

EC862: Monetary Economics II
Capital Market Imperfections, Financial Structure and Financial
Development:
Business Cycle and Growth Effects

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Reading List
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Content: In this course I will analyze the interplay between capital market imperfections, business cycle fluctuations and growth. I am providing you with a quite extensive reading list, so that you can explore some sub-topics in more depth. Not all the topics will be covered in the lectures, but you will be encouraged to do so. The course will also include a section on panel data estimation, with an empirical exercise (see end of reading list).

Grading: Grading will be based on a final exam (40%) I will indicate during the lectures the subset of articles I expect everybody to read (the most important ones are starred); two referee reports (40%) on recent papers; a replication exercise (20%) using panel data techniques.

**A) CAPITAL MARKET IMPERFECTIONS, FINANCIAL STRUCTURE,
INVESTMENT AND BUSINESS CYCLE FLUCTUATIONS**

**1) Corporate Finance Primer: from the State Preference Model to Asymmetric
Information and Incomplete Contracts**

a) The Modigliani-Miller Theorem and the Irrelevance of Financial Structure

Modigliani, F and M. Miller (1958), "The Cost of Capital, Corporation Finance, and the Theory of Investment", American Economic Review, June, pp. 261-297.

* Ch. 7 in Sargent, T.J., **Macroeconomic Theory**, second edition.

b) Firms' Financial Structure under Asymmetric Information and Incomplete Contracts

* Walsh, C. E., **Monetary Theory and Policy**, (1998), MIT Press, Ch. 7

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* Myers, S.C. and N.S. Majluf (1984), "Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have", Journal of Financial Economics, 13, June, pp. 184-221.

* Stiglitz, J and A. Weiss (1981), "Credit Rationing in Markets with Imperfect Information", American Economic Review, June, pp. 393-410.

Bester, H. (1985), "Screening versus rationing in Credit Markets with Imperfect Information", American economic Review, 75(4), pp. 850-55.

* Williamson, S.D. (1987), "Costly Monitoring, Loan Contracts, and Equilibrium Credit Rationing:", Quarterly Journal of Economics, Vol. 102, pp. 135-145.

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Harris, M. and A. Raviv (1991), "The Theory of Capital Structure", The Journal of Finance, Vol. XLVI, March, 1991.

Hart, O. (1995), "Firms , Contracts and Financial Structure", Oxford University Press, Oxford, Chs. 5 and 6.

Townsend, R. (1979), "Optimal Contracts and Competitive Markets with Costly State Verification", Journal of Economic Theory, October pp. 265-293.

Gale, D. and M. Hellwig (1985), "Incentive Compatible Debt Contracts I: The One Period Problem", The Review of Economic Studies, 52, October, pp. 674-664.

De Meza, D. and D. Webb (1987), "Too Much Investment: A Problem of Asymmetric Information", Quarterly Journal of Economics, 102, pp. 281-292.

2) **Intermediation and Banking: An Introduction**

Diamond, D. and P. Dybvig (1983), "Bank Runs, Deposit Insurance, and Liquidity", Journal of Political Economy, June, pp. 401-419.

Jacklin, C. J. (1987), "Demand Deposits, Trading Restrictions, and Risk Sharing", in **Contractual Arrangements for Intertemporal Trade**, E. D. Prescott and N. Wallace, Eds. , Minneapolis, University of Minnesota Press, 1987, pp. 26-47.

Diamond, D. (1984), "Financial Intermediation and Delegated Monitoring", Review of Economic Studies, July, pp. 401-419.

Boyd, J.H. and E.C.Prescott (1986), “Financial Intermediary-Coalitions”, Journal of Economic Theory, April, pp.211-232.

Diamond, D.W. (1991), “Monitoring and Reputation: The Choice between Bank Loans and directly Placed Debt”, Journal of Political Economy, Vol. 99, No. 4, pp.689-719.

Hellwig, M. (1990), “Banking, Financial Intermediation, and Corporate Finance”, WWZ Discussion Paper No. 9015.

Rajan, R. (1992), “Insiders and Outsiders: The Choice between Relationship and Arms’-Length Debt”, Journal of Finance, 47, pp. 1367-1400.

Petersen, M, and R. Rajan (1994), “The Benefits of Lending Relationships: Evidence from Small Business Data”, Journal of Finance, 49, pp. 3-37.

Berger, A., L. Klapper, G. Udell and F. Gregory (2000), ” The Ability of Banks to Lend to Informationally Opaque Small Business”, Journal of Banking and Finance, Vol 25(12), pp 2127-67.

3) **Capital Market Imperfections, Investment and Business Cycle Fluctuations**

a) Single Agents Models, General Equilibrium Models and Aggregate Consequences

* Walsh, C. E., **Monetary Theory and Policy**, (1998), MIT Press, Ch. 7.

* Matsuyama, “K. (2007), “Aggregate Implications of Credit Market Imperfections”, NBER Macro Annual, 2007.
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* Gertler, Mark, (2007) comment on K. Matsuyama, “Aggregate Implications of Credit Market Imperfections” (see above for link).

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* Carlstrom and Fuerst, (1997)“Agency Costs, Net Worth, and Business Fluctuations: A Computable General Equilibrium Analysis”,American Economic Review, December, p. 893-910.

* Bernanke, B. M. Gertler and S. Gilchrist (1997), “Credit Market Frictions and Cyclical Fluctuations”, **Handbook of Macroeconomics**, J. Taylor and M. Woodford (eds), forthcoming, available also as NBER Working Paper 6455 at nber.org

* Kiyotaki, N. and J. Moore (1997), “Credit Cycles”, Journal of Political Economy, 105, N.2, April, pp. 211-248.

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Krishnamurthy. A. (2003), “Collateral Constraints and the Amplification Mechanism”, Journal of Economic Theory, 111, pp. 277-292

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Bacchetta, P. and R. Carminal, (2000) “Do Capital Market Imperfections Exacerbate Output Fluctuations?”, European Economic Review, 44(3), pp. 449-468.

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Cooley T, R. Marimon, V. Quadrini, (2003), “Aggregate Consequences of Limited Contract Enforceability”, NBER Working Papers 10132

J. Bailey Jones (2003), “The Dynamic Effects of Firm-Level Borrowing Constraints”, Journal of Money, Credit and Banking, vol. 35(5), pp. 743-762.

House, C.L. (2006), “Adverse Selection and the Financial Accelerator””, Journal of Monetary Economics, 53, pp. 1117-1134.

b) Aggregate Evidence on Financial Frictions, Shocks and Wedges

Queijo, V. (2005), "How Important Are Financial Frictions in the US and Euro Area?", Seminar paper no. 738, Institute for International Economic Studies, Stockholm University, August.

Christiano, L.J., R. Motto, and M. Rostagno (2006), "Financial Factors in Business Cycles", Northwestern University, mimeo

Cooper R. and J. Ejarque (2000), "Financial Intermediation and Aggregate Fluctuations: A quantitative Analysis", Macroeconomic Dynamics, 4(4), 423-447.

Chari, V.V., P. J. Kehoe, and E.R. McGrattan, "Business Cycle Accounting", Econometrica, Vol. 75(3), pp. 781-836, May.

Christiano, L. J. and J. M. Davis (2006), "Two Flaws in Business Cycle Accounting", Northwestern University, mimeo.
<http://faculty.wcas.northwestern.edu/~lchrist/research/wedges/wedges1.pdf>

Chari, V.V., P.J. Kehoe, and E.R McGrattan (2007), "Comparing Alternative Representations, Methodologies, and Decompositions in Business Cycle accounting", Federal Reserve Bank of Minneapolis, Research Department Staff Report 384, March.

c) Financing Constraints and Asset Markets

Gomes, J., A Yaron, and L. Zhang, (2006)" Asset Pricing Implications of Firms' Financing Constraints", (forthcoming, Review of Financial Studies).
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d) Firms' Dynamics

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e) Open economy

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Céspedes, L.P., R. Chang and A. Velasco (2000), "Balance Sheet Effects and Exchange rate Policy", NBER Working paper No. 7840, August.

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Iacoviello, M. and R. Minetti (2006) "Domestic and foreign lenders and International Business Cycles", (forthcoming, Journal of Monetary Economics).

f) Broad Credit Channel and Financial Accelerator Effects: Micro Evidence.

(i) Critical Reviews

* Schiantarelli, F. (1996) "Financial Constraints and Investment: Methodological Issues and International Evidence", Oxford Review of Economics Policy, Vol. 12, No. 2, pp. 70-89, also in **Is Bank Lending Important for the Transmission of Monetary Policy?**, edited by J. Peek and E.S. Rosengren, Federal Reserve Bank of Boston, Conference Series No. 39, June 1995.

* Hubbard, R.G. (1998), "Capital Market Imperfections and Investment", Journal of Economic Literature, March 1998

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(ii) Excess Sensitivity Approach: Micro evidence from q Models

* Fazzari, S., R.G. Hubbard, and B. Petersen (1988), “Financing Constraints and Corporate Investment”, Brookings Papers on Economic Activity, 1, pp. 141-195.

Hoshi, T., A.K. Kashyap, and D. Sharfstein (1990), “Corporate Structure and Investment: Evidence from Japanese panel Data”, Quarterly Journal of Economics, 106, pp.33-60.

* Gilchrist, S. and C.P. Himmelberg (1995), “Evidence on the Role of Cash Flow for Investment”, Journal of Monetary Economics, January, pp. 541-572.

Gilchrist S. and C.P. Himmelberg (1998), “Investment, Fundamentals and Finance”, NBER Macro Annual.

Hu, X. and F. Schiantarelli (1997), “Investment and Financing Constraints: A Switching regression Approach Using US Firms’ Panel Data”, The Review of Economics and Statistics, 1998

(ii) Micro Evidence from Euler Equations

* Whited, T. (1992), “Debt, Liquidity constraints, and and Corporate Investment: Evidence from Panel Data”, Journal of Finance, 47, September, 1425-1460.

* Bond, S., and C. Megir (1994), “Dynamic Investment Models and the Firms’ Financial Policy”, The Review of Economic Studies, 61, pp.197-222.

(iii) Criticism and Further Evidence on the Excess Sensitivity Approach

* Kaplan, S.N. and L. Zingales (1997) “Do Investment-Cash Flow Sensitivities Provide Useful Measures of Financing Constraints?”, Quarterly Journal of Economics, 1997, pp.169-215.

* Fazzari, S.M., R.G. Hubbard, and B.C. Petersen (2000), “Investment-Cash Flow Sensitivities Are Useful: A Comment on Kaplan and Zingales”, Quarterly Journal of Economics, May, pp. 695-705.

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(iii Balance Sheet Effects of Currency Composition of Debt)

Galindo, A., U. Panizza, F. Schiantarelli, “Debt Composition and Balance Sheet Effects of Currency Depreciation: A Summary of the Micro Evidence”, Emerging Market Review , Vol.4, 4, December, pp. 330-339. See also the papers on individual countries at

<http://www.elsevier.com/homepage/sae/econworld/econbase/ememar/frame.htm>
Then click on: ScienceDirect Full Text and Abstracts.

Bleakley, H. and Cowan, K. (2002), “Corporate Dollar Debt and Devaluations; Much Ado About Nothing?”, IFS Working Papers W01/22, Institute for Fiscal Studies.

Forbes, K. (2002), “How Do Large Depreciations Affect Firm Performance?”, Working papers 4379-02, Massachusetts Institute of Technology (MIT), Sloan School of Management.

(iv) Other

Kashyap, A.K., O.A. Lamont, and J. C. Stein (1994), “Credit Conditions and the Cyclical Behavior of Inventories”, Quarterly Journal of Economics, 109, N.3, August, pp. 565-592.

* Gertler, M. and S. Gilchrist (1994), “Monetary Policy, Business Cycles, and the Behavior of Small Manufacturing Firms”, Quarterly Journal of Economics, 109, pp. 309-340.

* Oliner, S.D., and G.D. Rudebush (1996), “Is there a Broad Credit Channel for Monetary Policy?”, FRB San Francisco Economic Review, No.1, pp.3-13.

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g) Bank Lending Channel

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B) FINANCIAL DEVELOPMENT, FINANCIAL STRUCTURE AND ECONOMIC GROWTH

1) Models

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* King, R. and R. Levine (1993a), “Finance, Entrepreneurship and Growth: Theory and Evidence, Journal of Monetary Economics, December, pp. 513-542.

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2) Econometric Evidence

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b) Industry and Firm Level Evidence

* Rajan, R.G. and Zingales, L. (1998), “Financial Dependence and Growth”, American Economic Review, June.

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(c) Time Series Evidence on Financial Development and Growth

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e) Financial Development, Financial Reform, and Financing Constraints

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