

Reinforcing Constraints*

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Abstract

Small firms face financing frictions, and trading their stocks entails non-negligible bid-ask spreads. I develop a model that studies how these characteristics are related and investigates their real effects. Bid-ask spreads increase both the firm's cost of equity and the opportunity cost of cash, which leads to tighter financial constraints, higher liquidation risk, and underinvestment. The ensuing decline in firm value affects the participation of competitive liquidity providers and widens the bid-ask spread further, then amplifying its detrimental effects on corporate policies and value. The model studies some regulatory proposal affecting financial markets from a corporate perspective, like designated market makers or financial transaction taxes.

Keywords: Financial constraints, transaction costs, real effects of financial markets, small firms

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