FINANCIAL CAPACITY AND OUTPUT FLUCTUATIONS IN AN ECONOMY WITH MULTIPERIOD FINANCIAL RELATIONSHIPS

ABSTRACT

This paper motivates a financial propagation mechanism in the context of an intertemporal production economy with asymmetric information where borrowers and lenders enter multiperiod financial relationships. A key feature is that aggregate output and borrowers' "financial capacity" - the maximum overhang of past debt they may feasibly carry - are determined jointly, much in the spirit of Gurley and Shaw (1955). Expectations of future economic conditons govern financial capacity which in turn may constrain current production, especially in bad times. A small but persistent shift in aggregate conditions may have a large impact on financial capacity, making the framework capable of motivating large endogenous fluctuations in financial constraints.

Key Words: asymmetric information, multiperiod contracts, financial capacity, business fluctuations.

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