Financial development, financial constraint, and firm investment: Evidence from Thailand

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ABSTRACT

This paper examines the effect of firm financial constraint and financial development on firm investment using data from non-financial companies in Thailand from 1999Q1 to 2015Q4. The empirical results showed a significant effect of firm financial constraint on their investment. The cash flow of firms had a positive effect on firm investment, while the leverage ratio of firms had a negative effect. Financial development also weakened the effect of firm financial constraint on firm investment. These effects were considerably higher in more financially constrained firms than less constrained ones.

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Introduction

Financial condition, or the financial constraint of a firm, is an important factor influencing firm investment. According to Farre-Mensa and Ljungqvist (2013) and Silva and Carreira (2012), financial constraint can be a measure of the firm’s financial condition or the firm’s balance sheet condition, such as firm cash flow, leverage, and size. In this case, the greater the financial constraint of firms, the weaker the firm’s financial condition. Also, firm investment is usually considered as the firm’s fixed assets, such as property, plant, equipment, and their depreciation (Bhaduri, 2005; Rungsomboon, 2005; Soumaya, 2012). Regarding the theory of firm investment, financially constrained firms are considered to have a weaker balance sheet condition and hence higher external funding costs, compared to those with lower financial constraints. This is because more financially constrained firms will have relatively low liquidity and capital as well as a higher default risk. As a result, the more financial constraint a firm has, the lower the firm investment, as firms will have greater difficulty in investing and finding external funding sources (Agca & Mozumdar, 2008; Butzen, Fuss, & Vermeulen, 2001; Gilchrist & Himmelberg, 1995; Rungsomboon, 2005). Bond, Elston, Mairesse, and MulKay (1997) and Chatelain, Generale, Hernando, Van Kalkbreuth, and Vermeulen (2003) explained that the financial condition of firms, including cash flow and firm size, can affect firm investment. Angelopoulou and Gibson (2007) and Guariglia (1999) also showed that leverage and the dividend payout ratio of firms can also affect firm investments. They explained that large firms with high cash flow, dividends, and with low leverage, will have less financial constraint. These firms generally have more opportunities to extend their investment compared with more constrained ones. Apart from firm financial constraint or condition, financial development can also influence investment, and affect the relationship between financial constraint and investment. According to Demirgüç-Kunt and Levine (2008) and Singh, Razi, Endut, and Ramlee (2008), financial development is the condition where there is the development of financial intermediaries and markets including financial institution development and capital market development. The effect...

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of financial development can weaken the impact of financial constraint on firm investment. Laeven (2003) and Love (2003) stated that financial development through banking sector and capital market development can support the firm balance sheet condition by increasing external funding opportunities and increasing investment opportunities for firms. This reduces the dependence of firms on their internal funding sources as well as improving the firm financial condition. Therefore, the effect of firm financial constraint on firm investment will become weaker when there is financial development that facilitates the firm increasing its investment by using its external funding sources to fund investment compared with previously using internal funds (Galindo, Schiantarelli, & Weiss, 2007).

Several studies have focused on the relationship between financial constraint, financial development, and firm investment, particularly the effect of financial constraint on firm investment, mainly in developed countries (Agca & Mozumdar, 2008; Bond et al., 1997; Chatelain et al., 2003; Chatelain & Tiomo, 2001; Love, 2003). Study on the effect of financial development on firm investment is still limited. Such study mostly focuses on developed countries and also on the individual aspect of financial development such as financial liberalization (Gelos & Werner, 2002; Harris, Schiantarelli, & Siregar, 1994; Schiantarelli, Weiss, & Jaramillo, 1996) and capital market development (Islam & Mozumdar, 2007; Laeven, 2003; Love, 2003). Therefore, this has resulted in a lack of case studies in developing countries, including Thailand and also of the study of the role of financial development and the effect of financial constraint on firm investment. Therefore, this paper aims to fill the gap by introducing an evidential study of Thailand as a case study of a developing Asian country. The aims of the paper are first to study the effect of firm financial constraint or financial condition on firm investment in Thailand, and second to examine the effect of financial development on firm investment or the way in which the financial constraint of firms affects their investment. This paper has three main motivations: First, this study fulfills the gap in the literature by also studying the influence of financial development on the way in which financial constraint affects firm investment which was rarely considered in the reviewed literature. In this case, we also focus on both aspects of financial development including banking sector development and capital market development in order to obtain more aspects of the influence of financial development on the way in which firm financial constraint affects their investment, as well as to supplement the previous papers which only focused on individual aspects of financial development. Second, we fill the gap in previous studies especially with regard to the effect of firm financial constraint or financial condition on firm investment, which previously was mostly focused on developed countries, by introducing an evidence study of Thailand as a case study of a developing Asian country. Concerning this study, the effect of financial constraint on firm investment as well as the effects of financial development on the way in which the financial constraint of firms affects their investment will be different from those in developed countries because the financial market in developed countries is considered to be more financially developed regarding size, capital, and liquidity compared to developing countries (Beck, Demirgüç-Kunt, & Levine, 2009; Beck & Levine, 2002). Consequently, the effect of financial constraint on firm investment as well as the effect of financial development on the way in which financial constraint affects firm investment will possibly be greater in a developing market than in developed ones because firms in a developing market will have greater difficulty in obtaining external funding sources compared to firms in a developed market. Thus, firm investment in a less-developed market will depend more on the firm’s internal source of funds as well as firm financial constraint, and the effect of financial development on the way in which financial constraint affects firm investment will become greater relative to a developed market in which there is more opportunity to obtain funding sources from the financial market. Therefore, this paper will shed light on a case study in a developing country, Thailand, which will has a relatively less-developed financial market than those cases reported in the literature in developed markets. Third, regarding the evidence study in Thailand, there is a lack of the study on both the effect of financial constraint on firm investment as well as the effect of financial development on the way that financial constraint affects firm investment. In addition, regarding financial market development in Thailand, the financial situation in Thailand has been continually developing, especially after the financial crisis period in 1997. Between 1998 and 2001, there was significant financial development focus on restructuring plans to support liquidity in the financial market and capital market development. This was mainly shown by the establishment of a Set-Trade dotcom PLC and Thai-NDVR PLC for electronic securities trading support, and the introduction of BATHNET to support the Thai payment system (Bank of Thailand [BOT], 2002). In 2003, BOT introduced the Financial Sector Master Plan Phase I (2003–2005) in order to expand commercial banking businesses and support capital market development. This was supported by the introduction of the Bond Electronic Exchange (BEX) in 2003, the Derivative Market PLC in 2004, and the Thai Future Exchange market (TFEX) in 2005 (BOT, 2010, 2015). The BOT also issued the Financial Sector Master Plan Phase II (2010–2015), with the aim of supporting financial competition and Thai banking development. This was followed by the issuing of the new Financial Development Master Plan (2016–2020), with the aim of improving financial development in the country in order to join the Asian Economic Community (AEC) (BOT, 2015). We can see that Thai financial development continued to develop since the financial crisis in 1997 and therefore it is worthwhile to conduct an evidence study in Thailand as a case study in an Asian developing country in order to explore how the financial development in the country affects the way that financial constraint of firms affects their investment. The results from this study may assist the BOT and policy makers to apply financial development policy to control the economy, especially through the firm sector in the future.

We first found a significant effect of firm financial constraint on firm investment in Thailand, and second, that financial development weakened the effect of firm financial constraint on firm investment. These effects were higher in

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