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Financial globalization and debt maturity in emerging economies

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Abstract

This paper studies how financial globalization affects debt structure in emerging economies. We find that by accessing international markets, firms increase their long-term debt and extend their debt maturity. In contrast, with financial liberalization, long-term debt decreases and the maturity structure shifts to the short term for the average firm. These effects are stronger in economies with less developed domestic financial systems. The evidence is consistent with financial integration having opposite effects on the firms that are able to integrate with world markets and obtain financing globally, relative to the firms that rely on domestic financing only.
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1. Introduction

The advocates of financial globalization argue that the integration of countries with the world financial system can have many benefits, particularly for emerging economies with

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segmented financial markets.[1] In a global financial environment, firms from financially underdeveloped economies gain access to mature financial markets, which are liquid and offer long-term financing. This integration also helps to develop the domestic financial systems.[2] As a consequence, the cost of capital decreases and financing constraints are relaxed.[3] Furthermore, by issuing debt in foreign jurisdictions, with better contract enforcement institutions, the level of risk for creditors decreases and debtors become more able to borrow long term.[4] All these potential advantages have prompted most emerging economies to liberalize their financial systems around the first half of the 1990s.

The crises that started in the mid 1990s with the Mexican devaluation have, however, raised concerns that globalization increases risks, making emerging economies vulnerable to financial distress. Different risks are usually associated with globalization and crises. A central one is the maturity risk derived from the shortening of the maturity structure, which exposes borrowers to potential rollover difficulties and interest rate fluctuations.[5] In fact, short-term debt has played an important role in the crises of Mexico 1994–95, East Asia 1997–98, Russia 1998, and Brazil 1998–99. The higher exposure to risks that globalization may bring about has led many economists to argue that countries should liberalize their financial systems gradually, and that those that have already liberalized might consider imposing some type of capital controls.[6]

The international finance literature offers different explanations to why globalization might expose emerging economies to maturity risk.[7] This literature argues that globalization can increase the maturity risk if it leads to exposure to international investors with information disadvantages, which may choose to lend short term to better monitor and discipline borrowers.[8] Also, if international investors were more risk averse than domestic investors, the maturity structure would shift to the short term, as foreign investors would charge borrowers from emerging markets a higher risk premium on long-

[1] At the macroeconomic level, cross-country capital mobility may lead to a more efficient allocation of world savings, boost growth and investment, and help smooth consumption. See, for example, Bekaert et al. (2005), Henry (2000a,b), and Obstfeld (1998).

[2] See, for example, Fischer (1998) and Mishkin (2003).

[3] See, for example, Bekaert and Harvey (2000), Edison and Warnock (2003), Lins et al. (2005), and Stulz (1999).

[4] See De la Torre and Schmukler (2005).

[5] A second risk commonly related to globalization is the over-borrowing syndrome, which arises because financial liberalization can generate lending booms and over-investment under the presence of moral hazard. As the expected rates of return are not realized, over-borrowing increases the chances of crises. See, for example, McKinnon and Pill (1997). The third risk typically mentioned is the exchange rate mismatch, which occurs because of the rise of foreign currency debt, while the income of borrowing countries remains in domestic currency. See, for example, Jeanne (2000a, 2003), Eichengreen and Hausmann (1999), and Frankel and Rose (1996).

[6] See, for example, Eichengreen and Wyplosz (1993), Krugman (1998), Rodrik (1998), Stiglitz (1999), and Tirole (2002).

[7] The corporate finance literature also provides arguments to explain the shortening of the debt maturity structure. Myers (1977) shows that when the value of firms depends on growth opportunities, shareholders might decide to under-invest to avoid passing the proceeds of future projects to bondholders. Short-term debt can avoid sub-optimal investment decisions. As firms from emerging economies typically face new growth opportunities when liberalization takes place, they might choose to borrow short term.

[8] Short-term debt forces borrowers to roll over their liabilities more frequently, giving them an incentive to make sound economic decisions. See Jeanne (2000b) and Rodrik and Velasco (2000).

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