

1. Introduction

How do capital market imperfections affect firms' markup policies? Do these imperfections tend to make markups procyclical or countercyclical? These are the two main issues we address in this paper.

The literature on the impact of financing constraints on firms' real decisions has received great impetus in recent years following the advances in the theory of information and incentives and the increased availability of panel data on individual firms. As well documented in Hubbard (1996), capital market imperfections are likely to play a role in all types of investment decisions taken by optimizing firms, namely investment in fixed capital, human capital, knowledge capital, and investment in inventories. One area of this literature that is still largely unexplored concerns the impact of financing constraints on another type of investment decision that forward-looking firms typically make, that is, investment in market shares by appropriately pricing their products.

Most theoretical papers on this subject rely on models of customer markets (Greenwald, Stiglitz, and Weiss, 1984; Bilal, 1989; Gottfries, 1991) and/or markets with consumer switching costs (Klemperer, 1987, 1995; Chevalier and Scharfstein, 1995, 1996). These models study imperfectly competitive firms which compete for a customer base that changes slowly over time as customers purchase a good repeatedly and only occasionally compare prices. In this case firms charge a low price for their product to attract new customers as a larger customer base tomorrow implies higher profits in the future. They therefore price below the single period profit maximizing level. A refinement of these models is the case in which customers face a fixed cost of switching to a different supplier. In any period firms trade off the benefits from charging a low price to attract first time buyers with the costs of not charging a high price to locked-in customers. Also here firms charge a price below the single period level to build a base of locked-in customers.

The story just described generally applies to firms that are not liquidity constrained and/or not in a recessionary period. In fact, when a firm is cash constrained or faces an increasing cost of external debt, it will cut investment in market share and