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journal homepage: www.elsevier.com/locate/jfecThe euro and corporate financing before the crisis[☆]Arturo Bris^{a,b}, Yrjö Koskinen^c, Mattias Nilsson^{d,*}^a IMD Switzerland^b ECGI, Belgium^c The Wharton School, University of Pennsylvania, USA^d University of Colorado, Boulder, USA

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ABSTRACT

We study the financing policies of European public corporations prior to the euro crisis. Using data from 11 euro countries and a control group of five other European countries over 1991–2006, we show that nonfinancial firms from euro countries with previously weak currencies considerably increased their debt financing after the introduction of the euro. The results are stronger for large firms, firms dependent on external financing, and for the latter part of the post-euro time period. Overall, the results support the hypothesis that the supply of capital increased following the introduction of the euro.

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1. Introduction

In 2009, the European Union celebrated the tenth anniversary of the introduction of the euro as its common

currency. In a report published in 2008, the European Commission claimed that the first decade of the Economic and Monetary Union was a “resounding success” (European Commission, 2008). Those words turned out to be premature. Soon after the celebrations were over, the euro area was tossed into a severe crisis from which it has yet to fully emerge from.

The extant macroeconomics literature has identified a private sector credit boom and related current account deficits as major causes for the crisis (Lane, 2012). This paper aims to participate in this debate on the roots of the crisis by providing firm-level evidence on corporate financing choices before the onset of the crisis. In particular, we examine if the euro has led to an increase in the use of debt financing for companies hailing from the euro area compared to other European companies.

Previous research by Bris, Koskinen, and Nilsson (2006, 2009) shows that the introduction of the euro resulted in

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increases in corporate valuations and investments for euro area firms compared to other European firms. Bris et al. attribute these findings mainly to a decrease in cost of equity and debt capital. As a result of decreased cost of capital, the demand for external financing is expected to have increased in the euro area compared to other comparable European countries. The supply of capital may have also increased in the euro area. For example, euro area financial markets have become less segmented since the introduction of the euro, as manifested by the increase in cross-border portfolio investments, in particular for bonds (see, e.g., De Santis and Gerard, 2006; Lane, 2006; Lane and Milesi-Ferretti, 2007). Thus, firms have become less dependent on domestic investors when raising external financing. In addition, the implementation of the ambitious legislation known as the Financial Services Action Plan (FSAP) during the first half of the 2000s has made it easier to provide financial services throughout the European Union and thus could have facilitated cross-border financial intermediation (Kalemli-Ozcan, Papaioannou, and Peydró, 2010). The euro countries may have been particularly well positioned to take advantage of this regulatory integration by already sharing a common currency.

We provide evidence that the introduction of the euro has led to an increase in external financing, especially debt financing, for firms hailing from euro countries. Based on our sample of public firms, nonfinancial firms are likely to have significantly contributed towards current account deficits among the crisis countries by borrowing more. Our results are stronger for firms from those euro countries that previously had weak currencies, consistent with the idea that increased external financing is due to higher demand for financing. However, there is clear evidence that increased supply has also been a major contributing factor. Large firms, who have better access to foreign banks and investors, have increased their debt financing more, despite the fact that previous research shows that their valuations increased less than the valuations for smaller firms [see Bris, Koskinen, and Nilsson (2009) for relative valuations]. Moreover, firms in industries that are more dependent on external financing have increased their debt financing more. Finally, results are stronger during the second half of our time period, partially due to the implementation of FSAP. These findings support the idea that improved supply of capital has led to increased use of external financing among the euro countries.

We estimate regressions where the change in total external financing, the change in debt, or the change in external equity, all normalized by lagged assets, are the dependent variables. As explanatory variables we use measures of size, profitability, collateral, a proxy for industry-level growth opportunities (corresponding to US industry Tobin's Q), together with dummies indicating firms in the euro area for the time the common currency has been in use. Our sample consists of 2,486 firms from 16 European countries in the period 1991–2006. In particular, we use corporate-level data from the 11 original countries that adopted the euro in 1999, and as our control sample we use the three EU countries that did not adopt the euro (Denmark, Sweden, and the UK) as well as Norway and Switzerland. Using a control sample allows us to compute differences-in-differences estimators to

measure the impact of the euro both cross-sectionally and in the time-series domain.

We show that the introduction of the euro has on average led to a 1.9% annual increase in external financing relative to assets for companies from the euro area compared to companies from our control countries. When we split the sample of euro firms between firms in weak euro countries (i.e., countries that suffered a currency crisis in the years before the introduction of the euro) and strong euro countries, we find that for the weak euro countries the annual increase in external financing is 4.2% of assets, composed of 2.6% increase in debt financing and 1.4% increase in external equity financing. For strong euro countries there is no increase in external financing, but equity issuance increases by 0.8% annually.

We also estimate individual country results, using firms from the UK as the benchmark. Among the individual euro countries, the results are the strongest for firms from the now-troubled countries of Italy, Portugal, and Spain, as well as for firms from the currently financially more solid northern euro countries of France, Netherlands, and Finland.¹ Among the non-euro countries, Denmark stands out as the only country in which firms on average significantly increased their external financing, in particular debt financing, after 1999.

Among industries, the results are the strongest for basic industries (agriculture, mining, and construction) and for service industries among the weak euro countries. Since construction is part of basic industries, the results for that industry are not surprising in view of the real estate boom in some euro countries. However, we should bear in mind that our results are relative to the control group, which is dominated by firms from the UK, and that the UK also experienced a real estate boom.

The results showing that firms from weak euro countries have on average raised more external financing than firms from strong euro countries is consistent with the explanation that demand for financing has increased, since Bris, Koskinen, and Nilsson (2006, 2009) show that the weak euro firms experienced higher increases in Q and investment levels after the introduction of the euro. In order to examine if supply of financing is also a major contributing factor for the increase in external financing in the euro area, we classify industries to be dependent on external financing by measuring the fraction of investments financed by external finance in corresponding industries in the US between 1991 and 1997 [following the procedure of Rajan and Zingales (1998)]. We then show that industries that are dependent on external financing have significantly increased their debt and equity financing compared to the control group after the introduction of the euro. The result holds for all euro firms, but it is much stronger for firms from weak euro countries (annual increase is 3.9% of assets in debt financing and 1.6% in equity financing). Interestingly, the results for debt financing are also stronger for large firms (defined as having above sample median average sales in the pre-euro period). For example, large firms from weak euro

¹ Note that Finland is classified as a weak euro-country in our analysis as it was hit by a significant currency crisis in the early 1990s.

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