

Choice of Financing Source in International Debt Markets¹

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This paper examines incremental debt financing decisions of large Asian firms over the period 1989–1998. We find that flotation costs, agency costs, and renegotiation and liquidation risk affect the choice of debt type and that firms in countries with well developed private bond markets have a higher probability of accessing international bond markets. Significant differences exist between the determinants of choice of debt type across Japanese and non-Japanese firms that cannot be explained by keiretsu associations. Moreover, there is no significant difference in the determinants of financing source for Japanese firms across independent firms, horizontal keiretsus, and vertical keiretsus. *Journal of Economic Literature* Classification Numbers: F39, G15, G21, G32. © 2001 Academic Press

I. INTRODUCTION

While studies of firms' capital structures initially focused on the optimal leverage decision, the discussion has broadened to incorporate issues relating to the structure

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of a firm's debt. The focus in these more recent studies has been on how firms choose between public and private debt sources,² and contingent on that choice, the determination of debt contract terms including maturity, secured status, and pricing of the debt.³ They explore how asymmetric information, agency costs, taxes, credit quality, reputation, and strength of the borrower/lender relationship affect these decisions.

Outside the United States there have been few studies of the choice of financing source, defined here as the choice between public and private (intermediated) debt. Consequently the primary objective of this paper is to extend the U.S. literature to consider the choice of financing source by Asian firms in international debt markets. It seeks answers to the following important questions. Are the determinants of financing source in international debt markets similar to those observed in studies of domestic debt markets? Do cross-country differences in government corruption, in legal rules affecting the enforcement of debt contracts, in the development of financial markets and institutions, and/or in corporate governance mechanisms, affect the choice? Is the behaviour of Japanese firms in selecting debt type different from that of other Asian firms? Does affiliation with a horizontal or vertical keiretsu affect the choice of financing source by Japanese firms?

Three main groups of hypotheses explaining the choice between public and private (intermediated) debt have been suggested. First, flotation costs hypotheses draw on the observation that flotation costs of public debt issues are high and have a large fixed cost component. With potential economies of scale, firms that issue in large quantities are likely to find public debt financing relatively more attractive (see Blackwell and Kidwell, 1988; and Easterwood and Kadapakkam, 1991). Second, agency cost hypotheses draw on the distinction that private debt involves the lender monitoring the firm's activities, while monitoring is not available with public issues. Only firms with high credit quality, and thus who do not need to be closely monitored, are able to use public debt financing which is then available at a lower interest rate. Firms exposed to greater incentive problems, in the form of asset substitution and underinvestment, receive more value from monitoring and will use private debt despite higher interest rates (see Diamond, 1984, 1989, 1991; and Rajan, 1992). Finally, the liquidation and renegotiation hypotheses recognise that, in the event of financial distress, private debt agreements are easier to renegotiate and provide for more flexible liquidation than public debt (see Berlin and Loeys, 1988; Chemmanur and Fulghieri, 1994; and Detragiache, 1994).

A number of recent empirical studies have found support for these hypotheses. With the exception of two Japanese studies (see Hoshi *et al.* 1992; and Anderson and Makhija 1999), the data relate to that of U.S. firms. Moreover the studies generally focus on balance sheet ratios of private debt (or public debt) to total

² See for example Houston and James (1996), Johnson (1997), and Krishnaswami *et al.* (1999).

³ See Dennis *et al.* (2000).

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