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## Economic policy uncertainty and capital structure choice: Evidence from China



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### ABSTRACT

This paper studies how economic policy uncertainty affects corporate capital structure for Chinese listed firms from 2003 to 2013. We show that as the degree of economic policy uncertainty increases, firms tend to lower their leverage ratios. However, firms that are from regions with lower degrees of marketization, are state-owned or have prior bank-firm relationships mitigate the negative effect of policy uncertainty. Moreover, we provide consistent evidence that this negative effect is sourced from the deterioration of the external financing environment. We also find that firms adjust their financing structures by using more trade credit when economic policy uncertainty increases. Our results are robust to sample selection, data frequency, model specification and endogeneity.

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## 1. Introduction

Due to the nature of policy decision-making and implementation processes, economic policies typically generate a large amount of uncertainty, which can impose profound impacts on the financial market and firm behaviour. Using alternative policy uncertainty measures, previous literature has

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explored the association between economic policy uncertainty and asset prices (Pastor and Veronesi, 2013; Brogaard and Detzel, 2015), corporate investment decisions (Julio and Yook, 2012; Gulen and Ion, 2013) and IPO activities (Colak et al., 2013). However, our understanding towards the effect of economic policy uncertainty on firms' capital structure choices, a core research question in corporate finance, is still limited. Meanwhile, prior research in this area has rarely paid attention to emerging or transition economies, where the financial markets tend to be highly regulated and prone to being influenced by government policy (Erb et al., 1996).

In the current study, we attempt to fill this void by empirically examining how economic policy uncertainty affects firms' capital structure decisions in China — a typical emerging financial market. We find strong evidence that Chinese firms' leverage ratios are negatively related to economic policy uncertainty, and that this effect is more pronounced for firms that are in regions with higher degrees of marketization, are non-state-owned or have no prior bank-firm relationship. We also identify the underlying mechanism of this effect as the deterioration of the external financing environment caused by policy uncertainty.

The idea that economic policy uncertainty may affect firms' capital structures is not new. Indeed, there are two alternative channels that are categorized by this study as the *supply* effect and the *demand* effect. The main idea of the supply effect is that uncertainty in economic policies will deteriorate the external financing environment. When economic policy uncertainty increases, the information asymmetry between borrowers and creditors will become more severe and, at the same time, firms' future cash flows will be more volatile — indicating higher default risk. Both of these effects can lead to higher external financing costs, with firms generally lowering their leverage ratios in seeking financial flexibility. In support of this idea, recent empirical studies on the U.S. financial market document that economic policy uncertainty increases the risk premium of municipal bonds (Gao and Qi, 2012), reduces the average leverage ratio of listed firms (Cao et al., 2013), and imposes additional costs and more stringent non-price terms on bank loan contracts at both aggregate and firm levels (Francis et al., 2014). On the other hand, the demand effect refers to a scenario where firms reduce their financing demands in face of increasing policy uncertainty. Prior research documents that when firms face high political uncertainty, they will be more conservative in making investment decisions (Bernanke, 1983; Bloom et al., 2007) and lower their investment level (Kang et al., 2014; Gulen and Ion, 2013; Wang et al., 2014). In summary, both channels assert a negative relationship between economic policy uncertainty and firms' capital structures; however, it is difficult to identify the dominating effect.

We choose Chinese listed firms as the experiment sample due to three considerations. First, as stated above, the limited research on this topic mainly focuses on the U.S. market and therefore our study on China can provide an "out-of-sample" test for the existing empirical results in a market with distinct institutional features, which play key roles in affecting corporate capital decisions.<sup>1</sup> It is therefore important to test whether the documented relationship between policy uncertainty and capital structure decisions holds in this market. Second, regional divergences of institutional environments and firm heterogeneities in terms of ownership structure and bank-firm relationships are more typical in the Chinese financial market (Fan et al., 2011; Allen et al., 2009). These characteristics generate significant cross-sectional variations, which can deepen our understanding of the possible asymmetry of the policy uncertainty effect. Third, China is still regarded as a transition economy moving from a planned towards a market-based economy. The primary source of financing in this market is bank loans (Allen et al., 2005; Ayyagari et al., 2010), with a bank loan environment that is extremely sensitive to variations in government policies.<sup>2</sup> This provides us with an ideal

<sup>1</sup> Though the Shanghai Stock Exchange and the Shenzhen Stock Exchange ranked sixth and eleventh in the world in terms of market capitalization at the end of June 2012 and China's capital market is transitioning to a more mature market through a process of financial reform and modernization, there are still distinct institutional features that could potentially affect corporate capital structure decisions. The most important features include the dominating role of state ownership in the Chinese capital market, the Chinese imposing of explicit or implicit control on the volume and price of equity issuance, and banking as the primary source of financing. For a more detailed discussion of these features, we refer readers to Chang et al. (2014).

<sup>2</sup> One recent example is that, in 2009, the Chinese central government proposed a stimulus plan amounting to 4 trillion Yuan, and to fund these investments, the government required banks to increase the supply of loans dramatically. As a result, the Chinese market experienced a jump of bank loans from 4.9 trillion Yuan in 2008 to 9.59 trillion Yuan in 2009.

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