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Banking sector reforms and corporate leverage in emerging markets☆

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ABSTRACT

Using a large panel of non-financial firms in emerging markets, we study the relation between detailed measures of banking sector reforms and corporate leverage. We find that banking sector reforms are associated with lower corporate debt in emerging market firms, consistent with the notion that these reforms improve banks' risk management and result in tighter lending standards, leading firms to use less bank debt in their capital structure. These effects are less pronounced for financially constrained firms, suggesting a relative increase in the supply of bank credit to firms which were rationed prior to the banking sector reforms.

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1. Introduction

In the past two decades, the banking sector has undergone large transformations in many countries around the world. These reforms include banking sector supervision and regulation, bank entry, bank

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privatization and deregulation of interest rates. The goal of these policies was to reduce government intervention and broaden the scope for market forces to operate in capital markets.

Financial deregulation policies were first advocated by McKinnon and Shaw in the 1970s (McKinnon, 1973; Shaw, 1973) especially for emerging markets, where state intervention in the financial sector was especially heavy handed. As reforms began to be implemented in the late 1980s and early 1990s, however, evidence emerged that in some circumstances they could lead to undesirable outcomes, such as high and volatile interest rates and macroeconomic and financial sector instability. These drawbacks were attributed to various factors, such as a mismanaged or premature reform process, inadequate bank prudential regulation and supervision, or weak institutions to protect property and contractual rights.[2]

Differing from the large portion of the literature that has focused on the impact of financial reforms on either aggregate credit or financial stability, in this paper we assess how banking reforms affect firms' choices of debt in their capital structure by reducing government intervention and in allowing market forces to operate.[3]

We concentrate on corporate debt in emerging markets since firms in these markets depend heavily on bank debt due to limited development of public debt markets. Therefore, domestic banking sector reforms should have a significant impact on the corporate leverage decisions in these markets. Using a detailed measure of banking sector reforms and a large panel of non-financial firms in 17 emerging markets during the period 1990–2002, we find that firms carry less (bank) debt in their capital structure following banking sector reforms. The evidence is consistent with the notion that these reforms foster efficient credit market development, which results in higher costs of bank funding, better pricing of risk, tightened lending standards and more stringent bank supervision.

Research by Schmukler and Vesperoni (2006) is closely related to ours in terms of focusing on debt in emerging markets. They study the impact of a number of financial reforms on debt maturity in seven emerging markets during the period 1980–1998. They consider three types of reforms: the first is the liberalization of foreign entry into the local stock market (Bekaert et al., 2005); the second is a proxy measure of liberalization of the domestic financial sector (Beck et al., 2000); and the third is the liberalization of controls on foreign capital flows (Kaminsky and Schmukler, 2003). They find that both stock market liberalization and domestic financial liberalization do not have a significant impact on the debt maturity of firms that actively access global markets, but they lead to shorter debt maturity in firms that do not access global markets. They also find that foreign capital flow liberalization has no significant effect. The paper concludes that the effects of financial liberalization are asymmetric in emerging markets, since firms that are not able to integrate in world capital markets appear unable to obtain long-maturity debt.

Our study complements their findings by focusing on banking sector reforms and how they affect capital structure decisions. We examine the relation between credit market reforms and corporate leverage by using a multidimensional measure of the reform process constructed by Abiad et al. (2010). Banking reforms are measured with an index, whose components track actual policy changes in several important dimensions of the regulatory environment: Bank supervision, bank competition, credit allocation, bank privatization and interest rates. We consider these reforms both separately and together as a banking sector reform index. We carry out our analysis for a large set of emerging markets by controlling for global trends and for changes in the macroeconomic environment.

The relation of these reforms with corporate leverage is gauged by a rich regression specification of the determinants of firm leverage. A standard measure of leverage is specified to depend on a set of firm-level

[2] In an early study, Diaz-Alejandro (1985) describes how mismanaged financial liberalization led to a deep financial crisis in Chile in the early 1980s. Haber and Musacchio (2005) claim that Mexico's financial crisis in 1994–95 was the result of failed bank privatization. Financial liberalization has been associated to a higher incidence of banking crises (Demirgüç-Kunt and Maksimovic, 1999) and more output volatility (Kaminsky and Schmukler, 2003). Detragiache et al. (2008) argue that foreign bank entry can lead to a reduction in credit to the private sector in poor countries, and Tressel and Detragiache (2008) find that liberalization spurs long-lasting credit market development only in countries with good property rights. Studies of deregulation in advanced countries have generally found positive effects, see for example Jayaratne and Strahan (1996), Stiroh and Strahan (2003), Cetorelli and Strahan (2006), Bertrand et al. (2007), and Guiso et al. (2006). Also, Galindo et al. (2007) find that financial liberalization improves the allocation of investment in developing countries.

[3] Most empirical research on the corporate financial structure has focused on U.S. data. Among international studies, Rajan and Zingales (1995) find that most firm characteristics that explain leverage in the U.S. have a similar explanatory power in other advanced economies. Booth et al. (2001) report a similar finding for developing country firms, but also show that country characteristics (captured by country fixed effects) account for a substantial fraction of the sample variation.

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