

the equilibrium changes in period t into a static part and a dynamic part as follows:

$$\begin{array}{rcc} & \text{static} & \text{dynamic} \\ \hat{K}_t & = & -\Delta - \frac{1}{(\xi+1)(R-1)}\Delta \\ \hat{q}_t & = & -\frac{R-1}{R}\frac{1}{\xi}\Delta - \frac{1}{R}\frac{1}{\xi}\Delta \end{array}$$

The static part corresponds to the values of \hat{K}_t and \hat{q}_t if dynamic feed-back were turned off, i.e. by assuming that $q_{t+1} = q^*$. This decomposition makes clear that the effect of the dynamic multiplier far outweighs the effect of the static multiplier for both the change in asset holdings and the change in asset price.

Note however, that the effects of shocks in KM97 are completely symmetric, i.e. the effects of a positive shock are just the mirror image of the effects of a negative shock, also displaying persistence and amplification. In a similar model, [Kocherlakota \(2000\)](#) addresses this issue by assuming that entrepreneurs have an optimal scale of production. In this situation, a borrowing constraint implies that shocks have asymmetric effects: After a positive shock the entrepreneurs do not change the scale of production and simply increase consumption; after negative shocks they have to reduce the scale of production since borrowing is constrained.

The main message of [Kocherlakota \(2000\)](#) is that financial frictions cannot generate large enough effects, since experts self-insure and hold liquid assets to withstand small shocks. Even if one assumes that agents are at the constraint, amplification is not large since a capital share – which is usually estimated to be around $1/3$ – is too small to make a sizable dent into current or future output. [Cordoba and Ripoll \(2004\)](#) argue that a capital share close to one will also not generate quantitatively significant effects. In this case the difference between marginal productivity of capital between productive and less productive agents is small and hence the economy is not far from first best solution. Hence the economy will not respond drastically to shocks. In sum, only a carefully chosen and empirically implausible capital share can generate significantly large amplification effects. The paper discussed in the next section puts many of these concerns to rest.