

**Boston College  
Department of Economics**

**EC862, Monetary Economics II:  
Capital Market Imperfections, Financial Structure,  
Investment, and Monetary Policy  
Module 1**

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**A) CAPITAL MARKET IMPERFECTIONS, INVESTMENT AND BUSINESS  
CYCLE FLUCTUATIONS**

**1) Corporate Finance Primer: from the State Preference Model to Asymmetric  
Information and Incomplete Contracts**

a) The Modigliani-Miller Theorem and the Irrelevance of Financial Structure

Modigliani, F and M. Miller (1958), The Cost of Capital, Corporation Finance, and the Theory of Investment , American Economic Review, June, pp. 261-297.

Ch. 7 in Sargent, T.J., **Macroeconomic Theory**, second edition.

b) Firms Financial Structure under Asymmetric Information and Incomplete Contracts

Jensen, M. and W. Meckling (1976), Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure , Journal of Financial Economics, pp. 305-360.

Myers, S.C. and N.S. Majluf (1984), Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have , Journal of Financial Economics, 13, June, pp. 184-221.

Stiglitz, J and A. Weiss (1981), Credit Rationing in Markets with Imperfect Information , American Economic Review, June, pp. 393-410.

Williamson, S.D. (1987), Costly Monitoring, Loan Contracts, and Equilibrium Credit Rationing: , Quarterly Journal of Economics, Vol. 102, pp. 135-145.

Williamson, S.D. (1986), Costly Monitoring, Financial Intermediation, and Equilibrium Credit Rationing , Journal of Monetary Economics, 18, pp. 159-179.

Harris, M. and A. Raviv (1991), The Theory of Capital Structure , The Journal of Finance, Vol. XLVI, March, 1991.

Hart, O. (1995), Firms , Contracts and Financial Structure , Oxford University Press, Oxford, Chs. 5 and 6.

Townsend, R. (1979), Optimal Contracts and Competitive Markets with Costly State Verification , Journal of Economic Theory, October pp. 265-293.

Gale, D. and M. Hellwig (1985), Incentive Compatible Debt Contracts I: The One Period Problem , The Review of Economic Studies, 52, October, pp. 674-664.

Walsh, C. E., **Monetary Theory and Policy**, (1998), MIT Press, Ch. 7

## 2) **Capital Market Imperfections, Investment and Business Cycle Fluctuations**

### a) Theory

Bernanke, B. and M. Gertler (1989), Agency Costs, Net Worth, and Business Cycle Fluctuations , American Economic Review.

Bernanke, B. and M. Gertler (1990), Financial fragility and Economic Performance , Quarterly Journal of Economics, February.

Gertler, M. and R.G. Hubbard (1989), Financial Factors in Business Cycle Fluctuations , in **Financial Market Volatility: Causes, Consequences, and Policy Recommendations**, federal Reserve Bank of Kansas City.

Carlson and Fuerst, Agency Costs, Net Worth, and Business Fluctuations: A Computable General Equilibrium Analysis ,American Economic Review, 1997

Bernanke, B. M. Gertler and S. Gilchrist (1997), Credit Market Frictions and Cyclical Fluctuations , **Handbook of Macroeconomics**, J. Taylor and M. Woodford (eds), forthcoming.

Kiyotaki, N. and J. Moore (1997), Credit Cycles , Journal of Political Economy, 105, N.2, April, pp. 211-248.

Bernanke, B.S., and A. Blinder, (1988), Credit, Money and Aggregate Demand , American Economic Review, May, pp. 435-439.

Walsh, C. E., **Monetary Theory and Policy**, (1998), MIT Press, Ch. 7

b) Evidence

(i) Broad Credit Channel and Financial Accelerator Effects.

Fazzari, S., R.G. Hubbard, and B. Petersen (1988), Financing Constraints and Corporate Investment , Brookings Papers on Economic Activity , 1, pp. 141-195.

Hoshi, T., A.K. Kashyap, and D. Sharfstein (1990), Corporate Structure and Investment: Evidence from Japanese panel Data , Quarterly Journal of Economics, 106, pp.33-60.

Whited, T. (1992), Debt, Liquidity constraints, and Corporate Investment: Evidence from Panel Data , 47, september, 1425-1460.

Bond, S., and C. Megir (1994), Dynamic Investment Models and the Firms Financial Policy , The Review of Economic Studies, 61, pp.197-222.

Gertler, M. and S. Gilchrist (1994), Monetary Policy, Business Cycles, and the Behavior of Small Manufacturing Firms , Quarterly Journal of Economics, 109, pp. 309-340.

Gilchrist, S. and C.P. Himmelberg (1995), Evidence on the Role of Cash Flow for Investment , Journal of Monetary Economics, January, pp. 541-572.

Gilchrist S. and C.P. Himmelberg (1998), Investment, Fundamentals and Finance , NBER Macro Annual.

Kashyap, A.K., O.A. Lamont, and J. C. Stein (1994), Credit Conditions and the Cyclical Behavior of Inventories , Quarterly Journal of Economics, 109, N.3, August, pp. 565-592.

Hu, X. and F. Schiantarelli (1997), Investment and Financing Constraints: A Switching regression Approach Using US Firms Panel Data , The Review of Economics and Statistics, 1998.

Schiantarelli, F. (1996) Financial Constraints and Investment: Methodological Issues and International Evidence , Oxford Review of Economics Policy, Vol. 12, No. 2, pp. 70-89, also in **Is Bank Lending Important for the Transmission of Monetary**

**Policy?**, edited by J. Peek and E.S. Rosengren, Federal Reserve Bank of Boston, Conference Series No. 39, June 1995.

Hubbard, R.G. (1998), Capital Market Imperfections and Investment , Journal of Economic Literature, March 1998

Kaplan, S.N. and L. Zingales (1997) Do Investment-Cash Flow Sensitivities Provide Useful Measures of Financing Constraints? , Quarterly Journal of Economics, 1997, pp.169-215.

Fazzari, S.M., R.G. Hubbard, and B.C. Petersen (1998), Investment-Cash Flow Sensitivities Are Useful: A Comment on Kaplan and Zingales , unpublished.

(ii) Bank Lending Channel

(much more on this in the second half of the course taught by J. Peek)

Kashyap, A.N., J.C. Stein, and D.W. Wilcox (1993), Monetary Policy and Credit Conditions: Evidence from the Composition of External Finance , American Economic Review, 83, no. 1, March, pp.78-98.

Oliner, S.D., and G.D. Rudebusch (1996), Monetary Policy and Credit Conditions: Evidence from the Composition of External Finance: Comment , American Economic Review, 86, no.1, March, pp. 300-309.

## **B) FINANCIAL DEVELOPMENT, FINANCIAL STRUCTURE AND ECONOMIC GROWTH**

### 1) Theory

Bencivenga, V. and B.D. Smith (1991), Financial Intermediation and Endogenous Growth , The Review of Economic Studies, April, pp. 195-209.

Greenwood, J. and B. Jovanovic Financial development, growth and the Distribution of Income , Journal of Political Economy, Journal of Political Economy , October 1990, pp. 1076-1107.

Levine, R. (1991), Stock Markets, Growth and Tax Policy , Journal of Finance, September 1991, pp. 1445-1465.

King, R. and R. Levine (1993), Finance, Entrepreneurship and Growth: Theory and Evidence, Journal of Monetary Economics, December, pp. 513-542.

Levine, R. (1997), Financial Development and Economic Growth: Views and Agenda , Journal of Economic Literature, June 1997, pp. 688-726.

b) Evidence

King R. and R. Levine (1993), Finance and Growth: Schumpeter May Be Right , Quarterly Journal of Economics, August, pp. 717-737.

Atje R. and B. Jovanovic (1993), Stock Markets and Development , European Economic Review, april, pp. 630-640.

Levine, R. and S. Zervos (1996), Stock Markets, Banks and Economic Growth , World Bank Policy Research Working paper, No. 1690, December.

Bandiera, Caprio, G. Jr., P. Honohan, and f. Schiantarelli (1997), Saving and Financial Liberalization , Mimeo, December.

Levine,R.,N. Loayza, and T. Beck, (1998), Financial Intermediation and Growth: Causality and Causes , unpublished

Beck,T., R. Levine, and N. Loayza (1999), Finance and the Sources of Growth , unpublished.

**C) OTHER TOPICS (IF THERE IS TIME)**

**2) Fiscal Policy, Consumption and Investment: The Effects of Fiscal Adjustments**

Giavazzi, F. & M. Pagano (1990). Can Severe Fiscal Adjustments be Expansionary? NBER Macroeconomics Annual. (in 14.451 course reader)

Alesina, A., Perotti R., & J. Tavares (1998). The Political Economy of Fiscal Adjustments , *Brookings Papers on Economic Activity*, No. 1, pp. 197-266.

Perotti, R. (1998). Fiscal Policy when Things are Going Badly , unpublished.

Alesina. A. & S. Ardagna (1998). Tales of Fiscal Adjustments , *Economic Policy*, forthcoming in October, 1998.

Blanchard, O. & R. Perotti (1998): An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output , unpublished.

Alesina, A., S. Ardagna, R. Perotti, and F. Schiantarelli (1999), Fiscal Policy, Profitability, and Investment , unpublished.

