U. Jerman & V. Quadrini
Macroeconomics Effects of Financial Shocks

Discussion by Pietro Reichlin - LUISS

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this paper tries to fill this gap

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- When output is high, firms issue more debt
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- a lot of investment is financed through retained earnings

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- issuing equities is very costly (asymm info)
- debt acts as a discipline device for managers
- collateral and credit ratings play important role
- firms may go bankrupt and bankruptcy is costly
- there is an external finance premium (typically counter-cyclical)

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But this is not J&Q paper..

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debt repayment is self-enforcing if **current output not too high**, **value of firm not too low**, **dividends not too high**

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Adverse financial shock $\Rightarrow$ employment and dividends down

Adverse output shock $\Rightarrow$ default less attractive $\Rightarrow$ enforc. constraint relaxed $\Rightarrow$ mild impact on employment

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Financial frictions introduce an important source of volatility into the model

Only way to understand big swings in output and labor along the cycle is by introducing financial frictions

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But internal funds seem to play no role in J&Q's paper

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3. Agents can default on m only at interim stage
4. m exactly equals revenue $F(k, l)$

The limited commitment problem - A simplified scheme

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Firms balance sheet:

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$$\underbrace{m + b'}_{\text{Tot Borr.}} = \underbrace{k' + d + Rb}_{\text{Tot. exp.}}$$

$$m \leq F(k)$$

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$$\Rightarrow \qquad F(k) \leq \xi V'/R \qquad \text{(self-enf. constr.)}$$

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- Can we make no default self-enforcing by imposing a low enough Intratemporal Loan? This would be equivalent to imposing $m < F(k)$, i.e., the firm retains some internal funds
- Why default on Intratemporal loans only? What happens when you allow for default on intertemporal loans?
- Is it true that all firms are debt constrained? Financial shocks have a very asymmetric effects on (small and big) firms

Questions (cont.)

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Then,

$$\textbf{Value of firm} \uparrow \quad \Rightarrow \quad \xi \downarrow$$