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Domestic bank health and foreign direct investment ☆

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This article provides evidence on the link between Japanese firms' foreign direct investment (FDI) and domestic bank health during the 1990s. Analysis of FDI by 420 industrial firms reveals that financial health of a firm's main bank and non-main banks both positively and significantly relates to the firm's FDI around the globe. The estimated impact of main bank health is smaller than that of non-main banks' financial health, suggesting that close bank-firm ties cushion the impact of bank health deteriorations albeit partially. Regressions also reveal that the sensitivity to domestic bank health varies across firms and investments projects. The variation patterns are consistent with the view that bank health affects FDI by changing the availability of bank credit. *J. Japanese Int. Economies* **22** (3) (2008) 291–309. Aoyama Gakuin University, Graduate School of International Management, Shibuya 4-4-25, Shibuya-ku, Tokyo 150-8366, Japan.
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1. Introduction

Factors affecting the firm's foreign direct investment (FDI) behavior are of considerable interest to researchers in many strands of academic research. The literature's traditional focus is on firm-specific resources conferring competitive advantage on firms in foreign markets and contractual and non-contractual costs associated with their international transfers. However, these

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factors do not explain why FDI flows from and into an economy fluctuate even in the short-run, oftentimes substantially (Blonigen, 1997). In studying this issue, researchers pay increasing attention to financial factors affecting the firm's ability to acquire foreign-based assets. Leading studies include Froot and Stein (1991), Klein and Rosengren (1994), Kogut and Chang (1996) and Blonigen (1997) on the influence of foreign exchange rate.

In a recent study, Klein et al. (2002) contribute to this literature by highlighting a previously unstudied factor affecting the firm's ability to grow abroad, economic health of domestic banks. They find that, in response to deteriorations of domestic banks' financial health in the early 1990s, Japanese firms cut back on US direct investment substantially. The impact of bank health declines was not uniform across firms. Firms affiliated with a financially weak bank through the main bank relationship were particularly strongly affected. Research has advanced that main banks accumulating knowledge about borrowers that is unavailable to arms-length creditors facilitate firm growth by alleviating asymmetric information problems (Hoshi et al., 1991; Aoki et al., 1994). Klein et al.'s (2002) finding suggests that deteriorations of bank health undermine the value of main bank relationship.

Despite this and other important implications, evidence on the FDI–bank health link in Japan or elsewhere is still scant. In this article, I contribute to increasing our knowledge on this subject by supplying new evidence from Japan's banking crisis in the 1990s. My main research interest is in the relative impact of financial conditions of main banks and non-main banks, an issue unaddressed by Klein et al. (2002). As noted by Horiuchi et al. (1988) and Aoki et al. (1994) among others, Japanese firms borrowing exclusively from main banks are rare. Rather, firms usually borrow more from non-main banks than from the main bank. Studying the influence of financial health of non-main banks will therefore contribute to more complete understanding of the impact of banking crisis on Japanese FDI. Comparing main banks and non-main banks also sheds light on the unique role main banks play in the finance of Japanese firms, which is difficult to grasp if one focuses on main banks. In response, I consider the influence of financial conditions of all major banks a firm deals with in estimating the FDI–bank health link.

My research sample is 420 industrial firms listed on the first section of Tokyo Stock Exchange (TSE) over the sample period, 1990–2000. I examine the influence of domestic bank health on these firms' FDI around the globe in two steps. The first step involves regressions based on bank-level data aggregating FDI by firms sharing the same main bank. Regressions relating a bank's financial health measured by Moody's credit rating to affiliated firms' FDI strongly suggest that main bank health constrained Japanese firms' overseas expansions during the 1990s.

The second step involves firm-level regressions jointly estimating the effects of main banks' and non-main banks' financial health. Negative binominal regressions of FDI count show that financial conditions of main banks and non-main banks both positively and significantly relate to borrower firms' FDI. The main finding of this study is that financial health of non-main banks exerts a greater impact on borrower firms' FDI than that of main banks and therefore is a more binding constraint on the Japanese firm's overseas expansions. This pattern appears robustly in alternative specifications, FDI measures, and estimation samples. Moreover, the patterns of variation of bank health sensitivities across firms and investments are consistent with the view that bank health correlates with FDI because of its impacting credit supply.

Overall, results reported in this article lend strong support to the notion that FDI flows from a bank-dependent economy like Japan are sensitive to domestic banks' financial health. The finding that a firms' FDI correlates more with financial health of arms-length creditors (non-main banks) than that of relationship creditors (main banks) has two major implications. First, the link between FDI and domestic bank health may be observed in various economies outside

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