Relational Contracts in Frictional Markets with Rematching

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.

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

More Results
- Non-stationary optimal relational contracts are not unique.
- Welfare is non-monotonic in the rematching prob.

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.