that ultra-low interest rates can be contractionary through their negative impact on industry competition. The traditional expansionary effect of low interest rates is well-known, a decline in long-term interest rate increases the incentive to invest as future cash flows are valued more *ceteris paribus*. This paper shows that there is a second *strategic* effect of lower interest rates that makes industry leaders invest more aggressively to keep industry followers at bay, which in turn disincentivizes industry followers from investing. The strategic effect raises expected cash flow for industry leader at the expense of industry follower. We show that the strategic effect always dominates the traditional effect at sufficiently low interest rate, leading to lower market competition and growth.

The strategic effect is driven by dynamic forward-looking incentives of industry leaders who want to maintain a lead over industry followers for a long period of time. A decline in interest rate makes leaders more patient and as a result they perceive future competitive threats from industry followers as more “imminent”. Thus lower interest rates increase leader’s strategic incentive to invest and widen the steady-state productivity gap between industry leaders and followers.

Why does a symmetric argument not apply to market followers? The reason is that low interest rates elicit investment response from industry followers only if they can ultimately achieve the high payoffs associated with market leadership. However, future industry leadership endogenously becomes less attainable for current followers because of the strong investment response of current industry leaders to low interest rates.

We illustrate our main result through a model rooted in the dynamic competition literature (e.g. [Aghion, Harris, Howitt and Vickers \(2001\)](#)). Two firms compete in an industry both intra-

temporally, through price competition, and inter-temporally, by investing in productivity-enhancing technology. Investment increases the probability that a firm improves its productivity position relative to its competitor. The decision to invest in the model is a function of the current productivity gap between the leader and the follower, which is the key state variable of the model. A larger productivity gap gives the leader a larger share of industry profits and thereby making the industry more concentrated. The model includes a continuum of industries, all of which feature the dynamic game between the leader and follower. Investment decisions within each industry induce a steady state stationary distribution of productivity gaps across markets and hence overall industry concentration and productivity growth.

Our model induces an inverted-U shaped supply-side relationship between economic growth and the interest rate. Starting from a high level of the interest rate, growth increases as the interest rate declines because the traditional expansionary effect dominates the dynamic strategic effect. However, as the interest rate declines further, the endogenous investment response of the leader and follower causes the strategic effect to dominate, and economic growth begins to fall. The key implication of our model is that this positive relationship between the interest rate and economic growth *must* happen before the interest rate hits zero.

Is the mechanism behind the model empirically plausible? The steady-state predictions of our model provide a unified explanation for a number of important facts regarding interest rate, industry competition and productivity growth. As in the model, the fall in long term rates has been associated with a rise in industry concentration, higher markups and corporate profit share, and a decline in business dynamism.<sup>1</sup> The rise in market concentration has been followed by a global decline in productivity growth since 2005. The relative timing of an initial decline in the interest rate followed by rising concentration and ultimately a decline in productivity growth is also predicted by the model. Finally, the decline in productivity growth started in 2005, well before the Great Recession, and it is global in nature. This suggests a common global cause for the slowdown such as a decline in long-term interest rates.

Our model also predicts a widening of the productivity-gap between industry leaders and

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<sup>1</sup>See De Loecker and Eeckhout (2017), Barkai (2018), Autor, Dorn, Katz, Patterson and Van Reenen (2017), Gutiérrez and Philippon (2016, 2017), Grullon, Larkin and Michaely (2016), Davis and Haltiwanger (2014), Decker, Haltiwanger, Jarmin and Miranda (2016), Haltiwanger (2015), Hathaway and Litan (2015), and Andrews, Criscuolo and Gal (2016).

followers as the interest rate declines. Using firm-level data from multiple OECD countries, [Berlingieri, Blanchenay and Criscuolo \(2017\)](#) and [Andrews et al. \(2016\)](#) show that the productivity gap between the 90th versus 10th percentile firms within industries has been increasing since 2000. Moreover, the productivity gap between leaders and followers has risen most in industries where productivity growth has slowed the most. The rise in within-sector productivity differential is also global, again suggesting a common global cause such as a decline in interest rates.<sup>2</sup>

In addition, our model generates a sharp prediction that can be directly tested using high frequency data: the asymmetric “on impact” valuation response of industry leaders versus followers when long-term rate ( $r$ ) declines. We show a decline in  $r$  benefits industry leaders more than industry followers, and this effect becomes stronger at lower levels of initial  $r$ . We test this hypothesis using CRSP-Compustat merged data from 1962 onward. We construct a “leader portfolio” that goes long industry leaders and short industry followers, and examine the portfolio’s performance in response to changes in the ten year Treasury rate. The model’s prediction is strongly confirmed in the data. The leader portfolio exhibits higher returns in response to a decline in interest rates for  $r$  below a threshold, and this response becomes stronger at lower levels of  $r$ .

Importantly, our empirical results are not driven by industry leaders have higher duration for mechanical or spurious reasons. If industry leaders had higher duration for spurious reasons, then they would have higher P/E ratio and the difference in P/E ratio between industry leader and follower would explain our asymmetric valuation response to a decline in  $r$ . However, we show that differences in P/E ratio do not explain our core result. Our empirical result thus reflects that lower  $r$  impacts relative firm valuations not only through changing the discount rate but also through endogenous changes in future cash flows that favor the current leader. This particular prediction would not emerge naturally from other models.

Our paper contributes to the large literature on endogenous growth.<sup>3</sup> The key difference be-

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<sup>2</sup>Relatedly [Gutiérrez and Philippon \(2016, 2017\)](#) and [Lee, Shin and Stulz \(2016\)](#) show a sharp decline of investment relative to operating surplus and that the investment gap is especially pronounced in concentrated industries. Furthermore, [Cetto, Fernald and Mojon \(2016\)](#) show in a two-variable VAR that a negative shock to long-term interest rates leads to a decline in productivity growth.

<sup>3</sup>Contributions to this literature include [Aghion and Howitt \(1992\)](#), [Klette and Kortum \(2004\)](#), [Acemoglu and Akcigit \(2012\)](#), [Akcigit, Alp and Peters \(2015\)](#), [Akcigit and Kerr \(2018\)](#), [Garcia-Macia, Hsieh and Klenow \(2018\)](#), [Acemoglu, Akcigit, Bloom and Kerr \(2019\)](#), [Aghion, Bergeaud, Boppart, Klenow and Li \(2019b\)](#), and [Atkeson and Burstein \(2019\)](#), among others.

tween our model and other studies in the literature, e.g. [Aghion et al. \(2001\)](#), is that we allow market leaders to endogenously accumulate a strategic advantage. In our view, market leaders in the real world invest not only for higher flow profits but, importantly, also to build strategic advantage and to consolidate their leads. For example, leaders may conduct defensive R&D, erect entry barriers, or engage in predatory acquisition as in [Cunningham, Ederer and Ma \(2019\)](#).

Our paper shows that these strategic incentives become stronger as the interest rate declines, leading to rising market concentration and lower productivity growth. While the model in our paper has no financial frictions, we believe that introducing financing constraints would further strengthen our results<sup>4</sup>. For example, using data on interest rates and imputed debt capacity, we show that the decline in long-term rates has disproportionately favored industry leaders relative to industry followers.

In contemporaneous work, [Akcigit and Ates \(2019\)](#) and [Aghion, Bergeaud, Boppart, Klenow and Li \(2019c\)](#) respectively argue that a decline in technology diffusion from leaders to followers and the advancement in information and communication technology—which enables more efficient firms to relatively expand—could have contributed to the rise in firm inequality and low growth. While we do not explicitly study these factors in our model, the economic forces highlighted by our theory suggest that low interest rates could magnify market leaders’ incentives to take advantage of these changes in the economic environment.

Our paper contributes to the literature on dynamic patent race models (e.g. [Budd, Harris and Vickers \(1993\)](#), [Hörner \(2004\)](#)) by deriving first-order approximations of the recursive value functions when the discount rate is small. We are able to provide sharp, analytic characterizations of the asymptotic equilibrium in the limiting case when discounting tends to zero, even as the ergodic state space becomes infinitely large. Our technique should be applicable to other stochastic games of strategic interactions with a large state space and low discounting. Earlier work relies on numerical methods (e.g. [Budd et al. \(1993\)](#), [Acemoglu and Akcigit \(2012\)](#)) or imposes significant restrictions on the state space to keep the analysis tractable (e.g. [Aghion et al. \(2001\)](#) and [Aghion, Bloom, Blundell, Griffith and Howitt \(2005\)](#)).

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<sup>4</sup>For some related work on financial constraints and productivity growth, see [Caballero, Hoshi and Kashyap \(2008\)](#), [Gopinath, Kalemli-Ozcan, Karabarbounis and Villegas-Sanchez \(2017\)](#) and [Aghion, Bergeaud, Cetter, Lecat and Maghin \(2019a\)](#).

This paper is also related to the broader discussion surrounding “secular stagnation” in the aftermath of the Great Recession. Some explanations, e.g., [Summers \(2014\)](#), focus primarily on the demand side and highlight frictions such as the zero lower bound and nominal rigidities.<sup>5</sup> Others such as [Barro \(2016\)](#) have focused more on the supply-side, arguing that the fall in productivity growth is an important factor in explaining the slow recovery.

Our analysis suggests that these two views might be complementary. For example, the decline in long-term interest rates might initially be driven by a weakness on the demand side. But a decline in interest rates can then have a contractionary effect on the supply-side by increasing market concentration and reducing productivity growth. An additional advantage of this framework is that one does not need to rely on financial frictions, liquidity traps, nominal rigidities, or zero lower bound to explain the persistent growth slowdown such as the one we have witnessed since the Great Recession.

## 2 Model and steady state predictions

This section outlines a model, rooted in the dynamic patent race literature, that illustrates our key theoretical insight: at very low long-term interest rate, the traditional expansionary effect of low interest rates is dominated by the strategic contractionary effect.

### 2.1 Setup

#### Consumer

The consumer side of the model is intentionally simplistic. Time is continuous. There is a representative consumer who, at each instance, chooses consumption  $Y(t)$  and supplies labor  $L(t)$  according to the within-period utility function  $U(t) = \ln Y(t) - L(t)$ . The consumption good is

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<sup>5</sup>See e.g., [Krugman \(1998\)](#), [Eggertsson and Krugman \(2012\)](#), [Guerrieri and Lorenzoni \(2017\)](#), [Benigno and Fornaro \(2019\)](#) and [Eggertsson, Mehrotra and Robbins \(2017\)](#).

aggregated from differentiated goods according to:

$$\ln Y(t) \equiv \int_0^1 \ln y(t; \nu) d\nu,$$

where  $\nu$  is an index for markets, and  $y(t; \nu)$  is aggregator of each duopoly market:

$$y(t; \nu) = \left[ y_1(t; \nu)^{\frac{\sigma-1}{\sigma}} + y_2(t; \nu)^{\frac{\sigma-1}{\sigma}} \right]^{\frac{\sigma}{\sigma-1}}. \quad (1)$$

$y_i(t; \nu)$  is the quantity produced by firm  $i$  of market  $\nu$ .

Let  $P(t) \equiv \exp\left(\int_0^1 \ln p(t; \nu) d\nu\right)$  be the aggregate price index and  $p(t; \nu) = \left[ p_1(t; \nu)^{1-\sigma} + p_2(t; \nu)^{1-\sigma} \right]^{\frac{1}{1-\sigma}}$  be the price index for market  $\nu$ . We normalize the wage rate to one. This normalization, together with the preference structure, implies that the value of aggregate output as well as the total revenue in each market are always equal to one:  $P(t)Y(t) = p(t; \nu)y(t; \nu) = 1$ .

### Within-market competition

We now discuss the within-market dynamic game between duopolists. For expositional simplicity, we drop the market index  $\nu$  and describe the game for a generic market.

**Static block** Over each time instance, the duopolists compete à la Bertrand in the product market. Let  $z_1(t), z_2(t) \in \mathbb{Z}_{>0}$  denote the (log-)productivity levels of the two market participants; the marginal cost of a firm with productivity  $z$  is  $\lambda^{-z}$  with  $\lambda > 1$ .

The CES within-market demand structure in equation (1) and Bertrand competition implies that profits in each market is homogeneous of degree zero in both firms' marginal costs and can therefore be written as functions of their productivity gap rather than the productivity levels of both firms. Specifically, let  $s(t) = |z_1(t) - z_2(t)| \in \mathbb{Z}_{\geq 0}$  be the state variable that captures the productivity gap of the two firms. When  $s = 0$ , the two participants are said to be neck-to-neck; when  $s > 0$ , one of the firm is a temporary leader ( $L$ ) while the other is a follower ( $F$ ). Let  $\pi_s$  denote the profit of the leader in a market with productivity gap  $s$ , and likewise let  $\pi_{-s}$  be the profit of

the follower in the market.<sup>6</sup> Conditioning on the state variable,  $\pi_s$  and  $\pi_{-s}$  no longer depend on the time index or individual productivities ( $z_1(t), z_2(t)$ ) and have the following properties.

**Lemma 1.** *Follower's flow profits  $\pi_{-s}$  are non-negative, weakly decreasing, and convex; leader's and joint profits,  $\pi_s$  and  $(\pi_s + \pi_{-s})$ , are bounded, weakly increasing, and eventually concave in  $s$  (a sequence  $\{a_s\}$  is eventually concave iff there exists  $\bar{s}$  such that  $a_s$  is concave in  $s$  for all  $s \geq \bar{s}$ ).*

It can be easily verified that  $\lim_{s \rightarrow \infty} \pi_{-s} = 0$  and  $\lim_{s \rightarrow \infty} \pi_s = 1$ . Nevertheless, our theoretical results apply to any sequence of profits that satisfy the technical properties in Lemma 1, including alternative market structures including Cournot competition and limit pricing (see Appendix A). Hence, we let  $\pi \equiv \lim_{s \rightarrow \infty} \pi_s$  denote the limiting total profits in each market as  $s \rightarrow \infty$ , and we derive our theory using the notation  $\pi$ .

A higher productivity gap  $s$  is associated with higher joint profits and more unequal profits between the leader and the follower. We interpret state  $s$  to be more competitive than state  $s'$  if  $s < s'$  and more concentrated if  $s > s'$ . As an example of the market structure, the case of perfect substitutes within market ( $\sigma = \infty$ ) under Bertrand competition generates profit  $\pi_s = 1 - e^{-\lambda s}$  for leaders and  $\pi_{-s} = 0$  for followers (e.g., see Peters (2018)).

**Dynamic block** Each firm can invest to improve its productivity, which evolves in step-increments. Investment  $\eta_s \in [0, \eta]$  in each state  $s$  is bounded above by  $\eta$  and carries a marginal cost  $c$ . Specifically, the firm can choose to pay a cost  $c\eta_s$  in exchange for a Poisson rate  $\eta_s$  with which the firm's productivity improves by one step, i.e. cost of production declines proportionally by  $\lambda^{-1}$ .<sup>7</sup> Given investment decisions  $\{\eta_s, \eta_{-s}\}$  over interval  $\Delta$  at time  $t$ , state  $s$  transitions according to

$$s(t + \Delta) = \begin{cases} s(t) + 1 & \text{with probability } \Delta \cdot \eta_s \\ s(t) - 1 & \text{with probability } \Delta \cdot (\kappa + \eta_{-s}) \\ s(t) & \text{otherwise.} \end{cases}$$

<sup>6</sup>These profit functions  $\pi_s$  and  $\pi_{-s}$  can be written as  $\pi_s = \frac{\rho_s^{1-\sigma}}{\sigma + \rho_s^{1-\sigma}}$  and  $\pi_{-s} = \frac{1}{\sigma \rho_s^{1-\sigma} + 1}$ , where  $\rho_s$  is implicitly defined by  $\rho_s = \lambda^{-s} \frac{(\sigma + \rho_s^{1-\sigma}) \rho_s^{1-\sigma}}{\sigma \rho_s^{1-\sigma} + 1}$ . These expressions are derived in Appendix A; also see Aghion et al. (2001).

<sup>7</sup>The central results of the model are not dependent on the assumption that investment intensity is bounded with a constant marginal cost. We show in a numerical example in section B.1 of the appendix that our central results are similar when investment is modeled as unbounded with convex marginal costs. The bounded investment with a constant marginal cost allows for an analytical characterization of the equilibrium as the interest rate approaches zero.



The technology diffusion parameter  $\kappa$  is the exogenous Poisson rate that the follower catches up by one step; it can also be seen as the rate of patent expiration.

Firms discount future payoffs at interest rate  $r$ . We take  $r$  to be exogenous for now. Section 2.4 endogenizes  $r$  by closing the model in general equilibrium. Each firm's value  $v_s(t)$  in state  $s$  at time  $t$  can be expressed as the expected present-discount-value of future profits net of investment costs:

$$v_s(t) = \mathbb{E} \left[ \int_0^\infty e^{-r\tau} \{ \pi(t+\tau) - c(t+\tau) \} | s \right].$$

Firms are forward looking, thus they invest not only for gains in the flow profits in higher states, but, more importantly, they invest in order to also enhance market positions, thereby enabling them to reach for even higher profits in the future. For the follower, closing the productivity gap by one step enables him to further close the gap in the future and eventually catch up with the leader. For the leader, widening the productivity gap brings higher profits, the option value to further increase the lead in the future, as well as higher persistence of market leadership, because it would now take the follower additional steps to catch up.

We look for a stationary symmetric Markov-perfect equilibrium such that the value functions and investment decisions depend on the state but not the time index. The HJB equations for firms in state  $s \geq 1$  are

$$rv_s = \pi_s + (\kappa + \eta_{-s})(v_{s-1} - v_s) + \max_{\eta_s \in [0, \eta]} \{ 0, \eta_s (v_{s+1} - v_s - c) \} \quad (2)$$

$$\begin{aligned} rv_{-s} = & \pi_{-s} + \eta_s (v_{-(s+1)} - v_{-s}) + \kappa (v_{-(s-1)} - v_{-s}) \\ & + \max_{\eta_{-s} \in [0, \eta]} \{ 0, \eta_{-s} (v_{-(s-1)} - v_{-s} - c) \}. \end{aligned} \quad (3)$$

In state zero, the HJB equation for either market participants is

$$rv_0 = \pi_0 + \eta_0 (v_{-1} - v_0) + \max_{\eta_0 \in [0, \eta]} \{ 0, \eta_0 (v_1 - v_0 - c) \}.$$

**Definition 1. (Equilibrium)** Given interest rate  $r$ , a symmetric Markov-perfect equilibrium is a

collection of value functions and investment decisions  $\{\eta_s, \eta_{-s}, v_s, v_{-s}\}_{s=0}^{\infty}$  that satisfy the infinite collection of equations in (2) and (3). The collection of flow profits  $\{\pi_s, \pi_{-s}\}_{s=0}^{\infty}$  are generated by duopolistic competition in the static block.

**Discussions on the investment technology** Market leaders in the real world invest not only for higher flow profits but, importantly, also to acquire and to consolidate strategic advantage. By modeling follower catch-up as a step-by-step process, leaders in our model are able to act on such strategic incentives through building a large productivity lead; in the real world, such incentives could also manifest by leaders conducting defensive R&D, erecting entry barriers, and engaging in predatory acquisition. The goal of our theory is to show that this strategic incentive becomes stronger as the interest rate declines; this is the key driving force behind how low  $r$  leads to rising market concentration and lower productivity growth in our model.

Our model also has a number of auxiliary assumptions on the investment technology; for instance, the productivity diffusion parameter  $\kappa$  and investment parameter  $c$  are both state-independent, and the investment cost is linear in  $\eta$  within a bounded range. These assumptions are made for expositional simplicity and are not crucial for our key results.

We elaborate on these discussions as well as other robustness issues in section 5.

### **Aggregation: Steady-state and productivity growth**

**Steady-state** In each market, firms engage in both static competition—by maximizing flow profits, taking the productivity gap as given—and dynamic competition—by strategically choosing investment in order to raise their own productivity and maximize the present discounted value of future payoffs. The state variable in each market follows an endogenous Markov process with transition rates governed by the investment decisions  $\{\eta_s, \eta_{-s}\}_{s=0}^{\infty}$  of market participants. We define a steady-state equilibrium as one in which the distribution of productivity gaps in the entire economy,  $\{\mu_s\}_{s=0}^{\infty}$ , is time invariant. The steady-state distribution of productivity gaps must satisfy the property that, over each time instance, the density of markets leaving and entering each

state must be equal. This implies the following equations:

$$\underbrace{2\mu_0\eta_0}_{\substack{\text{density of markets} \\ \text{going from state 0 to 1}}} = \underbrace{(\eta_{-1} + \kappa)\mu_1}_{\substack{\text{density of markets} \\ \text{going from state 1 to 0}}}, \quad (4)$$

$$\underbrace{\mu_s\eta_s}_{\substack{\text{density of markets} \\ \text{going from state } s \text{ to } s+1}} = \underbrace{(\eta_{-(s+1)} + \kappa)\mu_{s+1}}_{\substack{\text{density of markets} \\ \text{going from state } s+1 \text{ to } s}} \text{ for all } s > 0, \quad (5)$$

(the number “2” on the left-hand-side of the first equation reflects the fact that a market leaves state zero if either participant makes a successful innovation).

**Definition 2. (Steady-State)** Given equilibrium investment  $\{\eta_s, \eta_{-s}\}_{s=0}^{\infty}$ , a steady-state is the distribution  $\{\mu_s\}_{s=0}^{\infty}$  ( $\sum \mu_s = 1$ ) over the state space that satisfies equations (4) and (5).

**Productivity growth** The aggregate productivity is defined as the total cost of production relative to total value of output. Because the wage rate is normalized to one, aggregate productivity is inversely proportional to the aggregate price index  $P(t)$ . The aggregate productivity growth rate at time  $t$ , defined as  $g \equiv -d \ln P(t)/dt$ , can be written as an average of the productivity growth rate of each market—aggregated from firm-level investment decisions—weighted by the distribution over the productivity gap:

$$g = \ln \lambda \cdot \sum_{s=0}^{\infty} \mu_s \mathbb{E}[g_s],$$

recalling that  $\lambda$  is the proportional productivity increment for each successful investment.

**Lemma 2.** *In a steady state, the aggregate productivity growth rate is*

$$g = \ln \lambda \left( \sum_{s=0}^{\infty} \mu_s \eta_s + \mu_0 \eta_0 \right).$$

The lemma shows that aggregate productivity growth can be simplified as the average productivity growth rate of market leaders, weighted by the fraction of markets in each state. Given that productivity improvements by followers also contribute to the growth of aggregate productivity, it might appear puzzling that follower investment decisions ( $\eta_{-s}$ ) are absent from equation (2).

The apparent omission is a direct consequence of the fact that, in a steady-state, the productivity growth rate of market leaders is, on average, the same as that of market followers. In fact, as we prove Lemma 2 in Appendix A, aggregate productivity growth rate can also be written as a weighted average productivity growth rate of market followers,  $g = \ln \lambda \cdot \sum_{s=1}^{\infty} \mu_s (\eta_{-s} + \kappa)$ .

## 2.2 Analysis of the equilibrium and steady state

We first analyze the equilibrium structure of the two-firm dynamic game in a generic market, again dropping the market index  $v$ . We then aggregate market equilibrium to the economy and study aggregate comparative statics with respect to the interest rate  $r$ .

### Equilibrium in each market

We impose the following regularity conditions.

**Assumption 1.** 1. *The upper bound of investment,  $\eta$ , is sufficiently high:  $\eta > \kappa$  and  $2c\eta > \pi$ .* 2.  $\pi_1 - \pi_0 > c\kappa > \pi_0 - \pi_{-1}$ .

The first assumption ensures that firms can scale up investment  $\eta_s$  to a sufficiently large amount if they choose to. The condition ( $\eta > \kappa$ ) means that, if the follower does not invest and the leader invests as much as possible, then the productivity gap tends to widen on average. The condition ( $2c\eta > \pi$ ) means that if both firms choose to invest as much as possible, the total flow payoff ( $\pi_s + \pi_{-s} - 2c\eta$ ) is negative in any state.

The second parametric assumption rules out a trivial equilibrium in which firms do not invest even when they are state zero, resulting in a degenerate steady-state distribution with zero growth.

Because investment costs are linear in investment intensities, firms generically invest at either the upper or lower bound in any state. Investment effectively becomes a binary decision, and any interior investment decisions can be interpreted as firms playing mixed strategies. For exposition purposes, we focus on pure-strategy equilibria in which  $\eta_s \in \{0, \eta\}$ , but all of our results hold in mixed-strategy equilibria as well. Also note that even though the dynamic duopoly game does not always emit an unique equilibrium—because of the discreteness of the state space—we present

results that hold across all equilibria.

Let  $n + 1$  be the first state in which the market leader chooses not to invest,  $n + 1 \equiv \min \{s | \eta_s < \eta\}$ ; likewise, let  $k + 1$  be the first state in which the market follower chooses not to invest,  $k + 1 \equiv \min \{s | \eta_{-s} < \eta\}$ .

**Lemma 3.** *The leader invests in more states than the follower,  $n \geq k$ . Moreover, the follower does not invest in states  $s = k + 2, \dots, n + 1$ .*

The lemma establishes that in any equilibrium, the leader must maintain investments in more states than the follower does. To understand this, note that the productivity gap closes at a slow rate  $\kappa$  if the follower does not invest in the state and at a faster rate  $\eta + \kappa$  if the follower does. Firms are motivated to invest because of the high future flow payoffs after consecutive successful investments. The leader is motivated to invest in all states  $s \leq n$  in order to reach state  $n + 1$ , so that he can enjoy the flow payoff  $\pi_{n+1}$  without having to pay the investment costs in that state. The state  $(n + 1)$  is especially attractive if the follower does not invest in that state, because the leader can enjoy the payoff for a longer period, in expectation, before the state stochastically transitions down to  $n$ , after which he has to incur investment cost again.

The follower, on the other hand, is also motivated by future payoffs. He incurs investment costs in exchange for the possibility of closing the gap and catching up with the leader, and for the possibility of eventually becoming the leader himself in the future so that he can enjoy the high flow payoffs. In other words, investment decisions for both forward-looking firms are motivated by high flow profits in the high states, and the incentive to reach these states is stronger for the leader because the leader is closer to those high-payoff states.

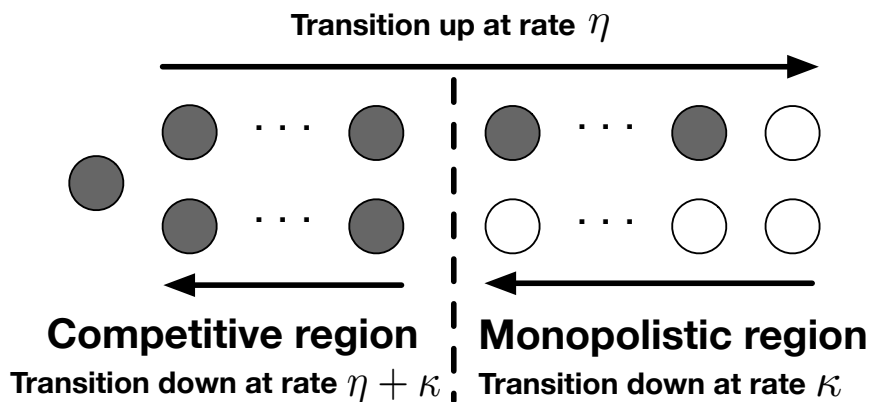
Another way to understand the intuition is to consider the contradiction brought by  $n < k$ . Suppose the leader stops investing before the follower does. In this case, the high flow payoff  $\pi_{n+1}$  is transient for the leader and market leadership is fleeting because of the high rate of downward state transition; this implies that the value for being a leader in state  $n + 1$  is low. However, because firms are forward-looking and their value functions depend on future payoffs, the low value in state  $n + 1$  “trickles down” to affect value functions in all states, meaning the incentive for the follower to invest—motivated by the dynamic prospect of eventually becoming the leader in state



when interest rate  $r$  is small (because  $\{\pi_s\}$  is eventually concave in  $s$ ), and our main result concerns the comparative statics of the economy as we take the interest rate  $r$  close to zero.

### Analysis of the steady-state

The fact that the leader invests in more states than the follower enables us to partition the set of non-neck-to-neck states  $\{1, \dots, n+1\}$  into two regions: one in which the follower invests ( $\{1, \dots, k\}$ ) and the other in which the follower does not ( $\{k+1, \dots, n+1\}$ ). In the first region, the state transitions up with Poisson rate  $\eta$  and transitions down with rate  $(\eta + \kappa)$ . In expectation, the state  $s$  decreases over time in this region, and the market structure tends to move towards being more competitive. For this reason, we refer to this as the *competitive region*. Note that this label is not a reflection of the static profits, which can be very high for leaders in this region. Instead, the label reflects the fact that joint profits tend to decrease *dynamically*. In the second region, the downward transition happens at a lower rate ( $\kappa$ ), and the market structure tends to stay monopolistic and concentrated. We refer to this as the *monopolistic region*.



The aggregate productivity growth rate in the economy is a weighted average of the productivity growth in each market; hence, aggregate growth depends on both the investment decisions in each market structure as well as the distribution of market structure, which in turn is a function of the investment decisions. The following lemma shows that the aggregate growth rate can be characterized by the fraction of markets in each region.

**Lemma 4.** *In a steady-state induced by investment cut-off states  $(n, k)$ , the aggregate productivity growth*

rate is

$$g = \ln \lambda \left( \mu^C \cdot (\eta + \kappa) + \mu^M \cdot \kappa \right),$$

where  $\mu^C \equiv \sum_{s=1}^k \mu_s$  is the fraction of markets in the competitive region and  $\mu^M \equiv \sum_{s=k+1}^{n+1} \mu_s$  is the fraction of markets in the monopolistic region. The fraction of markets in each region satisfies

$$\begin{aligned} \mu_0 + \mu^C + \mu^M &= 1, & \mu_0 &\propto (\kappa/\eta)^{n-k+1} (1 + \kappa/\eta)^k, \\ \mu^C &\propto (\kappa/\eta)^{n-k} \left( (1 + \kappa/\eta)^k - 1 \right), & \mu^M &\propto \frac{1 - (\kappa/\eta)^{n-k+1}}{1 - \kappa/\eta}. \end{aligned}$$

The lemma shows that fractions of markets in the competitive and monopolistic regions are sufficient statistics for steady-state growth, and that markets in the competitive region contributes more to aggregate growth than those in the monopolistic region. This is intuitive: in the competitive region, both firms invest, and, consequently, productivity improvements are rapid, state transition rate is high, dynamic competition is fierce, leadership is contentious, and market power tends to decrease over time. On the other hand, the follower ceases to invest in the monopolistic region, and, once markets are in this region, they tend to become more monopolistic over time. This monopolistic region also includes markets in state  $n + 1$ , where even the leader stops investing. On average, this region features low rate of state transition and low productivity growth.

The lemma further implies that, conditioning on the follower investing at all ( $k \geq 1$ ), steady-state growth is strictly increasing in the mass of markets in the competitive region and decreasing in the mass of markets in the monopolistic region. Stated in terms of the investment decisions,  $g$  is increasing in  $k$  decreasing in  $(n - k)$ . Higher  $k$  implies follower investing in more states, thereby raising the steady-state fraction of markets in the competitive region. By contrast, higher  $(n - k)$  expands the monopolistic region and reduces the fraction of markets in the competitive region and the neck-to-neck state, with a negative net effect on aggregate productivity growth when  $k \geq 1$ .

The last result of this section provides a lower bound of steady-state growth rate.

**Lemma 5.** *If followers invest at all ( $k \geq 1$ ), then the steady-state aggregate productivity growth is bounded below by  $\ln \lambda \cdot \kappa$ , the step-size of productivity increments times the rate of technology diffusion.*



### 2.3 Steady-state comparative statics: declining interest rate toward zero

Our key theoretical results concern the limiting behavior of aggregate steady-state variables as the interest rate declines toward zero. Conventional intuition suggests that, *ceteris paribus*, when firms discount future profits at a lower rate, the incentive to invest should increase because the cost of investment is lower relative to future benefits. This intuition holds in our model, and we formalize it into the following lemma.

**Lemma 6.**  $\lim_{r \rightarrow 0} k = \lim_{r \rightarrow 0} (n - k) = \infty$ .

The result suggests that, as the interest rate declines toward zero, firms in all states tend to raise investment. In the limit, as firms become arbitrarily patient, they sustain investment even when arbitrarily far behind or ahead: followers are less easily discouraged, and leaders are less lazy.

However, the fact that firms raise investment in all states does not translate into high aggregate investment and growth. These aggregate economic variables are averages of the investment and growth rate in each market, weighted by the steady-state distribution of market structure. A decline in the interest rate not only affects state-dependent investment decisions but also shifts the steady-state distribution of market structures. As Lemma 4 shows, a decline in the interest rate can boost aggregate productivity growth if and only if it expands the fraction of markets in the competitive region; conversely, if more markets are in the monopolistic region—for instance if  $n$  increases at a “faster” rate than  $k$ —aggregate productivity growth rate could slow down.

Our main result establishes that, as  $r \rightarrow 0$ , a slow down in aggregate productivity growth is inevitable and is accompanied by a decline in investment and a rise in market power.

**Proposition 1.** *As  $r \rightarrow 0$ ,*

1. *The fraction of markets in the competitive region vanishes, and the monopoly region becomes absorbing:*

$$\lim_{r \rightarrow 0} \mu^C = 0; \quad \lim_{r \rightarrow 0} \mu^M = 1.$$

2. *The productivity gap between leaders and followers diverges:*

$$\lim_{r \rightarrow 0} \sum_{s=0}^{\infty} \mu_s s = \infty.$$

3. *Aggregate investment to GDP ratio declines:*

$$\lim_{r \rightarrow 0} c \cdot \sum_{s=0}^{\infty} \mu_s (\eta_s + \eta_{-s}) = c\kappa.$$

4. *Aggregate productivity growth slows down:*

$$\lim_{r \rightarrow 0} g = \kappa \cdot \ln \lambda.$$

5. *Industry leaders take over the whole market, with high profit shares and markups:*

$$\lim_{r \rightarrow 0} \sum_{s=0}^{\infty} \mu_s \frac{\pi_s}{p_s y_s} = 1,$$

where  $p_s y_s$  is the total revenue of market  $s$ .

6. *Market dynamism declines, and leadership becomes permanently persistent:*

$$\lim_{r \rightarrow 0} \sum_{s=0}^{\infty} M_s \mu_s = \infty,$$

where  $M_s$  is the expected time before a leader in state  $s$  reaches state zero.

7. *Relative market valuation of leaders and followers diverges:*

$$\lim_{r \rightarrow 0} \frac{\sum_{s=0}^{\infty} \mu_s v_s}{\sum_{s=0}^{\infty} \mu_s v_{-s}} = \infty.$$

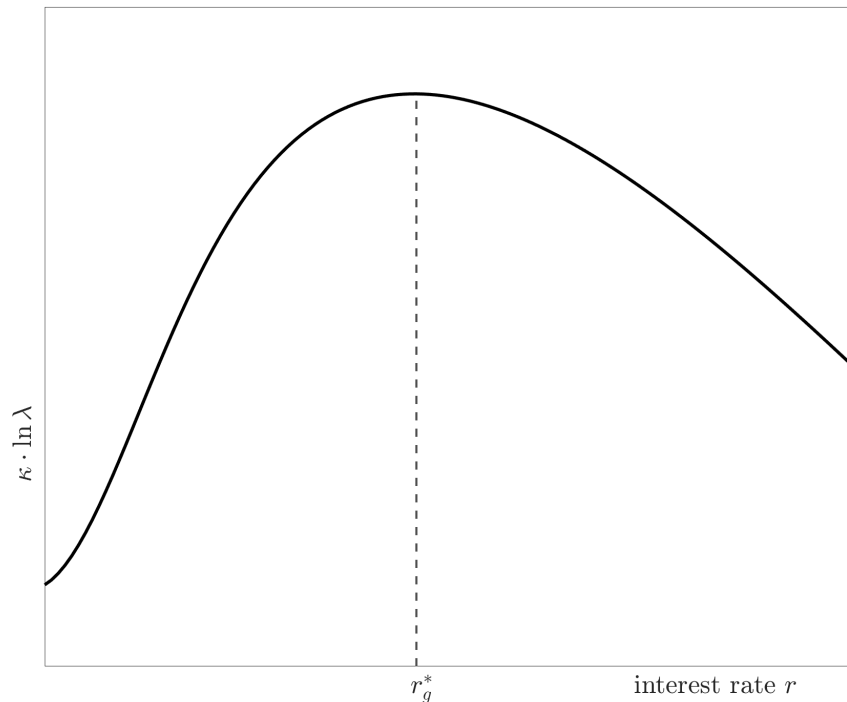
The proposition states that, as  $r \rightarrow 0$ , all markets are in the monopolistic region in a steady-state, and leaders almost surely stay permanently as leaders. Followers cease to invest, and leaders invest only to counteract the exogenous technology diffusion. As a result, aggregate investment and productivity growth decline and converge to their respective lower bounds governed by the parameter  $\kappa$ .

The proposition highlights two competing forces of low interest rates on steady-state growth. As standard intuition goes, lower rates are expansionary as firms in all states tend to invest more. On the other hand, low rates are also anti-competitive, as leader's investment response to low  $r$

is stronger than follower's. Proposition 1 shows that this second, anti-competitive force always dominates when the level of interest rate  $r$  is sufficiently low.

The result therefore implies an inverted-U relationship between steady-state growth and the interest rate, as depicted in Figure 1. In a high- $r$  steady-state (i.e.  $r > r_g^*$ ), few firms invest in any markets; consequently, a significant mass of markets are in the neck-to-neck state, and aggregate productivity growth is low. A marginally lower  $r$  raises all firms' investments, and the expansionary effect dominates by drawing mass of markets out of the neck-to-neck state into the competitive region. When  $r < r_g^*$ , however, most markets are in the monopolistic region, in which followers cease to invest, and aggregate productivity growth is again low. The anti-competitive effect of low interest rates also generates other implications: a rising leader-follower productivity gap, diverging relative market valuation of leaders, a rising profit share of the leader, rising average markups, and declining business dynamism.

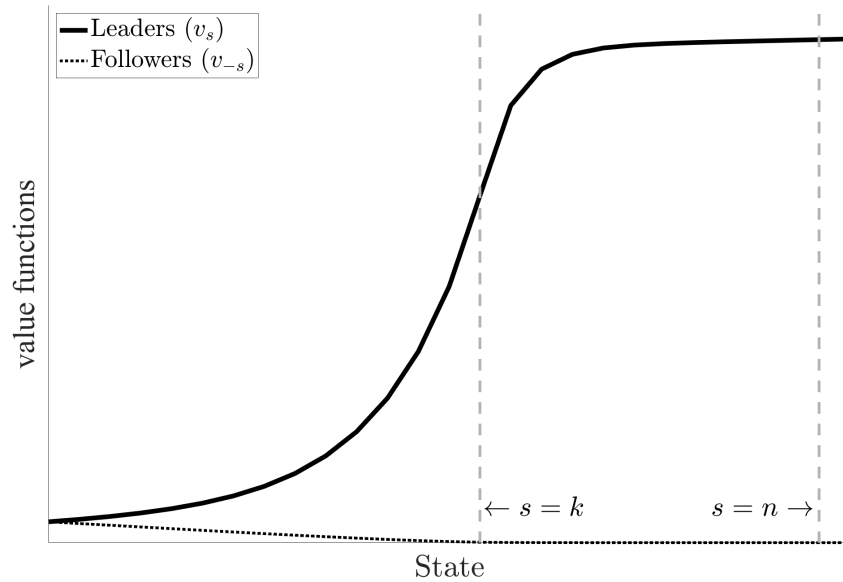
Figure 1: Steady-state growth: inverted-U



To gain intuitions for why leaders' investments are more responsive to low  $r$  than followers',

it is useful to first demonstrate the firm value functions, as shown in the figure 2. The solid black curve represents the value function of the leader, whereas the dotted black curve represents the value function of the follower. The two dashed and gray vertical lines respectively represent  $k$  and  $n$ , the last states in which the follower and the leader invest, and together they separate the state space into the competitive and monopolistic regions.

Figure 2: Value functions



Lemma 6 shows that, as  $r \rightarrow 0$ , the *number* of states in both competitive and monopolistic regions diverge to infinity. Proposition 1 shows that the *fraction* of markets in the monopolistic region converges to one, which can happen if and only if the *number* of states in the monopolistic region asymptotically dominates that in the competitive region, i.e., the leader raises investment at a “faster rate” in response to lower interest rates than the follower does.

Intuitively, as the figure demonstrates, the firm value of leaders in the competitive region is small relative to the value towards the end of the monopolistic region, close to state  $n + 1$ . Therefore, a leader would experience a sharp decline in firm value once he falls back from the monopolistic region into the competitive region. A patient leader sustains investment even far into the monopolistic region to avoid the future prospect of falling back; he stops investing if and only if he expects to stay in the monopolistic region for a sufficiently long time. As a leader becomes

infinitely patient, even the distant threat of losing market power is perceived to be imminent; consequently, leaders scale back investment only if they expect to never leave the monopolistic region, causing market leadership to become endogenously permanent.

Why does a symmetric argument not apply to the follower, i.e., why does a patient follower stop investing once he falls more than  $k$  steps behind (even though  $k$  could be large)? The reason is that patience motivates the follower to invest *if and only if future leadership is attainable*. Consider the follower's decision in state  $k$ . As  $r \rightarrow 0$ ,  $k$  expands, meaning the follower in this marginal state is falling further behind, and—because the leader invests consistently in all states 0 through  $k$  to retain leadership—the follower's prospect of catching up and becoming a future leader diminishes and becomes too low once he falls to over  $k$  steps behind. In other words, once sufficiently behind, the prospect of becoming a future leader is perceived to be too low even for a patient follower, who then gives up endogenously.

Proposition 1 is an aggregate result that builds on sharp analytic characterizations of the dynamic game between duopolists in each market. The duopolist game is rooted in models of dynamic patent races and is notoriously difficult to analyze: the state variable follows an endogenous stochastic process, and firms' value functions are recursively defined hence depend on flow payoffs and investment decisions in every state of the ergodic steady-state distribution  $\{\mu_s\}_{s=0}^{n+1}$ . Even seminal papers in the literature rely on numerical methods (e.g. [Budd et al. \(1993\)](#), [Acmoglu and Akcigit \(2012\)](#)) or restrictive simplifications<sup>8</sup> to make the analysis tractable. Relative to the literature, our analysis of an economy in a low-rate environment is further complicated by the fact that, as  $r$  declines, the ergodic state space  $\{0, 1, \dots, n + 1\}$  expands indefinitely.

In order to obtain Proposition 1, we derive a set of results that characterize the asymptotic equilibrium as  $r \rightarrow 0$ , effectively enabling us to analytically solve for the value functions as a first-order approximation around  $r = 0$  and analytically characterize the rate at which equilibrium investments ( $k$  and  $n$ ) diverge to infinity as  $r \rightarrow 0$ . We relegate the formal proof to the appendix. In what follows, we provide a sketch of the proof, in four steps. Each step aims to explain a specific feature in the shape of value functions. We use  $x \rightarrow y$  to denote  $\lim_{r \rightarrow 0} x = y$ . Note that

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<sup>8</sup>For instance, [Aghion et al. \(2001\)](#) and [Aghion et al. \(2005\)](#) assume leaders do not invest in all  $s \geq 1$ , effectively restricting the ergodic state space as  $\{0, 1\}$ .

flow profits are bounded above by 1 (recall 1 the flow profit earned by a monopolist who charges infinite markup), hence  $rv_s \leq 1$  for all  $s$ .

**Step 1: the value of leader in state  $n + 1$  is asymptotically large.** Formally,  $\lim_{r \rightarrow 0} rv_{n+1} > 0$ . To see this, note the leader stops investing in state  $n + 1$  if and only if the marginal investment cost is higher than the change in value function, implying

$$c \geq v_{n+2} - v_{n+1} \geq \frac{\pi_{n+2} - rv_{n+1}}{r + \kappa}, \quad (6)$$

where the last inequality follows from rearranging the HJB equation (2) for state  $n + 2$ . This in turn generates a lower bound for  $rv_{n+1}$ :

$$rv_{n+1} \geq \pi_{n+2} - c(r + \kappa) \rightarrow \pi - c\kappa.$$

**Step 2: the value of follower in state  $k + 1$  is asymptotically small.** Formally,  $rv_{-(k+1)} = 0$ . This is because even a patient follower finds the marginal change in value function  $v_{-k} - v_{-(k+1)}$  not worth the investment cost, despite knowing that, if he gives up, the market structure tends to move in the leader's favor indefinitely, as the leader will continue to invest in many states beyond  $k + 1$ . As  $(n - k)$  grows large,  $v_{-k} - v_{-(k+1)}$  is small if and only if  $v_{-k}$  is low.

**Step 3: the value of being in the neck-to-neck state is asymptotically small.** Formally,  $rv_0 \rightarrow 0$ . This is because as  $k \rightarrow \infty$ , the market in state zero could expect to spend a significant fraction of time in the competitive region (states  $s = 1, \dots, k$ ), in which both firms invest at the upperbound and the joint flow payoff is negative ( $\pi_s + \pi_{-s} < 2c\eta$  under Assumption 1). In an equilibrium,  $k$  must diverge at a rate exactly consistent with an asymptotically small  $v_0$  ( $rv_0 \rightarrow 0$ ). Because firms are forward-looking, an asymptotically large  $v_0$  can only be consistent with a slowly rising  $k$  as  $r \rightarrow 0$ , but this in turn implies that  $v_{-k}$  must be large which contradicts the earlier statement  $rv_{-k} \rightarrow 0$ . Conversely, the fact that  $v_0$  must be non-negative (as firms can always guarantee at least zero payoff over every instance) imposes an upper bound on the rate at which  $k$  diverges.

**Step 4: a leader experiences an asymptotically large decline in value as he falls from the monopolistic region into the competitive region.** Formally,  $\lim_{r \rightarrow 0} r(v_{k+1} - v_k) > 0$ . This follows from the fact that  $v_{n+1}$  is asymptotically large (step 3) and  $v_0$  is asymptotically small (step 1).

Step 4 implies that falling back into the competitive region is costly for the leader. Hence, starting from state  $k + 1$ , the leader keeps investing in additional states to consolidate market power and to diminish the prospect of falling back. The firm value increases as the productivity gap widens, and the leader stops only when the value function is sufficiently high, as characterized by (6). As a leader becomes infinitely patient, he must invest in sufficiently many states beyond  $k$  until the prospect of falling back into the competitive region vanishes, thereby perpetuating market leadership and causing the monopolistic region to become endogenously absorbing<sup>9</sup>.

## 2.4 Closing the model

Our focus has been on understanding how the supply side, or production side, of the economy responds to a fall in long-term interest rates. It is relatively straightforward to close the model in general equilibrium by adding a demand-side through an Euler equation following [Aghion et al. \(2001\)](#) and [Benigno and Fornaro \(2019\)](#). Closing the model also explicitly identifies that movements in the interest rate might come from shifts in the Euler equation on the demand side. We formally introduce the demand-side and solve for equilibrium interest rate and growth rate. Consider inter-temporal preferences

$$\int_0^{\infty} U(t)^{\frac{\theta-1}{\theta}} e^{-\rho t} dt$$

that generate an Euler equation  $g(t) = \dot{Y}(t) = \frac{1}{\theta} (r(t) - \rho)$ , which is an upward-sloping relationship between the aggregate growth rate  $g$  and interest rate  $r$ . Coupled with the production side inverted-U relationship between  $g$  and  $r$ , the two curves pin down the level of the growth rate and interest rate on a balanced growth path, along with a stationary distribution of productivity gaps across markets.

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<sup>9</sup>While we have focused on steady state dynamics in this section, section B.2 in the appendix solves for transition dynamics for productivity and market power

Interest rate shocks that we refer to in the main text can be simply seen as shocks to the consumer discount rate  $\rho$  (as in [Krugman \(1998\)](#)). An issue with this interpretation is that the interest rate is bounded below by the discount rate  $\rho$ , and any positive growth rate is incompatible with the interest rate being close to zero even as  $\rho \rightarrow 0$ . This issue is an artifact of the consumer side being frictionless; any incomplete markets and idiosyncratic risk would generate additional terms in the Euler equation that push down the real interest rate for any level of the growth rate. For instance, [Benigno and Fornaro \(2019\)](#) use idiosyncratic, uninsurable unemployment risk to microfound the following Euler equation

$$g(t) = \frac{1}{\theta} (r(t) - \rho + b).$$

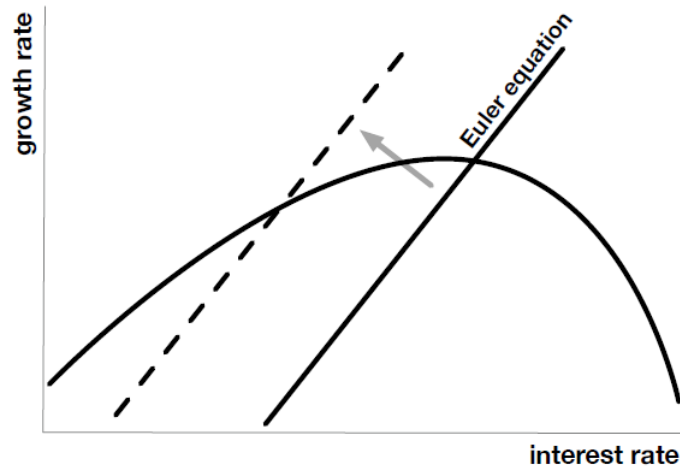
The term  $b \geq 0$  measures the severity of the unemployment risk under their specific microfoundation model, but it can be more broadly seen as a catch-all term for any shock on the consumer side that pushes consumers towards saving more and consuming less, including changes in preferences, tightened borrowing constraints (e.g., [Eggertsson and Krugman \(2012\)](#)), or structural shifts such as an aging population and rising inequality (e.g., [Summers \(2014\)](#)).

Figure 3 shows the consumer-side Euler equation as an upward sloping line. An inward shift in the consumer-side curve lowers the interest rate and increases concentration. If the prevailing interest rates are low, (i.e., if the economy is on the upward sloping region of the production-side curve), then a decline in the interest rate is also contractionary as productivity growth slows.

Hence, the model presents an alternative interpretation of “secular stagnation.” As in traditional secular stagnation explanations, an initial inward shift in the consumer-side curve can lower equilibrium interest rates to very low levels. However, “stagnation” is not due to monetary constraints such as the zero lower bound or nominal rigidities. Instead, a large fall in interest rates can make the economy more monopolistic for reasons laid out in the model, thereby lowering innovation and productivity growth.



Figure 3: Growth and interest rates in general equilibrium



### 3 Empirical evidence for steady state predictions

Proposition 1 summarizes our main result that the strategic contractionary effect dominates the traditional expansionary effect at low interest rates. The result is based on steady-state analysis and has a number of predictions regarding the longer-run relationship between outcome variables such as market concentration, productivity growth and leader-follower investment gap, and the interest rate. We summarize these predictions and test them empirically in this section.

First, our model predicts that a fall in long-term rate is associated with a rise in market concentration. The left panel of Figure A5 in the appendix plots the profit share of GDP against the 10-year real U.S. Treasury rate over time and it shows a negative correlation. The right panel shows a negative correlation between the share of market value that goes to the top-5 percents of firms within an industry and the 10-year treasury rate<sup>10</sup>. Market concentration increases as the long-term interest rate declines.

Second, our model shows that as interest rates decline, “business dynamism,” defined as the likelihood of a follower overtaking the leader, declines. One proxy for firm dynamism uses establishment entry and exit information for the United States from 1985 to 2014.<sup>11</sup> Figure A6 in the

<sup>10</sup>each industry is weighted by market value in calculating the aggregate concentration measure

<sup>11</sup>The establishment entry and exit rates time series for the United States comes from the US Census’ Business Dynamics Statistics database.

appendix shows that lower interest rates are associated with both a decline in the entry and exit rates of establishments in the United States. From the model's perspective, this decline in business dynamism reflects higher market power of industry leaders and the reduced incentives to enter new markets by followers.

Third, as figure 1 showed, proposition 1 predicts a decline in productivity growth for  $r < r_g^*$ . As is well-known in the productivity literature (e.g., [Cette et al. \(2016\)](#)), there is a marked slowdown in productivity growth in many advanced economies around 2005, well before the Great Recession. This suggests that there is a common global factor, not related to the Great Recession, that may be responsible for the growth slowdown. Our model suggests the low level of long-term rates is a possible factor.<sup>12</sup>

Fourth, proposition 1 shows that as interest rates decline toward zero, the steady state *average gap* in productivity growth between leaders and followers widens. [Berlingieri et al. \(2017\)](#) use firm level productivity data from OECD countries and estimate productivity separately for “leaders”, defined as firms in the 90th percentile of the labor productivity distribution for a given 2-digit industry, and “followers” defined as firms in the 10th percentile of the distribution.

The authors show that, consistent with Proposition 1, the gap between leaders and followers increased steadily from 2000 to 2014 as long term interest rates fell. Figure A7 in the appendix shows their main result. The left panel shows that as interest rates fell from 2000 to 2014, the gap in labor productivity between leaders and followers (within an industry) grew for both manufacturing and services firms. The right panel shows that the larger gap in productivity between leaders and followers is robust to using alternative multi-factor productivity measures. A similar result is found in the study by [Andrews et al. \(2016\)](#), which shows a widening gap in labor productivity of frontier versus laggard firms in both manufacturing and services for OECD firms.

The study by [Andrews et al. \(2016\)](#) also shows additional cross-sectional evidence in support of the model. In particular, the study shows that industries in which the productivity gap between the leader and the follower is *rising* the most are the same industries where sector-aggregate pro-

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<sup>12</sup>As in the model, investment as a share of GDP has also declined with lower interest rates. In related papers, [Jones and Philippon \(2016\)](#) show that increase in industry concentration is associated with lower firm investment and [Gutiérrez and Philippon \(2016\)](#) show that investment is not correlated with market valuation and profitability after 2000s.

ductivity is *falling* the most. This is a subtle prediction of the model that is borne out in the data. Both the model and the data suggest that low interest rates lead to a large gap between the leader and follower in productivity investment; as a result, total investment in productivity of the industry falls.

Fifth, relatedly, investment and innovation gap between industry leaders and followers also increases as interest rate falls. Using compustat data, the left panel of figure A8 in the appendix shows that the share of capital expenditure going to the top 5% of firms within an industry has increased over time as interest rate declined. The right panel shows that the share of patents going to industry leaders has also increased over time as interest rate fell. The patent count data is from Leonid Kogan and Stoffman (2017), and covers all utility patents issued in the period between 1926 and 2010. We match this data to Compustat firms to construct patent concentration ratio within an industry over time. Industry concentration ratios are averaged using industry market values.

The long-term relationship between interest rate and the outcomes discussed above is consistent with our model's predictions. The model thus provides a parsimonious and unified description of a number of important macro variables.

## **4 Asymmetric valuation response of leaders vs. followers to interest rate shocks**

Outcome variables analyzed in the previous section, such as market concentration and productivity growth, are slow moving, which limits the statistical power of how much we can learn from the analysis. However, as we explain in this section, our theory has very specific predictions regarding the relative change in valuation of industry leaders versus followers when interest rates change. We use these predictions to generate additional empirical tests based on higher frequency stock market data on firm valuation.

## 4.1 Asymmetric valuation responses: theory

Our key mechanism implies that, starting from a steady-state with a low interest rate, a further decline in  $r$  raises the expected future cash flows of current market leaders by causing their leadership to become more persistent. Hence, on impact, a decline in  $r$  immediately raises the firm value of market leaders relative to followers, and the asymmetric valuation response is larger at lower pre-shock levels of the interest rate. We now formalize this result and explain the intuition behind it.

Let us start with a steady-state economy with interest rate  $r$  and consider an unexpected and permanent decline in the interest rate  $-\Delta r$ . Lower discounting of future cash flows raises market values of all firms; moreover, investment decisions respond endogenously, further affecting firm valuations. Let us focus on the immediate, on-impact effect of the shock on the *relative* firm value between market leaders and followers. Let  $v_s$  and  $\hat{v}_s$  respectively denote the pre- and post-shock value function in state  $s$ . Define  $\frac{\hat{V}^L}{V^L} \equiv \frac{\sum_{s=0}^{\infty} \mu_s \hat{v}_s}{\sum_{s=0}^{\infty} \mu_s v_s}$ . Note that the numerator evaluates leaders' market value in the new equilibrium using the productivity gap distribution from the pre-shock steady-state; therefore,  $\Delta \ln V^L \equiv \frac{\hat{V}^L}{V^L} - 1$  captures the *on-impact* effect of the interest rate shock  $-\Delta r$  on the total value of market leaders, before the economy starts transitioning to the new, post-shock steady-state. We define  $\frac{\hat{V}^F}{V^F}$  and  $\Delta \ln V^F$  analogously for followers.

**Proposition 2.** *Consider a steady-state with interest rate  $r$ . As a first-order approximation around  $r \approx 0$ , a permanent decline in the interest rate has the following on-impact, proportional effect on the valuation of leaders and followers:*

$$-\frac{\Delta \ln V^L}{\Delta r} = \frac{1}{r} \quad \text{and} \quad -\frac{\Delta \ln V^F}{\Delta r} = \frac{1}{-r \ln r} \quad .$$

The proposition states that, starting from a steady-state with low  $r$ , a small decline in the interest rate  $-\Delta r$  immediately raises leaders' market value by a proportion of  $1/r$  and raises followers' value by a proportion of  $1/(r \ln r)$ . The relative valuation response between leaders and followers,  $\frac{-\Delta \ln V^L / \Delta r}{-\Delta \ln V^F / \Delta r} = -\ln r$ , increases and diverges to infinity as  $r \rightarrow 0$ .

Proposition 2 implies an empirically-testable prediction about the on-impact asymmetric response in market value to a decline in the interest rate. Starting from a low- $r$  steady-state and

following an unexpected further decline in the interest rate, market leaders at the time of the shock should experience immediate valuation gains relative to market followers. The asymmetric valuation effect should be more pronounced when the pre-shock interest rate is lower.

Importantly, low  $r$  affects relative firm valuations not only through changing the discount rate but also through changes in future cash flows that favor the current market leaders. These predictions would not emerge naturally from other models, and they form a powerful test of our model's dynamics.

The concept of duration helps elucidate the intuition behind the proposition. Formally, the duration of a financial asset is the sensitivity of its log-valuation to the interest rate:  $D \equiv -\Delta(\ln V)/\Delta r$ . The duration of a zero coupon bond that matures at time  $T$  is exactly equal to  $T$ ; more generally, the duration of an asset is a weighted average of the payout time. If a cash flow stream has more cash flow in the future then  $D$  is higher. Moreover, as  $r$  falls, cash flows that are further away in the future will receive larger weights. A firm with cash-flows in the more distant future will see its  $D$  rise as  $r$  falls. The sensitivity of duration to  $r$ —the second derivative of valuation with respect to  $r$ —is termed as "convexity".

Proposition 2 implies that, starting from a low- $r$  steady-state, the average leader has a higher duration as well as a higher convexity than the average follower. This result might seem puzzling at first: markets are ergodic in the model, and therefore it is actually the followers who have more profits in the future, as they eventually catch up after a sufficiently long time. In this sense, *holding cash-flows constant*, followers in the model should have a payoff stream with higher duration than leaders. Therefore, followers should mechanically benefit from a decline in the interest rate.

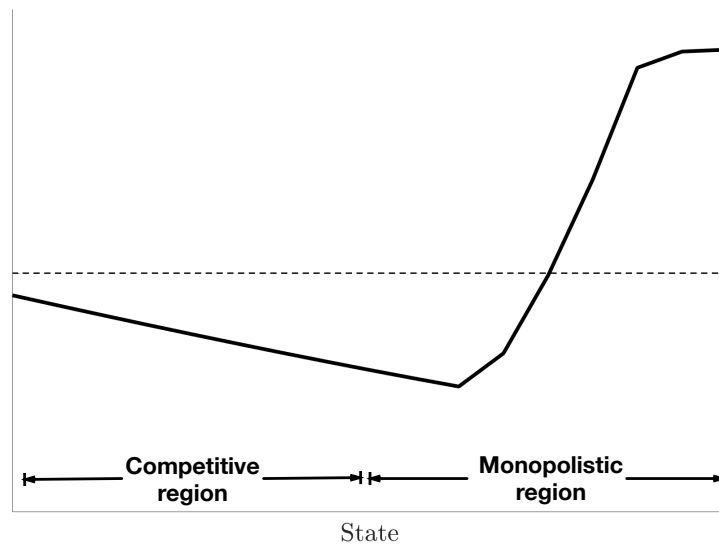
Why do leaders have higher steady-state duration than followers at low rates, as implied by Proposition 2? This is because investments respond endogenously to interest rates, and, consequently, *cash flows are expected to change*. Leaders tend to raise investments more than followers do. The endogenous investment response increases leader's duration and the persistence of market power. Changes in future cash flows are key in explaining why leaders may have longer duration than followers.

The proposition shows that, if the interest rate declines from an already low level, the endoge-

nous investment response dominates the mechanical duration effect, and therefore leader value unambiguously increases more than follower value. To understand why the asymmetric valuation effect depends on the initial, pre-shock levels of interest rate, note that the endogenous investment and valuation responses of leaders and followers to a sudden decline in  $r$  depend on the productivity gap in the respective industries.

If a state is inside or close to the competitive region, a lower interest rate actually reduces the relative value of leaders versus followers: because of the followers' investment responses, maintaining leadership becomes more difficult. On the other hand, in a state closer to the end of the monopolistic regions, a lower interest rate boosts the relative value of leaders versus followers because, as the far-ahead leaders now raise investments following lower  $r$ , the productivity gap tends to widen even further than in the previous steady-state. Figure 4 below visualizes the intuition. It plots, after a decline in  $r$ , the state-by-state valuation response of market leaders relative to the average follower in the economy (i.e. it plots  $\frac{\Delta \ln v_s / \Delta r}{\Delta \ln V^L / \Delta s}$  for  $s \geq 0$ ).

Figure 4: State-by-state change in leader's value relative to the average follower



Proposition 2 aggregates these state-by-state valuation effects to the entire economy. Following the result of Proposition 1, if the initial interest rate is high, the steady-state features a significant mass of markets in the competitive region and a small mass of markets in the monopolistic region.

Therefore, the average leader in the economy experiences a valuation loss relative to the average follower if the interest rate declines. Conversely, starting from a low- $r$  steady-state, a large fraction of markets are deep into the monopolistic region, and, therefore, the average leader experiences valuation gains relative to the average follower in the economy when the interest rate declines. The lower is the initial interest rate, the stronger is this asymmetry.

This reasoning suggests that whether leaders benefit from a negative shock to the interest rate depends on the initial interest rate in the steady-state. There exists a critical level of interest rate,  $r_{val}^*$ , below which a negative interest rate shock  $-\Delta r$  benefits leaders and above which the shock benefits followers. Figure 5 numerically verifies that this is indeed the case. Starting from a high-level of interest rate ( $r > r_{val}^*$ ), a decline in  $r$  hurts leaders on average; yet, starting from a low-level of  $r$  ( $r < r_{val}^*$ ), a further decline in  $r$  unambiguously causes leaders' market value to appreciate relative to followers,' and the asymmetry becomes stronger when the initial pre-shock level of interest rate is lower.

Figure 5: Asymmetric valuation effects: plotting  $\frac{\hat{V}^L/V^L}{\hat{V}^F/V^F}$  at various initial  $r$

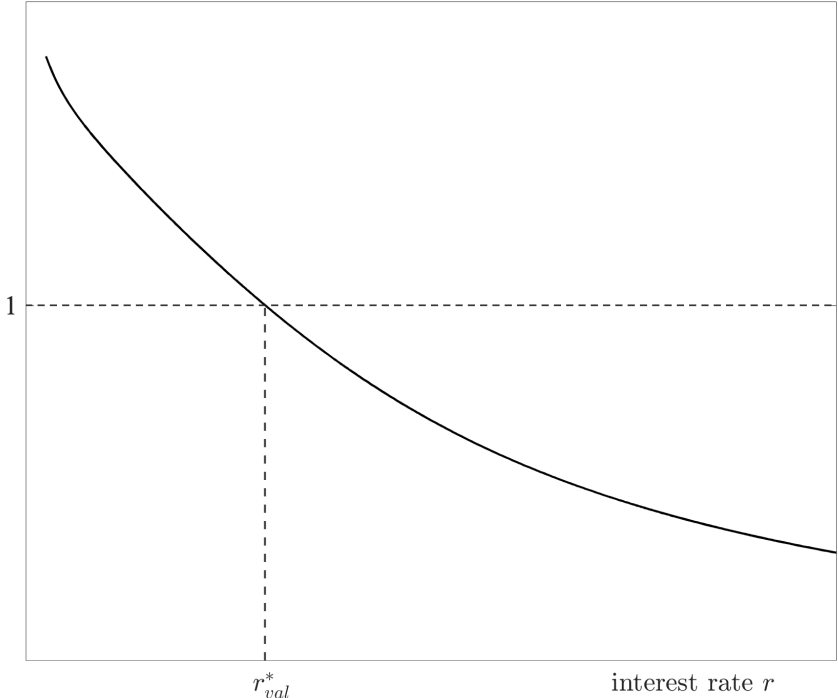


Figure A2 in the appendix demonstrates the entire time path of the relative valuation between leaders and followers. Starting from a steady-state and following a sudden but permanent decline in the interest rate, the relative market value of all leaders relative to all followers experiences a discrete jump, as characterized by Proposition 2. As time proceeds, the average productivity gap rises, and the relative valuation continues to increase until it eventually converges to the new steady-state level.

## 4.2 Testing the asymmetric effects of interest rate shocks on firm value

Proposition 2 implies that, starting from a low level of the interest rate, a decline in the interest rate immediately raises the relative market value of leaders versus followers, and this effect magnifies as interest rate goes to zero. The empirical analysis presented here implements a triple difference-in-difference specification to test this prediction.

The data set for the analysis is the CRSP-Compustat merged data set from 1980 onward, which is used to compute excess returns for industry leaders versus followers in response to a change in interest rates. The 10-year Treasury yield is used as the default measure of the long-run interest rate, and robustness tests using the real interest rate and alternative definitions of the interest rate yield are also shown.<sup>13</sup>

The analysis focuses on 1980 onward as the default time period since this is the period over which the most consistent time series (e.g., for the real interest rate) is available. Nonetheless, robustness tests are shown for the earliest available CRSP-Compustat data set from 1960 onward. The 10-year yield is used because it is the longest available historical time series. The Fama-French definition is the default classification for industries, and results using alternative definitions of industries are shown as robustness tests.

The baseline definition of industry “leaders” is size as measured by market value. A firm is classified as an industry leader if it is in the top 5 percent of firms in the industry based on market value at the beginning of the period when excess returns are computed. We also use the top five

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<sup>13</sup>We prefer using the nominal interest rate given the measurement error introduced in attempting to measure the real interest rate. Inflation expectations have been relatively well-anchored during the time period analyzed.



firms in an industry for robustness. Robustness results in the appendix show similar results when sorting firms based on EBITDA and sales.

The key empirical test implied by the model at the firm level can be written as,

$$R_{i,j,t} = \alpha_{j,t} + \beta_0 D_{i,j,t-1} + \beta_1 D_{i,j,t-1} * \Delta i_t + \beta_2 D_{i,j,t-1} * i_{t-1} + \beta_3 D_{i,j,t-1} * \Delta i_t * i_{t-1} + \varepsilon_{i,j,t} \quad (7)$$

where  $R_{i,j,t}$  is the dividend and split-adjusted stock return of firm  $i$  in industry  $j$  from date  $t - 91$  days to  $t$  (i.e., one quarter growth), and  $D_{i,j,t-1}$  is an indicator variable equal to 1 if firm  $i$  is in the top 5% of market capitalization in its industry  $j$  at date  $t - 91$ . Firms with  $D_{i,j,t-1}=1$  are called leaders while the rest are called followers. The variable  $i_t$  is the 10-year interest rate, with  $i_{t-1}$  being the interest rate 91 days prior and  $\Delta i_t$  being the change in the interest rate from date  $t - 91$  to  $t$ . All regressions are value-weighted and standard errors are dually clustered by industry and date. The parameters  $\alpha_{j,t}$  are industry-time period fixed effects.

The key coefficients of interest are  $\beta_1$  and  $\beta_3$ . A negative estimate of  $\beta_1$  implies that a decline in the interest rate leads to a larger increase in the stock return of industry leaders. A positive estimate of  $\beta_3$  implies that this effect is stronger when the level of interest rates is lower. In other words, a negative estimate of  $\beta_1$  and a positive estimate of  $\beta_3$  signify that industry leaders experience higher excess returns when interest rates fall, and this effect is amplified when interest rates start from a low level. This is the key prediction of the model.

Table 1 shows the results of estimating (7) on the merged CRSP-Compustat data set from 1980 onward. Only the relevant coefficients are displayed in the tables, but the actual regression includes all variables specified in the equation (7). Column (1) estimates equation (7) without interactions with the level of interest rate. The coefficient  $\beta_1$  is negative and significant; leaders earn positive excess return when the interest rate falls.

Column (2) presents estimates from the full specification (7). The coefficient  $\beta_3$  is positive and significant as predicted by the model. Excess returns for leaders are *higher* in response to a fall in the interest rate when the level of the interest rate is lower. This is succinctly captured by  $\beta_1$  which reflects the increase in excess returns when interest rates fall near the zero lower bound (i.e., when  $i_{t-1} \approx 0$ ). The excess return near the zero lower bound in column (2) (3.88) is three times the

Table 1: Differential Interest Rate Responses of Leaders vs. Followers: Top 5 Percent

	Stock Return					
	(1)	(2)	(3)	(4)	(5)	(6)
Top 5 Percent=1 x $\Delta i$	-1.187*** (0.260)	-3.881** (1.113)	-4.415*** (0.893)	-3.582** (1.104)	-4.109*** (0.858)	-4.182*** (0.529)
Top 5 Percent=1 x $\Delta i$ x Lagged $i$		0.293** (0.095)	0.346*** (0.079)			0.301*** (0.045)
Top 5 Percent=1 x $\Delta i$ x Lagged real $i$ (Clev)				0.540** (0.197)	0.634*** (0.156)	
Firm $\beta$ x $\Delta i$						14.10*** (0.795)
Firm $\beta$ x $\Delta i$ x Lagged $i$						-1.260*** (0.082)
Sample						
Controls	N	N	Y	N	Y	
Industry-Date FE						Y
N	61,313,604	61,313,604	44,104,181	59,305,323	43,279,694	61,299,546
R-sq	0.403	0.403	0.415	0.400	0.413	0.409

Standard errors in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

Regression results for the specification  $\Delta \ln(P_{i,j,t}) = \alpha_{j,t} + \beta_0 D_{i,j,t} + \beta_1 D_{i,j,t} \Delta i_t + \beta_2 D_{i,j,t} i_{t-1} + \beta_3 D_{i,j,t} \Delta i_t i_{t-1} + X_{i,j,t} \gamma + \varepsilon_{i,j,t}$  for firm  $i$  in industry  $j$  at date  $t$ .  $\Delta \ln(P_{i,j,t})$  is defined here as the log change in the stock price for firm  $i$  in industry  $j$  from date  $t - 91$  to  $t$  (one quarter growth).  $D_{i,j,t}$  is defined here as an indicator equal to 1 at date  $t$  when a firm  $i$  is in the top 5% of market capitalization in its industry  $j$  on date  $t - 91$ . Firms with  $D_{i,j,t}=1$  are called leaders while the rest are called followers.  $i_t$  is defined as the nominal 10-year Treasury yield, with  $i_{t-1}$  being the interest rate 91 days prior and  $\Delta i_t$  being the change in the interest rate from date  $t - 91$  to  $t$ . Controls  $X$  include a firm's asset-liability ratio, debt-equity ratio, book-to-market ratio, and percent of pre-tax income that goes to taxes. Industry classifications are the Fama-French industry classifications (FF). Lagged real rates were built using monthly 10-year inflation expectations from the Cleveland Fed and the daily 10-year Treasury yield at the beginning of each month (post-1982). Standard errors are dually clustered by industry and date.

average excess return of 1.19 in column (1).

One concern with these results is that the measure of industry leaders is spuriously correlated with balance sheet factors that are more sensitive to interest rate movements. For example, perhaps leaders are more levered and a fall in the interest rate helps lower the interest burden. To test for this, and other related concerns, we include a number of firm level characteristics as controls by including all the interaction of the firm level characteristic with the change in interest rate as well as the level of the interest rate. We include the following firm-level characteristics, a firm's asset-liability ratio, debt-equity ratio, book-to-market ratio, and the percent of pre-tax income that goes to taxes. The number of observations decreases because we have to limit the sample to Com-

pustat firms with the available data on firm financials. Column (3) shows that the inclusion of this extensive list of firm-level controls does not change the coefficients of interest materially.

Columns (4) and (5) use the ten year real interest rate for the *level* of the lagged interest rate in equation (7). The change in the interest rate continues to be measured by the change in the 10-year nominal bond yield given that there are no reasonable estimates of the change in the real yield over short time intervals. Furthermore, the change in nominal and real yields over short horizon is likely to be dominated by the change in the nominal interest rate. The real interest rate is calculated by subtracting 10-year inflation expectations published by the Cleveland Federal Reserve. Using the real interest rate, the coefficient ( $\beta_3$ ) on the interaction term increases significantly.

Column (6) controls for another potentially spurious firm-level attribute. What if industry leaders are spuriously more cyclical? If a fall in the interest rate represents changing economic expectations, industry leaders might generally be more responsive to changing market conditions irrespective of the level of interest rate. To test for this possibility, the market beta of each firm is estimated using historical data as of  $t - 1$  and then it is interacted with both the change in the interest rate and the level of the interest rate in column (6). As before, the main coefficients of interest are not materially affected.

Table 2 performs a time-series version of the excess return test implemented in Table 1. In particular, the results are based on the following specification,

$$R_t = \alpha + \beta_0 i_{t-1} + \beta_1 \Delta i_t + \beta_2 \Delta i_t * i_{t-1} + \varepsilon_t \quad (8)$$

where  $R_t$  is the market-capitalization weighted average of returns for a stock portfolio that goes long industry-leader stocks and goes short industry-follower stocks from date  $t - 91$  to  $t$ . We refer to this portfolio as the “leader portfolio.” Given that observations have overlapping differences, we compute standard errors using a Newey-West procedure with a maximum lag length of 60 days to account for built-in correlation. A negative estimate of coefficient  $\beta_1$  would signify that a decline in interest rates boosts the return on the leader portfolio, while a positive estimate of  $\beta_2$  would signify that the positive response of the return on the leader portfolio to a decline in interest rates is larger when the level of the interest rate is lower.

Table 2: Portfolio Returns Response to Interest Rate Changes: Top 5 Percent

	Portfolio Return					
	(1)	(2)	(3)	(4)	(5)	(6)
$\Delta i_t$	-1.150*** (0.309)	-3.819*** (0.641)	-3.515*** (0.591)	-2.268*** (0.602)	-3.657*** (0.949)	-3.115*** (0.768)
$i_{t-1}$		0.0842 (0.050)		0.0336 (0.044)	0.160* (0.071)	0.148* (0.070)
$\Delta i_t \times i_{t-1}$		0.294*** (0.059)		0.117* (0.056)	0.328*** (0.081)	0.255* (0.100)
real $i_{t-1}$ (Clev)			0.179* (0.079)			
$\Delta i_t \times$ real $i_{t-1}$ (Clev)			0.535*** (0.120)			
Excess Market Return				-0.168*** (0.023)		
High Minus Low				0.0371 (0.044)		
$(\Delta i_t > 0)=1 \times \Delta i_t$					0.341 (1.717)	
$(\Delta i_t > 0)=1 \times \Delta i_t \times i_{t-1}$					-0.102 (0.170)	
PE Portfolio Return						-0.293*** (0.074)
N	9,016	9,016	8,597	9,016	9,016	7,402
R-sq	0.044	0.089	0.087	0.228	0.092	0.219

Standard errors in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

Regression results for the specification  $R_t = \alpha + \beta_0 i_{t-1} + \beta_1 \Delta i_t + \beta_2 \Delta i_t i_{t-1} + \varepsilon_t$  at date  $t$ .  $R_t$  is defined as the market-capitalization weighted average of returns for a stock portfolio that goes long in leader stocks and goes short in follower stocks from date  $t - 91$  to  $t$ . Leaders are defined as the firms in the top 5% of market capitalization in its FF industry on date  $t - 91$ .  $i_t$  is defined as the nominal 10-year Treasury yield, with  $i_{t-1}$  being the interest rate 91 days prior and  $\Delta i_t$  being the change in the interest rate from date  $t - 91$  to  $t$ . Standard errors are Newey-West with a maximum lag length of 60 days prior. Real rates were built using monthly 10-year inflation expectations from the Cleveland Fed and the daily 10-year Treasury yield (post-1982). In column 5, the terms  $(\Delta i_t > 0) = 1$  and  $(\Delta i_t > 0) = 1 \times i_{t-1}$  were suppressed from the table. Their coefficients are 0.0222 (0.602) and -0.0616 (0.086), respectively.

The estimates reported in columns (1) and (2) confirm earlier results. A decline in the interest rate is associated with positive returns for the leader portfolio, and this positive return response to a decline in the interest rate is larger in magnitude when the interest rate is lower. Column (3) uses the 10-year real interest rate level as before. The coefficient on the interaction between the real rate and the change in interest rate is even stronger than in Table 1 (0.54 versus 0.30).

Column (4) shows that the results are not driven by the excess market return of the HML fac-

tor.<sup>14</sup> Column (5) shows that the results are driven by both positive and negative changes in interest rates. In particular, the excess return results are materially unchanged whether only positive changes in interest rates or only negative changes in interest rate are used.

Column (6) shows that our empirical results are not driven by industry leaders have higher duration for mechanical or spurious reasons. If industry leaders had higher duration for spurious reasons, then they would have higher P/E ratio and the difference in P/E ratio between industry leader and follower at the time of interest rate shock would explain our asymmetric valuation response to a decline in  $r$ . Column (6) controls for a “PE portfolio” that is long the top 5% of firms by PE in an industry and short the rest. Inclusion of the PE portfolio return does not change the coefficients of interest, and the leader-minus-follower portfolio is itself negatively correlated with the PE portfolio.<sup>15</sup> This result shows that lower  $r$  impacts relative firm valuations not only through changing the discount rate but also through endogenous changes in future cash flows that favor the current leader as our model predicts.

Tables A1 and A2 in appendix show the robustness of results in Tables 1 and 2 to using CRSP-Compustat data from 1960 onward.<sup>16</sup> Table A3 in the appendix shows robustness to alternative definitions: top 5 instead of top 5 percent for industry leadership, SIC instead of Fama French industry classification, and sorting on EBITDA and sales instead of market value for defining leadership.

The baseline specification constructs returns and interest rate changes at a quarterly frequency. This reflects our view that this is the appropriate frequency because it captures interest rate movements that are deemed more permanent. Figure 6 plots the histograms of interest rate changes in the sample, from daily to annual frequency. On average interest rates went down during this time period. However, there is substantial variation with the change in the interest rate being positive on a high fraction of days. As already shown, the key findings are symmetric to whether the change in the interest rate is positive or negative.

As one moves from daily to annual frequency, the range of interest rate changes increases. This

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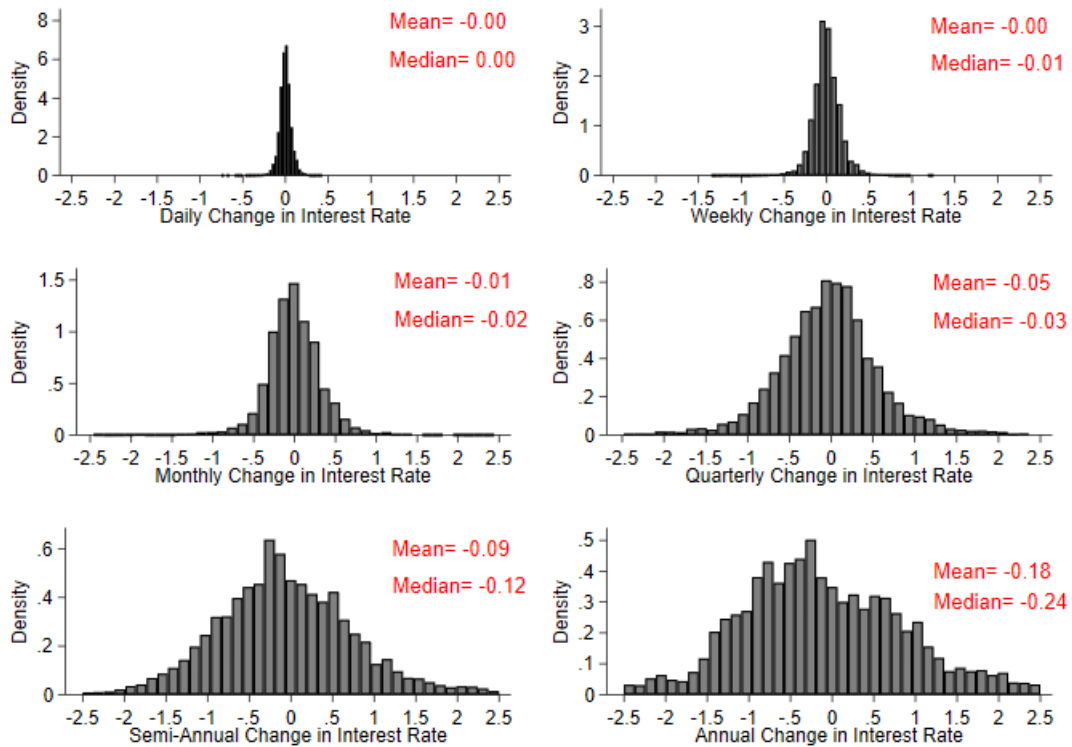
<sup>14</sup>We cannot control for the small minus big size factor because it is very highly correlated with the leader portfolio.

<sup>15</sup>The number of observations declines because earnings data are missing on certain dates.

<sup>16</sup>Real interest rate prior to 1980 is computed by subtracting realized inflation from the nominal rate.

is another reason to focus on longer term differences; investors need sufficient time to incorporate a large change in interest rates when forming expectations. Table A4 in the appendix repeats the core specification for interest rate changes at frequencies ranging from daily to annual. For reasons discussed above, the effect tends to be stronger when the interest rate change is computed over longer horizons.

Figure 6: Distribution of Interest Rate Changes at Varying Frequencies



The panels plots the histograms of interest rate changes in our sample, from daily to annually.

Another robustness test concerns the exact interest rate used in the specification. For example, do the excess return results depend on whether the change in the interest rate is at the short versus the long end of the yield curve? Statistically this is a somewhat hard test to perform because interest rate movements along the yield curve tend to be highly correlated. Table A5 in the appendix shows the correlation matrix of quarterly changes in forward rates of varying non-overlapping durations. The correlations are generally quite high, leading to problems of collinearity in joint testing. The lowest correlation is in the range of 0.7 to 0.75 between change in 0-2 forward rate and longer term forward rates (e.g. 10-30).

Table 3 presents estimates of equation (8) using the forward rate of varying duration. The main takeaway is that the results shown above are similar for interest rate changes throughout the yield curve (columns (1) through (6)). When both the 0-2 and 10-30 forward rates are put in the specification together (columns (7) and (8)), both ends of the yield curve appear to be independently important, with some evidence that the longer end of the yield curve is more important.

Table 3: Portfolio Returns Response to Interest Rate Changes: Along the Yield Curve

	30-Year		2-Year		10-30 Forward		2-Year & 10-30 Fwd.	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
$\Delta i_t$	-1.129**	-4.537***						
	(0.348)	(0.826)						
$\Delta i_t \times i_{t-1}$		0.362***						
		(0.077)						
$\Delta i_{t,0,2}$			-0.584*	-3.535***			-0.126	-2.066*
			(0.244)	(0.833)			(0.349)	(0.970)
$\Delta i_{t,0,2} \times i_{t-1}$				0.280***				0.145
				(0.069)				(0.080)
$\Delta i_{t,10,30}$					-1.084**	-4.165***	-0.938	-3.138**
					(0.354)	(0.835)	(0.523)	(1.043)
$\Delta i_{t,10,30} \times i_{t-1}$						0.334***		0.289**
						(0.080)		(0.107)
N	8,006	8,006	8,065	8,065	8,006	8,006	8,006	8,006
R-sq	0.036	0.078	0.021	0.063	0.030	0.066	0.031	0.084

Standard errors in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

Regression results for the specification  $R_t = \alpha + \beta_0 i_{t-1} + \beta_1 \Delta i_t + \beta_2 \Delta i_t i_{t-1} + \varepsilon_t$  at date  $t$  in columns 1-2 and  $R_t = \alpha + \beta_0 i_{t-1} + \beta_{1,1} \Delta i_{t,0,2} + \beta_{1,2} \Delta i_{t,10,30} + \beta_{1,3} \Delta i_{t,0,10} + \beta_{2,1} \Delta i_{t,0,2} i_{t-1} + \beta_{2,2} \Delta i_{t,10,30} i_{t-1} + \beta_{2,3} \Delta i_{t,0,10} i_{t-1} + \varepsilon_t$  at date  $t$  in columns 3-8.  $R_t$  is defined as the market-capitalization weighted average of returns for a stock portfolio that goes long in leader stocks and goes short in follower stocks from date  $t - 91$  to  $t$ . Leaders are defined as the firms in the top 5% of market capitalization in its FF industry on date  $t - J$ .  $i_t$  is defined as the nominal 30-year Treasury yield, with  $i_{t-1}$  being the interest rate  $J$  days prior and  $\Delta i_t$  being the change in the interest rate from date  $t - 91$  to  $t$ .  $i_{t,0,2}$ ,  $i_{t,0,10}$  and  $i_{t,10,30}$  are the 2-year and 10-year Treasury yield and 10 to 30 forward Treasury yield, respectively. Standard errors are Newey-West with a maximum lag length of 60 days prior. We cannot reject that the main and interaction coefficients in columns 7 and 8 are not equal.

Figure 7 plots the coefficients  $\{\beta_{0,j}\}$  of the following specification:

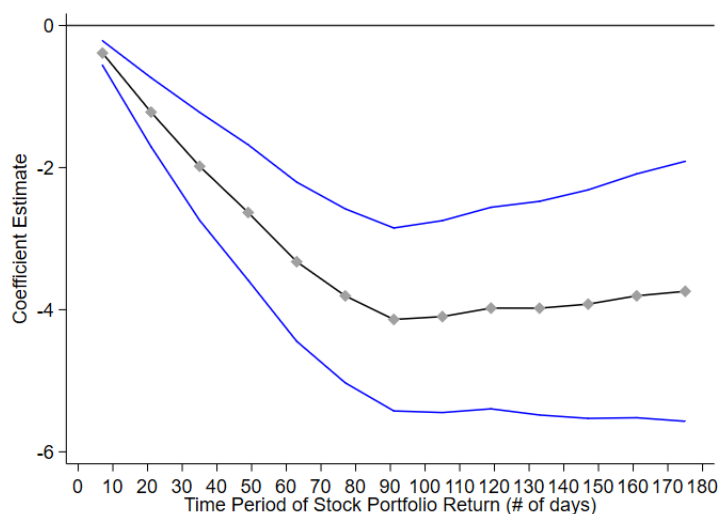
$$R_{t+j} = \alpha_j + \beta_{0,j} \Delta i_t + \beta_{1,j} \Delta i_{t-1} + \beta_{2,j} \Delta i_t * i_{t-1} + \varepsilon_t \quad (9)$$

$R_{t+j}$  is defined as the market-capitalization weighted average of returns for a stock portfolio that goes long in leader stocks and goes short in follower stocks from date  $t$  to  $t + j$ . In this specification,  $\Delta i_t$  is defined as the change in the interest rate from date  $t$  to  $t + 91$ . The coefficients  $\beta_{0,j}$  can be

interpreted as the effect of a change in interest rates from  $t - 91$  to  $t$  on the returns of the leader portfolio from time  $t$  to time  $t + j$  when the level of interest rates at  $t - 1$  is equal to zero. In other words, the figure represents the impulse response function at a daily frequency of the leader portfolio return to a change in interest rate over one quarter.

As the figure shows, the effect of a change in interest rates starts quickly but the full effect is not realized until about 90 days. Further, there is no evidence of reversal over the following quarter. The increase in the value of the leader portfolio is persistent.

Figure 7: Impulse Response of Changes in Interest Rate when Rate is Zero



The figure plots the coefficients  $\{\beta_{0,j}\}$  of the specification  $R_{t+j} = \alpha_j + \beta_{0,j}\Delta i_t + \beta_{1,j}\Delta i_{t-1} + \beta_{2,j}\Delta i_t * i_{t-1} + \varepsilon_t$  at date  $t$ .  $R_{t+j}$  is defined as the market-capitalization weighted average of returns for a stock portfolio that goes long in leader stocks and goes short in follower stocks from date  $t$  to  $t + j$ .  $\Delta i_t$  is defined here as the change in the interest rate from date  $t$  to  $t + 91$ . Leaders are defined as the firms in the top 5% of market capitalization in its FF industry on date  $t$ . Standard errors are Newey-West with a maximum lag length of 60 days prior.

## 5 Discussion of alternative modeling assumptions

The key force in our model is the desire by industry leaders to gain strategic advantage over followers by making it more difficult for followers to catch up. We feel that this force is quite natural in many, if not most, practical settings. In our model, strategic advantage can be acquired through building a large productivity lead. In the real world such incentives could also manifest through other actions that industry leaders might be able to undertake. For example, leaders may



have the opportunity to invest in defensive R&D, to erect entry barriers, or engage in predatory acquisitions. Our main result will be further strengthened in the presence of such possibilities. The key insight from our model is that low interest rate increases the incentive of leaders to engage in strategic investment that prevents future catch up by followers.

Our model's insight is also consistent with the notion that there is an ever expanding "kill zone" around industry giants' area of influence that makes it very difficult for young startups to thrive. As the Economist headlined in one of its recent reports, "American tech giants are making life tough for startups"<sup>17</sup>. Our theory highlights why such kill-zones are more likely to exist at very low interest rates.

There are alternative dynamic competition models that implicitly rule-out the possibility that leaders can build strategic advantage over followers by assuming that technological innovation is always leap-frog in nature (e.g. [Aghion et al. \(2001\)](#)). However, for our purposes, leap-frogging would be a somewhat extreme assumption since real world often gives leaders the opportunity to build strategic advantage. Moreover, it is easy to verify that leapfrogging would kill off leaders' strategic incentives, and we would not get leader's valuation to rise faster when  $r$  falls at low interest rates. Thus our empirical results reject the notion that leap-frogging is the dominant process through which firms compete.

Our model also made the assumption that the technologies for productivity improvements—the exogenous catch-up rate  $\kappa$  and the marginal cost of investment  $c$ —are independent of the productivity gap between the two firms. This assumption can be relaxed without materially changing the conclusions. For example, consider an alternative environment in which the both  $\kappa_s$  and  $c_s$  are increasing and bounded in the productivity gap  $s$  for the leader, with  $\lim_{s \rightarrow \infty} c_s = \bar{c}$  and  $\lim_{s \rightarrow \infty} \kappa_s = \bar{\kappa}$ . It is easy to show that Propositions 1 and 2 remain valid as long as the upper bounds  $\bar{\kappa}$  and  $\bar{c}$  satisfy assumption 1. Intuitively, the results characterize the asymptotic equilibrium as  $r \rightarrow 0$ , and, consequently, the finite state-to-state variations in  $\kappa_s$  and  $c_s$  do not affect firms behavior when they are sufficiently patient.

Our baseline model further assumes that the marginal cost of investment is independent of the

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<sup>17</sup>The Economist, June 2, 2018

investment intensity  $\eta_s$ , and that  $\eta_s$  is bounded above by  $\eta$ . These assumptions are also in place for analytic tractability. We relax these assumptions by modeling investment cost as a convex function  $c(\eta)$  for any  $\eta \geq 0$ , and we numerically verify, using a wide range of specifications for  $c(\cdot)$ , that our key Propositions 1 and 2 remain to hold, and, specifically,  $\lim_{r \rightarrow 0} g = \ln \lambda \cdot \kappa$  under these flexible formulations. The main intuition, that an infinitely patient leader has the incentive to secure persistent leadership, that the average follower completely gives up, and that growth is entirely driven by technological diffusion  $\kappa$ , remain to hold across these flexible investment specifications. In appendix B.1 we numerically solve the model and graphically demonstrate its equilibrium properties using a quadratic investment cost  $c(\eta)$ .

Finally firms in our model live in a Modigliani-Miller world, i.e. they do not face any financial frictions. This is intentional. We use the model to illustrate that, even when firms are not handicapped by asymmetric financing constraints, the strategic incentive of market leaders becomes stronger as  $r \rightarrow 0$ , and such incentive causes market power to increase in low-rate environments.

Empirical evidence suggests that introducing financial frictions would further strengthen our results since declining long-term interest rate is associated with bigger financing gap between industry leaders and followers. We show this fact by constructing the interest rate faced by industry leaders (the top 5% of firms in any industry) versus industry followers in Compustat data. We impute a firm's interest rate by dividing interest expense by total debt, and then plot the median imputed interest rate for industry leaders and followers in the left panel of figure 8 over time. The figure also plots bootstrapped standard errors.

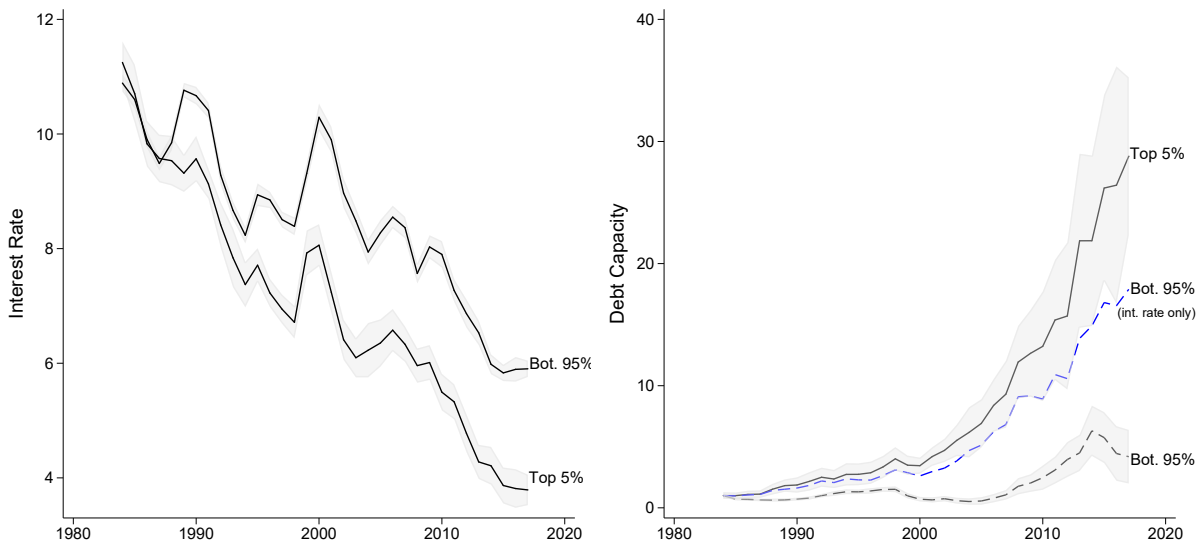
The figure shows that as risk-free rate falls over time, the interest rate paid by industry leader and follower also falls. However, importantly, the spread in basis points *increases* with a fall in  $r$ . This shows that financing cost falls *less* than one-for-one for industry follower relative to industry leader. The decline in relative cost of borrowing for industry leaders when interest rate is low gives them an additional reason to build strategic advantage over industry followers.

The increase in strategic advantage for industry leaders through financing advantage can further be seen in the right panel of figure 8 that plots the relative debt capacities for median industry leader and follower. Let  $\pi$  be EBIT for a firm,  $i$  the firm's interest rate and  $D$  its maximum debt

capacity.  $D$  can be backed out by the minimum interest coverage ratio,  $k_{min}$  that banks demand, using the formula  $k_{min} = \frac{\pi}{i^*D}$ . A recent note from the federal reserve suggests that  $k_{min} = 2$  (Francisco Palomino and Sanz-Maldonado (2019)).

The right panel of figure 8 plots imputed debt capacity for median industry leader and follower using the firm's reported interest rate and EBIT. Debt capacities are normalized to one at the beginning of sample. We can see that over time, as long-term interest rate has fallen, the debt-capacity gap between industry leader and follower has expanded massively. The middle blue line shows how much of the gap is coming from median leader and follower getting charged different interest rate alone, i.e. it plots the follower's debt capacity assuming the follower continues to earn leader's EBIT throughout the sample period. Figure 8 makes it clear that low interest rates have given industry leaders a huge financing advantage. They can use this advantage to, for example, threaten potential entrants with price wars or predatory acquisitions. All of this was assumed away in our model, but would only strengthen the results if considered explicitly.

Figure 8: Interest rate and debt capacity for industry leaders and followers



## 6 Conclusion

We have highlighted a new key force in this paper. Industry leaders' incentive to build strategic advantage increases more aggressively as long-term interest rate falls. The build up of this strategic force discourages followers from investing, making industry structure more monopolistic. For sufficiently lowly interest rates, productivity growth also slows down.

Our framework delivers a unified explanation for a number of important macro trends associated with falling interest rate, including "secular stagnation". The slowdown in productivity growth is global as it shows up in almost all advanced economies. The slowdown started well before the Great Recession, suggesting that cyclical forces related to the crisis are unlikely to be the trigger. And the slowdown in productivity is highly persistent, lasting well over a decade. The long-run pattern suggests that explanations relying on price stickiness or the zero lower bound on nominal interest rates are unlikely to be the complete explanation.

This paper introduces the possibility of low interest rates as the common global "factor" that drives the slowdown in productivity growth. The mechanism that the theory postulates delivers a number of important predictions that are supported by empirical evidence. A reduction in long term interest rates increases market concentration and market power in the model. A fall in the interest rate also makes industry leadership and monopoly power more persistent. There is empirical support for these predictions in the data, both in aggregate time series as well as in firm-level panel data sets.

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## A Appendix: Proofs

### A.1 Properties of flow profits and steady-state growth rate

In this appendix section, we prove lemmas 1 and 2.

In the main text, we model market structure as Bertrand competition, generating a sequence of state-dependent flow profits  $\{\pi_s, \pi_{-s}\}$  that satisfy properties outlined in Lemma 1, and that  $\lim_{s \rightarrow \infty} \pi_s = 1$ ,  $\lim_{s \rightarrow -\infty} \pi_s = 0$ . Our theoretical results hold under any sequence of flow profits that satisfy Lemma 1; hence, our theory nests other market structures. We use  $\pi \equiv \lim_{s \rightarrow 0} \pi_s$  to denote the limiting total profits in each market, and we exposit using the notation  $\pi$ .

**Lemma 1: Follower's flow profits  $\pi_{-s}$  are non-negative, weakly decreasing, and convex; leader's and joint profits ( $\pi_s$  and  $(\pi_s + \pi_{-s})$ ) are bounded, weakly increasing, and eventually concave in  $s$  (a sequence  $\{a_s\}$  is eventually concave iff there exists  $\bar{s}$  such that  $a_s$  is concave in  $s$  for all  $s \geq \bar{s}$ ).**

**Proof.** Let  $\delta_i$  be the market share of firm  $i$ . The CES demand structure within each market implies that  $\delta_i \equiv \frac{p_i y_i}{p_1 y_1 + p_2 y_2} = \frac{p_i^{1-\sigma}}{p_1^{1-\sigma} + p_2^{1-\sigma}}$ . Under Bertrand competition, the price charged by a firm with productivity  $z_i$  must solve  $p_i = \frac{\sigma(1-\delta_i) + \delta_i}{(\sigma-1)(1-\delta_i)} \lambda^{-z_i}$  (recall we normalize wage rate to 1). Aghion et al. (2001) and Atkeson and Burstein (2008) provides detailed derivations of these expressions.

Define  $\rho_s$  as an implicit function of the productivity gap:  $\rho_s^\sigma = \lambda^{-s} \frac{(\sigma \rho_s^{\sigma-1} + 1)}{\sigma + \rho_s^{\sigma-1}}$ . It can be verified that flow profits satisfy  $\pi_s = \frac{1}{\sigma \rho_s^{\sigma-1} + 1}$  for any productivity gap  $s$ . The fact that follower's flow profits is convex in  $s$  follows from algebra. Moreover,  $\lim_{s \rightarrow \infty} \rho_s^\sigma \lambda^s = 1/\sigma$  and  $\lim_{s \rightarrow -\infty} \rho_s^\sigma \lambda^s = \sigma$ ; hence, for large  $s$ ,  $\pi_s \approx \frac{1}{\sigma \frac{1}{\lambda^{-\frac{\sigma-1}{\sigma}s} + 1}}$  and  $\pi_{-s} \approx \frac{1}{\sigma \frac{2\sigma-1}{\sigma} \lambda^{\frac{\sigma-1}{\sigma}s} + 1}$ . The eventual concavity of  $\pi_s$  and  $(\pi_s + \pi_{-s})$  as  $s \rightarrow \infty$  is immediate.

**Lemma 2: In a steady state, the aggregate productivity growth rate is  $g \equiv \ln \lambda (\sum_{s=0}^{\infty} \mu_s \eta_s + \mu_0 \eta_0)$ .**

**Proof** The expression  $(\sum_{s=0}^{\infty} \mu_s \eta_s + \mu_0 \eta_0)$  tracks the weighted-average growth rate of the productivity frontier in the economy, i.e., the rate at which markets leave the current state  $s$  and move to state  $s + 1$ . In a steady-state, the growth rate of frontier must be the same as the rate at which states fall down by one step, from  $s + 1$  to  $s$ ; hence, aggregate growth rate  $g$  can also be written as  $g = \ln \lambda (\sum_{s=1}^{\infty} \mu_s (\eta_{-s} + \kappa))$ .

To prove the expression formally, we proceed in two steps. First, we express aggregate productivity growth as a weighted average of productivity growth in each market. We then use the fact that, given homothetic within-market demand, if a follower in state  $s$  improves productivity by one step (i.e. by a factor  $\lambda$ ) and a leader in state  $s - 1$  improves also by one step, the net effect should be equivalent to one step improvement in the overall productivity of a single market.

Aggregate productivity growth is a weighted average of productivity growth in each market:

$$\begin{aligned} g &= -\frac{d \ln P}{d \ln t} = -\frac{d \int_0^1 \ln p(v) dv}{d \ln t} \\ &= -\sum_{s=0}^{\infty} \mu_s \times \frac{d [\int_{z^F} \ln p(s, z^F) dF(z^F)]}{d \ln t}, \end{aligned}$$

where we use  $(s, z^F)$ , the productivity gap and the productivity of the follower, to index for markets in the second line. Now recognize that productivity growth rate in each market,  $-\frac{d \ln p(s, z^F)}{d \ln t}$ , is a function of only the productivity gap  $s$  and is invariant to the productivity of follower,  $z^F$ . Specifically, suppose the follower in market  $(s, z^F)$  experiences an innovation, the market price index becomes  $p(s - 1, z^F + 1)$ . Similarly, if the leader experiences an innovation, the price index becomes  $p(s + 1, z^F)$ . The corresponding log-changes in price indices are respectively

$$\begin{aligned} a_s^F &\equiv \ln p(s - 1, z^F + 1) - \ln p(s, z^F) \\ &= -\ln \lambda + \ln [\rho_{s-1}^{1-\sigma} + 1]^{\frac{1}{1-\sigma}} - \ln [\rho_s^{1-\sigma} + 1]^{\frac{1}{1-\sigma}}, \end{aligned}$$

$$\begin{aligned} a_s^L &= \ln p(s + 1, z^F) - \ln p(s, z^F) \\ &= \ln [\rho_{s+1}^{1-\sigma} + 1]^{\frac{1}{1-\sigma}} - \ln [\rho_s^{1-\sigma} + 1]^{\frac{1}{1-\sigma}}, \end{aligned}$$

where  $\rho_s$  is the implicit function defined in the proof for Lemma 1. The log-change in price index is independent of  $z^F$  in either case. Hence, over time interval  $[t, t + \Delta]$ , the change in price index for markets with state variable  $s$  at time  $t$  follows

$$\Delta \ln p(s, z^F) = \begin{cases} a_s^L & \text{with probability } \eta_s \Delta, \\ a_s^F & \text{with probability } (\eta_{-s} + \kappa \cdot \mathbf{1}(s \neq 0)) \Delta. \end{cases}$$

The aggregate productivity growth can therefore be written as

$$g = -\mu_0 2\eta_0 a_0 - \sum_{s=1}^{\infty} \mu_s \times (\eta_s a_s^L + (\eta_{-s} + \kappa) a_s^F).$$

Lastly, note that if both leader and follower in a market experiences productivity improvements, regardless of the order in which these events happen, the price index in the market changes by a factor of  $\lambda^{-1}$ :

$$a_s^F + a_{s-1}^L = a_s^L + a_{s+1}^F = -\ln \lambda \quad \text{for all } s \geq 1.$$

Hence,

$$\begin{aligned} g &= -\mu_0 2\eta_0 a_0 - \sum_{s=1}^{\infty} \mu_s \times (\eta_s a_s^L + (\eta_{-s} + \kappa) a_s^F) \\ &= -\mu_0 2\eta_0 a_0 - \sum_{s=1}^{\infty} \mu_s \times (\eta_s a_s^L + (\eta_{-s} + \kappa) (-\ln \lambda - a_{s-1}^L)) \\ &= \ln \lambda \cdot \sum_{s=1}^{\infty} \mu_s (\eta_{-s} + \kappa) - \left( \sum_{s=1}^{\infty} \mu_s \times (\eta_s a_s^L - a_{s-1}^L (\eta_{-s} + \kappa)) + \mu_0 2\eta_0 a_0 \right). \end{aligned}$$

Given that steady-state distribution  $\{\mu_s\}$  must follow

$$\mu_s (\eta_{-s} + \kappa) = \begin{cases} \mu_{s-1} \eta_{s-1} & \text{if } s > 1, \\ 2\mu_0 \eta_0 & \text{if } s = 1, \end{cases} \quad (10)$$

we know

$$\begin{aligned}
& \sum_{s=1}^{\infty} \mu_s \times \left( \eta_s a_s^L - a_{s-1}^L (\eta_{-s} + \kappa) \right) + \mu_0 2\eta_0 a_0 \\
&= \sum_{s=1}^{\infty} \mu_s \eta_s a_s^L + \mu_0 2\eta_0 a_0 - \left( \sum_{s=1}^{\infty} \mu_s a_{s-1}^L (\eta_{-s} + \kappa) \right) \\
&= 0.
\end{aligned}$$

Hence aggregate growth rate simplifies to  $g = \ln \lambda \cdot \sum_{s=1}^{\infty} \mu_s (\eta_{-s} + \kappa)$ , which traces the growth rate of productivity laggards. We can also apply substitutions in (10) again to express productivity growth as a weighted average of frontier growth:

$$g = \ln \lambda \cdot \left( \sum_{s=1}^{\infty} \mu_s \eta_s + 2\mu_0 \eta_0 \right).$$

## A.2 Structure of Equilibrium

It is useful to first understand the structure of value functions given any sequence of (potentially non-equilibrium) investment decisions  $\{\eta_s\}_{s=-\infty}^{\infty}$ . The fact that firms are forward-looking implies that value function in each state can be written as a weighted average of flow payoffs in all ergodic states induced by the investment decisions, i.e.

$$v_s = \sum_{s'=-\infty}^{\infty} \lambda_{s'|s} \times PV_{s'}, \quad \text{where} \quad \sum_{s'=-\infty}^{\infty} \lambda_{s'|s} = 1 \quad \text{for all } s. \quad (11)$$

The term  $PV_{s'} \equiv \frac{\pi_{s'} - c\eta_{s'}}{r}$  represents the permanent value in state  $s'$ , i.e. the present-discounted value of flow payoff in state  $s'$  if the firm stays in that state permanently;  $s' > 0$  means the firm is a leader when the productivity gap is  $s'$ , and  $s' < 0$  means the firm is a follower when the productivity gap is  $-s'$ . In equilibrium, the firm value in state  $s$  can be written as a weighted average of the permanent value across all ergodic states. The weight  $\lambda_{s'|s}$  can be interpreted as the present-discount fraction of time that the firm is going to be  $s'$  steps ahead of his competitor, given that he is currently  $s$  steps ahead. The weights  $\{\lambda_{s'|s}\}_{s'=-\infty}^{\infty}$  form a measure conditional on the current state  $s$ . When the current state  $s$  is high, the firm is expected to spend more time in higher indexed states, and the conditional distribution  $\{\lambda_{s'|s+1}\}_{s'=-\infty}^{\infty}$  first-order stochastically dominates

$\{\lambda_{s'|s}\}_{s'=-\infty}^{\infty}$  for all  $s$ .

Likewise, let  $w_s \equiv v_s + v_{-s}$  be the joint value of leader and follower in state  $s$ . Following the same logic as in equation (11), we can rewrite  $w_s$  as a weighted average of the sum of permanent values of leader and follower in every state:

$$w_s = \sum_{s'=0}^{\infty} \tilde{\lambda}_{s'|s} \cdot (PV_{s'} + PV_{-s'}), \quad \text{where } \sum_{s'=0}^{\infty} \tilde{\lambda}_{s'|s} = 1. \quad (12)$$

The weights  $\tilde{\lambda}_{s'|s}$  can be interpreted as the present-discounted fraction of time that the state variable is  $s'$ , i.e. when either firm is  $s'$  steps ahead of the other, conditioning on the current gap being  $s$ ; hence,  $\tilde{\lambda}_{s'|s} = \lambda_{s'|s} + \lambda_{s'| -s}$ . It is easy to verify that  $\{\tilde{\lambda}_{s'|s+1}\}$  first order stochastically dominate  $\{\tilde{\lambda}_{s'|s}\}$ .

To understand how interest rates affect value functions when investment decisions  $\{\eta_s\}$  are held constant, note that the firm value in state  $s$  can be written as a weighted average of the permanent state payoff in state  $s$  and the firm value in neighboring states  $s - 1$  and  $s + 1$ :

$$v_s = \frac{r}{r + \kappa + \eta_{-s} + \eta_s} \cdot PV_s + \frac{\kappa + \eta_{-s}}{r + \kappa + \eta_{-s} + \eta_s} v_{s-1} + \frac{\eta_s}{r + \kappa + \eta_{-s} + \eta_s} v_{s+1}$$

Holding investment decisions constant, a fall in interest rate  $r$  reduces the relative weight on the permanent value of state  $s$ , thereby reducing the difference in value functions across states. In fact, holding investment decisions fixed, if there is a state in which the leader chooses not to invest at all ( $\eta_{\bar{s}} = 0$  for some  $\bar{s}$ ), then  $rv_s \rightarrow rv_0$  for all  $s \leq \bar{s}$ .

We now prove results about the structure of equilibria. For expositional purposes, we assume firms play pure strategies (i.e. they invest at either lower or upper bounds  $\eta_s \in \{0, \eta\}$ ); all of our claims hold for mixed strategy equilibria (i.e. those involving interior investment intensities).

**Lemma 3.** **The leader invests in more states than the follower,  $n \geq k$ . Moreover, the follower does not invest in states  $s = k + 1, \dots, n + 1$ .** Recall  $n + 1$  is the first state in which market leaders choose not to invest, and  $k + 1$  is the first state in which followers choose not to invest:  $n + 1 \equiv \min \{s | s \geq 0, \eta_s < \eta\}$  and  $k + 1 \equiv \min \{s | s \leq 0, \eta_s < \eta\}$ .

**Proof** Suppose  $n < k$ , i.e. leader invests in states 1 through  $n$  whereas follower invests in states 1 through at least  $n + 1$ . We first show that, if these investment decisions were optimal, the value functions of both leader and follower in state  $n + 1$  must be supported by certain lower bounds. We then reach for a contradiction, showing that, if  $n < k$ , then market power is too transient to support these lower bounds on value functions.

The HJB equation for the leader in state  $n + 2$  implies

$$\begin{aligned} rv_{n+2} &= \max_{\eta_{n+2} \in [0, \eta]} \pi_{n+2} + \eta_{n+2} (v_{n+3} - v_{n+2} - c) + \left( \eta_{-(n+2)} + \kappa \right) (v_{n+1} - v_{n+2}) \\ &\geq \pi_{n+2} + (\eta + \kappa) (v_{n+1} - v_{n+2}). \end{aligned}$$

The fact that leader does not invest in state  $n + 1$  implies  $c \geq v_{n+2} - v_{n+1}$ ; combining with the previous inequality, we obtain

$$rv_{n+1} \geq \pi_{n+2} - c(\eta + \kappa + r).$$

The HJB equation for the follower in state  $n + 1$  implies

$$\begin{aligned} rv_{-(n+1)} &= \max_{\eta_{-(n+1)} \in [0, \eta]} \pi_{-(n+1)} + \left( \eta_{-(n+1)} + \kappa \right) (v_{-n} - v_{-(n+1)}) - c\eta_{-(n+1)} \\ &\geq \pi_{-(n+1)} + \kappa (v_{-n} - v_{-(n+1)}). \end{aligned}$$

The fact that follower chooses to invest in state  $n + 1$  implies  $c \leq v_{-n} - v_{-(n+1)}$ ; combining with the previous inequality, we obtain

$$rv_{-(n+1)} \geq \pi_{-(n+1)} + c\kappa. \quad (13)$$

Combining this with the earlier inequality involving  $rv_{n+1}$ , we obtain an inequality on the joint value in state  $n + 1$ :

$$rw_{n+1} \geq \pi_{n+2} + \pi_{-(n+1)} - c(\eta + r) \quad (14)$$

We now show that inequalities (13) and (14) cannot both be true. To do so, we construct alter-

native economic environments with value functions  $\hat{w}_{n+1}$  and  $\hat{v}_{-(n+1)}$  that respectively dominate  $w_{n+1}$  and  $v_{-(n+1)}$ ; we then show that even these dominating value functions  $\hat{w}_{n+1}$  and  $\hat{v}_{-(n+1)}$  cannot satisfy both inequalities.

First, fix  $n$  and fix investment strategies (leader invests until state  $n + 1$  and follower invests at least through  $n + 1$ ); suppose for all states  $1 \leq s \leq n + 1$ , follower's profits are equal to  $\pi_{-(n+1)}$  and leader's profits are equal to  $\pi_{n+2}$ ; two firms each earn  $\frac{\pi_{-(n+1)} + \pi_{n+2}}{2}$  in state zero. The joint profits in this modified economic environment are independent of the state by construction; moreover, the joint flow profits always weakly dominate those in the original environment and strictly dominate in state zero ( $\pi_{n+2} + \pi_{-(n+1)} \geq \pi_1 + \pi_{-1} > 2\pi_0$ ). Let  $\hat{w}_s$  denote the value function in the modified environment;  $\hat{w}_s > w_s$  for all  $s \leq n + 1$ .

Consider the joint value in this modified environment but under alternative investment strategies. Let  $\bar{n}$  index for investment strategies: leader invests in states 1 through  $\bar{n}$  whereas the follower invests at least through  $\bar{n} + 1$ . Let  $\hat{w}_s^{(\bar{n})}$  denote the joint value in state  $s$  under investments indexed by  $\bar{n}$ ; we argue that  $\hat{w}_{\bar{n}+1}^{(\bar{n})}$  is decreasing in  $\bar{n}$ . To see this, note that the joint flow payoffs in all states 0 through  $\bar{n}$  is constant by construction and is equal to  $(\pi_{n+2} + \pi_{-(n+1)} - 2c\eta)$ —total profits net of investment costs. The joint flow payoff in state  $\bar{n} + 1$  is  $(\pi_{n+2} + \pi_{-(n+1)} - c\eta)$ . Hence, the joint market value in state  $\bar{n} + 1$  under the investment strategies indexed by  $\bar{n}$  is equal to

$$\hat{w}_{\bar{n}+1}^{(\bar{n})} = \frac{\pi_{n+2} + \pi_{-(n+1)} - 2c\eta \left(1 - \tilde{\lambda}_{\bar{n}+1|\bar{n}+1}^{(\bar{n})}/2\right)}{r},$$

where  $\tilde{\lambda}_{\bar{n}+1|\bar{n}+1}^{(\bar{n})}$  is the present discount fraction of time that the market spends in state  $\bar{n} + 1$ , conditioning on the current state is  $\bar{n} + 1$ , and that firms follow investment strategies indexed by  $\bar{n}$ . The object  $\tilde{\lambda}_{\bar{n}+1|\bar{n}+1}^{(\bar{n})}$  is decreasing in  $\bar{n}$ : the more states in which both firms invest, the less time that the market will spend in the state  $\bar{n} + 1$  in which only one firm (the follower) invests. Hence,  $\hat{w}_{\bar{n}+1}^{(\bar{n})}$  is decreasing in  $\bar{n}$ , and that  $\hat{w}_1^{(0)} \geq \hat{w}_{n+1}^{(n)} > w_{n+1}$ . The same logic also implies  $\hat{v}_0^{(0)} = \frac{1}{2}\hat{w}_0^{(0)} > \frac{1}{2}w_0 = v_0$ .

Consider the follower's value  $\hat{v}_{-1}^{(0)}$ , in the alternative environment, when investment strategies are indexed by zero, i.e. firms invest in states 0 and  $-1$  only. We know  $\hat{v}_{-1}^{(0)}$  must be higher than

$v_{-(n+1)}$  because

$$\begin{aligned}
\hat{v}_{-1}^{(0)} &= \frac{\pi_{-(n+1)} - c\eta + \kappa\hat{v}_0^{(0)}}{r + \kappa + \eta} \\
&> \frac{\pi_{-(n+1)} - c\eta + \kappa v_0}{r + \kappa + \eta} \\
&\geq \frac{\pi_{-(n+1)} - c\eta + \kappa v_{-n}}{r + \kappa + \eta} \\
&= v_{-(n+1)}.
\end{aligned}$$

We now show that the inequalities  $r\hat{v}_{-1}^{(0)} \geq \pi_{-(n+1)} + c\kappa$  and  $r\hat{w}_1^{(0)} \geq \pi_{n+2} + \pi_{-(n+1)} - c(\eta + r)$  cannot both hold. We can explicitly solve for the value functions from the HJB equations:

$$\begin{aligned}
\hat{w}_0^{(0)} &= \frac{\pi_{n+2} + \pi_{-(n+1)} - 2c\eta + 2\eta\hat{w}_1^{(0)}}{r + 2\eta} \\
\hat{w}_1^{(0)} &= \frac{\pi_{n+2} + \pi_{-(n+1)} - c\eta + (\eta + \kappa)\hat{w}_0^{(0)}}{r + \eta + \kappa} \\
\hat{v}_{-1}^{(0)} &= \frac{\pi_{-(n+1)} - c\eta + (\eta + \kappa)\hat{w}_0^{(0)}/2}{r + \eta + \kappa}
\end{aligned}$$

Solving for  $\hat{w}_1^{(0)}$  and  $\hat{v}_{-1}^{(0)}$ , we obtain

$$\begin{aligned}
r\hat{w}_1^{(0)} &= \pi_{n+2} + \pi_{-(n+1)} - c\eta \left( 1 + \frac{\eta + \kappa}{r + 3\eta + \kappa} \right) \\
(r + \eta + \kappa)r\hat{v}_{-1}^{(0)} &= r(\pi_{-(n+1)} - c\eta) + (\eta + \kappa) \left( \frac{\pi_{n+2} + \pi_{-(n+1)}}{2} - c\eta \frac{r + 2\eta + \kappa}{r + 3\eta + \kappa} \right)
\end{aligned}$$

That  $r\hat{v}_{-1}^{(0)} \geq \pi_{-(n+1)} + c\kappa$  implies

$$\begin{aligned}
&(r + \eta + \kappa)r\hat{v}_{-1}^{(0)} \\
&= r(\pi_{-(n+1)} - c\eta) + (\eta + \kappa) \left( \frac{\pi_{n+2} + \pi_{-(n+1)}}{2} - c\eta \frac{r + 2\eta + \kappa}{r + 3\eta + \kappa} \right) \\
&\geq (r + \eta + \kappa) (\pi_{-(n+1)} + c\kappa) \\
\implies (\eta + \kappa) \left( \frac{\pi_{n+2} - \pi_{-(n+1)}}{2} - c\eta \frac{r + 2\eta + \kappa}{r + 3\eta + \kappa} \right) &\geq (r + \eta + \kappa) c\kappa + c\eta r
\end{aligned}$$



Since  $\frac{\pi_{n+2} - \pi_{-(n+1)}}{2} \leq \frac{\pi_{n+2}}{2} < c\eta$ , it must be the case that

$$(\eta + \kappa) c\eta > (r + \eta + \kappa) c\kappa + c\eta r + (\eta + \kappa) c\eta \frac{r + 2\eta + \kappa}{r + 3\eta + \kappa}.$$

On the other hand, that  $r\hat{w}_1^{(0)} \geq \pi_{n+2} + \pi_{-(n+1)} - c(\eta + r)$  implies  $r \geq \eta \frac{\eta + \kappa}{r + 3\eta + \kappa}$ ; hence the previous inequality implies

$$\begin{aligned} (\eta + \kappa) c\eta &> (r + \eta + \kappa) c\kappa + (\eta + \kappa) c\eta \frac{\eta}{r + 3\eta + \kappa} + (\eta + \kappa) c\eta \frac{r + 2\eta + \kappa}{r + 3\eta + \kappa} \\ &= (r + \eta + \kappa) c\kappa + (\eta + \kappa) c\eta, \end{aligned}$$

which is impossible; hence  $n \geq k$ .

We now show that the follower does not invest in states  $s \in \{k + 1, \dots, n + 1\}$ .

First, note

$$\begin{aligned} (r + \eta + \kappa) (v_{-s} - v_{-s-1}) &= \pi_{-s} - \pi_{-s-1} + \kappa (v_{-s+1} - v_s) + \eta (v_{-s-1} - v_{-s-2}) \\ &\quad + \max \{ \eta (v_{-s+1} - v_s - c), 0 \} - \max \{ \eta (v_{-s} - v_{-s-1} - c), 0 \}. \end{aligned}$$

Suppose  $v_{-s+1} - v_s \geq (v_{-s} - v_{-s-1})$ , then

$$\begin{aligned} (r + \eta + \kappa) (v_{-s} - v_{-s-1}) &\geq \pi_{-s} - \pi_{-s-1} + \kappa (v_{-s+1} - v_s) + \eta (v_{-s-1} - v_{-s-2}) \\ \implies (r + \eta) (v_{-s} - v_{-s-1}) &\geq \pi_{-s} - \pi_{-s-1} + \eta (v_{-s-1} - v_{-s-2}). \end{aligned}$$

If  $v_{-s+1} - v_s < (v_{-s} - v_{-s-1})$ , then

$$\begin{aligned} (r + \eta) (v_{-s} - v_{-s-1}) &< \pi_{-s} - \pi_{-s-1} + \eta (v_{-s-1} - v_{-s-2}) \\ &\quad + \max \{ \eta (v_{-s+1} - v_s - c), 0 \} \\ &\quad - \max \{ \eta (v_{-s} - v_{-s-1} - c), 0 \} \\ &\leq \pi_{-s} - \pi_{-s-1} + \eta (v_{-s-1} - v_{-s-2}). \end{aligned}$$

To summarize, for all  $s$ ,

$$v_{-s+1} - v_{-s} \geq (v_{-s} - v_{-s-1}) \iff (r + \eta)(v_{-s} - v_{-s-1}) \geq \pi_{-s} - \pi_{-s-1} + \eta(v_{-s-1} - v_{-s-2}) \quad (15)$$

Now suppose  $\eta_{-k-1} = 0$  but  $\eta_{-s'} = \eta$  for some  $s' \in \{k+2, \dots, n+1\}$ . This implies

$$v_{-(k-1)} - v_{-k} \geq c > v_{-k} - v_{-k-1} < v_{-s'+1} - v_{-s'},$$

implying there must be at least one  $s \in \{k+2, \dots, n+1\}$  such that  $v_{-s+1} - v_{-s} \geq v_{-s} - v_{-s-1} < v_{-s-1} - v_{-s-2}$ . Applying (15),

$$(r + \eta)(v_{-s} - v_{-s-1}) \geq \pi_{-s} - \pi_{-s-1} + \eta(v_{-s-1} - v_{-s-2}) \quad (16)$$

$$(r + \eta)(v_{-s-1} - v_{-s-2}) < \pi_{-s-1} - \pi_{-s-2} + \eta(v_{-s-2} - v_{-s-3})$$

Inequality (16) and  $v_{-s} - v_{-s-1} < v_{-s-1} - v_{-s-2}$  implies  $r(v_{-s} - v_{-s-1}) > \pi_{-s} - \pi_{-s-1}$ ; convexity in follower's profit functions further implies  $r(v_{-s} - v_{-s-1}) > \pi_{-s-1} - \pi_{-s-2}$ . Hence it must be the case that  $(v_{-s-2} - v_{-s-3}) > (v_{-s-1} - v_{-s-2})$ . Applying (15) again,

$$(r + \eta)(v_{-s-2} - v_{-s-3}) < \pi_{-s-2} - \pi_{-s-3} + \eta(v_{-s-3} - v_{-s-4}).$$

That  $r(v_{-s-2} - v_{-s-3}) > \pi_{-s-2} - \pi_{-s-3}$  further implies  $(v_{-s-3} - v_{-s-4}) > (v_{-s-2} - v_{-s-3})$ . By induction, we can show

$$v_{s-1} - v_{s-2} < v_{s-2} - v_{s-3} < \dots < v_{-n} - v_{-(n+1)}.$$

But

$$\begin{aligned} (r + \eta + \kappa)(v_{-n} - v_{-(n+1)}) &\leq \pi_{-n} - \pi_{-(n+1)} + \kappa(v_{s+1} - v_s) + \eta(v_{-n+1} - v_{-n+1}) \\ &\implies (r + \eta)(v_{-n} - v_{-(n+1)}) \leq \pi_{-n} - \pi_{-(n+1)} \end{aligned}$$

which is a contradiction, given convexity of the profit functions. Hence, we have shown  $v_{-k} - v_{-(k+1)} \geq v_{-s} - v_{-s-1}$  for all  $s \in \{k+1, \dots, n+1\}$ , establishing that follower cannot invest in these states.

**Lemma 4:** In a steady-state induced by investment cutoffs  $(n, k)$ , the aggregate productivity growth rate is  $g = \ln \lambda \cdot (\mu^C (\eta + \kappa) + \mu^M \kappa)$ , where  $\mu^C$  is the fraction of markets in the competitive region ( $\mu^C = \sum_{s=1}^k \mu_s$ ) and  $\mu^M$  is the fraction of markets in the monopolistic region ( $\mu^M = \sum_{s=k+1}^{n+1} \mu_s$ ). The fraction of markets in each region satisfies

$$\begin{aligned} \mu_0 + \mu^C + \mu^M &= 1, & \mu_0 &\propto (\kappa/\eta)^{n-k+1} (1 + \kappa/\eta)^k, \\ \mu^C &\propto (\kappa/\eta)^{n-k} \left( (1 + \kappa/\eta)^k - 1 \right), & \mu^M &\propto \frac{1 - (\kappa/\eta)^{n-k+1}}{1 - \kappa/\eta}. \end{aligned}$$

**Proof.** Given the cutoff strategies  $(n, k)$ , aggregate productivity growth is (from Lemma 3)

$$g = \ln \lambda \cdot \left( \sum_{s=1}^n \mu_s \eta + 2\mu_0 \eta \right).$$

The steady-state distribution must follow

$$\mu_s \eta = \begin{cases} \mu_1 (\eta + \kappa) / 2 & \text{if } s = 0 \\ \mu_{s+1} (\eta + \kappa) & \text{if } 1 \leq s \leq k-1 \\ \mu_{s+1} \kappa & \text{if } k \leq s \leq n+1 \\ 0 & \text{if } s > n+1 \end{cases}$$

Hence we can rewrite the aggregate growth rate as

$$\begin{aligned}
g &= \ln \lambda \cdot \left( 2\mu_0\eta + \sum_{s=1}^{k-1} \mu_s\eta + \sum_{s=k-1}^n \mu_s\eta \right) \\
&= \ln \lambda \cdot \left( \mu_1(\eta + \kappa) + \sum_{s=2}^k \mu_s(\eta + \kappa) + \sum_{s=k}^{n+1} \mu_s\kappa \right) \\
&= \ln \lambda \cdot \left( \mu^C(\eta + \kappa) + \mu^M\kappa \right),
\end{aligned}$$

as desired.

To solve for  $\mu_0$ ,  $\mu^C$ , and  $\mu^M$  as functions of  $n$  and  $k$ , note that steady-state distribution follows:

$$\mu_s\eta = \begin{cases} \mu_1(\eta + \kappa)/2 & \text{if } s = 0 \\ \mu_{s+1}(\eta + \kappa) & \text{if } 1 \leq s \leq k-1 \\ \mu_{s+1}\kappa & \text{if } k \leq s \leq n+1 \\ 0 & \text{if } s > n+1. \end{cases}$$

We can rewrite  $\mu_s$  as a function of  $\mu_{n+1}$  for all  $s$ . Let  $\alpha \equiv \kappa/\eta$ , then

$$\mu_s = \begin{cases} \mu_{n+1}\alpha^{n+1-s} & \text{if } n+1 \geq s \geq k \\ \mu_{n+1}\alpha^{n+1-k}(1+\alpha)^{k-s} & \text{if } k-1 \geq s \geq 0 \end{cases}$$

Hence  $\mu_0 = \mu_{n+1}\alpha^{n+1-k}(1+\alpha)^k$ . The fraction of markets in the competitive and monopolistic regions can be written, respectively, as

$$\begin{aligned}
\mu^M &= \mu_{n+1} \sum_{s=k+1}^{n+1} \alpha^{n+1-s} = \mu_{n+1} \frac{1 - \alpha^{n-k+1}}{1 - \alpha} \\
\mu^C &= \mu_{n+1}\alpha^{n+1-k} \sum_{s=1}^k (1+\alpha)^{k-s} = \mu_{n+1}\alpha^{n-k} \left( (1+\alpha)^k - 1 \right).
\end{aligned}$$

**Lemma 5: If follower invests in state 1, then the steady-state aggregate productivity growth is bounded below by  $\ln \lambda \cdot \kappa$ , the step-size of productivity increments times the rate of technology diffusion.**

**Proof.** Given  $k \geq 1$ , the fraction of markets in the competitive region can be written as

$$\begin{aligned}
\mu^C &= \sum_{s=1}^k \mu_s \\
&= \mu_1 + \underbrace{\mu_1 (1 + \alpha)^{-1}}_{=\mu_2} + \cdots + \underbrace{\mu_1 (1 + \alpha)^{-(k-1)}}_{=\mu_k} \\
&= \underbrace{\mu_0 \frac{\kappa + \eta}{2\eta}}_{=\mu_1} \frac{1 - (1 + \alpha)^{-k}}{1 - (1 + \alpha)^{-1}} \\
&\geq \mu_0 \frac{\kappa + \eta}{2\eta}
\end{aligned}$$

Aggregate growth rate can be re-written as

$$\begin{aligned}
g &= \ln \lambda \cdot \left[ (1 - \mu_0) \kappa + \mu^C \eta \right] \\
&\geq \ln \lambda \cdot \left[ (1 - \mu_0) \kappa + \mu_0 \frac{\kappa + \eta}{2} \right] \\
&\geq \ln \lambda \cdot \left[ (1 - \mu_0) \kappa + \mu_0 \kappa \right] \\
&= \ln \lambda \cdot \kappa,
\end{aligned}$$

as desired.

### A.3 Asymptotic Results as $r \rightarrow 0$

**Lemma A.1.**  $\Delta w_0 \equiv w_1 - w_0 = \frac{rw_0 + 2c\eta - 2\pi_0}{2\eta}$ ;  $\Delta w_0$  is bounded away from zero.

**Proof** The equality comes from the HJB equation  $rw_0 = 2\pi_0 - 2c\eta + 2\eta(w_1 - w_0)$ . That  $\Delta w_0$  is bounded away from zero follows from the fact that  $rw_0 \geq 0$  and assumption 1 ( $2c\eta > \pi \equiv \lim_{s \rightarrow 0} \pi_s + \pi_{-s} > 2\pi_0$ ). QED.

### A.3.1 Mathematical Preliminaries

Consider the following recursive formulation of value functions:

$$ru_{s+1} = \lambda + p(u_s - u_{s+1}) + q(u_{s+2} - u_{s+1})$$

The HJB equation states that, starting from state  $s + 1$ , there's a Poisson rate  $p$  of moving down one state, and rate  $q$  of moving up; the flow payoff is  $\lambda$  and discount rate is  $r$ .

Fix a state  $s$ . Given  $u_s$  and  $\Delta u_s \equiv u_{s+1} - u_s$ , we can solve for all  $u_{s+t}$  with  $t > 0$  as recursive functions of  $u_s$  and  $\Delta u_s$ ; for instance,

$$u_{s+2} - u_{s+1} = \frac{ru_s - \lambda}{q} + \left(\frac{p+r}{q}\right)\Delta u_s,$$

$$u_{s+3} - u_{s+3} = \frac{ru_s - \lambda}{q} + \left(\frac{p+r}{q}\right)(u_{s+2} - u_{s+1}) + \frac{r\Delta u_s}{q},$$

and so on. The recursive formulation generically does not have a closed-form representation. However, as  $r \rightarrow 0$ , the value functions do admit asymptotic closed form expressions, as Proposition A.1 shows. In what follows, let  $\sim$  denote asymptotic equivalence as  $r \rightarrow 0$ , i.e.  $x \sim y$  iff  $\lim_{r \rightarrow 0} (x - y) = 0$ .

**Proposition A.1.** Let  $\delta \equiv \frac{ru_s - \lambda}{q}$ ,  $a \equiv p/q$ ,  $b \equiv r/q$ , then for all  $t > 0$ ,

$$u_{s+t} - u_s \sim (\Delta u_s) \frac{1 - a^t}{1 - a} + \delta \frac{t - \frac{a - a^t}{1 - a}}{1 - a}$$

$$+ \Delta u_s \cdot b \frac{(t-1)(1+a^t)(1-a) - (2-a)(a^t - a)}{(1-a)^3}$$

$$+ \delta b \frac{1}{(1-a)^3} \left( \frac{(t-2)(t-1)}{2} (1-a) - (t-3)a^t - a(2-a)(t-1) + 2a(1-a) \right)$$

$$\begin{aligned}
u_{s+t} - u_{s+t-1} &\sim \Delta u_s a^{t-1} + \delta \frac{1 - a^{t-1}}{1 - a} \\
&+ \Delta u_s b \frac{((t-1)(1+a^t) - (t-2)(1+a^{t-1}))(1-a) - (2-a)(a^t - a^{t-1})}{(1-a)^3} \\
&+ \delta b \frac{1}{(1-a)^3} \left( \frac{(t-2)(t-1) - (t-2)(t-3)}{2} (1-a) - (t-3)a^t + (t-4)a^{t-1} - a(2-a) \right)
\end{aligned}$$

The following simplifications of the formulas will be useful if  $t \rightarrow \infty$  as  $r \rightarrow 0$ :

1. when  $a < 1$ :

$$u_{s+t} - u_{s+t-1} \sim \Delta u_s a^{t-1} + \frac{\delta}{1-a} + \frac{b\Delta u_s}{(1-a)^2};$$

(a) if  $r\Delta u_s \rightarrow 0$ ,

$$u_{s+t} - u_s \sim \Delta u_s \frac{1}{1-a} + \frac{t\delta}{1-a};$$

(b) if  $r\Delta u_s \not\rightarrow 0$ ,

$$r(u_{s+t} - u_s) \sim \frac{r\Delta u_s}{1-a}.$$

2. when  $a > 1$ ,  $r\Delta u_s \rightarrow 0$ , and  $\Delta u_s + \frac{\delta}{a-1} \not\sim 0$ ,

$$r(u_{s+t} - u_s) \sim \left( \Delta u_s + \frac{\delta}{a-1} \right) \frac{ra^t}{a-1},$$

$$r(u_{s+t} - u_{s+t-1}) \sim \left( \Delta u_s + \frac{\delta}{a-1} \right) ra^{t-1}.$$

If  $\Delta u_s + \frac{\delta}{a-1} \sim 0$ ,

$$u_{s+t} - u_s \sim -\frac{b\delta}{(1-a)^4} \cdot a^{t+1}.$$

Suppose the flow payoffs are state-dependent  $\{\lambda_s\}$ , i.e.

$$ru_{s+1} = \lambda_{s+1} + p(u_s - u_{s+1}) + q(u_{s+2} - u_{s+1})$$

If  $\lambda$  is an upper bound for  $\{\lambda_s\}$ , then the formulas provide asymptotic lower bounds for  $u_{s+t} - u_{s+t-1}$  and  $u_{s+t}$  as functions of  $u_s$  and  $\Delta u_s$ . Conversely, if  $\lambda$  is a lower bound for  $\{\lambda_s\}$ , then the

formulas provide asymptotic upper bounds for  $u_{s+t} - u_{s+t-1}$  and  $u_{s+t}$ .

**Remark.** One can analogously write  $u_s$  and  $\Delta u_s$  as asymptotic functions of  $\Delta u_{s+t}$  and  $u_{s+t}$ . Proposition A.1. is the mathematical result that enables us to derive our propositions in the main text, and we will apply it repeated throughout the rest of this appendix.

**Proof of Proposition A.1.** The recursive formulation can be re-written as

$$u_{s+1} - u_s = \Delta u_s$$

$$\begin{aligned} u_{s+2} - u_{s+1} &= a(u_{s+1} - u_s) + \frac{r(u_{s+1} - u_s) + ru_s - v}{q} \\ &= a\Delta u_s + b\Delta u_s + \delta \end{aligned}$$

$$u_{s+2} - u_s = (1 + a)\Delta u_s + b\Delta u_s + \delta$$

Likewise,

$$u_{s+3} - u_{s+2} = a^2\Delta u_s + (1 + 2a)b\Delta u_s + (1 + a)\delta + o(r^2)$$

$$u_{s+3} - u_s = (1 + a + a^2)\Delta u_s + (1 + 1 + 2a)b\Delta u_s + (1 + 1 + a)\delta + b\delta + o(r^2)$$

Applying the formula iteratively, one can show that

$$u_{s+t+1} - u_{s+t} = a^t\Delta u_s + \delta \sum_{z=0}^{t-1} a^z + b\Delta u_s \sum_{z=1}^t za^{z-1} + b\delta \sum_{z=1}^{t-1} \sum_{m=1}^z ma^{m-1} + o(r^2)$$

$$u_{s+t+1} - u_s = \Delta u_s \sum_{z=0}^t a^z + \delta \sum_{z=0}^t \sum_{m=0}^{z-1} a^m + b\Delta u_s \sum_{z=1}^t \sum_{m=1}^z ma^{m-1} + b\delta \sum_{x=1}^{t-1} \sum_{z=1}^x \sum_{m=1}^z ma^{m-1} + o(r^2)$$

One obtains the proposition by applying the following formulas for power series summation:

$$\sum_{z=0}^t a^z = \frac{1 - a^{t+1}}{1 - a}$$



$$\sum_{z=0}^t \sum_{m=0}^{z-1} a^m = \frac{t+1 - \frac{a-a^{t+1}}{1-a}}{1-a}$$

$$\sum_{z=1}^t \sum_{m=1}^z ma^{m-1} = \frac{t(1+a^{t+1})(1-a) - (2-a)(a^{t+1}-a)}{(1-a)^3}$$

$$\sum_{x=1}^{t-1} \sum_{z=1}^x \sum_{m=1}^z ma^{m-1} = \frac{1}{(1-a)^3} \left( \frac{t(t-1)}{2} (1-a) - (t-2)a^{t+1} - a(2-a)t + 2a(1-a) \right).$$

The third and fourth summations formulas follow because

$$\begin{aligned} \sum_{m=1}^z ma^{m-1} &= (1 + 2a + 3a^2 + \dots + za^{z-1}) \\ &= \left( \frac{1-a^z}{1-a} + a \frac{1-a^{z-1}}{1-a} + \dots + a^{z-1} \frac{1-a}{1-a} \right) \\ &= \left( \frac{1+a+\dots+a^{z-1}}{1-a} - \frac{za^z}{1-a} \right) \\ &= \left( \frac{1-a^z}{(1-a)^2} - \frac{za^z}{1-a} \right) \end{aligned}$$

$$\begin{aligned} \sum_{z=1}^s \sum_{m=1}^z ma^{m-1} &= \sum_{z=1}^s \left( \frac{1-a^z}{(1-a)^2} - \frac{za^z}{1-a} \right) \\ &= \frac{s}{(1-a)^2} - \frac{a-a^{s+1}}{(1-a)^2} - \frac{a}{1-a} \sum_{z=1}^s za^{z-1} \\ &= \frac{s}{(1-a)^2} - \frac{a-a^{s+1}}{(1-a)^2} - \frac{a}{1-a} \left( \frac{1-a^s}{(1-a)^2} - \frac{sa^s}{1-a} \right) \\ &= \frac{s(1-a)}{(1-a)^3} - \frac{a(1-a) - (1-a)a^{s+1}}{(1-a)^3} - \frac{a-a^{s+1}}{(1-a)^3} + \frac{sa^{s+1}(1-a)}{(1-a)^3} \\ &= \frac{s(1+a^{s+1})(1-a) - (2-a)(a^{s+1}-a)}{(1-a)^3} \end{aligned}$$

$$\begin{aligned}
\sum_{x=1}^{s-1} \sum_{z=1}^x \sum_{m=1}^z ma^{m-1} &= \sum_{x=1}^{s-1} \frac{x(1+a^{x+1})(1-a) - (2-a)(a^{x+1}-a)}{(1-a)^3} \\
&= \frac{1}{(1-a)^3} \left( \sum_{x=1}^{s-1} x(1-a) + xa^{x+1}(1-a) - (2-a)(a^{x+1}-a) \right) \\
&= \frac{1}{(1-a)^3} \left( \frac{s(s-1)}{2}(1-a) + a^2(1-a) \underbrace{\sum_{x=1}^{s-1} xa^{x-1}}_{=\frac{1-a^{s-1}}{(1-a)^2} - \frac{(s-1)a^{s-1}}{1-a}} \right. \\
&\quad \left. - a(2-a)(s-1) - (2-a)a^2 \frac{1-a^{s-1}}{1-a} \right) \\
&= \frac{1}{(1-a)^3} \left( \frac{s(s-1)}{2}(1-a) - (s-2)a^{s+1} - a(2-a)s + 2a(1-a) \right)
\end{aligned}$$

### A.3.2 Proofs of Lemma 6: $\lim_{r \rightarrow 0} k = \lim_{r \rightarrow 0} (n - k) = \infty$

Recall  $n$  and  $k$  are the last states in which the leader and the follower, respectively, chooses to invest in an equilibrium. Both  $n$  and  $k$  are functions of the interest rate  $r$ . Also recall that we use  $w_s \equiv v_s + v_{-s}$  to denote the total firm value of a market in state  $s$ .

**We first prove  $\lim_{r \rightarrow 0} (n - k) = \infty$ .**

Suppose  $k$  and  $(n - k)$  are both bounded as  $r \rightarrow 0$ ; let  $N$  be an upper bound for  $n$ , i.e.  $N \geq n(r)$  for all  $r$ .

Consider the sequence of value functions  $\hat{v}_s$  under alternative investment decisions: leader follows equilibrium strategies and invests in  $n(r)$  states whereas follower does not invest at all. The sequence of value function dominates the equilibrium value functions ( $\hat{v}_s \geq v_s$ ) for all  $s \geq 0$ , because:

1. The joint value is higher in every state  $\hat{w}_s \geq w_s$ , because a) flow payoffs are weakly higher and that 2) the value functions  $\hat{w}_s$  place higher weights on higher states (which have higher flow payoffs) than  $w_s$ . Hence the firm value in state zero is higher  $\hat{v}_0 \geq v_0$ .
2. The leader's value function can be written as a weighted average of flow payoffs in  $s > 0$  and the value of being in state zero; the flow payoffs are the same for all  $s > 0$ , and  $\hat{v}_0 \geq v_0$ .

Furthermore when follower does not invest, the leader's value function always places higher weights in states with higher payoffs; hence  $\hat{v}_s \geq v_s$  for all  $s > 0$ .

We now look for a contradiction to the presumption that  $n$  is bounded. As  $r \rightarrow 0$ ,

$$r\hat{v}_{N+1} = \frac{r\pi_{N+1} + \kappa r\hat{v}_N}{r + \kappa} \rightarrow r\hat{v}_N,$$

$$r\hat{v}_N = \frac{r(\pi_N - c\eta_N) + \kappa r\hat{v}_{N-1} + \eta_N r\hat{v}_{N+1}}{r + \kappa + \eta_N} \rightarrow r\hat{v}_{N-1},$$

and so on. By induction,  $r\hat{v}_s \sim r\hat{v}_0$  for all  $-N + 1 \leq s \leq N + 1$ .

Also note that leader stops investing in state  $n + 1$  implies

$$\lim_{r \rightarrow 0} r v_{n+1} \geq \pi_{n+2} - c\kappa,$$

thus  $\lim_{r \rightarrow 0} r\hat{v}_0 \geq \pi_{n+2} - c\kappa$ .

$$\text{Lastly, note } \Delta\hat{v}_0 \geq \Delta\hat{v}_0 = \frac{r\hat{v}_0 - (2\pi_0 - 2c\eta)}{2\eta} = \frac{r\hat{v}_0 - (\pi_0 - c\eta)}{\eta}.$$

Putting these pieces together, we apply Proposition A.1 to compute a lower bound for  $\Delta\hat{v}_n$  as a function of  $\hat{v}_0$  and  $\Delta\hat{v}_0$  (substituting  $u_s = \hat{v}_0$ ,  $u_{s+t} = \hat{v}_{n+1}$ ,  $a = \kappa/\eta$ ,  $b = r/\eta$ ,  $\delta = \frac{r\hat{v}_0 - (\pi_{n+2} - c\eta)}{\eta}$ ):

$$\begin{aligned} \lim_{r \rightarrow 0} \Delta\hat{v}_{n+1} &\geq \lim_{r \rightarrow 0} \left( \Delta\hat{v}_0 (\kappa/\eta)^n + \frac{r\hat{v}_0 - (\pi_{n+2} - c\eta)}{\eta} \frac{1 - (\kappa/\eta)^n}{1 - \kappa/\eta} \right) \\ &\geq \lim_{r \rightarrow 0} \frac{r\hat{v}_0 - (\pi_0 - c\eta)}{\eta} (\kappa/\eta)^n + \frac{r\hat{v}_0 - (\pi_{n+2} - c\eta)}{\eta} \frac{1 - (\kappa/\eta)^n}{1 - \kappa/\eta} \\ &\geq \lim_{r \rightarrow 0} \frac{\pi_{n+2} - c\kappa - (\pi_0 - c\eta)}{\eta} (\kappa/\eta)^n + \frac{\pi_{n+2} - c\kappa - (\pi_{n+2} - c\eta)}{\eta} \frac{1 - (\kappa/\eta)^n}{1 - \kappa/\eta} \\ &> \lim_{r \rightarrow 0} c (\kappa/\eta)^n + \frac{c(\eta - \kappa)}{\eta} \frac{1 - (\kappa/\eta)^n}{1 - \kappa/\eta} \\ &= c, \end{aligned}$$

where the last inequality follows from assumption 1, that  $\pi_{n+2} - \pi_0 \geq \pi_1 - \pi_0 > c\kappa$ . But this is a contradiction to the claim that leader stops investing in state  $n + 1$  (i.e.  $\Delta\hat{v}_{n+1} \leq c$  for any  $r$ ).

Next, suppose  $\lim_{r \rightarrow 0} k = \infty$  but  $(n - k)$  remain bounded. Let  $\epsilon \equiv 2c\eta - \lim_{s \rightarrow \infty} (\pi_s + \pi_{-s})$ ;  $\epsilon > 0$  under assumption 1. The joint flow payoff  $\pi_s + \pi_{-s} - 2c\eta$  is negative and bounded above

by  $-\epsilon$  in all states  $s \leq k$ . The joint market value in state 0 is

$$\begin{aligned} w_0 &= \sum_{s'=0}^k \tilde{\lambda}_{s'|0} \cdot (PV_{s'} + PV_{-s'}) + \sum_{s'=k+1}^{n+1} \tilde{\lambda}_{s'|0} \cdot (PV_{s'} + PV_{-s'}) \\ &\leq \frac{-\epsilon}{r} \cdot \left( \sum_{s'=0}^k \tilde{\lambda}_{s'|0} \right) + \sum_{s'=k+1}^{n+1} \tilde{\lambda}_{s'|0} \cdot (PV_{s'} + PV_{-s'}). \end{aligned}$$

As  $k \rightarrow \infty$  while  $n - k$  remain bounded, the present-discount fraction of time that the market spends in states  $s \leq k$  converges to 1 ( $\sum_{s'=0}^k \tilde{\lambda}_{s'|0} \rightarrow 1$ ), implying that  $\lim_{r \rightarrow 0} r w_0$  is negative. Since firms can always ensure non-negative payoffs by not taking any investment, this cannot be an equilibrium, reaching a contradiction. Hence  $\lim_{r \rightarrow 0} (n - k) = \infty$ .

To show  $\lim_{r \rightarrow 0} k = \infty$ , we first establish a few additional asymptotic properties of the model.

**Lemma A.2.** The following statements are true:

1.  $r v_n \sim \pi - c\kappa$ , where  $\pi \equiv \lim_{s \rightarrow \infty} \pi_s$ .
2.  $v_{n+1} - v_n \sim c$ .
3.  $r(n - k) \sim 0$ .
4.  $rk \sim 0$ .

**Proof**

1. The claim follows from the fact that if the leader invests in state  $n$  but not in state  $n + 1$ , then

$$v_{n+2} - v_{n+1} = \frac{\pi_{n+2} - r v_{n+1}}{r + \kappa} \leq c$$

$$v_{n+1} - v_n = \frac{\pi_{n+1} - r v_n}{r + \kappa} \geq c$$

implying

$$\pi - c\kappa = \lim_{r \rightarrow 0} (\pi_{n+2} - c\kappa) \geq \lim_{r \rightarrow 0} r v_n \geq \lim_{r \rightarrow 0} (\pi_{n+1} - c\kappa) = \pi - c\kappa,$$

as desired.

2. The claim follows from the previous one:  $v_{n+1} - v_n = \frac{\pi_{n+1}}{r+\kappa} - \frac{rv_n}{r+\kappa} \sim \frac{\pi - rv_n}{\kappa} \sim c$ .
3. The previous claims show  $rv_n \sim \pi - c\kappa$  and  $\Delta v_n \sim c$ . We apply Proposition A.1 to iterate backwards and obtain

$$\begin{aligned} \lim_{r \rightarrow \infty} r(v_k - v_n) &\geq \lim_{r \rightarrow \infty} -\frac{r^2}{\kappa^2} \frac{rv_n - (\pi - c\eta)}{(1 - \eta/\kappa)^4} (\eta/\kappa)^{n-k+1} \\ &\sim -\frac{r^2}{\kappa^2} \frac{c(\eta - \kappa)}{(1 - \eta/\kappa)^4} (\eta/\kappa)^{n-k+1} \end{aligned}$$

Since  $|\lim_{r \rightarrow 0} r(v_k - v_n)| \leq \pi$ , it must be the case that  $\lim_{r \rightarrow 0} r^2 (\eta/\kappa)^{n-k+1}$  remain bounded; therefore  $r(n-k) \sim 0$ .

4. We apply Proposition A.1 to find a lower bound for  $w_k - w_0$ :

$$\begin{aligned} \lim_{r \rightarrow 0} r(w_k - w_0) &\geq \lim_{r \rightarrow 0} \left( \Delta w_0 + \frac{rw_0 - (\pi - 2c\eta)}{a-1} \right) \frac{ra^k}{a-1} \\ &\geq \lim_{r \rightarrow 0} \left( \frac{2c\eta - \pi}{a-1} \right) \frac{ra^k}{a-1}. \end{aligned}$$

Since  $r(w_k - w_0)$  stays bounded, it must be the case that  $ra^k$  is bounded; therefore  $rk \sim 0$ .

**Lemma A.3.**  $rv_{-k} \sim r\Delta v_{-k} \sim rv_{-n} \sim \Delta v_{-n} \sim 0$ .

**Proof.** First, note that follower does not invest in state  $k+1$  implies  $c \geq \Delta v_{-(k+1)}$ . We apply Proposition A.1 to find an upper bound for  $(v_{-n} - v_{-k})$  as a function of  $rv_{-k}$  and  $\Delta v_{-(k+1)}$ :

$$v_{-n} - v_{-k} \leq \lim_{r \rightarrow 0} \left( -\Delta v_{-(k+1)} \frac{\eta}{\eta - \kappa} + (n-k) \frac{rv_{-k}}{\eta - \kappa} \right).$$

Hence,  $v_{-n} - v_{-k} \leq -c \frac{\eta}{\eta - \kappa}$  and  $r(v_{-n} - v_{-k}) \sim 0$ .

Let  $m \equiv \text{floor}(k + \frac{n-k}{2})$ . That the follower does not invest in state  $m$  implies that  $c \geq \Delta v_{-m}$ .

Proposition A.1. provides a lower bound for  $v_{-(n+1)} - v_{-n}$  as a function of  $rv_{-m}$  and  $\Delta v_{-(m+1)}$ :

$$\begin{aligned} \lim_{r \rightarrow 0} \left( v_{-(n+1)} - v_{-n} \right) &\geq \lim_{r \rightarrow 0} -\Delta v_{-(m+1)} (\kappa/\eta)^{n-m} + \frac{rv_{-m} - \pi_{-m}}{\eta - \kappa} \\ &= \lim_{r \rightarrow 0} \frac{rv_{-m}}{\eta - \kappa}, \end{aligned}$$

where the equality follows from  $\lim_{m \rightarrow \infty} \pi_{-m} \rightarrow 0$ . Since the LHS is non-positive, it must be the case that  $\lim_{r \rightarrow 0} \Delta v_{-n} = \lim_{r \rightarrow 0} rv_{-m} = 0$ . But since  $rv_{-n} \leq rv_{-m}$ , it must be that  $rv_{-n} \sim rv_{-k} \sim 0$ . That  $r\Delta v_{-k} \sim 0$  follows directly from the HJB equation for state  $k$ .

**We now prove**  $\lim_{r \rightarrow 0} k = \infty$ .

We first show that, if  $k$  is bounded, both  $rw_k$  and  $r\Delta w_k$  must be asymptotically zero in order to be consistent with  $rv_{-k} \sim 0$ . Specifically, we use the fact that  $0 \leq \pi_{-s}$  for all  $0 \leq s \leq k$  and apply Proposition A.1 (simplification 1a, substituting  $u_s \equiv v_{-k+1}$ ,  $u_{s+t} = v_0$ ,  $t = k+1$ ,  $\Delta u_s = \Delta v_{-k}$ ,  $a = \frac{\eta}{\eta+\kappa}$ ,  $b = \frac{r}{\eta+\kappa}$ ,  $\delta = \frac{rv_{-(k+1)} - (-c\eta)}{\eta+\kappa}$ ) to find an asymptotic upper bound for  $rv_0$ :

$$\begin{aligned} \lim_{r \rightarrow 0} rv_0 &= \lim_{r \rightarrow 0} r \left( v_0 - v_{-(k+1)} \right) \\ &\leq \lim_{r \rightarrow 0} \frac{r}{1 - \kappa/\eta} \left( \Delta v_{-(k+1)} + k \frac{rv_{-(k+1)} + c\eta}{\eta} \right) \end{aligned}$$

If  $k$  is bounded, the last expression converges to zero, implying that  $rv_0 \sim rw_0 \sim 0$ . Lemma A.1 further implies that  $\Delta w_0 \sim c$ . Upper bounds for  $rw_k$  and  $r\Delta w_k$  can be found, as functions of  $\Delta w_0$  and  $rw_0$ , using Proposition A.1 (simplification 2, substituting  $u_s \equiv w_0$ ,  $u_{s+t} = w_k$ ,  $t = k$ ,  $\Delta u_s = \Delta w_0$ ,  $a = \frac{\eta+\kappa}{\eta}$ ,  $b = \frac{r}{\eta}$ ,  $\delta = \frac{rw_0 - (-2c\eta)}{\eta}$ ):

$$\begin{aligned} \lim_{r \rightarrow 0} (rw_k - rw_0) &\leq \lim_{r \rightarrow 0} \left( \Delta w_0 + \frac{rw_0 + 2c\eta}{\kappa} \right) \frac{\eta}{\kappa} r \left( \frac{\eta + \kappa}{\eta} \right)^k \\ \lim_{r \rightarrow 0} (r\Delta w_k) &\leq \lim_{r \rightarrow 0} \left( \Delta w_0 + \frac{rw_0 + 2c\eta}{\kappa} \right) r \left( \frac{\eta + \kappa}{\eta} \right)^{k-1}. \end{aligned} \tag{17}$$

If  $k$  is bounded, the RHS of both inequalities converge to zero, implying  $rw_k \sim r\Delta w_k \sim 0$ .

We now look for a contradiction. Suppose  $rw_k \sim r\Delta w_k \sim 0$ ; we apply Proposition A.1 (sim-

simplification 1a, substituting  $u_s \equiv w_k$ ,  $u_{s+t} = w_{n+1}$ ,  $t = n + 1 - k$ ,  $\Delta u_s = \Delta w_k$ ,  $a = \frac{\kappa}{\eta}$ ,  $b = \frac{r}{\eta}$ ,  $\delta = \frac{rw_k - (\pi_k - c\eta)}{\eta}$ ) and obtain  $\frac{rw_k - (\pi_k - c\eta)}{\eta - \kappa}$  as an asymptotic upper bound for  $w_{n+1} - w_n$  (noting that  $\pi_k$  is a lower bound for  $\pi_s$  for all  $n \geq s \geq k$ ). Lemma A.2 part 2 further implies that

$$\begin{aligned} \lim_{r \rightarrow 0} \frac{rw_k - (\pi_k - c\eta)}{\eta - \kappa} &\geq c \\ \iff \lim_{r \rightarrow 0} rw_k &\geq \pi_k - c\kappa, \end{aligned} \quad (18)$$

which, by assumption 1 ( $\pi_1 - \pi_0 \geq c\kappa$ , i.e., firms in state 0 have incentive to invest when sufficiently patient), implies  $\lim_{r \rightarrow 0} rw_k > 0$ . This contradicts the presumption that  $rw_k \sim 0$ . QED.

The fact that  $\lim_{r \rightarrow 0} r\Delta w_k > 0$ , together with inequality (17), implies  $\lim_{r \rightarrow 0} r \left( \frac{\eta + \kappa}{\eta} \right)^k > 0$ . We summarize these statements into a lemma, which will be useful later.

**Lemma A.4.**  $\lim_{r \rightarrow 0} r \left( \frac{\eta + \kappa}{\eta} \right)^k > 0$  and  $\lim_{r \rightarrow 0} r\Delta w_k > 0$ .

### A.3.3 Proof of Proposition 1.

Lemma 4 implies  $g = \ln \lambda \times (\mu^C \cdot (\eta + \kappa) + \mu^M \cdot \kappa)$ . We now show  $\lim_{r \rightarrow 0} (\kappa/\eta)^{n-k} (1 + \kappa/\eta)^k = 0$ , which, based on Lemma 4, is a sufficient condition for  $\mu^M \rightarrow 1$ ,  $\mu^C \rightarrow 0$ , and  $g \rightarrow \kappa \cdot \ln \lambda$ .

To proceed, we first find a lower bound for  $\Delta w_k$  by applying simplification 2 of Proposition A.1 (substituting  $u_s \equiv w_0$ ,  $u_{s+t} = w_k$ ,  $t = k$ ,  $\Delta u_s = \Delta w_0$ ,  $a = \frac{\eta + \kappa}{\eta}$ ,  $b = \frac{r}{\eta}$ ,  $\delta = \frac{rw_0 - (\pi - 2c\eta)}{\eta}$ ):

$$\lim_{r \rightarrow 0} r\Delta w_k \geq C_2 \equiv \lim_{r \rightarrow 0} \left( \Delta w_0 + \frac{rw_0 - (\pi - 2c\eta)}{\kappa} \right) r \left( \frac{\eta + \kappa}{\eta} \right)^k. \quad (19)$$

Simplification 1 of Proposition A.1 provides asymptotic bounds for  $\Delta w_n$  (substituting  $u_s \equiv w_k$ ,  $u_{s+t} = w_n$ ,  $t = n - k$ ,  $\Delta u_s = \Delta w_k$ ,  $a = \frac{\kappa}{\eta}$ ,  $b = \frac{r}{\eta}$ ; the upper bound is obtained using  $\delta = \frac{rw_k - (\pi_k - c\eta)}{\eta}$  and the lower bound is obtained using  $\delta = \frac{rw_k - (\pi - c\eta)}{\eta}$ ):

$$\lim_{r \rightarrow 0} \left[ \Delta w_k \left( \left( \kappa/\eta \right)^{n-k} + \frac{r\eta}{(\eta - \kappa)^2} \right) + \frac{rw_k + c\eta - \pi_k}{\eta - \kappa} \right] \geq \lim_{r \rightarrow 0} \Delta w_n$$

and

$$\lim_{r \rightarrow 0} \Delta w_n \geq \lim_{r \rightarrow 0} \left[ \Delta w_k \left( (\kappa/\eta)^{n-k} + \frac{r\eta}{(\eta - \kappa)^2} \right) + \frac{rw_k + c\eta - \pi}{\eta - \kappa} \right].$$

Since  $\lim_{r \rightarrow 0} \pi_k = \pi$ , the lower and upper bounds coincide asymptotically. Furthermore, Lemma A.2 shows  $\Delta w_n \sim c$ ; hence,

$$c \sim \Delta w_k \left( (\kappa/\eta)^{n-k} + \frac{r\eta}{(\eta - \kappa)^2} \right) + \frac{rw_k + c\eta - \pi}{\eta - \kappa}. \quad (20)$$

Next, we apply simplification 1b of Proposition A.1 to obtain (substituting  $u_s \equiv w_k$ ,  $u_{s+t} = w_n$ ,  $t = n - k$ ,  $\Delta u_s = \Delta w_k$ ,  $a = \frac{\kappa}{\eta}$ ,  $b = \frac{r}{\eta}$ ; the simplification applies because  $\lim_{r \rightarrow 0} r\Delta w_k > 0$ , as stated in Lemma A.4):

$$r(w_n - w_k) \sim \frac{r\Delta w_k}{(\eta - \kappa)/\eta} \quad (21)$$

$$\implies \pi - c\kappa - rw_k \sim \frac{r\Delta w_k}{(\eta - \kappa)/\eta} \quad (22)$$

where equivalence (22) follows from part 1 of Lemma A2.

Substituting asymptotic equivalence (22) into (20), we obtain

$$\begin{aligned} c &\sim c + \Delta w_k \left( (\kappa/\eta)^{n-k} + \frac{r\eta}{(\eta - \kappa)^2} \right) - \frac{r\eta\Delta w_k}{(\eta - \kappa)^2} \\ &\iff 0 \sim \Delta w_k (\kappa/\eta)^{n-k} \end{aligned}$$

Inequality (19) implies

$$0 \geq \lim_{r \rightarrow 0} \left( \Delta w_0 + \frac{rw_0 - (\pi - 2c\eta)}{\kappa} \right) \left( \frac{\eta + \kappa}{\eta} \right)^k (\kappa/\eta)^{n-k}$$

Given  $\Delta w_0 \geq 0$ ,  $rw_0 \geq 0$ , and  $2c\eta - \pi > 0$ , the inequality can hold if and only if

$$\lim_{r \rightarrow 0} \left( \frac{\eta + \kappa}{\eta} \right)^k (\kappa/\eta)^{n-k} = 0,$$

as desired.



### A.3.4 Proof of Proposition 2.

Let  $(k, n)$  be the equilibrium investment decisions under interest rate  $r$  and  $(k_2, n_2)$  be the investments under  $r - \Delta r$ . Proposition A.1 enables us to provide first-order approximations of value functions before and after the interest rate shock  $\Delta r$  (denoted by  $\{v_s\}_{s=-\infty}^{\infty}$  and  $\{\hat{v}_s\}_{s=-\infty}^{\infty}$  respectively). We then use these expressions to show

$$\begin{aligned}\frac{\hat{V}^F}{V^F} &= \frac{\sum_{s=1}^{n+1} \mu_s \hat{v}_{-s}}{\sum_{s=1}^{n+1} \mu_s v_{-s}} + O(r) \\ &= \frac{k_2}{k} + O(r).\end{aligned}$$

The fact that  $r \left( \frac{\eta + \kappa}{\eta} \right)^k$  converges to a non-negative constant (c.f. Lemma A.4) implies

$$\frac{\hat{V}^F}{V^F} = \frac{\log(r - \Delta r)}{\log r} + O(r).$$

The part about the on-impact, proportional change in the total market value of leaders formally follows from similar derivations, but it has a more straight-forward intuition. As  $r \rightarrow 0$ , market leadership becomes endogenous absorbing, and the total market value of leaders becomes inversely proportional to the interest rate ( $rV^L$  converges to a non-negative constant). Hence, following a decline in interest rate, the value of leaders changes proportionally with the interest rate, i.e.  $\hat{V}^L/V^L = \frac{r}{r-\Delta r} + O(r)$ .

Before we prove the claim, we first establish two lemmas.

**Lemma A.5.**  $\Delta v_{-k} \sim c, v_{-k} \sim \frac{c}{1-\kappa/\eta}, v_{-(n+1)} \sim 0$ . Proof. Note that  $v_{-(k-1)} - v_{-k} \geq c, v_{-(k-2)} - v_{-(k-1)} \geq c$ , and  $c \geq v_{-k} - v_{-(k+1)}$ . The HJB equation for followers in state  $k-1$  and  $k$  respectively imply

$$\begin{aligned}rv_{-(k-1)} &= \pi_{-(k-1)} + \eta \left( v_{-(k-2)} - v_{-(k-1)} - c \right) \\ &\quad + \kappa \left( v_{-(k-2)} - v_{-(k-1)} \right) + \eta \left( v_{-k} - v_{-(k-1)} \right)\end{aligned}$$

$$\begin{aligned}
rv_{-k} &= \pi_{-k} + \eta \left( v_{-(k-1)} - v_{-k} - c \right) \\
&\quad + \kappa \left( v_{-(k-1)} - v_{-k} \right) + \eta \left( v_{-(k+1)} - v_{-k} \right).
\end{aligned}$$

Substituting the previous inequalities, we get

$$rv_{-(k-1)} \leq \pi_{-(k-1)} + \kappa c + \eta \left( v_{-k} - v_{-(k-1)} \right)$$

$$rv_{-k} \geq \pi_{-k} + (\eta + \kappa) \left( v_{-(k-1)} - v_{-k} \right) - 2\eta c.$$

Hence,

$$rv_{-(k-1)} - rv_{-k} \leq \pi_{-(k-1)} - \pi_{-k} - (2\eta + \kappa) \left( v_{-(k-1)} - v_{-k} \right) + (2\eta + \kappa) c$$

$$\Leftrightarrow \left( v_{-(k-1)} - v_{-k} \right) \leq \frac{\pi_{-(k-1)} - \pi_{-k}}{2\eta + \kappa + r} + \frac{2\eta + \kappa}{2\eta + \kappa + r} c,$$

which implies  $\lim_{r \rightarrow 0} \left( v_{-(k-1)} - v_{-k} \right) \leq c$ . Coupled with the fact that  $v_{-(k-1)} - v_{-k} \geq c$ , this establishes that  $v_{-(k-1)} - v_{-k} \sim c$ .

That  $v_{-k} - v_{-(n+1)} \sim \frac{c}{1-\kappa/\eta}$  can be obtained by applying simplification 1a) of Proposition A1. It remains to show  $v_{-(n+1)} \sim 0$ . Note that we can write  $v_{-(n+1)}$  as a weighted average of the flow payoffs in states  $k+1$  through  $n+1$  and the value function in state  $-k$ :

$$v_{-(n+1)} = \sum_{s=k+1}^{n+1} \epsilon_s \pi_{-s} + \epsilon_k v_{-k}, \quad \text{where } \sum_{s=k}^n \epsilon_k = 1.$$

The flow payoffs  $\pi_{-k}$  approach zero as  $r \rightarrow 0$ ; hence,  $v_{-(n+1)} \sim \epsilon_k v_{-k}$ . The term  $\epsilon_k$  can be found

by solving the recursive relationship

$$\begin{aligned}
v_{-(n+1)} &= \frac{\kappa}{r + \kappa} v_{-n} \\
v_{-n} &= \frac{\kappa}{r + \kappa + \eta} v_{-(n-1)} + \frac{\eta}{r + \kappa + \eta} v_{-(n+1)} \\
&\vdots \\
v_{-(k+1)} &= \frac{\kappa}{r + \kappa + \eta} v_{-k} + \frac{\eta}{r + \kappa + \eta} v_{-(k+2)}.
\end{aligned}$$

It is easy to see that  $\epsilon_k < (\kappa/\eta)^{n-k}$ ; hence, as  $r \rightarrow 0$ ,  $\frac{v_{-(n+1)}}{v_{-k}} \rightarrow 0$ . This implies that  $v_{-(n+1)} \sim 0$  and  $v_{-k} \sim \frac{c}{1-\kappa/\eta}$ , as desired. QED.

We now show  $\frac{\hat{V}^F}{V^F} = \frac{k_2}{k} + O(r)$ . The total market value of followers is

$$\begin{aligned}
&\sum_{s=1}^k \mu_s v_{-s} + \sum_{s=k+1}^{n+1} \mu_s v_{-s} \\
&= \underbrace{2\mu_0 (av_{-1} + a^2v_{-2} + \dots + a^k v_{-k})}_{\text{total value of followers in the competitive region}} \\
&\quad + \underbrace{\mu_{k+1} (v_{-(k+1)} + bv_{-(k+2)} + b^2v_{-(k+3)} + \dots + b^{n-k} v_{-(n+1)})}_{\text{total value of followers in the monopolistic region}},
\end{aligned}$$

where  $a \equiv \frac{\eta}{\eta+\kappa}$  and  $b \equiv \eta/\kappa$ . We analyze the two terms separately.

First, we show the total value of followers in the competitive region scales with  $k$  asymptotically, i.e.,  $\sum_{s=1}^k \mu_s v_{-s} \sim Ck$  for some constant  $C$ . For any  $m < k$ , we can write  $\sum_{s=1}^k \mu_s v_{-s}$  as

$$\sum_{s=1}^k \mu_s v_{-s} = 2\mu_0 \left( \sum_{s=1}^{m-1} a^s v_{-s} + \sum_{s=m}^k a^s v_{-s} \right)$$

Lemma A.5 shows  $\Delta v_{-k} \sim c$  and  $v_{-k} \sim \frac{c}{1-a}$ . For any  $s' \geq m$ , we apply Proposition A.1 to generate asymptotic upper- and lower-bounds for  $v_{-s'}$  and  $\Delta v_{-s'}$ . Specifically, let

$$\begin{aligned}
\overline{v_{-s'}} &\equiv \frac{c}{1-a} (1 - a^{k-s'}) + \frac{ca}{1-a} \left( (k-s') - \frac{a - a^{k-s'}}{1-a} \right), \\
\underline{v_{-s'}} &\equiv \frac{c}{1-a} (1 - a^{k-s'}) + \frac{ca - \frac{\pi_m}{\eta+\kappa}}{1-a} \left( (k-s') - \frac{a - a^{k-s'}}{1-a} \right),
\end{aligned}$$

$$\overline{\Delta v_{-s'}} \equiv ca^{k-s'} + ca \frac{(1 - a^{k-s'-1})}{1 - a},$$

$$\underline{\Delta v_{-s'}} \equiv ca^{k-s'} + \left( ca - \frac{\pi_m}{\eta + \kappa} \right) \frac{(1 - a^{k-s'-1})}{1 - a}.$$

Then

$$\lim_{r \rightarrow 0} (\overline{v_{-s'}} - v_{-s'}) \geq 0 \geq \lim_{r \rightarrow 0} (v_{-s'} - \underline{v_{-s'}}),$$

$$\lim_{r \rightarrow 0} (\overline{\Delta v_{-s'}} - \Delta v_{-s'}) \geq 0 \geq \lim_{r \rightarrow 0} (\underline{\Delta v_{-s'}} - \Delta v_{-s'}).$$

Next, for all  $s < m$ , we apply Proposition A.1 again to find upper and lower bounds for  $v_{-s}$  using  $\overline{v_{-m}}$ ,  $\underline{v_{-m}}$ ,  $\overline{\Delta v_{-m}}$ , and  $\underline{\Delta v_{-m}}$ . Specifically, let

$$\overline{v_{-s}} \equiv \overline{v_{-m}} + \overline{\Delta v_{-m}} \frac{1 - a^{m-s}}{1 - a} + \frac{ca - \frac{\pi_m}{\eta + \kappa}}{1 - a} \left( m - s - \frac{a - a^{m-s}}{1 - a} \right),$$

$$\underline{v_{-s}} \equiv \underline{v_{-m}} + \underline{\Delta v_{-m}} \frac{1 - a^{m-s}}{1 - a} + \frac{ca - \frac{\pi_s}{\eta + \kappa}}{1 - a} \left( m - s - \frac{a - a^{m-s}}{1 - a} \right),$$

then

$$\lim_{r \rightarrow 0} (\overline{v_{-s}} - v_{-s}) \geq 0 \geq \lim_{r \rightarrow 0} (v_{-s} - \underline{v_{-s}}).$$

Using these bounds for  $v_{-s}$ , we can now find upper and lower-bounds for  $\sum_{s=1}^k \mu_s v_{-s}$ :

$$\lim_{r \rightarrow 0} \left( 2\mu_0 \left( \sum_{s=1}^{m-1} a^s \overline{v_{-s}} + \sum_{s'=m}^k a^{s'} \overline{v_{-s'}} \right) - \sum_{s=1}^k \mu_s v_{-s} \right) \geq 0 \geq \lim_{r \rightarrow 0} \left( 2\mu_0 \left( \sum_{s=1}^{m-1} a^s \underline{v_{-s}} + \sum_{s'=m}^k a^{s'} \underline{v_{-s'}} \right) - \sum_{s=1}^k \mu_s v_{-s} \right)$$

These bounds simplifies to

$$\lim_{r \rightarrow 0} \left( 2\mu_0 c \left( \frac{a}{1-a} \right)^2 k - \sum_{s=1}^k \mu_s v_{-s} \right) \geq 0 \geq \lim_{r \rightarrow 0} \left( 2\mu_0 (c - \pi_m / \eta) \left( \frac{a}{1-a} \right)^2 k - \sum_{s=1}^k \mu_s v_{-s} \right).$$

Since  $m$  is arbitrarily chosen,  $\pi_m$  can be made arbitrarily close to zero. hence, we conclude that

$$\sum_{s=1}^k \mu_s v_{-s} \sim 2\mu_0 c \left( \frac{a}{1-a} \right)^2 k.$$

We now compute the market value of followers in the monopolistic region. Using Proposition

A1, we derive

$$v_{-(k+s)} \sim v_{-k} - \frac{c}{1 - \kappa/\eta} (1 - (\kappa/\eta)^s) \sim \frac{c}{1 - \kappa/\eta} (\kappa/\eta)^s,$$

thus

$$\begin{aligned} & \sum_{s=k+1}^{n+1} \mu_s v_{-s} \\ = & \mu_{k+1} \left( v_{-(k+1)} + (\eta/\kappa) v_{-(k+2)} + (\eta/\kappa)^2 v_{-(k+3)} + \cdots + (\eta/\kappa)^{n-k} v_{-(n+1)} \right) \\ \sim & \mu_{k+1} \frac{\alpha c}{1 - \alpha} (n - k) \end{aligned}$$

The total market value of followers is thus

$$\begin{aligned} V^F & \equiv \sum_{s=1}^k \mu_s v_{-s} + \sum_{s=k+1}^{n+1} \mu_s v_{-s} \\ & \sim 2\mu_0 c \left( \frac{a}{1-a} \right)^2 k + \mu_{k+1} \frac{\alpha c}{1 - \alpha} (n - k) \\ & = 2\mu_0 \left( c \left( \frac{a}{1-a} \right)^2 k + \left( \frac{\eta}{\eta + \kappa} \right)^{k+1} \frac{\alpha c}{1 - \alpha} (n - k) \right) \\ & \sim 2\mu_0 c \left( \frac{a}{1-a} \right)^2 k. \end{aligned}$$

Now consider the new equilibrium characterized  $(k_2, n_2)$  under interest rate  $r - \Delta r$ . Let value functions be denoted by  $\hat{v}_s$  under the new equilibrium. The market value of followers, evaluated using the steady-state under  $r$ , is

$$\hat{V}^F \equiv \sum_{s=1}^k \mu_s \hat{v}_{-s} + \sum_{s=k+1}^{n+1} \mu_s \hat{v}_{-s}.$$

Following the same derivation as before, we can show

$$\hat{V}^F \sim 2\mu_0 c \left( \frac{a}{1-a} \right)^2 k_2,$$

thus

$$\frac{\hat{V}^F}{V^F} = \frac{k_2}{k} + O(r),$$

as desired. That  $\frac{\hat{V}^F}{V^F} = \frac{\log(r-\Delta r)}{\log r} + O(r)$  follows from the convergence of  $r \left(\frac{\eta+\kappa}{\eta}\right)^k$  to a non-negative constant (Lemma A.4.)

The on-impact, proportional change in the total market value of leaders can be derived analogously, as Proposition A.1 enables us to derive an asymptotic analytic approximation for the value functions. We omit the derivations here and instead provide a simpler intuition for the result. As interest rate converges to zero, the total market value of leaders becomes inversely proportional to the interest rate ( $rV^L$  converges to a non-negative constant). Hence, following a small decline in interest rate, the value of leaders changes proportionally with the interest rate, i.e.  $\hat{V}^L/V^L = \frac{r}{r-\Delta r} + O(r)$ .

## B Appendix

### B.1 A numerical illustration

In this numerical exercise, we relax the assumption that investments are bounded with a constant marginal cost; instead, we parametrize the investment cost as a quadratic function of the investment intensity:  $c(\eta) = \delta\eta^2/2$  for  $\eta \in [0, \infty)$ , where  $\delta$  is a cost parameter. This is done for three reasons. First, we demonstrate numerically that Proposition 1 survive beyond the bounded and constant-marginal-cost specification. Second, a convex cost function implies that first-order conditions with respect to investments are sufficient for the model solution, reducing computational burdens. Third, the specification implies that changes in investment intensities are smoothed out across states, thereby getting around the discrete changes in investments in the "bang-bang" solution of the baseline model. All other ingredients remain unchanged from the baseline model.

The HJB equations of the numerical model follow

$$rv_s = \max_{\eta \geq 0} \pi_s - \eta^2/2 + (\kappa + \eta_{-s})(v_{s-1} - v_s) + \eta(v_{s+1} - v_s)$$

$$rv_{-s} = \max_{\eta \geq 0} \pi_{-s} - \eta^2/2 + (\kappa + \eta)(v_{-(s-1)} - v_{-s}) + \eta_s(v_{-(s+1)} - v_{-s})$$

$$rv_0 = \max_{\eta \geq 0} \pi_0 - \eta^2/2 + \eta_0 (v_{-1} - v_0) + \eta (v_1 - v_0).$$

We now provide demonstrations of the investment function  $\{\eta_s\}$ , the steady-state distribution  $\{\mu_s\}$ , and value functions as well as how these functions change in response to lower interest rates. We also provide numerical illustrations of how steady-state levels of productivity growth vary with interest rates. In generating these numerical plots, we parametrize the within-market demand aggregator using  $\sigma = \infty$ , the case in which two firms produce perfect substitutes.

The top panel in Figure A3 shows the investment functions of the leader and follower across states for a high interest rate. The figure illustrates the leader dominance of Lemma 3; the leader invests more in all states beyond the neck-to-neck state. The dotted lines show the investment functions of the leader and follower for a lower interest rate. Both the leader and follower invest more in all states when the interest rate is lower, which represents the static effect of lower interest rates on investment.

However, as the bottom panel demonstrates, the leader's investment response to a lower interest rate is stronger than the follower's response for all states. The stronger response of the leader's investment to lower interest rates is the driving force behind the strategic effect through which lower interest rates boost market concentration.

The top panel of Figure A4 shows that, following a decline in  $r$ , the steady-state distribution of market structure shifts to the right, and aggregate market power increases.

Why does the leader's investment respond more to a lower interest rate? The bottom panel of Figure A4 shows the leader's and follower's value functions before and after a decline in the interest rate. The change in the leader's value is larger than the change in the follower's value; this is the key driver behind the leader's stronger investment response following a drop in  $r$ . Finally, Figure 1 numerically verifies the central result of the Proposition above. For a low enough interest rate, a further decline in the interest rate leads to lower growth. Figure 1 also verifies that  $g \rightarrow \kappa \cdot \ln \lambda$  in the numerical exercise with variable investment intensity.

Figure 5 demonstrates Proposition 2, that declines in interest rate has asymmetric on-impact effects on the market value of leaders and followers. Starting from a high-level of interest rate, declines in  $r$  hurts leaders on average; yet, starting from a low-level of  $r$ , further declines in  $r$  un-

ambiguously causes leaders' market value to appreciate relative to followers', and the asymmetry becomes stronger when the initial, pre-shock level of interest rate is lower.

## B.2 Transitional dynamics: productivity and market power

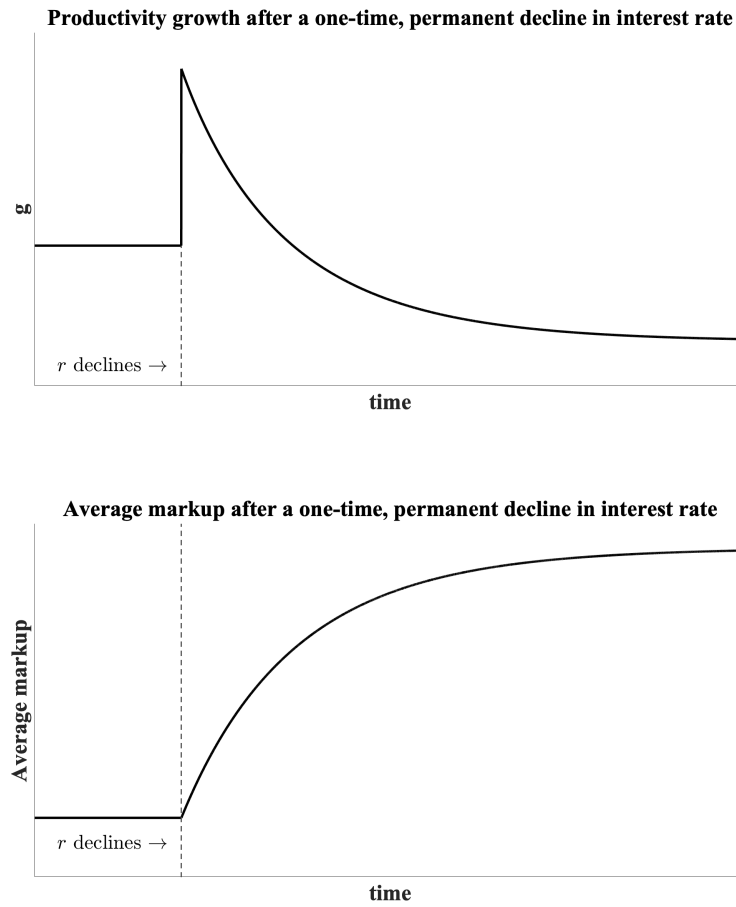
Proposition 1 implies that, starting from a high level of the interest rate, a declining interest rate is at first expansionary—measured by *steady-state* growth—and only becomes contractionary when  $r$  falls sufficiently low; yet, *steady-state* market power tends to rise when  $r$  declines, starting from any level.

Something parallel is also true for transitional dynamics after an unanticipated, permanent change in interest rates, though for different reasons. Starting from a steady-state, a permanent decline in the interest rate immediately moves market participants to a new equilibrium, featuring higher investments and productivity growth given any productivity gap (top panel of figure A1). The equilibrium distribution of productivity gaps (markups) starts to rise, although it moves slowly, as depicted in the lower panel.

Over time, as the distribution of state variable converges to the new steady-state and as the average productivity gap (markup) increases, the equilibrium growth rate and investment eventually decline to the new steady-state level. Whether productivity growth is higher or lower in the new steady-state relative to the initial one, depends on the level of the starting interest rate before the interest rate falls. If the starting interest rate is sufficiently low, then the growth rate would be lower in the new steady-state. Productivity growth along the transitional path in such a case is depicted in the top panel of Figure A1.



Figure A1: Time-path of markup and growth rate following a shock to  $r$



## Appendix Tables and Figures

[These tables and figures are referenced in the main text.]

Figure A2: market value of leaders respond more to decline in  $r$ , especially when initial  $r$  is low

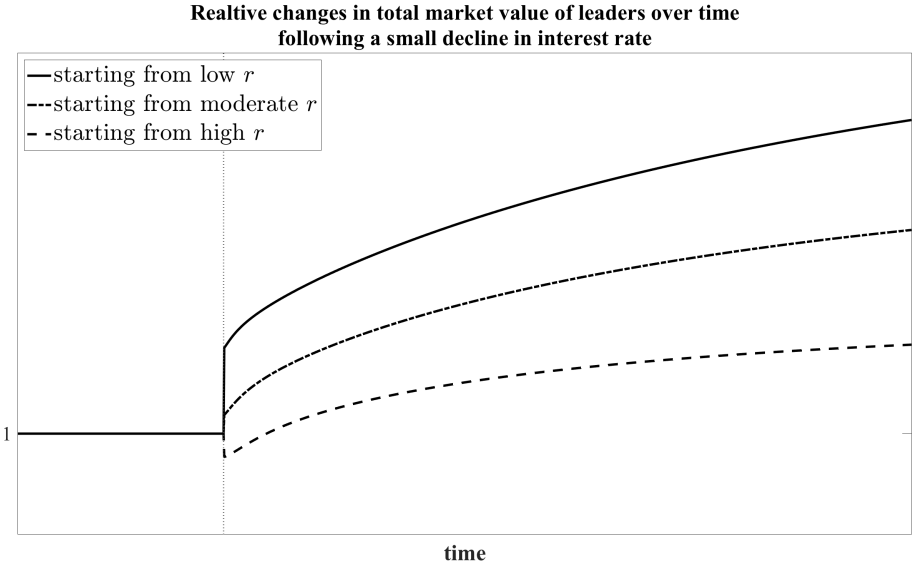


Figure A3: Investment response to a decline in  $r$

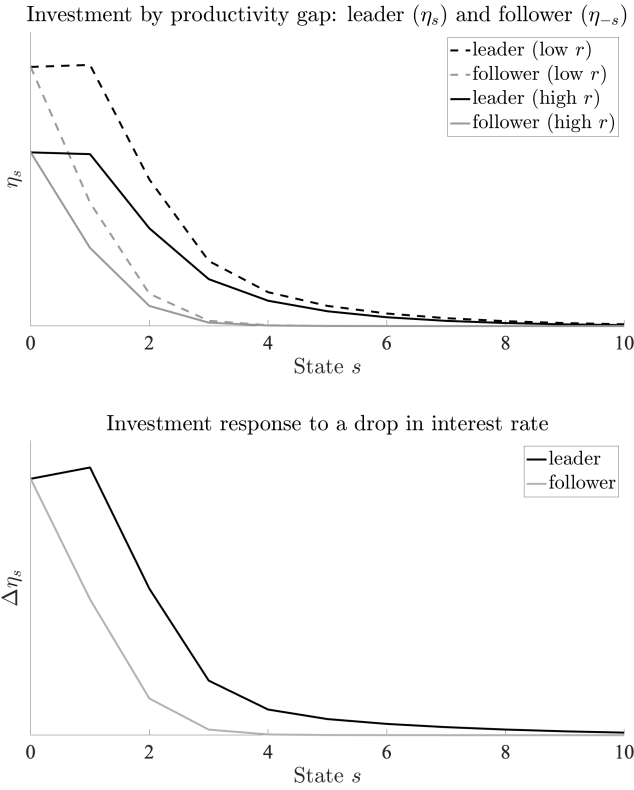


Figure A4: Response of steady-state distribution and value functions to a decline in  $r$

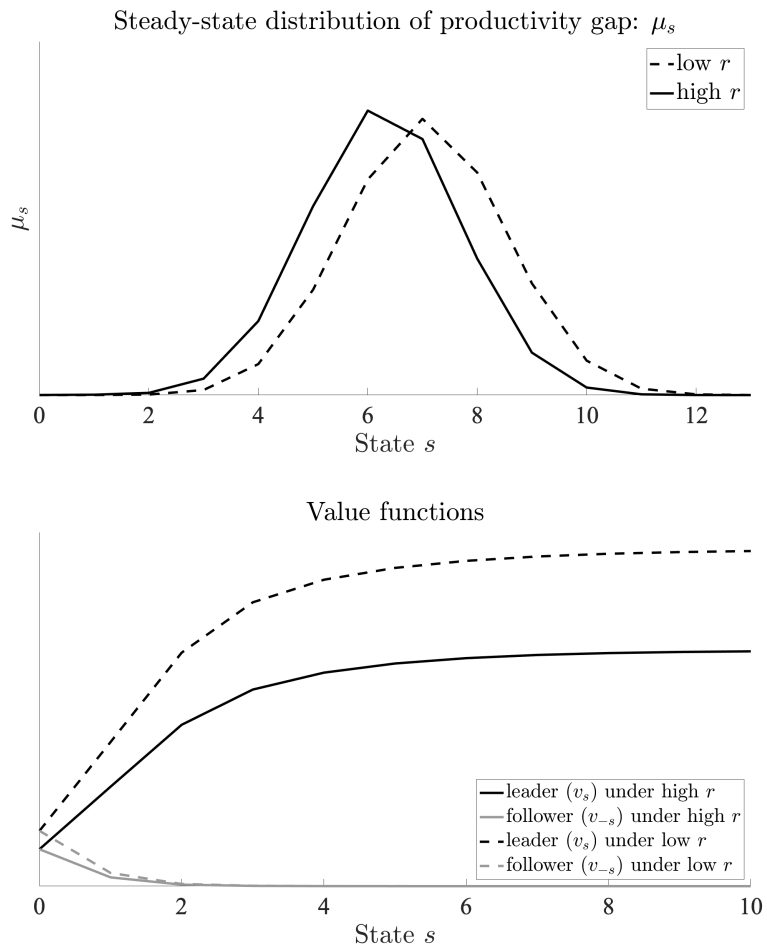


Figure A5: Aggregate profit share, market concentration and interest rate

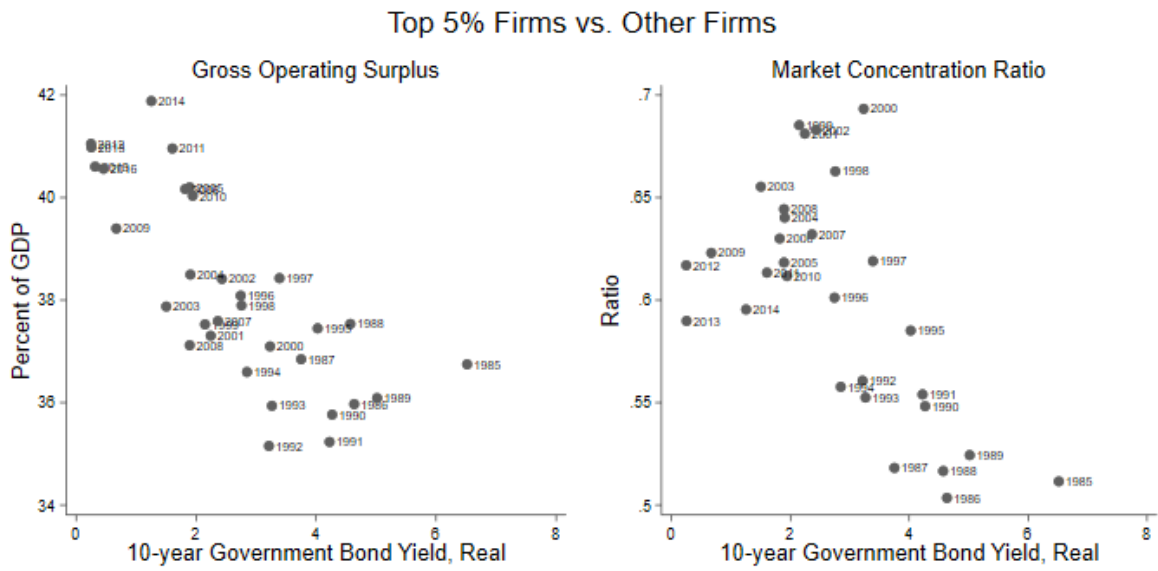


Figure A6: Business Dynamism

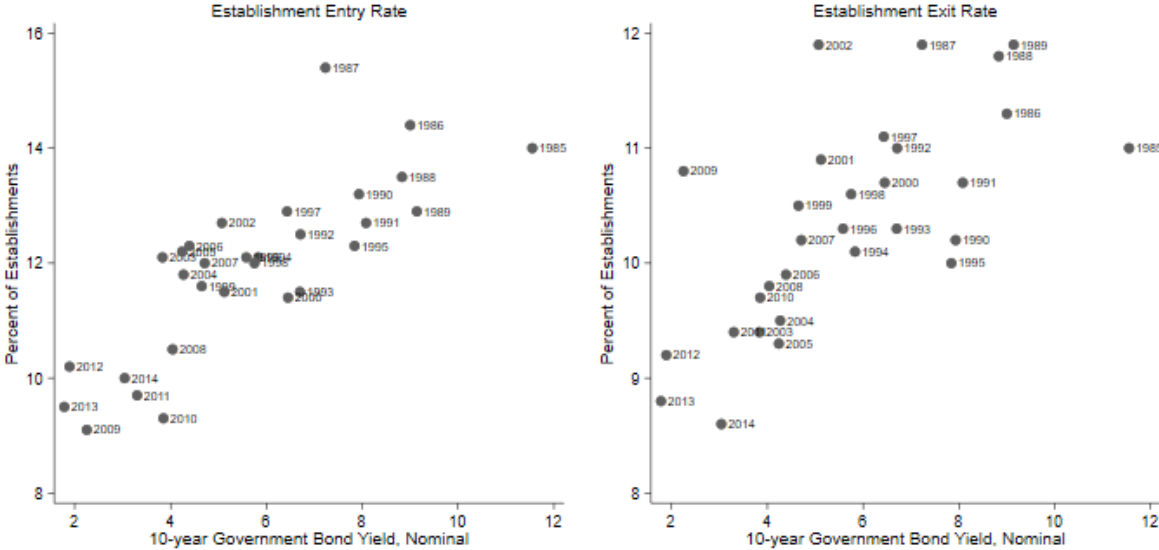


Figure A7: Widening productivity gap between leaders and followers

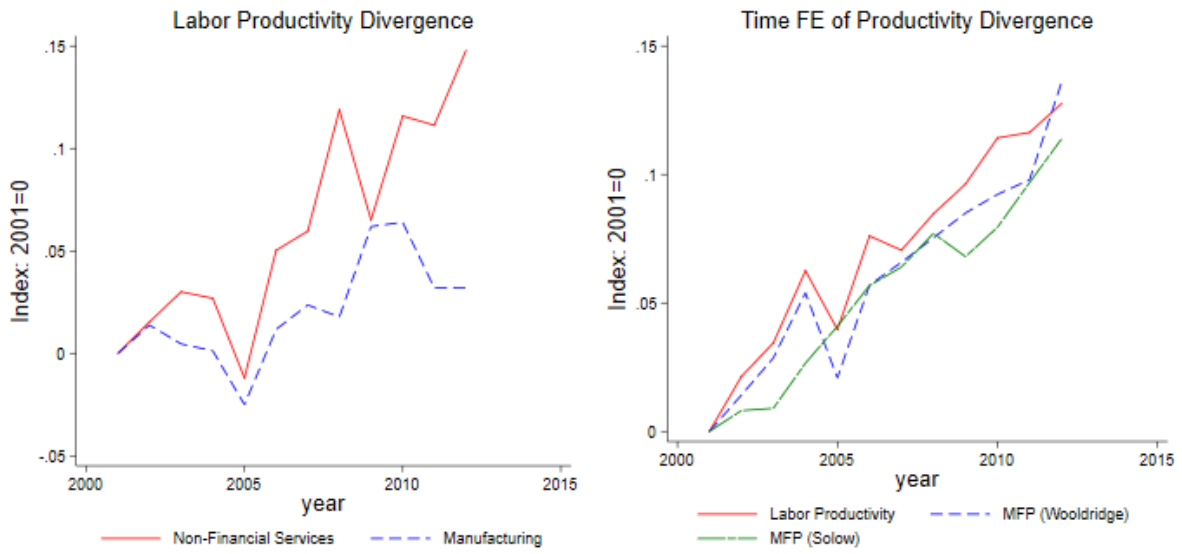


Figure A8: Within-industry investment and patent count concentration against interest rate

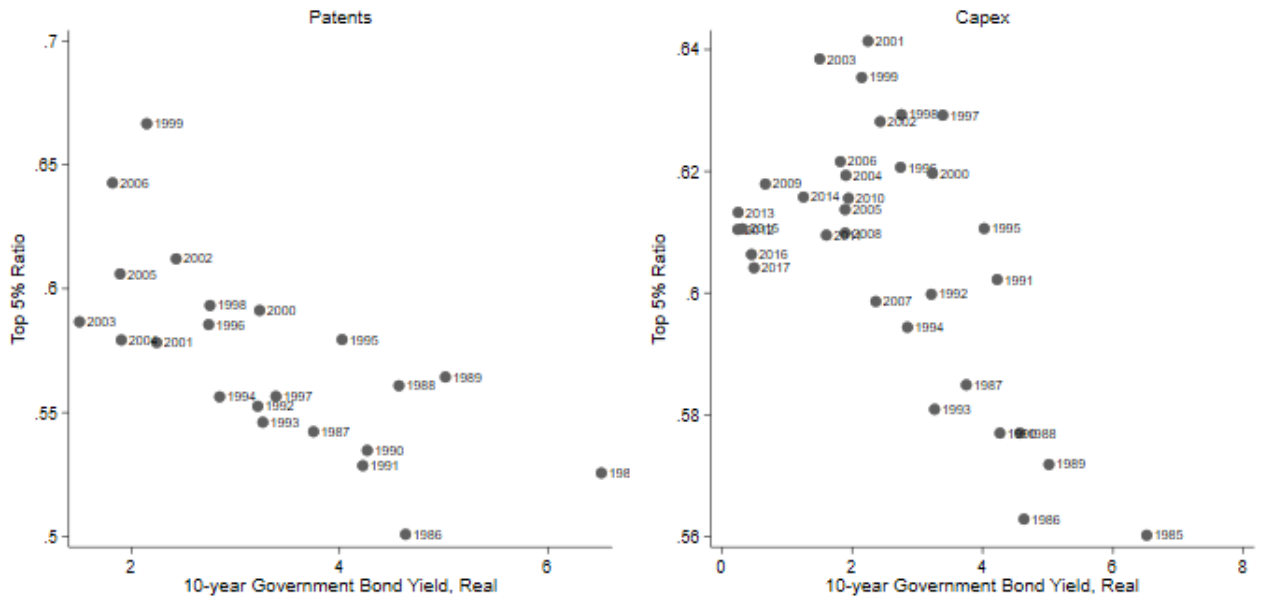


Figure A9: GZ spread

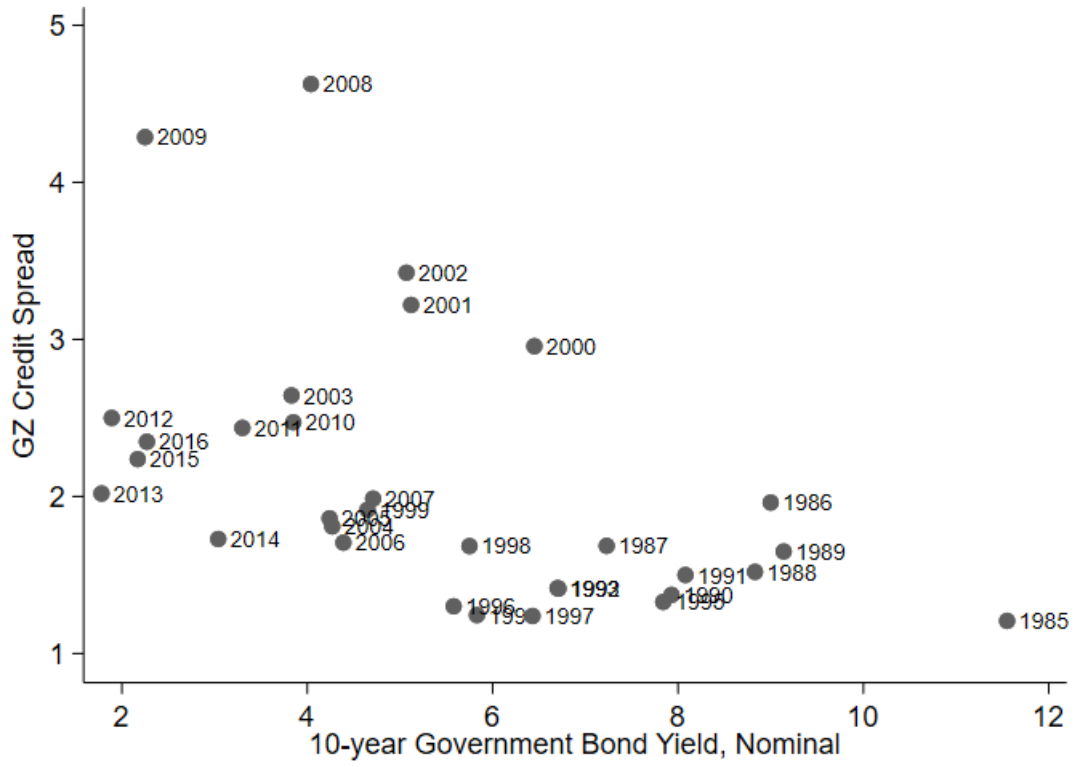




Table A1: Differential Interest Rate Responses of Leaders vs. Followers: Top 5 Percent (Full Sample)

	Stock Return					
	(1)	(2)	(3)	(4)	(5)	(6)
Top 5 Percent=1 x $\Delta i$	-1.019*** (0.219)	-3.303** (0.943)	-4.390*** (0.883)	-2.183*** (0.595)	-3.175*** (0.654)	-3.493*** (0.517)
Top 5 Percent=1 x $\Delta i$ x Lagged $i$		0.254** (0.084)	0.341*** (0.079)			0.259*** (0.044)
Top 5 Percent=1 x $\Delta i$ x Lagged real $i$ (Clev and Fred)				0.330** (0.116)	0.497*** (0.125)	
Firm $\beta$ x $\Delta i$						11.74*** (0.919)
Firm $\beta$ x $\Delta i$ x Lagged $i$						-1.096*** (0.098)
Sample						
Controls	N	N	Y	N	Y	
Industry-Date FE						Y
N	74,103,576	74,103,576	46,832,612	74,103,576	46,832,612	73,745,550
R-sq	0.426	0.426	0.423	0.426	0.423	0.430

Standard errors in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ 

Regression results for the specification  $\Delta \ln(P_{i,j,t}) = \alpha_{j,t} + \beta_0 D_{i,j,t} + \beta_1 D_{i,j,t} \Delta i_t + \beta_2 D_{i,j,t} i_{t-1} + \beta_3 D_{i,j,t} \Delta i_t i_{t-1} + X_{i,j,t} \gamma + \varepsilon_{i,j,t}$  for firm  $i$  in industry  $j$  at date  $t$ .  $\Delta \ln(P_{i,j,t})$  is defined here as the log change in the stock price for firm  $i$  in industry  $j$  from date  $t - 91$  to  $t$  (one quarter growth).  $D_{i,j,t}$  is defined here as an indicator equal to 1 at date  $t$  when a firm  $i$  is in the top 5% of market capitalization in its industry  $j$  on date  $t - 91$ . Firms with  $D_{i,j,t}=1$  are called leaders while the rest are called followers.  $i_t$  is defined as the nominal 10-year Treasury yield, with  $i_{t-1}$  being the interest rate 91 days prior and  $\Delta i_t$  being the change in the interest rate from date  $t - 91$  to  $t$ . Controls  $X$  include a firm's asset-liability ratio, debt-equity ratio, book-to-market ratio, and percent of pre-tax income that goes to taxes. Industry classifications are the Fama-French industry classifications (FF). Lagged real rates were built using monthly 10-year inflation expectations from the Cleveland Fed and the daily 10-year Treasury yield at the beginning of each month (post-1982), and the CPI series from the FED (pre-1982). Standard errors are dually clustered by industry and date.

Table A2: Portfolio Returns Response to Interest Rate Changes: Top 5 Percent (Full Sample)

	Portfolio Return					
	(1)	(2)	(3)	(4)	(5)	(6)
$\Delta i_t$	-0.985*** (0.277)	-3.237*** (0.616)	-2.210*** (0.497)	-1.874*** (0.558)	-3.176*** (0.909)	-2.885*** (0.797)
$i_{t-1}$		0.0597 (0.048)		0.00316 (0.042)	0.0222 (0.075)	0.0927 (0.067)
$\Delta i_t \times i_{t-1}$		0.255*** (0.058)		0.0727 (0.053)	0.234** (0.081)	0.281** (0.106)
<i>real</i> $i_{t-1}$ (Clev and Fred)			0.285*** (0.074)			
$\Delta i_t \times \textit{real} i_{t-1}$ (Clev and Fred)			0.344*** (0.103)			
Excess Market Return				-0.204*** (0.019)		
High Minus Low				0.0153 (0.037)		
$(\Delta i_t > 0) = 1 \times \Delta i_t$					-0.103 (1.569)	
$(\Delta i_t > 0) = 1 \times \Delta i_t \times i_{t-1}$					0.00546 (0.163)	
PE Portfolio Return						-0.272*** (0.055)
N	13,190	13,190	13,190	13,190	13,190	10,575
R-sq	0.025	0.049	0.058	0.243	0.049	0.151

Standard errors in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$

Regression results for the specification  $R_t = \alpha + \beta_0 i_{t-1} + \beta_1 \Delta i_t + \beta_2 \Delta i_t i_{t-1} + \varepsilon_t$  at date  $t$ .  $R_t$  is defined as the market-capitalization weighted average of returns for a stock portfolio that goes long in leader stocks and goes short in follower stocks from date  $t - 91$  to  $t$ . Leaders are defined as the firms in the top 5% of market capitalization in its FF industry on date  $t - 91$ .  $i_t$  is defined as the nominal 10-year Treasury yield, with  $i_{t-1}$  being the interest rate 91 days prior and  $\Delta i_t$  being the change in the interest rate from date  $t - 91$  to  $t$ . Standard errors are Newey-West with a maximum lag length of 60 days prior. Real rates were built using monthly 10-year inflation expectations from the Cleveland Fed and the daily 10-year Treasury yield (post-1982), and the CPI series from the FED (pre-1982). In column 5, the terms  $(\Delta i_t > 0) = 1$  and  $(\Delta i_t > 0) = 1 \times i_{t-1}$  were suppressed from the table. Their coefficients are 0.0222 (0.602) and -0.0616 (0.086), respectively.

Table A3: Differential Interest Rate Responses of Leaders vs. Followers: Robustness Checks

	Top 5		SIC		EBITDA		SALES	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Top 5 Percent=1 x $\Delta i$	-1.106*** (0.273)	-3.847** (1.220)	-1.204*** (0.222)	-3.903*** (0.936)	-1.501*** (0.286)	-4.805*** (1.077)	-1.206** (0.350)	-3.685** (1.325)
Top 5 Percent=1 x $\Delta i$ x Lagged $i$		0.303** (0.105)		0.293*** (0.081)		0.372*** (0.092)		0.278* (0.112)
Sample								
Industry-Date FE	Y	Y	Y	Y	Y	Y	Y	Y
N	61,313,604	61,313,604	61,277,070	61,277,070	38,957,740	38,957,740	48,247,714	48,247,714
R-sq	0.403	0.403	0.403	0.404	0.427	0.428	0.411	0.412

Standard errors in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ 

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Regression results for the specification  $\Delta \ln(P_{i,j,t}) = \alpha_{j,t} + \beta_0 D_{i,j,t} + \beta_1 D_{i,j,t} \Delta i_t + \beta_2 D_{i,j,t} i_{t-1} + \beta_3 D_{i,j,t} \Delta i_t i_{t-1} + X_{i,j,t} \gamma + \varepsilon_{i,j,t}$  for firm  $i$  in industry  $j$  at date  $t$ . The definitions are the same as in Table 2 except for  $D_{i,j,t}$ . In columns 1 and 2, leaders are chosen by the top 5 number of firms by market capitalization within an industry and date. In columns 3 and 4, leaders are chosen by the top 5% of firms by market capitalization within an industry and date, where we change the definition of industry to be the 2-digit Standard Industry Classification (SIC) codes. In columns 5 and 6, leaders are chosen by the top 5% of firms by earnings before interest, taxes, depreciation, and amortization (EBITDA) within an industry and date. In columns 7 and 8, leaders are chosen by the top 5% of firms by sales within an industry and date. Standard errors are dually clustered by industry and date.

Table A4: Portfolio Returns Response to Interest Rate Changes: Top 5 Percent, Different Frequencies

	Yearly		Semi-Yearly		Monthly		Weekly		Daily	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$\Delta i_t$	-1.061** (0.403)	-5.570*** (1.134)	-1.188*** (0.345)	-4.594*** (0.764)	-1.000*** (0.196)	-2.365*** (0.463)	-0.964*** (0.171)	-1.846*** (0.309)	-0.839*** (0.170)	-1.244*** (0.208)
$i_{t-1}$		0.381** (0.134)		0.149 (0.080)		0.0273 (0.019)		0.00928 (0.005)		0.00327** (0.001)
$\Delta i_t \times i_{t-1}$		0.493*** (0.106)		0.385*** (0.073)		0.150*** (0.040)		0.0984** (0.035)		0.0470 (0.027)
Sample	All	All	All	All	All	All	All	All	All	All
N	9,037	9,037	8,962	8,962	9,081	9,081	9,099	9,099	9,080	9,080
R-sq	0.024	0.095	0.040	0.101	0.036	0.050	0.032	0.039	0.019	0.020

Standard errors in parentheses

\*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ 

Regression results for the specification  $R_t = \alpha + \beta_0 i_{t-1} + \beta_1 \Delta i_t + \beta_2 \Delta i_t i_{t-1} + \varepsilon_t$  at date  $t$ .  $R_t$  is defined as the market-capitalization weighted average of returns for a stock portfolio that goes long in leader stocks and goes short in follower stocks from date  $t - 91$  to  $t$ . Leaders are defined as the firms in the top 5% of market capitalization in its FF industry on date  $t - J$ .  $i_t$  is defined as the nominal 10-year Treasury yield, with  $i_{t-1}$  being the interest rate  $J$  days prior and  $\Delta i_t$  being the change in the interest rate from date  $t - 91$  to  $t$ . For columns 1 and 2,  $J = 364$ ; columns 3 and 4,  $J = 28$ ; columns 5 and 6,  $J = 7$ ; columns 7 and 8,  $J = 1$ , where 1 is one trading day. Standard errors are Newey-West with a maximum lag length of 60 days prior.

Table A5: Correlation Table of Forward Rates

Variables	0-2	2-3	3-5	5-7	7-10	10-30
0-2	1.00					
2-3	0.85	1.00				
3-5	0.85	0.85	1.00			
5-7	0.80	0.76	0.67	1.00		
7-10	0.70	0.65	0.47	0.53	1.00	
10-30	0.80	0.77	0.93	0.95	0.94	1.00

Correlation table of forward rates. P-values in parentheses.