

Essays in Finance: Pre-borrowing: Co-existence of Cash and Debt; Predators, Prey and Volatility on Wall Street.

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In three essays I explore the effects of financial frictions on agents' optimal decisions. In the first two essays I look jointly at liquidity and leverage decisions. First, in the theoretical framework I establish the pre-borrowing motive: the incentives for firms to issue debt earlier save proceeds in cash and then use internal liquid funds to finance investments. That strategy is a hedge against the volatility in the terms of borrowing. I explore implications of this motive in the setting of multi-period dynamic model of the firm, generating persistence in leverage and cash ratios that matches the observed data patterns. Also the model predicts that most risky firms would use revolving short term debt, which is also consistent with data. The safer firms with moderate liquidity needs are expected to rely on Long-term debt, while firms with a lot of liquidity needs and moderate risk profile will issue both short and long term debt. I test model implications on a sample of US publicly traded firms, and find that indeed, firms with more volatile market to book ratio are more likely to have positive debt and cash balances, as is predicted by the model. That finding is consistent with pre-borrowing motive, but can't be reconciled within other frameworks of precautionary demand for cash holdings. The third essay (co-authored with Richard Green) is looking at the difference in ability of traders in financial markets and demonstrates how it can translate into exaggerated fluctuations in employment on Wall Street. We show that even a very small shock to the fundamental profits can generate massive exit of traders from the market, essentially collapsing the market; while large positive shock would be required to bring market back to the large employment steady state, contributing to the growing literature studying the sources of excess volatility in financial markets.