Research Working Papers

Financial Constraints, Sectoral Heterogeneity, and the Cyclicality of Investment

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Following monetary policy contractions, firms with financial flexibility take advantage of declining prices for capital goods by increasing their investment.

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While investment in most sectors declines in response to a contractionary monetary policy shock, investment in the manufacturing sector *increases*. Using manually digitized aggregate income and balance sheet data for the universe of U.S. manufacturing firms, I show this increase is driven by the types of firms that are least likely to be financially constrained. A two-sector New Keynesian model with financial frictions can match these facts; unconstrained firms are able to take advantage of the decline in the user cost of capital caused by the monetary contraction, while constrained firms are forced to cut back.

JEL classifications: E22, E32, E52

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