THE IMPACT OF FINANCING CONSTRAINTS ON MARKUPS: THEORY AND EVIDENCE FROM ITALIAN FIRM LEVEL DATA

by

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Abstract

In this paper we look at both the theoretical and empirical behavior of price-cost margins when capital market imperfections affect firms' markup policies. We present a model of a firm operating in an industry with differentiated products and facing imperfect markets for financing operations. The model results in an Euler equation for the optimal price path which is estimated using data for several hundreds Italian firms over the period 1981-1993. The empirical results suggest that: (i) capital market imperfections are present in the sense that firms in our sample pay a premium on external finance which significantly depends on the debt to sales ratio; (ii) according to our estimates constrained firms find it optimal to cut price compared to unconstrained firms; (iii) as firms are more likely to be financially constrained in recessions, our results imply that financial market imperfections tend to make markups procyclical.

Keywords: Markup; Financing Constraints, Differentiated Products.
JEL Classification: D21, D43, D92, E30.

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