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Pancrazi et al. (2016) consider the so-called financial accelerator mechanism used in many articles since Bernanke et al. (1999) and show that the procedure of approximating the price of old capital by the net-of-depreciation price of new capital has profound implications when the capital depreciation rate is positive. When accounting for the appropriate price of capital, the effects of the financial accelerator are even stronger than originally assessed. Since the setup is the same as in Bernanke et al. (1999) where entrepreneurs borrow in credit markets to finance their investment in capital, the strength of the financial accelerator turns out to depend crucially on the dynamics of the price of capital. This conclusion has important first-order effects on the solution of a model that assumes a positive depreciation rate of capital together with investment adjustment costs.

*•* Aggregate demand: Households gain utility from consumption, leisure and real money balances. They work, consume, pay taxes, hold money, and invest their savings, in form of deposits, in a financial intermediary that pays the riskless rate of return. These deposits are transferred to entrepreneurs in the form of loanable funds. Entrepreneurs use capital and labor to produce wholesale goods that are sold to the retail sector. Each period, entrepreneurs have to accumulate capital that becomes available for production in the subsequent period. Entrepreneurs have to borrow from households via a financial intermediary to finance capital purchases. Since the financial intermediary has to pay some auditing costs to observe the idiosyncratic return to capital, an agency problem arises. The optimal contract leads to an aggregate relationship of the spread between the external finance costs and the risk-free rate and entrepreneurs’ financial conditions represented by the leverage ratio.

*•* Aggregate supply: Retail firms act under monopolistic competition. They buy wholesale goods produced byentrepreneurs in a competitive market and differentiate them at zero cost. Price stickiness is introduced viathe Calvo (1983) framework. Bernanke et al. (1999) assume that reoptimizing firms have to set prices prior to the

realization of shocks in that period, so that previous period’s expectations of the output gap and future inflation enter the New Keynesian Phillips curve.

*•* Shocks: This paper presents responses to a technology shock, as well as to a monetary policy shock.

*•* Calibration/Estimation: The model is calibrated at quarterly frequency.