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1. Credit Rating Inflation and Firms' Investments

2. Every Cloud Has a Silver Lining: Fast Trading, Microwave Connectivity, and Trading Costs

3. Local Crowding-Out in China

4. Monetary Policy and Global Banking

5. Safety Transformation and the Structure of the Financial System

6. Sovereign Debt Portfolios, Bond Risks, and the Credibility of Monetary Policy

7. Stock Market Returns and Consumption

8. The Employment Effects of Faster Payment: Evidence from the Federal Quickpay Reform

9. The Forced Safety Effect: How Higher Capital Requirements Can Increase Bank Lending

1. Credit Rating Inflation and Firms' Investments

ITAY GOLDSTEIN and CHONG HUANG
黄翀（加州大学欧文分校）

Abstract

1. We analyze credit rating effects on firm investments in a rational bond financing game that features a feedback loop.

2. The credit rating agency (CRA) inflates the rating, providing a biased but informative signal to creditors.

3. Creditors' response to the rating affects the firm's investment decision and thus its credit quality, which is reflected in the rating.

4. The CRA might reduce ex ante economic efficiency, which results solely from its strategic effect: the CRA assigns more firms high ratings and allows them to gamble for resurrection.

5. We derive empirical predictions on the determinants of rating standards and inflation and discuss policy implications.

Background

Critics claim that CRAs assign overgenerous ratings, and several empirical studies find support for this view.

These studies argue that the documented credit rating inflation may be due to conflicts of interest arising from the use of an "issuer-pays" business model, whereby CRAs are paid by the issuers they are assessing.

The concern is that by misleading creditors, inflated credit ratings help risky investments get funded and as a result have negative real effects.

Motivation

Credit ratings must provide creditors with some valuable information, as otherwise the ratings would be ignored and CRAs would have no effect.

But if CRAs provide informative (though potentially biased) signals, they should be able to increase, rather than decrease, economic efficiency, even if they do not lead to the first-best outcome.

The question then is whether CRAs with a motive to inflate ratings can have negative effects on economic efficiency in a world with rational creditors.

The main work

Hence, a high rating makes creditors more optimistic about the firm and more likely to invest in the firm's bonds, which reduces the firm's financial costs and impacts its investment decisions.

This is how the ratings end up having real effects.
For those firms for which financial costs are relatively high, the reduction in financial costs leads to inefficient risk-taking, as lower financial costs allow them to gamble for resurrection and pursue investments with low expected returns but high potential upside.

For firms for which financial costs are relatively low, the reduction in financial costs provides more skin in the game, which encourages a shift from high-risk, low-expected-return investments to low-risk, high-expected-return investments.

Hence, the overall effect of the CRA on economic efficiency depends on the relative strength of these opposing effects. CRAs' overall ex ante real effects thus depend on the economic environment. Specifically, when the upside return of a risky project is high, CRAs' overall ex ante real effects are negative.

2. Every Cloud Has a Silver Lining: Fast Trading, Microwave Connectivity, and Trading Costs

ANDRIY SHKILKO and KONSTANTIN SOKOLOV

Abstract

1. Modern markets are characterized by speed differentials, with some traders being fractions of a second faster than others.

2. Theoretical models suggest that such differentials may have both positive and negative effects on liquidity and gains from trade.

3. We examine these effects by studying a series of exogenous weather episodes that temporarily remove the speed advantages of the fastest traders by disrupting their microwave networks.

4. The disruptions are associated with lower adverse selection and lower trading costs.

5. In additional analysis, we show that the long-term removal of speed differentials results in similar effects and also increases gains from trade.

Background

Competition on relative speed is a defining characteristic of modern markets where trading firms invest heavily to gain a speed advantage over their rivals.

A rich theoretical literature suggests that such differentials may have opposing effects on liquidity and gains from trade.

On the one hand, speed may allow liquidity providers to reduce their adverse selection exposure and manage inventories more efficiently. Alternatively, speed may allow traders to pick off limit orders before liquidity providers adjust to new information.

The former effect has a positive impact on liquidity and may increase gains from trade, whereas the latter may have the opposite impact.

Motivation

What is it like in empirical research?

The main work

In the main analysis, we examine liquidity when heavy precipitation disrupts microwave transmissions between Chicago and New York.

During our 2011 through 2012 sample period, traders send information between the two cities via either a fiber optic cable or a microwave network. The microwave networks, which are about 30% faster than the cable, have two important characteristics.

First, only a small group of trading firms has access to them, and these firms engage in constant competition for the top speed by retrofitting continuously. Second, precipitation (i.e., rain and snow) disrupts them.

The first characteristic creates a speed advantage for select traders, whereas the second characteristic occasionally removes this advantage.

We show that when the microwave speed advantage is removed, adverse selection and trading costs decline by up to 6.7% and 5.2%, respectively.

3. Local Crowding-Out in China

YI HUANG, MARCO PAGANO, and UGO PANIZZA

黄毅（瑞士日内瓦国际与发展研究所）

Abstract

1. In China, between 2006 and 2013, local public debt crowded out the investment of private firms by tightening their funding constraints while leaving state-owned firms' investment unaffected.

2. We establish this result using a purpose-built data set for Chinese local public debt.

3. Private firms invest less in cities with more public debt, with the reduction in investment larger for firms located farther from banks in other cities or more dependent on external funding.

4. Moreover, in cities where public debt is high, private firms' investment is more sensitive to internal cash flow.

Background

In China, Local Government Debt almost quadrupled from 5.8% to 22% of GDP over the 2006 to 2013 period.

This increase in local public debt was due largely to the fiscal stimulus program carried out after 2008, worth US$590 billion, together with much-reduced reliance on central government debt and transfers to local governments.

The Chinese credit market provides an ideal setting to test this local crowding-out hypothesis because of its geographical segmentation.

In China, debt issuance by local governments ends up being absorbed by local banks and state-owned firms are often assisted by implicit or explicit government guarantees.

The main work

We show that the increase in local public debt crowded out private investment in the corresponding cities by inducing banks to tighten credit supply to local firms.

We collect debt data for all 293 prefecture-level cities from 2006 to 2013, our statistical analysis is limited to 261 such cities, as macroeconomic data are not available for 32 of these cities.

The first of these three approaches exploits variation in the location of firms within their respective cities.

The second approach exploits firm-level variation in firms' funding needs due to technological differences between industries.

Our third approach tests whether local government debt affects the sensitivity of firms' investment to internally generated funds, which is taken to be an indicator of the severity of firms' financing constraints.

We also show that the credit crunch spared state-owned enterprises.

4. Monetary Policy and Global Banking

FALK BRÄUNING and VICTORIA IVASHINA

Abstract

1. When central banks adjust interest rates, the opportunity cost of lending in local currency changes, but absent frictions—there is no spillover effect to lending in other currencies.

2. However, when equity capital is limited, global banks must bench-mark domestic and foreign lending opportunities.

3. We show that, in equilibrium, the marginal return on foreign lending is affected by the interest rate differential, with lower domestic rates leading to an increase in local lending, at the expense of a reduction in foreign lending.

4. We test our prediction in the context of changes in interest rates in six major currency areas.

Background

Global banks play an important role in many countries.

According to the Bank for International Settlements (BIS), as of June 2015, European and Japanese banks' claims on U.S. nonbank firms were USD 1.61 and 0.72 trillion, respectively.

Given the economic significance of global banks, questions have been raised about their role in the propagation of economic shocks from one country to another.

A growing literature studies the cross-border propagation of different shocks through the balance sheets of global banks.

We show that if a global bank is capital constrained, that is, if it needs to consider the allocation of a fixed amount of equity to back lending in multiple currencies—monetary policy in one country will affect its loan supply in all currencies.

The main work

In this paper, we study the role that global banks play in the cross-border effects of monetary policy.

We test our prediction in the context of changes in the IOER rate in six major currency areas between 2000 and 2016.

Overall, the central insight of the paper is that global banks' lending decisions in different currencies are interlinked and respond to both foreign and domestic monetary policy shocks.

We find a decrease in foreign-currency cross-border claims on foreign firms of 1.2% per 25-basis-point increase in the IOER rate differential between the foreign currency and the currency of a banks home country.

5. Safety Transformation and the Structure of the Financial System

WILLIAM DIAMOND

Abstract

1. This paper studies how a financial system that is organized to efficiently create safe assets responds to macroeconomic shocks.

2. Financial intermediaries face a cost of bearing risk, so they choose the least risky portfolio that backs their issuance of risk-less deposits: a diversified pool of nonfinancial firms' debt.

3. Nonfinancial firms choose their capital structure to exploit the resulting segmentation between debt and equity markets.

4. Increased safe asset demand yields larger and riskier intermediaries and more levered firms.

5. Quantitative easing reduces the size and riskiness of intermediaries and can decrease firm leverage, despite reducing borrowing costs at the zero lower bound.

Background

An important role of financial intermediaries is to issue safe, money-like assets, such as bank deposits and money market fund shares.

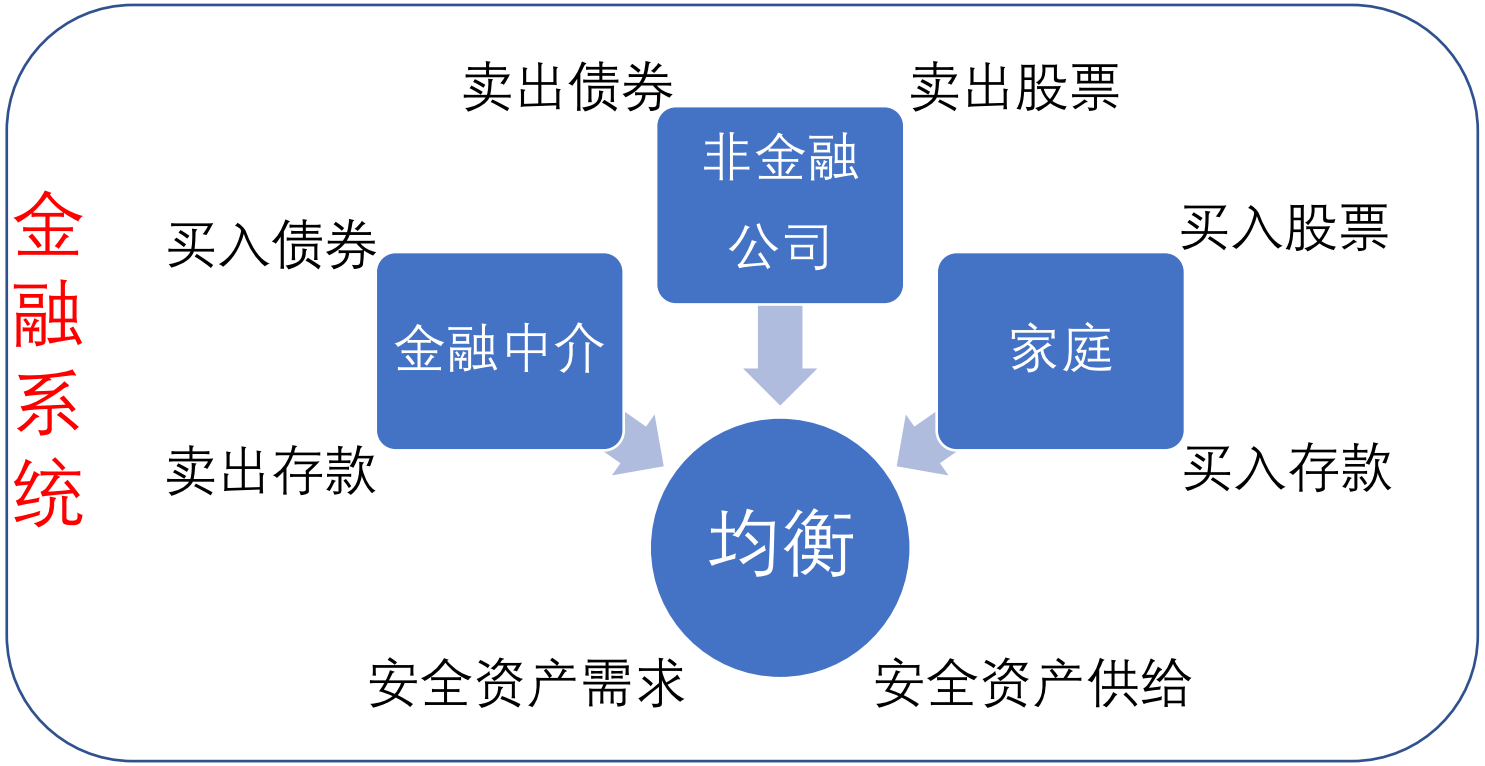
Financial intermediaries create safe assets by issuing riskless debt (deposits) backed by a diversified portfolio of risky assets.

Financial intermediaries face an agency cost of bearing risk, so they hold the lowest risk portfolio that backs their issuance of riskless debt.

The size of the financial sector is determined by the trade-off between the benefit of safe asset creation and this agency cost of bearing risk.

The main work

This paper presents a general equilibrium model of how the financial system is organized to meet this demand for safe assets.



If the demand for safe assets increases, financial intermediaries increase the quantity of safe assets that they supply to clear the market.

To back their increased supply of safe assets, intermediaries therefore buy more debt securities, which, in turn, induces the nonfinancial sector to increase its leverage.

6. Sovereign Debt Portfolios, Bond Risks, and the Credibility of Monetary Policy

WENXIN DU, CAROLIN E. PFLUEGER, and JESSE SCHREGER
（芝加哥大学布斯商学院）

Abstract

1. We document that governments whose local currency debt provides them with greater hedging benefits actually borrow more in foreign currency.

2. We introduce two features into a government' s debt portfolio choice problem to explain this finding: risk-averse lenders and lack of monetary policy commitment.

3. A government without commitment chooses excessively countercyclical inflation ex post, which leads risk-averse lenders to require a risk premium ex ante.

4. This makes local currency debt too expensive from the government's perspective and thereby discourages the government from borrowing in its own currency.

7. Stock Market Returns and Consumption

MARCO DI MAGGIO, AMIR KERMANI, and KAVEH MAJLESI

Abstract

1. This paper employs Swedish data on households' stock holdings to investigate how consumption responds to changes in stock market returns.

2. We instrument the actual capital gains and dividend payments with past portfolio weights.

3. Unrealized capital gains lead to a marginal propensity to consume of 23% for the bottom 50% of the wealth distribution and about 3% for the top 30% of the wealth distribution.

4. Household consumption is significantly more responsive to dividend payouts across all parts of the wealth distribution.

5. Our findings are consistent with households treating capital gains and dividends as separate sources of income.

Background

In the United States, stockholdings represent the largest share of financial assets on households' balance sheets. So, movements in stock prices and dividend payments might significantly affect households' consumption and savings decisions.

With soaring stock prices, households' savings rate is at a 12-year low, which raises the question of whether stock market trends do indeed drive households' spending habits.

A natural question that arises is thus how much of a decline in aggregate consumption should we expect if stock prices take a sudden turn for the worse as they did during past recessions?

Despite the central importance of these questions, the literature lacks a comprehensive study on the causal impact of changes in stock market wealth on households' consumption.

The main work

In this paper, we use household-level data from Sweden. Due to the presence of a wealth tax, we are able to obtain a full picture of households' balance sheets at the end of each year from 1999 to 2007, when the tax was repealed.

Even with such data, households' portfolio choices are endogenous.

One might be concerned that changes in capital gains and dividend income could be driven by dynamic changes in households' portfolios.

Indeed, changes in households' portfolios may be driven by factors such as the liquidation of stock holdings due to an expenditure shock or a large durable purchase, the very same factors that are likely responsible for household consumption.

The main work

We therefore implement a simulated IV strategy where we instrument the variations in capital gains and dividend income with the capital gains and dividend income that would have accrued had the household kept its portfolio the same as observed in previous years.

$$c_{it} = \alpha_i + \gamma_t + \beta_1(X_{it} \cdot r_t) + \beta_2 Dividend\ Income_{it} + \epsilon_{it},$$

where X_{it} is a vector of household i's shareholdings in the beginning of year t (which we approximate with holdings that we observe on the last day of year t – 1), r_t is the return during period t on portfolios held in the beginning of the period, and $Dividend\ Income_{it}$ is the observed dividend income of household i in period t.

8. The Employment Effects of Faster Payment: Evidence from the Federal Quickpay Reform

JEAN-NOËL BARROT and RAMANA NANDA

Abstract

1. We study the impact of Quickpay, a reform that permanently accelerated payments to small business contractors of the U.S. government.

2. We find a strong direct effect of the reform on employment growth at the firm level.

3. However, we document substantial crowding out of nontreated firms' employment within local labor markets.

4. While the overall net employment effect is positive, it is close to zero in tight labor markets.

5. Our results highlight an important channel for alleviating financing constraints in small firms, but emphasize the general-equilibrium effects of large-scale interventions, which can lead to lower aggregate outcomes depending on labor market conditions.

Background

In the United States, federal government procurement amounts to 4% of GDP with $100 billion of goods and services purchased directly from small firms.

Government contracts typically require payment one to two months following the approval of an invoice.

Thus government contractors are effectively lending to the government while simultaneously having to finance their payroll and working capital through the production process or by borrowing from banks.

Can paying small business contractors faster have a meaningful effect on their cash flows, facilitate hiring, and ultimately stimulate aggregate employment?

注：联邦快速支付改革（Federal Quickpay Reform）：在美国，政府向小企业延期支付货款的现象非常普遍。这种延期支付货款的行为使得小型企业向工人支付工资和收到货款之间产生错配，使得企业面临着一定的融资约束。鉴于此，2011年4月-9月，美国实施了“快速支付”改革，对于一部分企业将延期支付的期限从30天缩短到15天。（发票审批到付款；一部分小企业）

The main work

We study the impact of payment acceleration on firm-level employment in the United States in the context of the federal Quickpay reform of 2011.

We first estimate the direct effect of this policy to employment growth.

We next aggregate the results up to the level of local labor markets, to study whether these establishment-level results flow through to increases in aggregate employment measured at the commuting zone level.

We find that aggregate employment increases, but only in areas where unemployment is high relative to the number of vacancies. In tight labor markets, where vacancies are high relative to unemployment, we find no increase in aggregate employment.

These findings suggest the presence of a crowding out effect in tight labor markets, where the employment growth among treated firms comes at the expense of those who do not benefit from the improvement in cash flows stemming from accelerated payment.

9. The Forced Safety Effect: How Higher Capital Requirements Can Increase Bank Lending

SALEEM BAHAJ and FREDERIC MALHERBE

Abstract

1. Government guarantees generate an implicit subsidy for banks.

2. A capital requirement reduces this subsidy, through a simple liability composition effect.

3. However, the guarantees also make a bank undervalue loans that generates surplus in states of the world in which it defaults.

4. Raising the capital requirement makes the bank safer, which alleviates this problem.

5. We refer to this mechanism, which we argue is empirically relevant, as the forced safety effect.

Background

Since the global financial crisis, bank capital requirements have been substantially tightened.

Critics argue that higher capital requirements raise banks' cost of funds, thereby reducing credit provision and dampening economic activity.

Motivation

In this paper, we challenge such conventional wisdom.

The main work

At a given level of lending, a higher capital requirement reduces the value of the subsidy and hence it increases the bank's weighted average cost of funds.

But it also makes the bank safer, which can actually make the marginal loan more appealing and therefore induce an increase in lending.

谢谢大家！

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