Do Financing Constraints Explain Why Investment is Correlated with Cash Flow?

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This paper investigates the sources of the correlation between corporate cash flow and investment by undertaking an in-depth analysis of the 49 low-dividend firms identified by Fazzari, Hubbard, and Petersen (1988) as having an unusually high investment-cash flow sensitivity. We find that in only 15% of firm-years is there some question as to a firm's ability to access internal or external funds to increase investment. Strikingly, those firms that appear less financially constrained exhibit a significantly greater investment- cash flow sensitivity than firms that appear more financially constrained. We find this pattern for the entire sample period, for sub-periods, and for individual years. The results indicate that a higher sensitivity cannot be interpreted as evidence that a firm is more financially constrained. We discuss reasons and provide evidence why the opposite may be true. These findings challenge much of the existing evidence on the effects of financial constraints.

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