

productivity shock hits banks on the asset and the liability side of their balance sheets and leads to a contraction of inside money. The money multiplier collapses and “Fisher deflation” sets in (as the value of money rises). This effect is in sharp contrast to many other monetary models without a financial sector, which predict inflationary pressure after a negative productivity shock. Monetary policy can mitigate these adverse effects by essentially redistributing wealth towards the financial sector. It is not surprising that money is always shining through when one talks about liquidity and financial frictions.

Models discussed in this survey assume *various financing restrictions*. Depending on the underlying economic friction financing constraints can appear in different forms. For example debt/credit constraints limit the amount of debt financing. Often the limit is given by the value of the underlying collateral. In contrast, equity constraints limit the extent to which one can sell off risky claims. For example, when an agent has to have “skin in the game” he can sell off only a fraction of the risk. In incomplete-markets settings, risk along certain dimensions cannot be sold off at all and hence certain risks remain uninsurable. In models with limited participation certain agents in the economy are excluded from being active in certain markets altogether. Overlapping generation (OLG) models can be viewed in the same vein as currently living individuals cannot write contracts with yet unborn individuals.

The literature offers different *“micro-foundations”* for different financing frictions. First, there is the costly state verification framework à la [Townsend \(1979\)](#). The basic friction is due to asymmetric information about the future payoff of the project. While the debtor learns the true payoff of the project ex-post, the financier does not. Only if he pays some monitoring cost he also learns the true payoff. In such an environment debt is the optimal contract since it minimizes the socially wasteful monitoring costs. As long as the debt is paid off in full, there is no need to verify the true state. Only in case of default, the financier verifies the state. De-jure the financier has to pay the costs, but de-facto he passes them on to the borrower by charging a higher interest rate. This makes external funding more expensive. It drives a wedge between external and internal funding costs and explains why large fractions of projects are funded with retained earnings. Importantly, the interest rate increases with the borrowed amount as default and costly monitoring becomes more likely. Increasing the borrowing amount might become unattractive at some point, but the amount of borrowing is effectively not limited.

This is in contrast to quantity rationing as in [Stiglitz and Weiss \(1981\)](#) for non-collateralized credit. In their setting asymmetric information arises already ex-ante, i.e.