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Real Effects of Working Capital Shocks: Theory and Evidence from Micro data

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HIGHLIGHTS

- Our study investigates the real consequences of shocks in the first and second moments of working capital requirement (WCR) in the presence of financial frictions.
- We introduce a link from imperfect information about WCR to firms' performance.
- The uncertainty of being financially constrained influences firms' demand for inputs, albeit risk-neutrality.
- Unable to employ the projected level of prepaid input, constrained firms would encounter capacity underutilization, leading to misallocation of factors.
- Empirical assessment of our findings, using the "Annual Survey of Iranian Manufacturing Enterprises," shows that higher requirement for working capital tightens firms' hired prepaid inputs, production, and capacity utilization.
- Firms with more uncertain working capital will choose a lower level of production. These are especially scaled up, when firms face financial constraints.

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