Relational Contracts in Frictional Markets with Rematching

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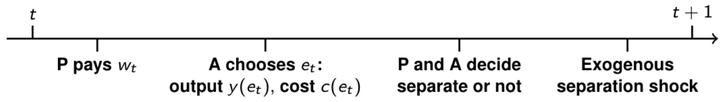
Introduction

- Many long-term relationships between and within firms are **informally sustained** by the value of future interactions.
- E.g.: **trading partnership** between buyers and suppliers; employment relationship between firms and workers.
- Opportunities to find a new partner **increases the temptation** to break the existing relationship.
- Players sustain **steady** relationships when market opportunities are scarce.
- Players restore credibility and incentives via **gradual cooperation** when market opportunities are abundant.

Framework

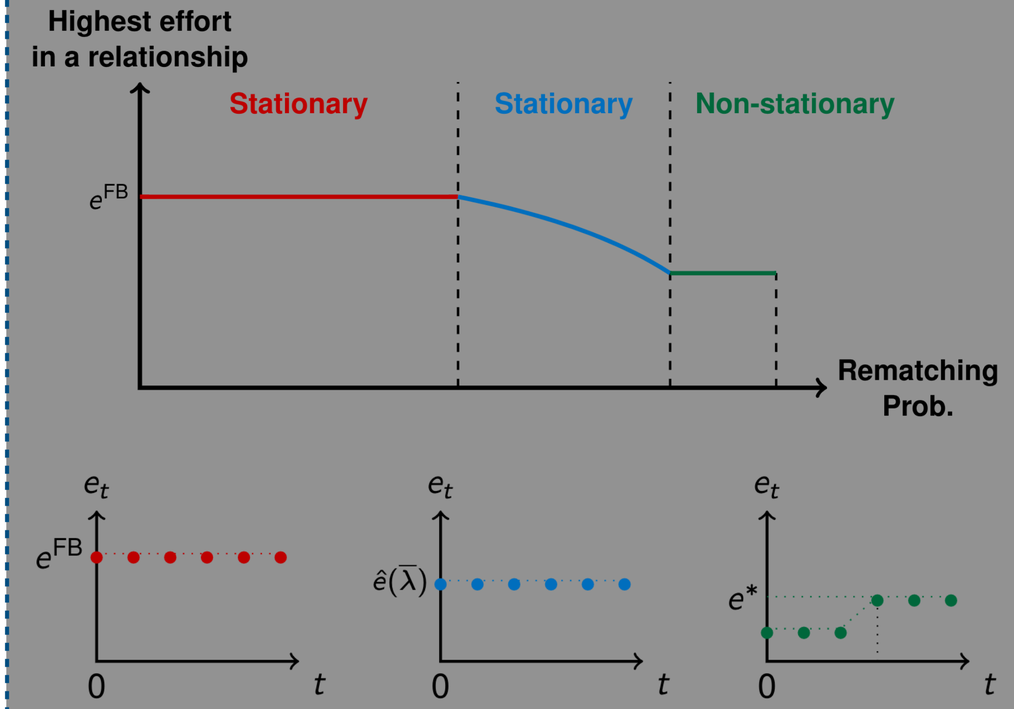
A matching market of principals and agents in which:

- Matched principal and agent repeatedly interact via **relational contracts**.
- Unmatched players **anonymously rematch** with some probability.
- Rematching prob is affected by **market characteristics** like search frictions and market thickness.



- **Solution concept:** symmetric steady-state eq with match-specific and self-enforcing relational contracts.

Market opportunities affect the value and dynamics of long-term relationships by weakening commitment.



Contributions

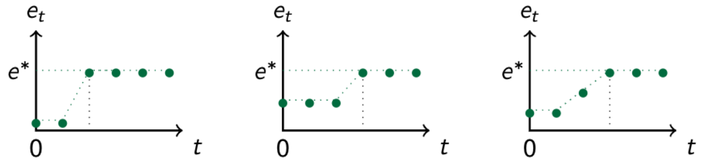
- **A general framework** to understand how market characteristics shape incentives and interactions in relationships.
- **A new channel** showing how market opportunities affect stationarity of relational contracts through endogenous outside options.
- **Novel testable implications** linking market environments and within-relationship interactions.

Key Conditions

- U_t, V_t : continuation payoffs; $U^{\varnothing}$, $V^{\varnothing}$: outside options; λ^A, λ^P: rematching probabilities; $\Pi_0 = \gamma^A U_0 + \gamma^P V_0$: welfare.
- **Endogenous** outside options: $U^{\varnothing} = \lambda^A U_0$, $V^{\varnothing} = \lambda^P V_0$.
- **IC**: $U_{t+1} \geq c(e_t)/(\delta\rho) + U^{\varnothing}$, $V_{t+1} \geq V^{\varnothing}$.

More Results

- Non-stationary optimal relational contracts are **not unique**.



- Welfare is **non-monotonic** in the rematching prob.