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Interest burden and external finance choices in emerging markets: Firm-level data evidence from Malaysia



Muhammed Zulkhibri*

Economic Research and Policy Department, Islamic Development Bank, P.O. Box 5925, Jeddah 21432, Saudi Arabia

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ABSTRACT

This paper provides empirical evidence on the credit channel of the monetary transmission mechanism within the framework of external finance choices using a firm-level panel data. We estimate the corporate finance behaviour in Malaysia, a country with relatively developed capital market, but significant involvement of banking sector in financing the economy using a panel dataset of over 900 listed firms in Malaysia for the period 1990–2010. The analysis suggests the following insights: firm-specific characteristics are important factor in explaining the corporate financing choices of firms; different monetary conditions affect the rate of interest charged by lenders to firms, with financially constrained firms paying a higher premium; and financially constrained firms have limited access to external finance and are severely affected during times of increasing interest rates. Overall, our results are consistent with the existence of credit channel and support the unequal propagation of monetary policy among firms in different monetary conditions.

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* Tel.: +966 2 646 6533; fax: +966 2 506047132.

E-mail address: khibri1974@yahoo.com

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1. Introduction

Despite the increasing importance of domestic and international bonds as a source of corporate finance, bank lending remains the dominant source of corporate finance in many emerging market economies. In Asia, bond finance has reached almost 30% of GDP, while bank lending dominates at around 50% of GDP. Moreover, evidence on internal finance also suggests that emerging markets rely more on internal funds than external sources of funding (Beck et al., 2002). The higher leverage and greater use of internal funds could be supported by higher tangibility of assets, higher profitability, or lower market-to-book values in emerging market corporations, but it could also reflect that they operate in riskier environments. In Malaysia, retained earnings account, an average for about 28.1% share of total finance, whereas short-term borrowings dominates the debts structure of Malaysian firms, accounting on average for more than 59.7% of total debts.

The policy rate and lending rates have a strong correlation with firms' effective interest rate over the years, in which it has played a significant role in determining the cost of financing for Malaysian firms (Zulkhibri, 2012). The policy interest rate has reached a very high position in the early 1990s fuelled by capital inflows of the growing global interest in emerging markets. Tight monetary policy during this period has induced other key interest rates – lending rates and effective interest rates of firm – to trend upward before starting to decline in the mid-1990s. Subsequently, the policy interest rate has reached another high of 9.4 percentage points in the run-up to the financial crisis in 1997 resulting from the rapid depreciation of exchange rate before starting trending downward to 3.2% in 2000. Despite increasing interest rate and declining profitability, firms in Malaysia kept on increasing their leverage prior to the crisis. Thus, the over reliance on bank financing prior to 1997/98 had exposed the corporate sector to liquidity and interest rate risk particularly during adverse demand and financial sector shocks in the economy.

Understanding the factors that link corporate finance and monetary policy at the firm-level is crucially important in order to explain the aggregate behaviour of investment and corporate finance specifically in emerging market economy.¹ The reasons why internal and external finance are important for investment and monetary policy transmission however remain controversial. Based on the micro-concepts of information asymmetry and agency problems, some theories indicate that firms' financing patterns begin with retained earnings, followed by riskless debts, and new equities (Myers, 1977; Myers and Majluf, 1984). Moreover, when external finance is represented by bank debts, there exists a cost differential and even rationing. Asymmetric information and contract incompleteness may limit firms' access to external finance and make them unable to fund profitable investment opportunities (Stiglitz and Weiss, 1981; Besanko and Thakor, 1987).² The extent of information asymmetry and agency problems thus is likely to be reflected in the characteristics of the firms' financial constraint (Fazzari et al., 1988).³ These theoretical evidences to some extent support the existence of the broad credit channel of monetary policy (Bernanke and Gertler, 1995; Bernanke et al., 1996; Hubbard, 1998).

Numerous publications have been devoted to a theoretical analysis of the firms' corporate finance, investment behaviour and monetary policy transmission in recent years. On the empirical side, the micro evidence is still far from complete. Most studies focus on developed economies (Mishkin, 1996). Among recent studies are Japan (Fuchi et al., 2005), the U.S. (Vijverberg, 2004), the U.K. (Mizen and Vermeulen, 2005; Guariglia, 2008), the euro area (Bond et al., 2003; Chatelain et al., 2003; De Haan and Sterken, 2006), Canada (Aivazian et al., 2005) and Spain (Gonzales and Lopez, 2007). Research work on emerging markets is more limited and very little is known about the linkages between corporate finance, investment and monetary policy transmissions mechanism operating in emerging markets. However, following the widespread of financial crisis in the emerging markets, studies pertaining to corporate finance, investment and monetary policy have gained prominent interest

¹ See Égert and MacDonald (2006) for a general review of monetary transmission mechanism in emerging economies.

² See Caballero (1999) for a review of the literature about investment with real constraints and Hubbard (1998) for a review of the literature about investment with financing constraints.

³ For an overview of this literature, we refer to Hubbard (1998). In order to test for additional power, some studies have tested the availability of internal finance in explaining investment behaviours (Carpenter et al., 1998; Kashyap et al., 1994).

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