Journal of International Money and Finance 32 (2013) 17–41

Contents lists available at SciVerse ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf

Private sector share of external debt and financial stability: Evidence from bank loans

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JEL classification:
F34
G32

Keywords:
International debt crisis
Private sector debt
Sovereign debt
Financial stability
Bank loan

A B S T R A C T

In the last two decades, the private sector has contracted a substantially larger share in the total amount of foreign-currency international debt (*private sector share of external debt*), especially in developing countries. In this paper, I empirically examine the effect of this phenomenon on bank loan prices. I find that the private sector share of external debt negatively and significantly impacts the price of bank loans. This result supports the hypothesis that private sector debt contributes to international financial stability to a greater degree than sovereign debt. Nevertheless, this impact is canceled out in the presence of fixed exchange regimes that are unsuitable with respect to fundamentals. In such circumstances, the private sector may take advantage of capital market distortions that are maintained by official authorities and thus exposes the country to further financial instability. Additional results corroborate the observation that the gain in financial stability stems from more efficient use of funds and reduced monitoring costs.

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1. Introduction

Since the 1990s, developing countries have seen a boom in the amount of international debt denominated in foreign currency (*external debt*, henceforth) contracted by the private sector. Among others, Obstfeld and Taylor (2004) and Gozzi et al. (2010) showed that the volumes of capital raised abroad by firms in 2005 is threefold that raised in 1991, a phenomenon more evident in developing

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doi:10.1016/j.jimonfin.2012.02.017

countries than in developed countries. As a result, the share of external debt contracted by the private sector has also substantially increased. Celasun and Harms (2011) documented that the private sector contracted 16% of the external debt disbursed to developing countries in 1990, while that figure rose to 77% in 2006. It is noteworthy that today, most of the external debt is contracted by the private sector. Brazil is a typical example. Public sector and sovereign entities contracted 90% of Brazilian external debt in 1990, while the private sector accounted for only 10%. In 2007, public sector and sovereign entities contracted only 40% of Brazilian external debt, while the figure for the private sector was 60%. However, what remains unclear, for the most part, is the impact of such a major development in international debt markets on international financial stability, and the reasons behind this impact.

In this paper, I examine the financial effects of the share of a country's external debt contracted by the private sector (*private sector share of external debt*, henceforth) on the cost of bank loans. Therefore, rather than basing this study on GDP-based debt measures, I focus on the *distribution* of a country's external debt, distinguishing in this regard between the public sector and the private sector. I measure the cost of debt using the *interest spread* on bank loans, which is the interest mark-up charged above the floating market interest rate. The interest spread captures the borrower's credit risk.[1] By looking at the cost of external debt, I explore the specific financial impact of private sector external debt. Also, I examine and measure the effect of this debt on the cost of debt, analyzing this cost for private and public sector borrowers separately. Second, I investigate the stabilizing effect of private sector external debt in the presence of market distortions, such as the existence of a fixed exchange regime that does not match macroeconomic fundamentals. By doing so, I look at whether the stabilizing effect of the private sector applies in all circumstances. Last, I investigate the channels through which private sector external debt promotes financial stability. On the one hand, I test the hypothesis that private sector borrowers are more efficient in their use of funds by looking at the effect of debt contracted by the private sector on economic growth. On the other hand, I test whether lenders are able to more closely monitor private sector borrowers by analyzing the effect of private sector external debt on the structure of lenders in syndicated loans.

External debt contracted by the private sector may promote *financial stability* for three reasons. First, private sector firms present stronger governance, which promotes efficiency in the use of funds. Instead, firms and financial institutions owned by states have been found to be subject to conflicts of interest with politicians and therefore tend to be less efficient (e.g., Bonin et al., 2005; Francis et al., 2009; Iannotta et al., 2007). Second, creditors' monitoring power is stronger whenever loans are contracted by private firms, rather than by state or public entities. In fact, states benefit from legal immunity (*sovereignty*), resulting in weak liquidation threat and enforcement power (see surveys provided by Eaton and Fernandez, 1995, and Sturzenegger and Zettelmeyer, 2006). This is not the case with borrowing by private sector firms, for which enhanced monitoring improves efficiency.[2] Third, the coordination of lenders is facilitated by local bankruptcy courts, whereas no such coordination mechanism exists with sovereign debt, preventing orderly workouts. Coordination among lenders contributes to efficiency and stability (e.g., Bolton and Scharfstein, 1996; Brunner and Krahnen, 2008; Morris and Shin, 2004; Guembel and Sussman, 2009). Therefore, the substitution of public sector debtors with private sector debtors is likely to help resolve conspicuous imperfections in international debt markets.

External debt contracted by the private sector may also engender *financial instability* for two reasons. First, the private sector may choose to issue external debt so as to take advantage of distortions in interest rates and currency markets; this is particularly true in the presence of currency pegs. For instance, Corsetti et al. (1998) identified excessive borrowing from the private sector as the main

[1] The market rate is typically the London Inter-Bank Offered Rate (LIBOR). For instance, assume interest is equal to LIBOR plus 50 basis point (bp), paid semi-annually. The 6-month LIBOR is the basis rate and 50 bp is the *interest spread*. The LIBOR represents the opportunity cost of lenders for risk-free investments and varies over the lifetime of the loan. The 50 bp interest spread is constant and compensates lenders for the credit risk attributed to the borrower.

[2] Note that the monitoring power of creditors still varies depending on national creditor rights and enforcement power. See, e.g., Esty and Megginson, 2003; La Porta et al., 2008.

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