Financial frictions, Investment and Tobin's q.

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A comment.

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October 2006.

Credit and the Macroeconomy
Bank of Finland.

1 A brief summary

1.1 A model

- A GE model with investment behaviour, in the presence of convex adjustment cost.

- A distinction between insiders (entrepreneurs) and outsiders (savers).

- Entrepreneurs with a rent-extracting advantage.

- Limited enforcement of contract:

▲ A possibility of default.

▲ Then the investor retains part of the value of the firm. And can start again. (No distinction between in and out).

▲ Take the money, run and come back!

1.2 Claims

- Financial frictions matter.

- $q \neq Q$.

- The wedge depend on shocks over time.

- Hence q does not explain all investment.

- As predicted, financial frictions generate a role for cash-flow.

- The model supports the GH95 evidence.

1.3 Nice features

- A new way to model imperfect financial frictions.

  Not based on fixed access costs and non-linearities.

  Hence a linear constraint which is met by any entrepreneur (for some range of parameters).

- A nice model, easily solved, easily compared (at least to some models).

- A development, from credit constraints (BGG) to investment.

2 The issue

2.1 Theory

The on-going controversy

1. The standard "neo-classical" view.

2. The introduction of financial frictions.

3. The challenge by Gomes and CE: the potency of *MP*.

4. The restoration of *FiFric* by LW.

2.2 Policy

At stake, the credit channel of monetary policy.

But also the efficiency of fiscal policy: how much boost for investment in the case of investment credit?

From LW, a restoration of the credit channel. And a potential enlargement!

3 Questions

3.1 Theoretically

1 - How to justify the limited enforcement device? θ?

No internal funds as collateral, etc. A story quite different from BG and BGG.

Incredible entrepreneurs in LW! An economy with solely LBO.

2 - Is the timing the right one?

You default in the future, not in the present. Does it matter?

3 - Is there a true difference between market power and capital market imperfections?

A contradiction between CE and LW if:

"*Market power* $\sim$ *Large firms* $\sim$ *Access to financial markets*".

But a possible reconciliation if:

"*Market power on the goods market* $\neq$ *Free access to financial markets*."

The balance sheet: also a problem for large firms!

Then CE and LW, just two ways to measure the same reality.

To summarize: is it the right way to model *FiFri*?

Open question...

3.2   Methodologically

CE's method: nesting models.

CE claim: in the presence of *MP*, *FiFric* does not matter. Not exactly what LW invalidate.

(But they are certainly right in saying that the way *FiFric* is modelled is crucial.)

Why not applying it to LW?

> Develop a bit the labor / goods market.

> (as in BGG).

3.3   Empirically

Do LW match the real data?

(not the simulated ones)

What they claim: "in line with GH95!"

- However, GH's $Q \neq$ LW's Q!

- What about the disaggregation made by GH? Maybe the drawback of the continuous, linear and elegant model of LW.

  Sometimes, one-size-fits-all not so good!

  (Basically, the claim made by CE.)

- How to match the data?

  LW's Q : based on the entrepreneur's discount factor (p.12).

  .....Unobserved!

  Can it be tested?

A suggestion: rather than differences in discount factors, why not assuming some informational asymmetry?

(Back to theory, yes)