Transitory versus permanent shocks: Explaining corporate savings and investment*

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Abstract

We model the investment and cash holdings decisions of a firm facing financing frictions and subject to permanent and transitory cash flow shocks. While cash holdings increase and investment decreases with the volatilities of either type of shocks, a higher correlation between these shocks makes the firm hold less cash and invest more. We verify these predictions using a sample of publicly traded U.S. firms from 1975 to 2014 and estimates of the permanent and transitory cash flow shocks obtained via structural estimation. Our analysis demonstrates that corporate policies are better understood when recognizing the separate effects of permanent and transitory shocks on cash flow risk.

Keywords: Cash holdings; Investment; permanent vs. transitory shocks.

JEL Classification Numbers: G31, G32, G35.

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