Equity Markets and Monetary Policy

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Abstract

We study the transmission of monetary policy though firms' equity financing. At the aggregate level, we document that firms respond to monetary expansions by increasing equity issuance, and that the response of equity flows is quantitatively more important than that of debt flows. At the micro level, we show that monetary stimulus significantly mitigates the stock price drop associated equity issuance, suggesting a reduction in the asymmetric information premium in equity markets. Motivated by this evidence, we construct a corporate finance model of equity financing under asymmetric information that can rationalize these findings. We use the model to study its aggregate implications. Monetary policy affects the composition of investment, by making firms with high productivity projects more willing to use external finance. If the arrival rate of investment opportunities is given, this means that monetary stimulus can contain the seeds of a subsequent productivity slowdown.

Keywords: Monetary policy transmission, equity issuance, firm investment opportunities, adverse selection.

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