Discussion of :

The Response of Corporate Financing and Investment to Changes in the Supply of Credit

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Outline

- Background of paper
- Broad Summary
- Interpretation & Critical remarks

Broad Context: Real effects of Financial Frictions

Internal Finance
(Cash Flows)

Investment

External Finance

INVESTMENT CASH-FLOW SENSITIVITY LITERATURE
Cash-flow shocks → Investment Shocks

Broad Context: Real effects of Financial Frictions

Internal Finance
(Cash Flows)

Investment

External Finance

Bonds

$\boxed{\text{Bank Debt}}$

Equity

BANKING LITERATURE
Shocks to Banks → Shocks on Investment
For bank dependent firms

THIS PAPER:

Internal Finance
(Cash Flows)

Investment

External Finance

Invst. grade Bonds

Junk Bonds

Bank Debt

Equity

LOW-GRADE BONDS
What happens when the market for this specific security collapses?
Can firms migrate to other forms of Funding?

How people read such papers

- Academics:
  - Is it well identified (ENDOGENEITY concerns)?
  - Is it NEW?

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- Policy-makers:
  - Does it inform us about AGGREGATE WELFARE effects of frictions

Summary

- **Using the 1989 collapse of Junk Bond market as exogenous shock**
  - Drexel, FIRREA, regulation of insurance
- **Dif in Dif: Changes in Financing & Investment of:**
  - junk-bond firms vs. similar unrated firms

	Pre-Shock	*Post-Shock*
Junk-rated		
Simlar Unrated		

Summary

	(Post-Shock) - (Pre-Shock)	
	LT Debt	Investment
Junk Rated	-10%	-10%
Similar Unrated	-4%	-5%

→NO SUBSTITUTION TO OTHER SOURCES OF CAPITAL (e.g. Banks or Equity)

→ONE-TO-ONE TRANSMISSION OF CREDIT TIGHTENING TO INVESTMENT

→Surprising, as these are large firms, less risky than their unrated counterparts…

What should a regulator conclude?

- Interpretation 1:

Even large firms are captive from their financing mode (cannot migrate to bank finance or equity financing quickly)

→ large aggregate cost from the collapse of junk bond market

→avoiding policies that might have accelerated this collapse, bailing out Drexel?

THREE CAVEATS WITH THIS INTERPRETATION

Caveat 1: the collapse can reflect adequate repricing (endogeneity critique)

- **Junk bond financing might have been artificially cheap**
- → Over investment (firms arbitraging financial markets):

  V(project)=NPV+V(financing)
- → Central planner cares only about NPV (financing is zero-sum game)
- → Firms connected to the junk-bond market might have financed projects beyond their marginal “socially” efficient project
- → Would not be welfare improving to prevent this repricing

Caveat 1 (cont.): Market segmentation

- Value of a project for firm shareholders:

V(cashflows) + V(financing)

Modigliani Miller: V(financing)=0

Tradeoff theory: V(financing)=tax shield=tD

Pecking order: V(financing)=-Cost(info/monitoring costs)

Market Timing: different markets have different pricing kernels

(Gabaix, Krishnamurthy, Vigneron [2007])

$$(I - \frac{C}{r_E}) + (D - \frac{r_D D}{r'_E})$$

Pricing Kernel of Equity market

Caveat 2: it's all about acquisitions

	(Post-Shock) - (Pre-Shock)	
	Capital Expenditures	Acquisitions
Junk Rated	-3%	-5%
Similar Unrated	-3%	-2%

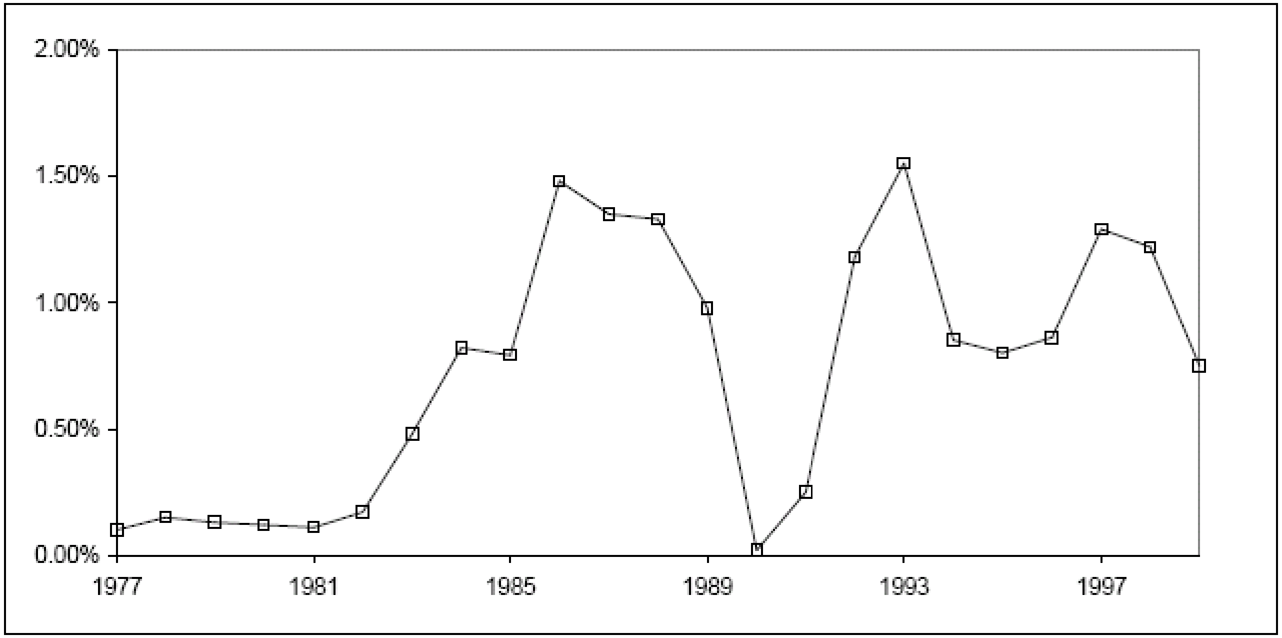
- More than half of Junk Bond Issuances were Acquisition-related in the late 80s (Kaplan-Holmstrom[2001])

- Not easy to quantify social value created by acquisitions
    - (financing is large part of NPV of acquisition)

- Real effects of M&A waves, IPO waves?

Caveat 3: Projects, killed or delayed?

- To assess cost of financing shock, need to ask whether projects done later
  - Firms might refrain from migrating to other financing because wait for junk bond market to wake up?



Conclusion

- Exciting Paper
  - Clinical study
  - Clear identification Strategy
- Interpretation: difficult in policy-making context
  - preventing junk bond market freeze in 1989: far from clear would have been efficient
- Key Question: segmentation of markets
  - Policy helping to bridge different segments?
  - Would avoid divergence and episodes of violent repricing?