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Corporate governance, bank concentration and economic growth

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ABSTRACT

We examine the effects of bank concentration and corporate governance among firms in terms of economic growth using panel data for 34 countries and 29 manufacturing sectors over the period 1980–2010. We show the following results: First, bank concentration exerts a negative effect on growth for industries that are most dependent on external financing. However, for countries with a high level of corporate governance bank concentration is less harmful to economic growth. Our results have important policy implications for emerging markets. Most importantly, they suggest that high corporate governance is a crucial means for promoting growth and prosperity in developing and emerging economies, in which we commonly observe under-developed financial sectors and high levels of bank concentration.

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1. Introduction

The level of corporate governance plays an important role in determining economic growth, particularly by affecting capital markets and resource allocation. It also has the potential to encourage innovation and thus growth. This is especially relevant for emerging and developing economies in this era of globalization. In the same vein, the effects of bank concentration on growth have been increasingly identified and discussed over the last decade. The majority of research on this topic has found a significant negative relation between bank concentration and economic development (Diallo and Koch, 2017 and Diallo and Zhang, 2017). The reasoning behind this is that bank concentration increases interest rates and the cost of credit creating an inefficient allocation of resources in the economy. However, it has been shown that high corporate governance increases access to financing by lowering the cost of credit.

The quality of corporate governance has several implications that may impact the difficulties discussed in the empirical literature related to bank concentration and growth. First, better corporate governance frameworks allow firms greater access to financing, thus lowering the cost of credit (Claessens and Yurtoglu, 2013; Doidge et al., 2007; Attig et al., 2008). Narayan et al. (2015) empirically investigate the link between corporate governance structure and stock market returns using comparative country data. They show that for countries with low quality of governance, corporate governance predicts stock market returns. However, for countries high level of corporate governance, they do not find any evidence between governance and stock market returns. Second, corporate governance has a significantly negative effect on the cost of equity capital among firms,

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and improvements in corporate governance result in significantly higher valuations (on Hong Kong, see Lei and Song (2008); on Latin America, see Cueto, 2008a,b, 2013; on Korea, see Black et al., 2001; Black et al., 2006 and Bae et al., 2012; Bai et al., 2004; Chen et al., 2009, 2011; Morey et al., 2009; Balasubramanian et al., 2010; Ammann et al., 2011 and Claessens et al., 2014). Khanna and Zyla (2010) use a survey of investors in emerging markets and show that corporate governance is a critical factor in their investment decisions. In addition, using an index measuring the de facto quality of corporate governance, Claessens and Yurtoglu (2013) show that emerging markets score below many advanced economies. However, none of these papers investigates the link between bank concentration, corporate governance and industrial growth. Thus, it is crucial to investigate this relationship in this period of low growth.

There are also papers that have analyzed the connection between corporate governance and crisis. For example, Johnson et al. (2000), Lemmon and Lins (2003) and Bae et al. (2012) point out that the Asian crisis in the 1990s was linked to countries' levels of corporate governance. Cornett et al. (2010) showed a positive correlation between rates of return and corporate governance during the financial crisis of 2008–2009. Despite these interesting findings, these papers do not link their results to bank concentration and economic growth as we do in this paper.

Moreover, this paper studies for the first time to which extent better corporate governance among firms attenuates the negative impact of bank concentration on industry growth. Specifically, when corporate governance is considered, we show that bank concentration is less harmful to growth for industries that depend heavily on external financing. Using a large panel of 34 countries and 29 industries over the period 1980–2010, this paper investigates the relationship between bank concentration and growth by taking into account the level of each country's corporate governance quality within each industry. Our dependent variables are the industry growth rate of output per-worker and the growth rate in terms of real value added. Bank concentration is measured by the share of assets of the three largest banks in terms of the total banking system in each country, as well as the Herfindahl-Hirschman index. Corporate governance is measured as an average of accounting standards, earning smoothing, and stock-price synchronicity taken from De Nicòlo et al. (2008). To measure external financial dependence, we use the method developed by Rajan and Zingales (1998), and by determining the external financing needs of U.S. companies. We then regress the industry growth rate of output per worker on the logarithm of the initial output per worker, the manufacturing share of each industry, the interaction between bank concentration and external financial dependence, and the triple interaction between bank concentration, corporate governance and external financial dependence.

Empirically, our first result shows that bank concentration has a negative effect on growth for financially dependent industries. More specifically, the difference in growth between an industry at the 75th percentile and the 25th percentile of external financial dependence is 2.03 percentage points lower in a country at the 75th percentile of bank concentration than in a country at the 25th percentile. This result is in line with Petersen and Rajan (1995), Black and Strahan (2002), Diallo and Koch (2017) and Diallo and Zhang (2017). Our main result shows that bank concentration is less detrimental to economic growth for industries in countries with high corporate governance. High corporate governance allows banks to supply more external financing to firms through a reduction in the overall cost of capital. This process increases investment, and thus economic growth.

To separate the real effect of corporate governance and bank concentration on growth, we introduce several types of control variables, following the literature. We first introduce creditor rights interacted with external dependence, following Djankov et al. (2008), who found that good creditor rights increases the level of financial development. We also introduce level of corruption interacted with external financial dependence to take into account the results of Rajan and Zingales (1998), who found that greater property rights have a positive and significant effect on the supply of financing for firms and their investments. The interaction terms between political stability and external dependence, as well as democracy and external financial dependence, are introduced to control for the results obtained by Fisman (2001), Chiu and Joh (2004), Charumilind et al. (2006), Faccio et al. (2006), Khwaja and Mian (2005), and Claessens et al. (2008). These authors analyzed the link between political connections and firms' access to finance, and valuation. Stulz and Williamson (2003) found culture and openness to be important in measuring levels of financing and corporate governance. To take this into account, we use ethnic tension, external conflict, religion and trade, all interacted with external financial dependence, as controls. Private credit, bank size, and capitalization are used to take into account the level of financial development. Finally, macroeconomic variables such as money growth and government consumption are introduced to measure the inflation rate and amount of government debt as controls. Using all these control variables, we show that high corporate governance mitigates the negative effects of bank concentration on growth for financially dependent industries. To measure bank concentration, we use the Herfindahl-Hirschman index to confirm our results listed above. We also use several measures of external financial dependence and exclude OECD countries in our sample. The remainder of the paper is organized as follows. Section 2 outlines the basic methodology and data, Section 3 presents the results, and Section 4 gives policy recommendations.

2. Methodology and data

2.1. Econometric model

In order to estimate the impact of bank concentration and corporate governance quality on economic growth across countries and industries, we estimate the following econometric model:

$$
\begin{aligned}
y_{j,k,t} - y_{j,k,t-1} = {} & \text{Constant} + \theta_j + \eta_{k,t} + \beta_1 * \text{Financial dependence}_j \times \text{Concentration}_{k,t} + \beta_2 * \text{Financial dependence}_j \\
& \times \text{Concentration}_k \times \text{CGQ}_k + \text{Controls}_{j,k,t} + \epsilon_{j,k,t}
\end{aligned}
$$

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