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Financial Factors in Business Fluctuations

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Recent research in macroeconomics -- both theoretical and empirical -- has resurrected the idea that capital market imperfections may be significant factors in business volatility by making new progress in characterizing the mechanisms. This paper outlines a case for a financial aspect to business fluctuations, in light of the contributions of this new literature. We present a theoretical model that explicitly motivates how financial factors may affect investment. We then report some existing tests of the model's basic predictions⁴ and also present two new sets of results. The first demonstrates that the inverse relation between sales variability and size documented in many studies may be due to financial rather than technological factors, in contrast to the conventional view. The second lends support to a theoretical prediction of the model. that the effects of capital market frictions on investment should be asymmetric -- having more impact in recessions than booms. The final section presents conclusions, and addresses some policy questions.

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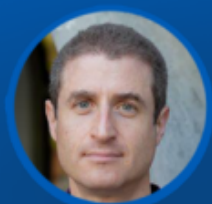
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