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Who benefits from capital account liberalization? Evidence from firm-level credit ratings data☆

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ABSTRACT

Using a novel panel data set on corporate foreign-currency credit ratings and capital account restrictions in advanced and emerging economies during 1995–2004, we find a strong positive effect of capital account liberalization on firms' credit risk, as measured by corporate credit ratings. As an identification strategy, we exploit within-country variation in firms' ability to obtain foreign currency and, thus, their ability to repay foreign currency debt. We find that liberalizing the capital account benefits significantly more those firms with more limited foreign currency access, namely, those producing nontradables. Our findings demonstrate a novel channel through which capital account restrictions affect economic outcomes, and they are robust to a broad range of alternative specifications.

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1. Introduction

Over the past four decades, the global economy has become ever more financially integrated, with the sum of cross-border assets and liabilities in the average country rising from about 50 percent of GDP in 1970 to over 400 percent in 2007. Starting in the mid-1980s, this trend has been accompanied also by a reduction in the extent of legal restrictions that countries impose on capital account transactions (See, e.g., Figure 1 in Quinn et al., 2011). However, only few advanced economies have completely eliminated capital controls; and more recent data indicate the possibility of a reversal of the previous trend towards freer capital markets, with several countries imposing new legal restrictions on capital account transactions or tightening existing ones (Schindler, 2009). Thus, the use of capital account restrictions is likely to remain an important and actively used policy instrument for countries aiming to limit or control the extent to which their economies are integrated with world financial markets.

However, despite the importance of capital controls, there remains considerable uncertainty regarding the relative costs and benefits of liberalizing the capital account. Although a large literature exists on the questions of how effective controls are, and through which channels they may operate, robust answers to these questions remain largely elusive. Among the many possible reasons for the lack of stronger results, two factors are likely to be important: the use of aggregated data in many studies, and the lack of sufficiently refined *de jure* measures of capital account openness. Aggregate data may hide important heterogeneities in the extent to which different subsets of an economy are affected, making it difficult to detect significant average effects. Finding a significant link between capital controls and economic outcomes is made difficult also by the fact that some of the most widely used capital controls indicators are crude, binary indicators which ignore variations in the degree of capital account restrictiveness.

In this paper, we address both shortcomings by studying a broad firm-level panel data set to explicitly address heterogeneities, and by using a new data set of capital controls which captures more subtle differences in capital control regimes across countries and time. The new capital controls index can also be disaggregated in novel ways, allowing for additional and innovative tests of our hypothesis. More specifically, we estimate the effects of capital account restrictions on firms' credit risk and thus on the conditions at which they can access credit in international capital markets. We study this channel in a broad panel data set using firm-level variation in long-term foreign-currency corporate credit ratings, a measure that is closely related to the cost of accessing international bond markets. In addition, credit ratings are also closely related to the pool of international investors firms can access as several regulations concerning international investors' investments in bonds are directly tied to credit ratings (Kisgen, 2006).

To identify the effects of capital account liberalization, we employ a difference-in-difference methodology similar to that in Rajan and Zingales (1998) by exploiting differences across firms/sectors in their access to foreign currency.[1] We argue that firms are able to issue foreign-currency debt if bondholders expect the issuing firms to eventually repay the debt. This requires the expectation of reasonably reliable future access to foreign currency. Given that credit ratings aim to measure a firm's credit worthiness for foreign currency debt, the ease with which a firm can obtain foreign currency should be reflected in the firm's ratings assessment.

As a proxy for such foreign currency access, we distinguish between whether a firm belongs to the tradables or the nontradables sector, on the grounds that firms in tradables have relatively easier access to foreign currency through their export earnings. Our key finding is that capital controls have a large negative effect on the credit ratings of firms in the nontradables sectors, while they are more neutral for firms in tradables sectors. Because tradables firms can generate foreign currency through exporting even when the capital account is restricted, lifting such restrictions has little impact on these firms' ability to issue foreign currency debt. By contrast, a restricted capital account does constrain firms in the nontradables sector in terms of issuing foreign currency debt. It is therefore intuitive that these

[1] Rajan and Zingales (1998) construct a measure of a firm's technological dependence on external finance and show that firms more in need of external finance grow faster in economies with more-developed financial markets.

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