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Financing and monitoring in an emerging economy: Can investment efficiency be increased?

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ABSTRACT

This study investigates the influence of the financial system on firms' investment efficiency in China. For this purpose, we employ country level data of capital markets and financial institutions along with financial data from 2797 Chinese firms in the period from 1998 to 2015. The firms are priori classified into four groups, by high and low values of financial constraints and agency problems. Results show that financial development influences firms' investments positively either directly or by reducing cash flow sensitivity. The impact remains the same for all types of firms. Moreover, the financial structure has an impact on investment efficiency of firms; this result also remains the same even after controlling levels of financial development. Study contributes that capital market based financial structure impacts investment decisions by reducing financing constraints and agency issue due to its strong monitoring ability.

1. Introduction

Economic development is dependent upon active role of financial institutions and financial markets. Financial development is identified by the ability of financial system (financial institutions, instruments and markets) to provide a mechanism to strengthen economic activity in an economy. (Gurley & Shaw, 1955) defined it as an increase in the number of financial institutions. Financial development is related to economic growth (Liang & Jian-Zhou, 2006). Financial development not only makes smooth flow of capital, but also bridges information gap between capital deficit and capital surplus units. To ease the information and lower transaction costs is the primary purpose of efficient financial system, which results in efficient and effective allocation of resources and thereby economic growth (Beck & Levine, 2004). Major tasks conducted by financial system are to maintain smooth flow of capital within economy and to develop efficient monitoring system to monitor the users of acquired funds.

Financial development is among the most vigorous elements of corporate decisions (Antzoulatos, Koufopoulos, Lambrinoudakis, & Tsiritakis, 2016). Economic theory illustrates that advancement of financial institutions and financial markets results in lowering the transaction costs and information asymmetries, thus maximizing the investment efficiency of economies. Structure of financial system is also important for corporate performance. Financial structure means whether the system is dependent upon financial institutions or financial markets. Researchers have debated a lot about relative importance of both types of structures in particular investment decisions of firms (Baum, Schäfer, & Talavera, 2011; Beck & Levine, 2002; F. Castro, A. E. G. Kalatzis, & C. Martins-Filho, 2015).

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Investment efficiency means creating balance between overinvestment and underinvestment. Investment inefficiency is caused by investment distortions. Two problems that affect the corporate investments adversely are agency problem and information asymmetry. These problems have been widely discussed in economic theories of firm behavior after 1960s. Agency problem arises due to mismatch of interest of shareholders with managers. It becomes the worst when firms have substantial amount of free cash, affecting investment efficiency adversely. Overinvestment hypothesis illustrates that when there is conflict of interest between different stakeholders of a firm, managers may exploit their discretionary rights if they have excess free cash flow and invest more in projects, which may not be in long-term favor of shareholders and result in overinvestment (Michael C Jensen, 1986). This problem may become severe if there is no efficient monitoring system for watching agents. On the other hand, the underinvestment hypothesis is grounded on asymmetric information, which illustrates that a firm's insiders and capital market investors have different level of information about the firm's future prospective. By this, transfer of wealth form new to existing shareholders may occur. This creates credit rationing and a wedge between the internal and external finance and ultimately financial constraints (Michael C Jensen, 1986; Michael C Jensen & Meckling, 1976; Myers & Majluf, 1984). Agency problem and financing constraints jointly affect investment efficiency of firms adversely by making investment cash flow sensitivity positive.

How financial system development and structure are related with a lower degree of financial constraints and agency problem comes out to be an essential topic in the literature. This study postulates that if there is a developed financial system and an appropriate financial structure is adopted, then problem of agency and asymmetric information can be controlled and then corporate investments will become more productive. Financial development is associated with active monitoring of corporate sector and flow of capital that reduces agency problem and financing constraints.

The number of studies, which have explained the role of financial development and financial structure, is scarce and their contradictory results have created more avenues of discussion. Most of these studies have been conducted in developed economies and have ignored emerging economies. As almost all of these studies are based upon cross-country comparison, they have dealt with the factor of heterogeneity between countries, while our work is the pioneer to study the individual companies within a single country instead of cross-country analysis. Considering the presence of information asymmetry and agency problem, the role of financial development and structure in determining corporate investment efficiency is quite a new topic for financial literature. No other study has discussed all these elements together, according to our best knowledge. Topic becomes more interesting because we have selected China as our case study that has unique financial and economic system in terms of its characteristics. Technically speaking, this work is to evaluate the financial development of Chinese economy in terms of financial system's main tasks i.e. capital flow and monitoring. This study is also to find the answer to the question that whether agency issue and information asymmetric problem are resolved well in financial institution based or financial market based financial system. Our study is different from existing literature in many aspects. First, almost all of the studies have studied this relationship in cross-country comparison and have not bothered the heterogeneity problem between countries. Second, there is no study, which has incorporated the problem of financing constraints and agency problem simultaneously. Third, no study has addressed this issue for Chinese economy as it has peculiar nature compared to other economies in the world. Moreover, we have analyzed the relationship between financial system and investment for different levels of financial developments. So this study shows a deep understanding of Chinese financial system and can diagnose shortcomings and suggest remedies.

The current manuscript is also a prominent addition in the existing literature to build the relationship between financial and real sides of the economy. Investment is core function for economy, so if it goes in right direction, economy will progress. As (Castro et al., 2015) suggested, the scrutiny of a corporate investment is a pertinent way to know the networks employed by financial systems to enhance economic growth. So this topic is to link macro and micro level economic activities. Purpose of this study is to determine what happens to corporate investment in response to financial structure and financial development when firm is having agency conflict as well as financial constraint and what lessons can be learnt from this for theoretical and practical usefulness. This manuscript is on the background, juncture of these streams: investments, financial constraints, agency problem, financial development and financial structure. No other research has related them all in a single study. Our study is different from all conventional works because we have focused a single economy with all its characteristics rather than studying cross-county comparison after ignoring individuality between economies.

China plays the most prominent role in global economy and is the fastest growing economy, as well as the biggest economy of the world. But in spite of all these hallmarks, Chinese economy has some obstacles internally like less developed financial system (Allen, Qian, & Qian, 2005). This makes our study more interesting and influential. If we compare banking system of China with stock markets, then we come to know that banking system is more important due to its larger size, but it is also inefficient because it has higher overhead cost to total assets ratio (Allen et al., 2005). China's bank-dominated financial sector is famous for its inefficiency and misallocation of capital (H. Chen, 2006). In contrast to (Hasan, Wachtel, & Zhou, 2009) who finds that development in financial sectors affects economy negatively, (Hao, 2006) advocates that development in financial sectors of China has contributed to its economic growth. According to (Allen et al., 2005), China's underdeveloped financial system does not match with blooming economic growth. State-owned banks are dominant over system but still they have a higher proportion of non-performing loans. Unfortunately, these institutions also have to finance state-owned enterprises which are sometimes in losses (Allen et al., 2005). Moreover, Chinese stock market is not old and developed as compared to most of the economically developed countries. As is stated by (Allen et al., 2005), share market of China is also not well-organized and fundamental values cannot be depicted by stock prices. But still China is the fastest growing economy and world's biggest economy by volume. So China provides a best case study for this title, as its financial system is in growth phase and corporations are exhibiting both agency and financial constraints problems. Moreover, Chinese economy is experiencing transition from centrally planned to market economy over last 30 years (Bhattacharjee & Han, 2014). Fig. 1 illustrates the main theme of our paper. This theme presents the theory that investment efficiency

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