# Financial Factors in Business Fluctuations

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# Summary of Gertler and Hubbard article

- Modern Macroeconomic Theory separates Business Cycle components into 3 broad categories

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3. Propagation Mechanisms - endogenous response that cause effects of shock to have dynamic effects.
    1. Financial Sector may be an important contributor to both amplification and propagation.

# Some Excerpts from the G & H article

- At a more formal level, recent research in macroeconomics- both theoretical and empirical-has resurrected the idea that capital market imperfections may be significant factors in business volatility by making new progress in characterizing the mechanisms.
- Over the last decade, much of the effort in macroeconomics has involved developing models of business fluctuations in which the structural relationships are explicit outcomes of rational economic behavior. The centerpiece is the "real business cycle" paradigm, developed by Kydland and Prescott (1982).
- First, financial factors are completely absent. Because all markets function perfectly in the competitive equilibrium growth model, the Modigliani-Miller theorem applies; financial structure is both irrelevant and indeterminate.

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- This latter feature has motivated a new stage of research aimed at enriching the endogenous component of the propagation mechanism. The common objective is to rationalize and test theories that can explain how relatively small exogenous shocks can produce large fluctuations in output.
- A third (research avenue), which we consider here, is to explore the implications of certain capital market imperfections.
- To this extent, it borrows heavily from the economics of information and incentives to explicitly motivate frictions in capital markets and, correspondingly, a meaningful role for financial structure in real economic activity.

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1. The first involves the firm's internal net worth, which becomes a critical determinant of the terms under which it can borrow in this type of environment.
2. The second main avenue stressed involves the supply of intermediary credit, particularly business loans supplied by commercial banks. Underlying this channel is the idea that certain classes of borrowers may find it prohibitively expensive to obtain financing by directly issuing securities on the open market. Financial intermediaries help overcome this friction by exploiting scale economies in the evaluation and monitoring of borrowers.

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- Overall, the theme that emerges from this initial empirical work is that financial factors are important to the behavior of small, growing firms, at least relative to large, mature firms.

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- Soft Capital investment can not be observed - entrepreneurs have incentive to use for their own purposes.
- Lenders structure payments to induce entrepreneurs to invest in soft capital.
- Introduces a new type of constraint: the Incentive Compatible constraint.

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  2. Increase in interest rates lowers investment - worsens the incentive problem and reduces the value of collateralizable assets.
  3. Investment fluctuations may exhibit asymmetries: downturns are sharper than expansions due to changes in net worth.