
Comments to

Giovanni Favara

**Agency Costs, Net Worth and Endogenous
Business Fluctuations**

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This paper

- Past literature (e.g., Bernanke and Gertler -89):
 - Can credit market imperfections amplify exogenous shocks or make them more persistent?
- This paper:
 - Can credit market imperfections be a source of business fluctuations (instability), too?
 - Answer: Yes, they can -- endogenous reversal / cycles
 - Key assumptions:
 - Variance of exogenous shocks = 0
 - Double-sided moral hazard
 - i.e., non-contractible effort both at the entrepreneurial and investor -level

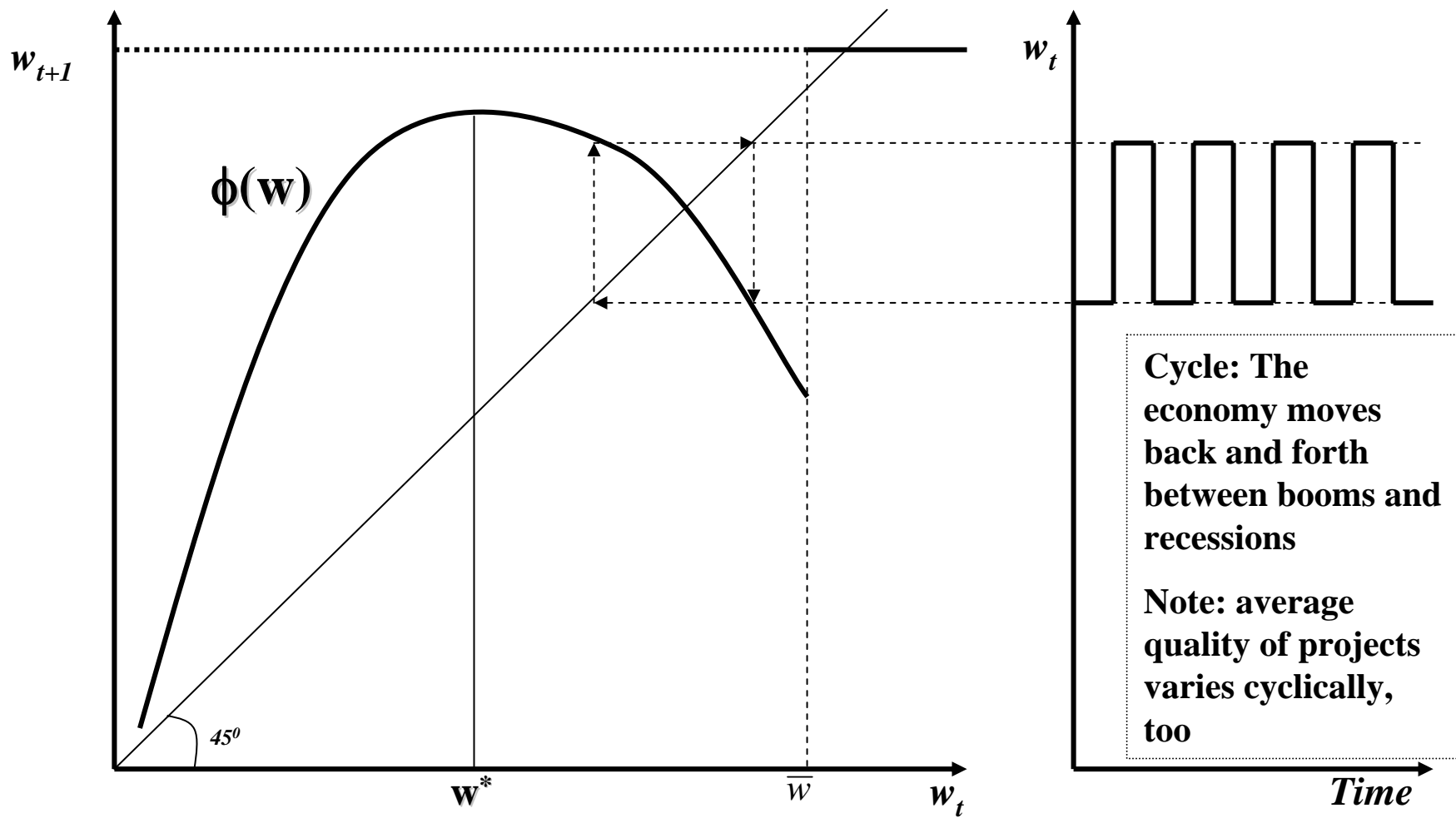
Key result: Endogenous reversal...

- During boom times, more wealth accumulation:
 - => entrepreneurs can rely on own (inside) funds
 - => need to borrow less
 - => investors less eager to intervene (i.e. to monitor)
 - => more "unproductive" projects are initiated
 - => less wealth accumulation

... and a cycle repeating itself over time

- During recessions, less wealth accumulation:
 - => entrepreneurs has to rely on outside funds
 - => investors more eager to intervene (i.e. to monitor)
 - => more "productive" projects are initiated
 - => more wealth accumulation
- ... and then it all starts over again...

Case: $w^* < \phi(w^*)$ and $\bar{w} < \phi(\bar{w})$



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Related literature

	Nature of market friction			
	Adverse selection	Borrower moral hazard	Investor moral hazard	Not explicit
This paper (Favara)	-	Yes	Yes	-
<i>Cited literature</i>				
Suarez & Sussman (JET, -97)	-	Yes	-	-
Azariadis & Smith (AER, -98)	Yes	-	-	-
Matsuyama (mimeo, -04)	-	-	-	(Multiplier)
Aghion, et al. (QJE, -99)	-	-	-	(Multiplier)
Aghion, et al. (JME, -04)	-	-	(Section 5.2)	(Multiplier)
<i>Some other papers with endogenous cycles (due to credit market frictions)</i>				
Reichlin & Siconolfi (ET, -04)	Yes	Yes	-	-
Matsuyama (AER, forthcoming)	-	-	-	(Multiplier)
Martin (mimeo, -06)	Yes	-	-	-
Sussman & Suarez (AF, -06)	-	(Strat. default)	-	-

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Questions / comments

1. Multiplier matters, but not details (Matsuyama & Aghion et al. -argument)?
2. What new insights are obtained by introducing investor moral hazard?
 - Relative to Reichlin and Siconolfi (ET, -04) (and also to Martin -06)?
3. Volume of lending
4. Smaller comments

Question / Comment #1

- Matsuyama & Aghion et al. (multiplier approach):
 - Details of credit market frictions matter only a little, if at all
 - What matters is that borrowers can pledge only up to a fraction of the project revenue
 - The amount firms can borrow is limited to μ times the amount of their current level of investible funds
 - This black box approach can be justified at the microeconomic level by resorting to
 - models with strategic default
 - CSV
 - models with interim moral hazard (of Holmström-Tirole -type)

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- Implications for the "multiplier" -approach?
 - Devil *is* in the details?
 - Does this paper argue that the results in this strand of literature depend on the particular microeconomic story used to justify the borrowing constraints?
 - How do the predictions of this model compare to those emerging from the multiplier models?
 - Which predictions are empirically *unique* to this model (and which are not)?
 - E.g. Volume of the credit vs. its composition / quality?
 - Matsuyama -06, AER: Similar predictions for the cyclical quality from a multiplier model?
 - Improvement in w causes a shift towards less productive projects

Question / Comment #2

- What new insights are obtained by introducing investor moral hazard?
- Especially relative to Reichlin and Siconolfi (ET, -04):
 - Cycles due to a switch of equilibrium contracts from "pooling" to "separating"
 - (driven by a kind of "investor moral hazard"?)
 - Predicts that adverse selection and borrower moral hazard more severe during booms
 - "Cleansing effect of recessions": Quality of projects goes down during upswings
- See also Martin (-06): Net worth pro-cyclical, accompanied by increased lending and investment

Question / Comment #3

- Volume of lending: pro-cyclical or counter-cyclical?
 - This model: When w_t is high (“boom”), the amount borrowed per entrepreneur decreases?
 - Empirical evidence:
 - In expansionary phases of the cycle, loan sizes increase
 - See, e.g., Asea & Blomberg (J of Econometrics, -98)
 - Total amount borrowed: $\eta e_t[m_t(w_t), w_t]$?
 - What if the size of projects was endogenized?
 - Martin (-06): Endogenous cycles with pro-cyclical lending
 - Barlevy (JME, -03): More efficient production arrangements need to borrow more?
 - “Need to borrow” vs. “ability to borrow”?

Question / Comment #4 (smaller comments)

1. Role of some assumptions

- $b = r$?
 - Normalization or something more?
- Loanable funds: $w_t > \eta e_t = \eta e_t[m_t(w_t), w_t]$
 - Implications for Lemma 2 and/or Proposition 2?

2. Existence of the rectangular limit (two-period) cycle? (fn. 25)

- How does map $w_{t+2} = \phi^2(w_t) \equiv \phi[\phi(w_t)]$ look like?
 - Continue with numerical example (3.3.3.) in the dynamic part?
- Slope of $\phi(w_t)$ at the steady state?

3. Discontinuity at \bar{w}

- Why does it emerge?
- Other types of outcomes? (e.g. interpretation of Figure 3c?)
 - Cycles with prolonged booms / recessions (Aghion et al. QJE, -99)
 - Leapfrogging or growth miracles (Matsuyama AER, -06)