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SCIENCE DIRECT
Journal of Financial Stability 1 (2004) 65–91
Journal of FINANCIAL STABILITY
www.elsevier.com/locate/jfstabil

Corporate financial structure and financial stability

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Abstract

Drawing on a unique dataset of flow-of funds and balance sheet data, this paper analyzes the impact of financial crises on aggregate corporate financing and expenditure in a range of countries. Investment and inventory contractions are the main contributors to lower GDP growth after crises, with a much greater effect in emerging market countries. The debt–equity ratio is correlated with investment and inventory declines following crises. Econometric analysis suggests that financial crises have a greater impact on expenditure and the financing of corporate sectors in emerging markets than in industrial countries. Industrial countries appear to benefit from a pick-up in bond issuance in the wake of banking crises. Although companies in emerging market countries hold more precautionary liquidity, this is evidently not sufficient to prevent a greater amplitude of response of expenditure to shocks.

JEL classification: E22; E44; G31

Keywords: Corporate finance; Financial instability

1. Introduction

This paper examines how corporate financial structure shapes the impact of a financial crisis on the real sector via its effects on flows of funds and on corporate real expenditures. It is one of the first papers to utilize extensive cross-country flow and balance sheet data and also to examine subcomponents of GDP in the wake of banking and currency crises rather than purely focusing on aggregate GDP.

The analysis of this paper compares and contrasts corporate financing and expenditure patterns during periods of financial crisis in OECD and emerging market (EME) countries.

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1572-3089/$ – see front matter
doi:10.1016/j.jfs.2004.06.003

The implications of corporate financial structure for financial fragility are measured here empirically by examining shifts in the size and composition of financial flows and expenditures by the corporate sector during a crisis, controlling for normal shifts in financing or expenditures that take place over the cycle.

The analysis suggests that investment and inventory contractions are the main contributors to lower GDP growth after crises and the effect is much greater in emerging market countries. There is a marked correlation of the debt–equity ratio to investment and inventory declines following crises. Financial crises have a greater and more consistently negative impact on corporate sectors in emerging markets than in industrial countries, although even in the latter the impact is not negligible. Industrial countries benefit from the existence of multiple channels of intermediation in that bond issuance is shown to pick up in the wake of banking crises.

The paper is structured as follows: Section 1 comprises a review of the relevant theoretical and empirical literature and suggests some testable hypotheses drawn from that literature; Section 2 outlines the data, and illustrates broad corporate financing patterns; Sections 3 and 4 provide empirical analysis of corporate expenditures and financial flows during financial turbulence; and Section 5 concludes. Inter alia it is suggested that the implications of financial structure for the impact of a crisis on the corporate sector, and thereby real output, strengthen the case for financial sector reforms and surveillance of the financial sector by governments and international financial institutions.

2. Literature review

This paper draws from several disparate financial and economic literatures, beginning with the *general determinants of corporate financial structure*. The first modern theory of the general determinants of corporate financial structure was the proof by Modigliani and Miller (1958) that under simplifying assumptions the balance sheet structure of a firm is irrelevant to the cost of capital. However, introducing differential microeconomic costs of bankruptcy between equity holders and debt holders stimulates firms to issue only equity. Conversely, the tax deductibility of interest payments encourages debt finance, with firms consequently absorbing “unnecessary” levels of business cycle risk and raising the risk of default (Gertler and Hubbard, 1989).

The understanding of corporate balance sheet structure was further refined by the introduction of asymmetric information and consequent adverse selection and moral hazard in the context of incomplete contracts. The availability of internal financing may thus impact on real decisions (Fazzari et al., 1988) as firms prefer to—or are constrained to—finance themselves by internal rather than external funds. Internal funds are more plentiful for large and established firms than in small and new firms, where the latter may be more typical of emerging market countries. A corollary is that financial systems that cope better with agency costs will supply more external financing, ceteris paribus.

The *literature on economic and financial development* provided insights into the different corporate financial structures of industrial and emerging market countries. King and Levine (1993) found that financial variables have a strong relation to capital accumulation, economic growth and productivity growth. Levine and Zervos (1998) concluded that stock