Credit Constraints, Firms' Precautionary Investment, and the Business Cycle

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This paper

* Modern macroeconomic model of financial frictions

* Firms face financing constraints

* Entrepreneurs face limited insurance markets against idiosyncratic shocks

Key finding from my point of view

* The model can deliver quanitiatively significant results
-> financial constraints matter even in the long run

My main point

* The models with financial frictions have difficulties mattering quantitatively in the long run

    - can deliver interesting theoretical predictions

    - Most of the models following Kiyotaki-Moore

* Main reason −> backloading of incentives

    - In the long run −> firms would accumulate significant collateral or promised utility so the constraints would not bind in the long run

* So, where is a "smoking gun" in this model?

    - many parts, but what drives amplification?

    - why does this model matter quanititatively?

Bringing all the models to one common denominator

* Financial frictions models have many bells and whistles but

    - key question: how to provide incentives (resolve frictions) dynamically

* Consider a dynamic principal-agent model

    - the same argument for financial friction models (one sided commitment, borrowing frictions, collateral constraints, etc.)

    - key: principal and agent have the same discount rates

* Agent provides some effort which is unobservable

Optimal way to provide incentives

* Consider perturbation: Provide a bit more consumption (increase promised utility tomorrow)

* Cost: intertemporal (Euler equation) distortion

* Benefit:

    - relaxes constraint tomorrow

    - but also relaxes constraint today (and all the dates before today)

Backloading

* Increasing profile of promises makes constraints not bind eventually

* In the financial friction models:

    - accumulate collateral to relax frictions

* Super general result (e.g., Ray's Econometrica paper)

So ...

* In general dynamic financial frictions models cannot generate quantitatively important implications in the long run

Smoking gun

* How to break the unavoidable backloading?

* Differential discount factors:

   - Agent is less patient than the principal

   - Perturbation is less potent

   - More stuff in the future helps with relaxing constraints but the agent does not care

* If the financial frictions models delivers quantitatively, there must be something with discounting.

Here

* Many moving parts

* My guess is that backloading is broken because of the finite-live of the entrepreneurs

* Otherwise, backload and resolve all the frictions

Overall – today's conference

* Look out for backloading.