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Financial market imperfections and corporate decisions: theory and evidence

2.1 Introduction

This chapter reviews the recent developments in the literature on financial market imperfections and the role that they play in explaining firms' capital structure choice and investment decisions. The objective of the chapter is twofold: on the one hand, we provide the theoretical background for the empirical analysis presented in the subsequent chapters; on the other hand, we aim at linking the literature on transitional economies with the core of the literature that focuses on developed economies.

The transition process of the Hungarian economy has several peculiarities that make the models surveyed in this chapter somewhat inappropriate for transitional economies. However, the Hungarian relatively advanced stage of development, and more importantly the recent accession to the European Union, call for a change in perspective in analysing its economic development. This chapter outlines the issues that are becoming of central importance as the process of transition is being completed.[1]

At the end of the seventies, the claim that financial markets were an important determinant of downturns and upturns that characterised the economy seemed unfounded and the task of proving this appeared to be extremely difficult. The challenge came mainly from real business cycle theory, that empirically proved able to match surprisingly well the behaviour of macroeconomic variables. Real business cycle models are stochastic growth models with optimising agents in which markets are complete. In such an environment the Modigliani-Miller theorem applies,[2] providing a formal proof of the

[1] Booth *et al.* (2001) investigate whether capital structure theory can be applied to countries characterised by different institutional structures. They find that variables that are relevant for explaining capital structure in the United States and in European countries are also relevant in developing countries. It seems therefore appropriate to deepen the theoretical linkages of the specific literature on transitional economies with the more general literature on developed economies.

[2] See Modigliani and Miller (1958).

irrelevance of the financial structure of firms. With symmetric information and the possibility for firms to obtain unlimited credit at the prevailing interest rate (perfectly elastic supply of capital), each investment project is valued on the basis of its expected payoff and degree of risk, and only the projects whose expected payoff exceeds the acquisition and installation cost of capital are undertaken. In such an environment there is no role for financial variables in the explanation of investment decisions and, in turn, of macroeconomic fluctuations.

In order to overcome the implications of the Modigliani-Miller theorem, it was necessary to change the underlying assumption of complete markets and introduce some form of asymmetric information. This has important consequences for the analysis of both firms' investment behaviour and capital structure choice. First, there is a more important role of financial intermediation: banks and financial intermediaries are considered not only as a channel of transmission of monetary and financial flows but also, and more importantly, as processors of information and controllers of borrowers' behaviour.

Second, asymmetric information introduces a relationship between the role of the bank in processing information and the determination of investment. When information is asymmetric, information processing becomes crucial: idiosyncratic risk cannot be completely diversified away and the actual service provided by the banking sector becomes the sorting of good from bad borrowers.

Third, asymmetric information has important implications not only for firms' external relations (e.g. the relationship between borrowers and lenders) but also for their internal relations, like the one between managers and shareholders. The fact that some actions of the management cannot be observed or verified implies that managers' objectives may not be perfectly aligned with those of the shareholders. This has profound implications for capital structure, since the latter can be designed in order to minimise the agency cost deriving from asymmetric information.

The recent literature has taken different directions in analysing the implications of financial market imperfections. It is possible to identify three main approaches. The first considers the long run consequences of financial market imperfections, analysing their effect on growth.[3] The second approach, discussed in Sec. 2.2, analyses the effects of imperfections in credit and financial markets on investment decisions and macroeconomic fluctuations.[4] The third approach, examined in Sec. 2.3, is mainly microeconomic and has made use of the recent developments in game theory and contract theory in order to

[3] This chapter will refer to these topics only marginally. A good survey of this literature is provided by Demirguc-Kunt and Levine (2001).

[4] Gertler (1988) provides a comprehensive overview of this literature from the fifties to the mid-eighties.