A Theory of Financing Constraints and Firm Dynamics

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Abstract

There is widespread evidence supporting the conjecture that borrowing constraints have important implications for firm growth and survival. In this paper we model a multiperiod borrowing/lending relationship with asymmetric information. We show that borrowing constraints emerge as a feature of the optimal long-term lending contract, and that such constraints relax as the value of the borrower's claim to future cash flows increases. We also show that the optimal contract has interesting implications for firm dynamics. In agreement with the empirical evidence, as age and size increase, mean and variance of growth decrease, and firm survival increases.

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