Accepted Manuscript

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PII: S1058-3300(16)30013-1
DOI: doi: 10.1016/j.rfe.2016.09.004
Reference: REVFIN 389

To appear in: *Review of Financial Economics*

Received date: 4 February 2016
Revised date: 15 September 2016
Accepted date: 20 September 2016

Please cite this article as: Quader, S.M., Differential effect of liquidity constraints on firm growth, *Review of Financial Economics* (2016), doi: 10.1016/j.rfe.2016.09.004

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# Differential effect of liquidity constraints on firm growth

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**Abstract**

Differential quantitative effects of internal finance on growth among firms facing different degrees of financial constraints are found in this paper using an unbalanced panel data on 1122 UK firms listed on the London Stock Exchange. The generalized methods of moments (GMM) estimation results are consistent with financial constraints arising from capital market imperfections and indicate a substantially greater sensitivity of growth to cash flow for firm years facing the most binding financial constraints. Furthermore, these firms can actually expand their size more than the extent of increase in cash flow they may have which supports the leverage effect hypothesis. The estimated impact decreases monotonically thereafter as financial constraints become less binding allowing the firms to finance successively bigger portion of their growth through external financing.

*Keywords:* Law of Proportionate Effects, Financial constraints, Growth cash flow sensitivity, Leverage effect, GMM.

*JEL classification:* C23, D82, G32, L25

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