The Role of Financial Constraints on Firm Investment in Developing Countries: The Case of Ethiopian Manufacturing

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A question of considerable interest in the literature of firm investment is if financial factors inhibit investment. Several studies that use both q-theoretic and Euler equation approaches report that investment is more sensitive to financial factors among firms that are more likely to face financing constraints. However, there is no consensus if these results can be interpreted as indicative of the presence of financial constraints. One major reason for this is the difficulty to isolate the effects of financial and fundamental factors since the two factors not only affect each other, but are also in return affected by investment. This paper uses panel VAR methodology to explicitly model the dynamics between firm investment, and its fundamental and financial determinants. The marginal product of capital and cash flow are used to measure fundamental and financial factors respectively. Analysis using a unique census-based dataset of Ethiopian manufacturing establishments shows that cash flow is an important determinant of investment. Orthogonalized impulse response shocks of cash flow elicit much larger investment response among small and privately owned firms compared respectively to larger plants and state-owned enterprises. I find that financial liberalization in more recent years has eased the cash flow sensitivity of investment, especially for financially more constrained small and privately owned firms.