Financial Frictions and Sources of Finance for European Firms

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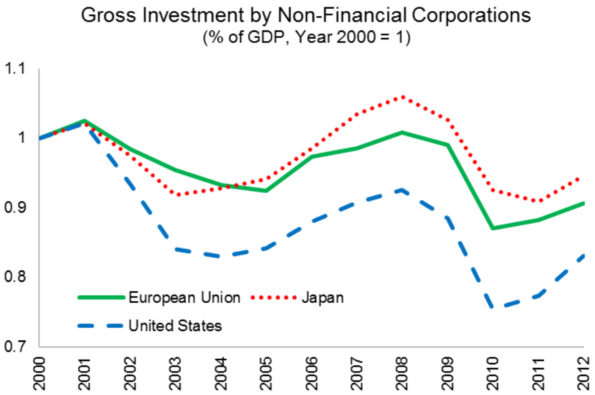
Slow Recovery in Europe: Sluggish Corporate Investment

Big question: Supply side (bank credit) or demand side (low demand/uncertainty) factors?—Both seems to be important



Source: Eurostat, Cabinet Office, and Bureau of Economic Analysis.

How do Firms Finance Investment?

Regardless of demand and supply factors behind sluggish investment, firms' sources of financing matters!

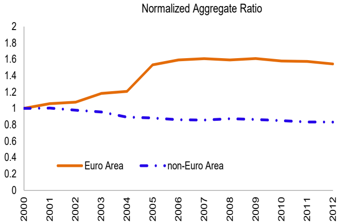
- Too much debt on firms' balance sheet: **debt overhang** problem $\Rightarrow$ Even strong banks will not lend $\Rightarrow$ Low Investment
- Too much short term debt: rollover risk $\Rightarrow$ worse under low demand/uncertainty $\Rightarrow$ Low Investment
- Too little equity financing: endangers cross-border equity ownership $\Rightarrow$ reduces risk sharing and increases uncertainty $\Rightarrow$ Low Investment
- Too much debt and financial frictions $\Rightarrow$ misallocation $\Rightarrow$ Low TFP

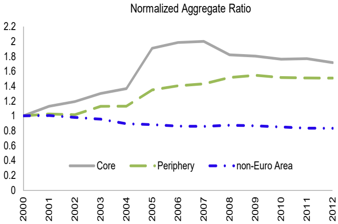
DATA MUST LINK SMEs Real and Financial Decisions

To get a full picture on debt overhang and misallocation, SMALL firm data is a MUST!

- ORBIS/AMADEUS database provided by Bureau van Dijk (BvD), harmonized worldwide (130million+).
- Collected from business registers, annual reports, and newswires; WE PUT TOGETHER a panel of firms DISC by DISC.
- Private SMEs as opposed to public firms (advantage over Compustat Global/Worldscope/Capital IQ/...).
- Listed firms account for 20-30 percent of the economic activity in Europe (33 percent maximum in US) so does not matter much for aggregate employment and output
- Consistent time coverage of Gross Output/Employment/Wage Bill: data captures **70-90 % of the aggregate economy** depending on the country.
- Mimics official size distribution for most countries: less than 250 employee firms account for 70 % of activity

Financial Debt/Total Liabilities





- **Core:** LT debt $\Rightarrow$ Large firms
- **Periphery:** ST loans and trade credit $\Rightarrow$ SMEs
- Firms with higher debt financing pre-crisis have **lower investment and sales** post-crisis
- Firms with higher trade credit, retained earnings and equity financing have **higher investment and sales** post-crisis

Summary and Policy Implications

1. Too much debt (especially short term bank debt) and too little equity financing in Europe
2. These patterns in firms' financing sources amplifies the recessionary effects of a crisis regardless of the reasons (demand for credit or supply of credit)
3. In the absence of pan-European risk sharing these recessionary effects get worse
   - Drop in output transfers one-to-one to drop in income/consumption/investment
4. Need more equity financing and **cross-border ownership of equity**, which will solve both problems