Abstract

This paper uncovers a novel interaction between production efficiency and economic stability. Using a tractable heterogeneous firms model, I prove the existence of an efficiency-stability trade-off in granular economies. Specifically, reducing misallocation increases business cycle volatility. This trade-off originates because firms choose their optimal size without internalizing their effect on aggregate consumption risk. Utilizing approximations and results on order statistics, I propose a tractable method to quantify this effect and show that commonly studied misallocation counterfactuals involve a sizeable increase in business cycle volatility. I discuss how different assumptions on the nature of misallocation and factor mobility influence this result.