Financial Constraint and Investment and The Firm Balance Sheet Channel of Monetary Policy Transmission

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Abstract:

Analyzing the effect of monetary shocks through monetary policy transmission channels is one of the central topics in the field of macroeconomics.

This paper aimed to explore the balance sheet channel of monetary policy transmission in Iran. For this purpose, the effect of the financial and balance sheet situation of firms on their investment was tested. In this paper, the cash flow, financial leverage, and size of the firm were used as the determinants of the financial situation of firms.

In this regard, the balance sheet data (2007-2018) of 50 non-financial firms in the Tehran Stock Exchange were studied by the GMM method.

The financial market is considered as a market with imperfect information. Therefore, there is a gap between the external and internal financing costs (external financing premium) caused by the asymmetric information in the financial market.

In this case, the lenders force the borrowers (firms) to pay a risk premium in order that the monitoring costs and the possible risk created by the borrowers.

The balance sheet channel suggests that a contractionary monetary policy decreases the cash flow and net worth of firms, thereby weakening their balance sheet situation. A weak financial

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situation increases an external financing premium and thus reduce an investment.

When there is a contractionary monetary policy, the firms with more financial constraints (those with a weaker financial situation) will have a greater reduction in their investment because of increasing an external risk premium, compared to ones with lower financial constraints (those with a better financial situation).

This shows that the balance sheet situation (cash flow and financial leverage) of the firms with lower financial constraints has a less effect on their investment, indicating the poorer performance of balance sheet channel than that of the firms with more financial constraints.

Therefore, the study of the effect of the balance sheet situation of firms on their investment supports the theories of the monetary transmission mechanism.

A monetary policy shock has a less effect on large firms compared to small ones. This is due to the higher net worth and cash situation of large firms.

Furthermore, large firms have a better reputation than small ones because of their relatively stronger balance sheet situation. This leads to the lowering of information and transaction costs as well as the default risk of large firms.

Moreover, this leads to a higher possibility for large firms to access external financing sources.

Therefore, large firms are facing with a lower financing premium compared to small ones, indicating the reduction in dependence of their investment on internal sources as well as the effect of a monetary policy shock on the investments.

Thus, this leads to a weaker effect of monetary policies through the balance sheet channel of the firm.

The results show that there is the balance sheet channel of monetary policy transmission in Iran. Furthermore, the findings indicate that in the firms with lower financial constraints (large firms), the performance of balance sheet channel is poorer than the ones with more financial constraints (small firms).

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