bank-based countries , such as Japan and Germany, the role of banks in equity financing is marginal and it is not very common for bankers to sit on the boards of directors of industrial firms or to play an active role in influencing industrial firms' strategic decisions. It is however true that, partly for historical reasons, large business groups have special informal relations with national financial institutions. Some of them are considered to play an important role not only in financing but also in acting as exclusive clubs where mutual shareholdings are organized and, more generally, decisions on corporate control are taken.[3]

It is common wisdom in Italy that members of large national business groups are likely to face more favorable lending practises than independent firms. The existence of these informal links, together with the more diversified nature of business groups is perceived as a distinctive advantage in obtaining external funds for affiliated firms. Moreover, most firms quoted at the national stock market are members of the largest business groups, this possibly enhancing the gap in accessing external markets between independent and affiliated firms. Subsidiaries of foreign multinational corporations are also likely to enjoy favorable relations with domestic banking institutions, although perhaps not as good as affiliates to large national groups . Moreover they have a distinctive advantage in tapping, directly or indirectly through the parent company, international capital markets.

No systematic investigation has been conducted so far on the effect of the form of ownership on the substitutability between internal and external finance. The purpose of this paper is to fill this gap and to test whether financial constraints are more severe for independent firms relative to affiliated firms, and whether there are differences between members of national groups and subsidiaries of foreign multinational corporations. One standard approach to assessing the substitutability of internal and external sources has been to investigate the excess sensitivity of investment to cash flow for different categories of firms.[4] In our paper we address this issue by investigating the role of cash flow both in leverage and investment equations. The advantage of

3 Mediobanca, by far the most important investment bank in Italy, is defined by the economic press as the "salon of italian capitalism".

4 See Fazzari, Hubbard and Petersen (1988) for a seminal contribution in this area. See also Hoshi, Kashyap and Scharfstein (1991) for an analysis of the implications of group membership in Japan.