FINANCIAL CONSTRAINTS AND INNOVATION: WHY POOR COUNTRIES DON’T CATCH UP

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Abstract
This paper examines micro-level channels of how financial development can affect macroeconomic outcomes like the level of income. Specifically, we investigate theoretically and empirically how financial constraints affect a firm’s innovation activities. Theoretical predictions are tested using unique firm survey data which provide direct measures for innovations and firm-specific financial constraints, as well as information on shocks to firms’ internal funds that can serve as firm-level instruments for financial constraints. We find unambiguous evidence that financial constraints restrain the ability of domestically owned firms to innovate and hence to catch up to the technological frontier. (JEL: O3, O16, G3)