Discussion of Claessens, Ueda, and Yafeh’s

Financial Frictions, Investment and Institutions

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Paper Summary

- **Their Motivation:** Financial frictions affecting investment have bad consequences for economic fluctuations and growth
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• **Their Question:** What types of policies reduce financial frictions?

• **Their Approach:** Examine q-dynamics in large cross-country firm-level panel dataset

• **Their Findings:** Shareholders’ rights policies reduce financial frictions affecting investment, especially for smaller firms
Agenda

Question and motivations are clear. I’ll discuss methodology:

1. Data
2. Model
3. Empirics
Data

• Good data set:
  – 48 countries including some poor countries (S. Africa, India, Sri Lanka, Malaysia, etc.)
  – Detailed financial and real variables
  – 1,000,000 firm-year observations

• Limitations:
  – Only publicly-traded
    • Less likely to be constrained
  – Results on shareholder rights vs. creditor rights driven by sample?
  – Is selection (e.g., extensive margin on IPOs) important in explaining cross-country variation?
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1. Justify use of average q (avg=marginal)
2. Motivate regression equation
3. Assist interpretation of regression results
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1. Justify use of average q (avg=marginal)
   - How important is intangible capital?
2. Motivate regression equation
3. Assist interpretation of regression results
Model

• Abel and Eberly (1994) in discrete time with financial frictions:

\[ rV(K, \epsilon) = \max \pi(K, \epsilon) \text{ (current return on capital)} - \phi(I, K) - \lambda(B, K, \epsilon) \text{ (adjustment costs)} + E\{V(K', \epsilon')\} - V(K, \epsilon) \text{ (capital gain)} \]
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  - \( \phi(I, K) \) - \( \lambda(B, K, \epsilon) \) (adjustment costs)
  + \( E\{V(K', \epsilon')\} - V(K, \epsilon) \) (capital gain)

• Relating marginal \( q \) to frictions:
  \( (r + \delta)V_1(K, \epsilon) = \pi_1(K, \epsilon) - \phi_2(I^*, K) - \lambda_2(I^*, K) \)
  + \( E\{V_1(K^*, \epsilon') - V_1(K, \epsilon)\} \)
Model

- In order to link to avg. $q$, assume everything is homogeneous degree 1, i.e.,:
  - $\pi(K,\epsilon) = \epsilon K$ (AK technology)
  - $\phi(I,K) = K \phi(I/K,1)$
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• Then:

  $$V(K, \varepsilon) = H(\varepsilon)K$$

  and

  $$q = \frac{V(K, \varepsilon)}{K} = V_1(K, \varepsilon) = H(\varepsilon)$$

  (Average Q=Marginal Q)
Issues

1. Firm size indeterminate (no curvature in K)
   – strange for firm-level analysis
2. Optimality is now independent of K
   \[ E\{q'\} = E\{H(\varepsilon' | \varepsilon)\} = \phi_1 + \lambda_1 \]
3. q is exogenous, determined purely by technology shock process, not frictions
   – convergence intuition doesn’t make sense
4. Investment identifies frictions
Graphically

\[ \phi_1 \]
Graphically

\[ \phi_1, \phi_1 + \lambda_1 \]
Graphically

\[ \text{Benefit} = q = H(\varepsilon) \]

\[ \phi_1 + \lambda_1 \]

Investment
Graphically
Estimation

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  q' - \mathbb{E}\{q'\} = u
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- Their timing decisions help identify more
Empirics/Results

• Result on shareholders’ rights appear fairly robust
• But possible measurement issues/important outliers
  – Intangible capital important?
    • Mean q is 3.3, 75\textsuperscript{th} percentile just 1.9, std. dev=157.2
    • Why doesn’t capital flow to “poor” firms?
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    • “Why doesn’t capital flow to poor, publicly-traded companies?”
  – marginal profit
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    • Again wide variance: mean=-0.2, std. dev=80.8
• Other measurement concerns: treatment of disinvestment, cash
• Opaque:
  – Identification depends greatly on timing assumptions
  – lots of triple interactions
    • Alternative? Get \(\phi\) and \(\lambda\) coefficients, country by country. Then plot against institution variables
Summary

• Great question
• Interesting data
• Convergence language is problematic
• Neat estimator
• Striking, robust result on shareholder’s rights
  – Hard to interpret, despite model and OLS