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# 863

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**The Impact of Financial Structure on  
Firms' Financial Constraints:  
A Cross-Country Analysis**

Berlin, February 2009

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## IMPRESSUM

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<http://www.diw.de>

ISSN print edition 1433-0210  
ISSN electronic edition 1619-4535

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# THE IMPACT OF FINANCIAL STRUCTURE ON FIRMS' FINANCIAL CONSTRAINTS: A CROSS-COUNTRY ANALYSIS\*

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February 11, 2009

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\*The authors gratefully acknowledge support of this research by grant Az. 10.06.2.121 from Fritz Thyssen Stiftung. The usual disclaimer applies.

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THE IMPACT OF FINANCIAL STRUCTURE ON  
FIRMS' FINANCIAL CONSTRAINTS:  
A CROSS-COUNTRY ANALYSIS

**Abstract**

We estimate firms' cash flow sensitivity of cash to empirically test how the financial system's structure and activity level influence their financial constraints. For this purpose we merge Almeida, Campello and Weisbach (2004), a path-breaking new design for evaluating a firm's financial constraints, with Levine (2002), who paved the way for comparative analysis of financial systems around the world. We conjecture that a country's financial system, both in terms of its structure and its level of development, should influence the cash flow sensitivity of cash of constrained firms but leave unconstrained firms unaffected. We test our hypothesis with a large international sample of 80,000 firm-years from 1989 to 2006. Our findings reveal that both the structure of the financial system and its level of development matter. Bank-based financial systems provide constrained firms with easier access to external financing.

Keywords: financial constraints, financial system, cash flow sensitivity of cash.

JEL Classification Numbers: G32, G30

# 1 Introduction

For many years, financial theory has stressed the role of financial constraints on firms' behavior, but it has rarely considered how obstacles to external financing may vary across different financial systems. Although stock markets can play a very important role in meeting firms' financing needs, a strong and solid banking system may be a workable alternative to meet firms' external funding requirements. Different corporate governance systems, different regimes of investor protection, and different corporate financing structures may all significantly influence agency conflicts, recognized as obstacles to external financing. Thus, the structure and the extent of the financial system of a specific country may be key determinants of the financial constraints that its firms face.

Anecdotal evidence documents significant differences in the structure of the financial macroeconomic environment. For instance, in 2005 the ratio of private credit by deposit money banks to GDP in Germany (1.23) is 2.5 times higher than the same indicator in the USA (0.48). Exactly the opposite is observed if we consider the stock market capitalization to GDP ratio for the same year: these indicators for USA and Germany equal 1.35 and 0.43, respectively. A natural question arises: in which countries are firms less likely to face obstacles in their access to external financing?

To address this issue, we begin by observing the liquidity policy of firms and relating it to the degree of financial frictions. While the traditional definition of financial constraints defined in terms of investment–cash flow sensitivity is highly controversial (e.g. Fazzari, Hubbard and Petersen (1988) and Kaplan and Zingales (1997)), we follow the recently developed approach of Almeida et al. (2004). They consider a firm as financially constrained if it accumulates cash out of its cash flow. Second, we interact cash flow with proxies for country-specific financial structure. The latter measures reflect the relative importance (measured by activity or size) of the stock market compared to that of the banking system (Levine (2002)). Finally, we consider whether our results are robust

after controlling for the level of development of the financial system.

We employ annual firm-level manufacturing sector data obtained from Global COMPUSTAT. The data provide detailed financial information for 6,970 firms located in 36 countries over the 1988–2006 period. This dataset is matched to country-level financial data from Beck, Demirgüç-Kunt and Levine (2000) which are utilized to compute financial structure and financial development proxies.

The results of the paper can be summarized as follows. Our empirical model quantifies the degree to which the effects of cash flow on cash may be strengthened or weakened by the structure of the financial system. We observe that companies located in market-based financial systems are more likely to be financially constrained. In contrast to earlier research such as Levine (2002), we find a significant role for financial structure while the level of financial development maintains its significance in explaining financial frictions. Hence, reduction of financial constraints, the main mechanism for turning stimuli from the financial sector into economic growth, depends on both the structure and the development of the financial system.

In the next section, we briefly review the financial constraints literature. Section 3 presents our empirical model and describes the data. The empirical results in Section 4 show that financial structure and development are important determinants of the degree of financial frictions. In Section 5 we consider how our findings may reflect constraints on firm behavior versus their preferences. Section 6 concludes.

## 2 Literature Review

Researchers have expended considerable effort in trying to understand the nature of financial constraints faced by firms. Information asymmetry, moral hazard and agency conflicts negatively affect the firm's borrowing capacity, which may cause an underinvestment problem. Fazzari et al. (1988) initiate a new stream of literature on financial

constraints and propose to employ a measure of investment-cash flow sensitivity as a gauge of financial frictions. If firms' access to external capital markets is limited, their reliance on internal resources implies that internally generated cash flows will influence their investment path.<sup>1</sup>

However, Kaplan and Zingales (1997) argue that these results are controversial, as they find that "those firms classified as less financially constrained exhibit a significantly greater investment-cash flow sensitivity than those firms classified as more financially constrained" (p.169).<sup>2</sup> This debate was further fueled by the investigations of Fazzari, Hubbard and Petersen (2000) and Kaplan and Zingales (2000). Doubts about the measurement of financial constraints brought forth Almeida and Campello (2002) and Moyen (2004), which broaden the analysis from the traditional cash flow-investment paradigms.

The innovative approach of Almeida et al. (2004) is based on the concept that scrutiny of the firm's financial management should indicate financial market imperfections earlier and more clearly than the observed path of capital investment expenditures, which typically exhibits time-to-build lags. In the presence of financial frictions, savings out of a firm's generated cash flow reflects the tradeoff between present and future investment opportunity that constrained firms face. Along these lines they study the relationship between the firm's generated cash flow and its cash balances. Data on US firms reveal that financially constrained firms exhibit a relatively higher propensity to save cash out of their cash flows.

A natural question is, therefore, whether the results of Almeida et al. (2004) are country-specific. Country-comparison studies on the relation between financial constraints and the financial environment are few in number and are exclusively based on the traditional proxy for external financing restrictions: the cash flow sensitivity of capital investment expenditures. For instance, Mairesse, Hall and Mulkey (1999) examine

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<sup>1</sup>See also Gilchrist and Himmelberg (1996) and Hoshi, Kashyap and Scharfstein (1991).

<sup>2</sup>For instance, see also Cleary (1999), Gomes (2001), and Cummings, Hassett and Oliner (2006).

the cash flow sensitivity of equipment and R&D investments of American, French and Japanese companies. They find that both types of investment are more strongly affected by cash flow for US companies operating in a market-based financial environment compared to the firms located in the bank-based (Japanese) or mixed (French) financial systems. Similar evidence is found in results from Bond, Harhoff and Reenen (1999) for German (bank-based) and British (market-based) financial systems. In addition, Bond, Elston, Mairesse and Mulkay (2003) confirm the finding of a higher cash flow sensitivity (stronger financing restrictions) in market-based financial systems employing data for Belgian, French, German and British companies. However, to the best of our knowledge, evidence on how the financial architecture affects a less ambiguous indicator for the existence of financial constraints—the cash flow sensitivity of cash—has not been produced.<sup>3,4</sup>

The above discussion suggests a scarcity of rigorous evidence on financial constraints in economies with different financial architecture. Most of the previous research has been implemented using US data and much less is known about other countries. A particularly interesting issue is whether the severity of obstacles in credit markets is correlated with the degree of a country's financial development. Previous research has shown that financial development has an effect on the severity of financial constraints facing firms (Love (2003)), but there have been very few firm-level studies investigating the joint effect of structure and development on the degree of financial frictions.<sup>5,6</sup> A

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<sup>3</sup>See Levine (2002) for a detailed review of the literature describing differences of market-based and bank-based financial systems.

<sup>4</sup>Khurana, Martin and Pereira (2006) study the linkage between financial development and the cash flow sensitivity of cash, but they do not focus on the nature of a more highly developed financial system as we do in this study.

<sup>5</sup>Using firm level data, Demirgüç-Kunt and Maksimovic (2002) find that financial development is robustly linked with access to external markets, but there is no support for either the bank-based or market-based view.

<sup>6</sup>Khurana et al. (2006) study the linkage between financial development and the cash flow sensitivity of cash, but they do not focus on the nature of a more highly developed financial system as we do in this study.



proper inquiry into this issue requires a cross-country approach based on similar empirical methodologies. In the next section, we discuss the test design we employ to link financial constraints faced by the firm to measure of financial system structure and level of development.

### 3 Empirical Implementation

#### 3.1 Model Design

To investigate whether firms' obstacles in obtaining external funds are affected by the country's financial system we need to model how financial constraints are related to indicators of financial system structure. Almeida et al. (2004) develop a basic econometric model which links firms' stocks of cash to their cash flow. A firm is considered as *financially constrained* if it builds up its stock of cash out of its cash flow. Their theoretical and empirical model is well suited for our purpose after augmenting their basic specification with country-level attributes of financial markets. Our regression model is thus:

$$\begin{aligned} \Delta CashHoldings_{it} = & \zeta + \alpha CashFlow_{it} + \delta Structure_{it} \\ & + \beta (CashFlow_{it} \times Structure_{it}) + X\gamma + \epsilon_{it} \end{aligned} \quad (1)$$

where  $i$  indexes the firm,  $t$  the year,  $\Delta CashHoldings$  is the change in the ratio of cash and short term securities to total assets;  $CashFlow$  is the ratio of cash flow, defined as income before extraordinary items plus depreciation, to total assets;<sup>7</sup> and  $Structure$  is a measure of financial system structure directly introduced into the specification and interacted with  $CashFlow$ . A vector of firm characteristics ( $X$ ) includes a set of controls (described below) and year fixed effects. Finally,  $\epsilon$  is an idiosyncratic error term assumed to possess the usual desirable characteristics. The key coefficients of interest,  $\alpha$  and

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<sup>7</sup>We replace missing values for income before extraordinary items by operating income minus operating expenses.

$\beta$  from Equation (1), jointly determine the degree of financial constraints for firms operating in countries with different financial structures. Depending on the measure of financial structure a firm is considered as financially constrained if its liquidity ratio is responsive to cash flows ( $\partial(\Delta CashHoldings)/\partial CashFlow = \alpha + \beta Structure_{it} > 0$ ). In contrast, unconstrained firms are not expected to show a statistically significant relationship between the liquidity ratio and cash flow ( $\alpha + \beta Structure_{it} = 0$ ).

Following Levine (2002), we make use of two different measures of financial structure: *StructureActivity* and *StructureSize*. The first indicator, *StructureActivity*, measures the activity of stock markets relative to that of banks. It equals the natural logarithm of the total value traded ratio (stock market total value traded/GDP) to the bank credit ratio (private credit from deposit money banks/GDP). The second indicator, *StructureSize*, proxies the relative size of stock markets. It is measured as the natural log of the market capitalization ratio (stock market capitalization/GDP) to the bank credit ratio.<sup>8</sup>

The elements of  $X$  are intended to control for a firm's financial characteristics that influence their managers' liquidity policy. The choice of variables is motivated by prior research on the determinants of cash holdings (e.g., Opler, Pinkowitz, Stulz and Williamson (1999) and Harford (1999)), subject to data availability. To control for economies of scale in cash management, we include the natural log of assets, *Size*, as a measure of firm size. As Global COMPUSTAT does not include the information needed to construct Tobin's  $Q$  (e.g., number of shares outstanding and stock price), we employ the ratio of future investment to current investment, *LeadInvestment*, as a measure of the firm's investment opportunities.<sup>9</sup> Additionally, the decision to hold cash crucially depends on current investments (*Investment*), changes in net working capital ( $\Delta NWC$ ) and changes in short term debt ( $\Delta ShortDebt$ ). While both net non-cash working cap-

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<sup>8</sup>Other measures of banking system size (e.g., total banking assets) yield qualitatively similar results.

<sup>9</sup>For a firm  $i$  and year  $t$ ,  $LeadInvestment_{it} = (Investment_{i,t+1} + Investment_{i,t+2})/Investment_{it}$ . We measure  $Investment_{it}$  as additions to fixed capital net of disposals.

ital and short term debt measures could be considered as cash substitutes, firms could reduce liquid assets because of increased capital investment activities. These three firm specific characteristics are normalized by total assets.

## 3.2 Data

We require both firm-level data and data on countries' financial structure to implement the empirical modeling described in the previous section. This section presents the main properties of the data, while Appendix 1 reports data sources.

The firm-level data are drawn from Standard and Poor's Global COMPUSTAT database. The strengths of the data are the use of consistent financial report information across a large number of countries and 18 years coverage. However, as with other multi-country firm-level datasets (e.g. Thomson Financial's Worldscope or Amadeus), its main problems are the following. First, accounting standards differ dramatically among countries used in the sample. Second, the dataset is not comprehensive as it covers mostly large corporations.

Our sample contains about 80,000 firm-years from 1989 through 2006. The exchange rate (local currency units per US dollar) from the World Bank's *World Development Indicators* (WDI) is used to convert financial data into US dollars. A number of sample selection criteria are applied. We only consider firms who have not undergone substantial changes in their composition during the sample period (e.g., participation in a merger, acquisition or substantial divestment). As these phenomena are not observable in the data, we calculate the growth rate of each firm's total assets and sales, and trim the annual distribution of these growth rates exceeding 100%. Second, we remove all firms that have fewer than three observations over the time span. Finally, all firm-specific variables are winsorized at the 2% level. We employ the winsorized data to reduce the potential impact of outliers upon the parameter estimates.

Our final data set contains 67,292 firm-years pertaining to 6,970 firms with complete

data for all variables used in the analysis. Descriptive statistics for the firm-year observations entering the analysis are presented in Table 2. The average (median) liquidity ratio (*Cash*) for our sample is 13.07% (8.49%) and the average (median) value of the *CashFlow* ratio is 11.42 (9.09). These values of *CashFlow* are comparable to those in Table 2 of Acharya, Almeida and Campello (2007).

The country-level measures that we use in our empirical analysis are constructed from the Financial Structure Database of Beck et al. (2000), updated in 2007.<sup>10</sup> The initial data are from 1960 to 2006. For each country-year, we compute two different measures of financial structure: *StructureActivity*  $\log(\text{total value traded ratio}/\text{bank credit ratio})$  and *StructureSize*  $\log(\text{market capitalization ratio}/\text{bank credit ratio})$ . The data reveal clear heterogeneity in the financial structures of 36 countries (see Table 1). For instance, the average lowest values of *StructureSize* are shown for countries with well established and traditionally strong banking systems (e.g. Austria and Germany), while the highest value of the measure is observed for the US, which is a clear example of a market-based economy. Similar patterns are revealed for the *StructureActivity* proxy. While these two measures are similar, with a correlation coefficient of 0.84, there are differences in the rankings. For instance, several countries (e.g. Chile) have high market capitalization and quite low turnover, indicating a preponderance of thinly traded assets. Therefore, the *StructureSize* measure is perhaps more questionable as it does not take into account the activity level of financial markets, but only the value of assets which may be traded.

In addition, Table 1 reports information on the main variable of interest: the liquidity ratio, or ratio of cash holdings to total assets. As anticipated, there are considerable variations in liquidity ratios across countries. The highest average liquidity ratio (19%) is maintained by Israeli companies, while the lowest (5%) is found for companies headquartered in Portugal, Chile and Colombia.

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<sup>10</sup>These data were accessed at [http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/FinStructure\\_60\\_04\\_final.xls](http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/FinStructure_60_04_final.xls) in March 2008.

The empirical literature investigating firms' capital structure behavior has utilized various indicators of financial constraints. In line with previous research (e.g., Fazzari et al. (1988), Gilchrist and Himmelberg (1996)) we assume that small firms and firms with low (or zero) dividend payout ratios are those most likely to face binding financial constraints. Conversely, larger firms and those with high dividend payout ratios are much less likely to face credit rationing. Accordingly, we partition the sample based on size (total assets) and the dividend payout ratio. The sample splits are based on firms' average values of the characteristic lying below the 30<sup>th</sup> or above the 70<sup>th</sup> percentile of the sample distribution. For instance, a firm with total assets above the 70<sup>th</sup> percentile of the distribution will be classed as large, while a firm with total assets below the 30<sup>th</sup> percentile will be classed as small. As such, the classifications are not mutually exhaustive. Table 3 reveals that patterns in several of the descriptive statistics remain the same if sub-categories are explored separately. For instance, the ratio of cash holdings to total assets is considerably higher for smaller and low-dividend-payout firms, while their cash flow ratio is noticeably lower than that of their larger or high-dividend-payout counterparts.

Given these assumptions about firms' classifications, we test whether firms in the classes expected to face binding financial constraints show a higher sensitivity of cash to cash flow.

## 4 Empirical Findings

### 4.1 Basic Specification

We analyze the differentials in financing constraints with respect to the nature of the financial system by estimating Equation (1). The results obtained using the two measures of financial structure are presented in Tables 4 and 5.

Table 4 shows estimates with *StructureActivity* as a proxy of financial structure. The

first two columns report results for small and large firms, respectively. Based on the point estimates, smaller (constrained) firms are highly sensitive to the changes in cash flow, while larger, unconstrained firms display a considerably lower sensitivity. The greater sensitivity of small firms supports the conjecture that smaller firms are more likely to be financially constrained, in line with results reported by Almeida et al. (2004). The direct effect of the *StructureActivity* measure is significantly negative, but the indirect effects of the measure, interacted with *CashFlow*, are significantly positive, increasing the cash flow sensitivity for small firms in more market-oriented financial systems. We find an interesting contrast in the results for subsamples defined by low (constrained) and high (unconstrained) payout ratios, reported in columns 3 and 4. While both categories of firms exhibit positive and significant effects for cash flow, low-payout firms also exhibit sensitivity to the financial structure proxy (direct effect), which appears to have no significant effect on high-payout firms. The indirect effect is operative for low-payout firms, with those in market-based economies exhibiting considerably larger sensitivity to cash flow than their counterparts in bank-based economies. This finding may indicate that the observed financial constraints on high-payout firms (the direct effect) gradually weakens for firms in more bank-based economies.

Table 5 reports results employing the *StructureSize* measure of financial structure. As in Table 4, the first two columns present estimate for small (constrained) and large (unconstrained) firms, respectively. Again, liquidity policies of both categories of firms are sensitive to cash flows. However, that sensitivity is almost triple as large for the small firms, confirming that this category of firms faces tighter financial constraints. The last two columns report results for high-payout and low-payout firms, respectively. Our data reveal that low-payout firms' liquidity display higher sensitivity to cash flows, compared to their high-payout counterparts. In addition, the interaction term ( $CF \times StructureSize$ ) appears to be significant for financially constrained firms, but insignificant for their unconstrained counterparts. This evidence buttresses our find-

ings from the size subsamples and further strengthens support for the hypothesis that bank-based financial systems provide easier access to external financing.

In order to gauge the sensitivity of cash flow as the financial structure measure changes across the sample space, we calculate selected percentiles of the empirical *Structure* distributions (using the point and interval estimates from Tables 4–5) and plot the impact of cash flow on  $\Delta CashHoldings$ . That is, for each measure we report  $\partial(\Delta CashHoldings)/\partial(CashFlow)$  as the *Structure* measure changes.<sup>11</sup> The point estimates and 95% confidence interval for each derivative are computed and plotted in Figures 1 and 2. Even a casual inspection of these derivatives shows that financial structure has important effects on constrained firms' liquidity, and varies considerably across countries with different financial architecture. In particular, one can see that an increase in the firm-level cash flow measure leads to an increase in cash holdings, with that effect strengthened for financially constrained firms in market-based systems with higher values of *StructureActivity* or *StructureSize*. When we turn to interpreting the effects of the cash flow sensitivity of cash for those firms hypothesized to be financially unconstrained, we find that their cash management is also sensitive to cash flow, but their responses are considerable smaller in magnitude. Furthermore, their sensitivity to their country's financial architecture is much less apparent.

## 4.2 Models augmented with Financial Development

A concern with the regression results shown in Tables 4 and 5 is that they may present an incomplete picture, as not only the structure but also the level of a country's financial development will affect the severity of financial constraints that firms face (e.g., Love (2003)). Our further analysis is based on the specifications introduced in the previous section which we augment with a variable measuring the level of financial development of the countries covered in the Global COMPUSTAT dataset. Following Levine (2002), we

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<sup>11</sup>Tables of numerical values underlying the graphs are available from the authors upon request.

employ two proxy measures for the strength of financial institutions. The first measure, *FinanceActivity*, is defined as  $\log(\text{bank credit ratio} \times \text{total value traded ratio})$ , while the second proxy, *FinanceSize*, is calculated as  $\log(\text{market capitalization ratio} \times \text{bank credit ratio})$ .<sup>12</sup> We present the descriptive statistics for these variables by country in Table 1.

Table 6 reports the results of estimating Equation (1) augmented by each of the *Finance* variables, alone and interacted with *CashFlow* (*CF*). For ease of presentation, we only report the coefficients that are of direct interest.<sup>13</sup> In Panel A, we show results for the *FinanceActivity* measure. First, for all subsamples, the coefficients on the *FinanceActivity* measure are negative, but a statistically significant coefficient appears only in the low payout ratio subsample. The estimated coefficients imply direct effects of financial development on firms' cash management which could be explained by the transactions motive for cash holdings. Manufacturing companies, facing difficulties in access to external funding, accumulate liquid assets as a cash buffer stock. The interaction term,  $CF \times FinanceActivity$ , is negative and significant for those firms which are *a priori* labeled as financially constrained. This result confirms the findings of Love (2003) who underlines the importance of financial development to address obstacles in external financing. Turning to the effects of financial structure, we note that the coefficients of the *StructureActivity* variable are positive and statistically significant for financially constrained firms. However, in contrast to the findings of Demirgüç-Kunt and Maksimovic (2002), we find that both financial structure and financial development play crucial roles in access to external funding for financially constrained firms.

Panel B of Table 6 shows the outcome of estimating the cash flow sensitivity of cash using *FinanceSize* as a proxy for financial development. The results from this analysis lead to nearly identical inferences about the difference in financial system as those drawn

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<sup>12</sup>Employing the private credit ratio (the value of financial intermediary credits to the private sector / GDP) instead of the bank credit ratio yields qualitatively similar results.

<sup>13</sup>Full results of the estimations are available from the authors upon request.



from Panel A. For all cash flow interactions (both structure and development), when coefficients are statistically significant in Panel A, the analogous parameter estimates in Panel B are also significant.

The evidence in Tables 4–6 indicate the existence of tighter financial constraints for firms operating in market-based financial systems and a negative relationship between financial development and the severity of financial constraints. In a theoretical study, Chakraborty and Ray (2006) suggest that a bank-based financial system encourages participation in production activities and provides funding to a larger number of entrepreneurs. Taking into account that monitoring is able to resolve some of the agency problems associated with raising funds, firms may enjoy better access to funds when monitored by banks rather than by the market. As argued by Allen and Gale (2000), banks have a comparative advantage in selecting investment projects based on established technologies. This feature is typical of the manufacturing firms which we study.

## **5 Financial constraints versus managers' preferences**

The pecking order theory suggests that firms prefer internal financing and try to maintain a stable dividend (Myers (1977)). If their generated cash flow is higher than capital expenditure, the firm may invest in liquid assets. If it is less than the desired level of investment, the firm reduces its cash holdings or sells its liquid assets. There is a general aversion to changing the company's dividends. Interestingly, these adjustment mechanisms imply the same sign for the relation between the change in cash holdings and cash flow as does the argument of Almeida et al. (2004). Firms with a high preference for internal financing and a stable dividend would save more than firms with a low preference. In the light of this theory the question arises: which phenomena do we actually observe? Is it the dependence of the company's preferences on measures of financial structure and development, or the dependence of the company's financial

constraints on these two features? Given that we find that firms in the lower quantile of the size distribution accumulate more cash out of cash flow in a market-based system may help to discriminate between those two conjectures. There is no plausible reason other than the fear of financial constraints why firms in a market-based system should have a higher preference for internal financing than in a bank-based system. Either they expect that their desire to keep dividends stable may be jeopardized because markets would not provide the necessary financing, or they feel the need to avoid constraints in funding positive net-present-value projects.

## 6 Conclusions

By taking into account country-level financial architecture, we advance our understanding of differences in the severity of the financial constraints facing firms. We approach the empirical challenge in light of the recently proposed theoretical framework developed by Almeida et al. (2004), in which a firm is considered as financially constrained if it retains cash out of its cash flow. We augment the cash holdings–cash flow sensitivity link with country-level indices of relative development of the stock market to the development of the banking system. This approach is applied to annual data obtained from Global COMPUSTAT for 6,970 manufacturing firms from 36 countries over the period 1989–2006. This firm-level dataset is merged with financial data from Beck et al. (2000) which provide country-level measures of financial structure.

Our empirical analysis of the data provides several interesting findings. In light of the negative conclusions of earlier research, we infer that financial architecture plays a crucial role in reducing obstacles to firms' access to finance in external markets. Using two definitions of financial constraints and two different measures of relative financial market organization, we find that the cash holdings–cash flow sensitivity is significantly higher for firms operating in market-based economies. The data also suggest that the

influence of financial structure is important even after controlling for the level of financial development.

Our findings are unique in light of previous studies, which have not shown such diverse and significant effects. As an important extension of the financial frictions literature, we identify variations in the cash flow sensitivity of cash holdings in different financial systems. These variations are robust to the inclusion of measures of investment opportunities, size, and cash substitutes. Given these results, further exploration along these lines could shed considerable light on the interactions between the attributes of financial system and firm liquidity when gauging the degree and impact of financial frictions.

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## Appendix 1: Data construction

The following variables are used in the annual empirical study.

*Global COMPUSTAT Industrial and Commercial Annual database:*

data10: Operating expenses  
data12: Depreciation and amortization  
data14: Operating income  
data34: Cash dividends total  
data60: Cash and short term investment  
data75: Current assets  
data89: Total assets  
data96: Short term borrowing  
data104: Current liabilities  
data145: Additions to fixed capital  
data177: Income before extraordinary items

*Financial Structure database:*

Bank credit ratio: Ratio of deposit money bank claims on domestic nonfinancial real sector (*International Financial Statistics* (IFS) lines 22, a through d) to total financial claims on nonfinancial real sector (sum of IFS lines 12, 22, and 42, a through d and 42h).

Market capitalization ratio: Ratio of value of listed shares to GDP, calculated using the following deflation method:  $(0.5) * [F_t/P_{et} + F_{t-1}/P_{et-1}]/[GDP_t/P_{at}]$  where  $F$  is stock market capitalization,  $P_e$  is end-of period consumer price index (CPI) (IFS line 64M..ZF or, if not available, 64Q..ZF), and  $P_a$  is average annual CPI (IFS line 64..ZF). The data are drawn from Standard and Poor's *Emerging Market Database* and *Emerging Stock Markets Factbook*. Data on GDP in US dollars are drawn from the electronic version of *World Development Indicators*.

Total value traded: Ratio of total shares traded on the stock market exchange to GDP.

*World Development Indicators database:*

PA.NUS.FCRF: Official exchange rate (Local currency unit per US\$, period average)

Table 1: Sample Composition, 1989–2006

Country	<i>Structure Activity</i>	<i>Structure Size</i>	<i>Finance Activity</i>	<i>Finance Size</i>	<i>Cash/ TotalAssets</i>	<i>N</i>
Australia	-0.64	-0.02	-1.11	-0.50	0.09	967
Austria	-2.87	-1.85	-2.92	-1.91	0.10	424
Belgium	-1.86	-0.17	-2.54	-0.85	0.12	499
Brazil	-0.64	0.21	-3.23	-2.38	0.12	676
Canada	-0.60	0.14	-1.70	-0.96	0.10	1,659
Chile	-1.93	0.46	-3.04	-0.65	0.05	344
Colombia	-3.13	-0.20	-6.50	-3.57	0.05	100
Denmark	-0.90	-0.34	-1.77	-1.21	0.14	749
Finland	-0.21	0.28	-1.17	-0.68	0.10	649
France	-0.89	-0.46	-1.17	-0.74	0.12	2,623
Germany	-1.03	-1.03	-0.85	-0.85	0.09	3,086
Greece	-0.50	0.16	-1.81	-1.16	0.09	226
Hong Kong, China	0.03	0.69	0.91	1.57	0.15	386
Hungary	-0.67	-0.27	-3.00	-2.60	0.10	69
India	0.12	0.18	-2.52	-2.46	0.06	1,299
Ireland	-1.31	-0.47	-1.65	-0.58	0.11	234
Israel	-1.29	-0.50	-1.82	-1.04	0.19	216
Italy	-0.95	-0.73	-1.68	-1.45	0.11	782
Japan	-1.01	-0.45	-0.80	-0.24	0.15	15,478
Korea, Rep.	0.38	-0.53	-0.03	-0.94	0.13	815
Malaysia	-0.61	0.48	-0.74	0.35	0.11	2,739
Netherlands	-0.46	-0.25	-0.20	0.01	0.09	827
New Zealand	-1.94	-0.90	-1.90	-0.86	0.06	149
Norway	-0.97	-0.67	-1.81	-1.50	0.15	441
Pakistan	0.52	-0.57	-2.39	-3.48	0.14	165
Poland	-1.55	-0.52	-4.29	-3.27	0.07	103
Portugal	-1.88	-1.16	-1.97	-1.25	0.05	172
Singapore	-0.28	0.37	-0.24	0.41	0.15	1,158
South Africa	-0.65	0.85	-1.55	-0.05	0.12	268
Spain	-0.36	-0.52	-0.62	-0.77	0.08	580
Sweden	0.19	0.38	-0.90	-0.61	0.13	929
Switzerland	-0.01	0.15	0.93	1.10	0.15	1,145
Thailand	-0.89	-0.67	-1.14	-0.92	0.07	1,473
Turkey	0.86	0.52	-2.73	-3.07	0.14	171
United Kingdom	-0.52	0.05	-0.15	0.42	0.12	4,629
United States	0.91	0.94	-1.00	-0.97	0.15	21,061
Total	-0.23	0.13	-0.97	-0.61	0.13	67,291

Note:  $N$  is the number of firm-years. Other variables are defined in the text.



Table 2: Descriptive Statistics, 1989–2006

Variable	$N$	$p25$	$p50$	$p75$	$\mu$	$\sigma$
$\Delta CashHoldings$	67,249	-0.0206	0.0008	0.0260	-0.0014	0.0939
$CashHoldings$	67,257	0.0303	0.0849	0.1791	0.1307	0.1425
$CashFlow$	67,291	0.0285	0.0909	0.1718	0.1142	0.2370
$StructureSize$	66,183	-0.4634	0.1108	0.7519	0.1278	0.7361
$StructureActivity$	66,091	-1.0204	-0.2903	0.3898	-0.2277	1.0820
$CF \times StructureSize$	66,183	-0.0441	0.0035	0.0798	0.0016	0.1797
$CF \times StructureActivity$	66,091	-0.1080	-0.0147	0.0581	-0.0659	0.2927
$FinanceSize$	66,183	-1.2173	-0.4893	-0.1744	-0.6090	0.8025
$FinanceActivity$	66,091	-1.6055	-0.7851	-0.3153	-0.9668	0.9877
$CF \times FinanceSize$	66,183	-0.1094	-0.0336	0.0076	-0.0501	0.2559
$CF \times FinanceActivity$	66,091	-0.1819	-0.0537	0.0024	-0.1178	0.3604
$LeadInvestment$	67,291	0.8345	1.5041	10.0000	4.0302	4.1432
$Size$	67,279	4.2600	5.4557	6.7285	5.4596	1.9497
$Investment$	61,458	0.0215	0.0413	0.0703	0.0535	0.0483
$\Delta NWC$	66,824	-0.0317	0.0050	0.0414	0.0021	0.0909
$NetWorkingCapital$	66,854	-0.0141	0.0856	0.1909	0.0660	1.9859
$\Delta ShortDebt$	66,472	-0.0122	0.0000	0.0111	-0.0034	0.0598
$ShortTermDebt$	66,626	0.0000	0.0333	0.1162	0.0832	0.3074

Notes:  $p25$ ,  $p50$ ,  $p75$  are the quartiles of the variables,  $N$  is the number of firm-years, while  $\mu$  and  $\sigma$  are their means and standard deviations.  $CashHoldings$  is cash and short term securities,  $CashFlow$  ( $CF$ ) is income before extraordinary items plus depreciation and amortization,  $ShortDebt$  is short term borrowing,  $Investment$  is additions to fixed capital,  $NWC$  is net non-cash working capital proxied by current assets minus current liabilities minus cash and equivalents,  $Size$  is total assets. All firm-specific variables except  $Size$  and  $LeadInvestment$  are normalized by total assets.

Table 3: Descriptive Statistics for Subsamples, 1989–2006

Variable	$\mu$	$\sigma$	$N$	$\mu$	$\sigma$	$N$
A: Size subsamples						
	Small			Large		
<i><math>\Delta</math>CashHoldings</i>	-0.01	0.13	20,659	0.00	0.07	20,580
<i>CashHoldings</i>	0.16	0.17	20,662	0.11	0.11	20,583
<i>CashFlow</i>	0.08	0.30	20,672	0.14	0.19	20,591
<i>LeadInvestment</i>	4.36	4.22	20,672	3.77	4.09	20,591
<i>Size</i>	3.48	1.25	20,672	7.39	1.51	20,591
<i>Investment</i>	0.05	0.05	18,769	0.06	0.05	18,887
$\Delta$ NWC	-0.00	0.12	20,644	0.00	0.07	20,274
<i>NetWorkingCapital</i>	0.04	3.56	20,650	0.05	0.14	20,291
$\Delta$ ShortDebt	-0.01	0.07	20,430	-0.00	0.05	20,344
<i>ShortTermDebt</i>	0.10	0.53	20,483	0.07	0.09	20,381
B: Payout ratio subsamples						
	Low			High		
<i><math>\Delta</math>CashHoldings</i>	-0.01	0.12	23,555	-0.00	0.07	17,714
<i>CashHoldings</i>	0.16	0.18	23,561	0.12	0.12	17,714
<i>CashFlow</i>	0.05	0.28	23,571	0.13	0.18	17,716
<i>LeadInvestment</i>	4.02	4.13	23,571	3.74	4.05	17,716
<i>Size</i>	4.96	1.80	23,569	6.03	1.98	17,716
<i>Investment</i>	0.05	0.05	22,030	0.05	0.04	16,361
$\Delta$ NWC	-0.01	0.11	23,481	0.00	0.07	17,502
<i>NetWorkingCapital</i>	0.02	3.34	23,494	0.10	0.18	17,515
$\Delta$ ShortDebt	-0.00	0.07	23,270	-0.00	0.05	17,495
<i>ShortTermDebt</i>	0.09	0.50	23,343	0.06	0.09	17,530

Note:  $N$  is the number of firm-years.  $\mu$  and  $\sigma$  represent mean and standard deviation respectively.

Table 4: Sensitivity of  $\Delta CashHoldings$  to  $CashFlow$  with Financial Structure Activity

	Firm Size		Payout Ratio	
	Small	Large	Low Payout	High Payout
	(1)	(2)	(3)	(4)
<i>CashFlow</i>	0.120*** (0.010)	0.035*** (0.007)	0.116*** (0.009)	0.030*** (0.008)
<i>StructureActivity</i>	-0.013*** (0.002)	-0.002* (0.001)	-0.006** (0.003)	-0.001 (0.002)
<i>CF</i> $\times$ <i>StructureActivity</i>	0.067*** (0.008)	0.014** (0.006)	0.068*** (0.008)	0.002 (0.007)
<i>LeadInvestment</i>	0.003*** (0.000)	0.000* (0.000)	0.003*** (0.000)	0.001* (0.000)
<i>Size</i>	0.026*** (0.004)	0.017*** (0.004)	0.029*** (0.003)	0.040*** (0.006)
<i>Investment</i>	-0.154*** (0.034)	-0.044 (0.028)	-0.231*** (0.029)	-0.226*** (0.031)
$\Delta NWC$	-0.149*** (0.020)	-0.147*** (0.024)	-0.155*** (0.016)	-0.292*** (0.026)
$\Delta ShortDebt$	0.089*** (0.029)	0.023 (0.032)	-0.021 (0.023)	-0.032 (0.035)
<i>N</i>	18,256	18,071	21,531	15,745
<i>R</i> <sup>2</sup>	0.10	0.06	0.11	0.15

Note: Each equation includes year dummy variables. Asymptotic cluster-robust standard errors are reported in parentheses. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

Table 5: Sensitivity of  $\Delta CashHoldings$  to  $CashFlow$  with Financial Structure Size

	Firm Size		Payout Ratio	
	Small	Large	Low Payout	High Payout
	(1)	(2)	(3)	(4)
<i>CashFlow</i>	0.094*** (0.009)	0.030*** (0.006)	0.088*** (0.009)	0.029*** (0.008)
<i>StructureSize</i>	-0.022*** (0.005)	-0.006** (0.002)	-0.007 (0.005)	-0.007* (0.004)
$CF \times StructureSize$	0.102*** (0.012)	0.020** (0.008)	0.101*** (0.012)	0.008 (0.010)
<i>LeadInvestment</i>	0.003*** (0.000)	0.001* (0.000)	0.003*** (0.000)	0.001* (0.000)
<i>Size</i>	0.026*** (0.004)	0.017*** (0.004)	0.029*** (0.003)	0.040*** (0.006)
<i>Investment</i>	-0.151*** (0.034)	-0.043 (0.028)	-0.231*** (0.029)	-0.224*** (0.031)
$\Delta NWC$	-0.152*** (0.020)	-0.147*** (0.024)	-0.157*** (0.016)	-0.292*** (0.026)
$\Delta ShortDebt$	0.088*** (0.029)	0.024 (0.032)	-0.022 (0.023)	-0.031 (0.035)
<i>N</i>	18,281	18,098	21,555	15,767
<i>R</i> <sup>2</sup>	0.10	0.06	0.11	0.15

Note: Each equation includes year dummy variables. Asymptotic cluster-robust standard errors are reported in parentheses. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

Table 6: Sensitivity of  $\Delta CashHoldings$  to  $CashFlow$ : Models Augmented by Financial Development Measures

A: <i>StructureActivity</i> and <i>FinanceActivity</i> measures				
	Firm Size		Payout Ratio	
	Small	Large	Low Payout	High Payout
<i>CashFlow</i>	0.093*** (0.012)	0.030*** (0.007)	0.077*** (0.012)	0.025*** (0.009)
<i>StructureActivity</i>	-0.008 (0.005)	0.000 (0.003)	0.010* (0.006)	0.003 (0.004)
$CF \times StructureActivity$	0.085*** (0.011)	0.021** (0.009)	0.093*** (0.010)	0.010 (0.011)
<i>FinanceActivity</i>	-0.005 (0.006)	-0.004 (0.003)	-0.018*** (0.006)	-0.004 (0.004)
$CF \times FinanceActivity$	-0.035*** (0.011)	-0.010 (0.008)	-0.050*** (0.010)	-0.010 (0.010)
N	18,256	18,071	21,531	15,745
$R^2$	0.10	0.06	0.12	0.15
B: <i>StructureSize</i> and <i>FinanceSize</i> measures				
	Firm Size		Payout Ratio	
	Small	Large	Low Payout	High Payout
<i>CashFlow</i>	0.075*** (0.010)	0.026*** (0.006)	0.060*** (0.011)	0.026*** (0.009)
<i>StructureSize</i>	-0.016*** (0.006)	-0.004 (0.003)	0.004 (0.006)	-0.003 (0.004)
$CF \times StructureSize$	0.109*** (0.012)	0.025** (0.010)	0.107*** (0.012)	0.015 (0.012)
<i>FinanceSize</i>	-0.012* (0.006)	-0.008** (0.003)	-0.027*** (0.007)	-0.011** (0.005)
$CF \times FinanceSize$	-0.033*** (0.011)	-0.010 (0.009)	-0.055*** (0.010)	-0.010 (0.010)
N	18,281	18,098	21,555	15,767
$R^2$	0.10	0.07	0.11	0.15

Note: Each equation includes *Size*, *Lead Investment*, *Investment*,  $\Delta NWC$ , and  $\Delta ShortDebt$  and year dummy variables. Asymptotic cluster-robust standard errors are reported in parentheses. \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%.

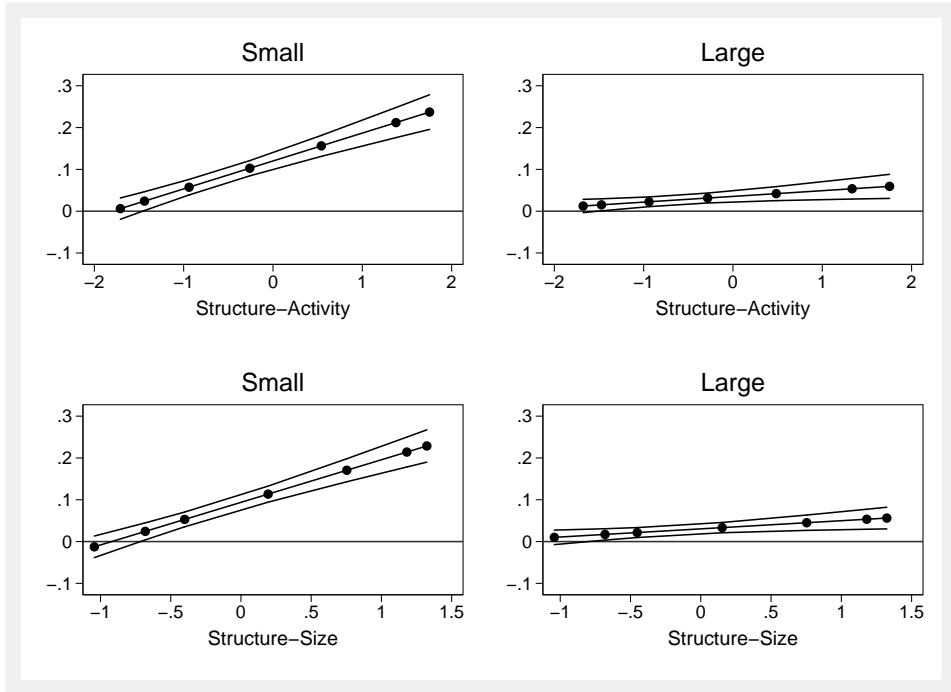


Figure 1: Cash flow sensitivity of  $\Delta CashHoldings$  by size groups.

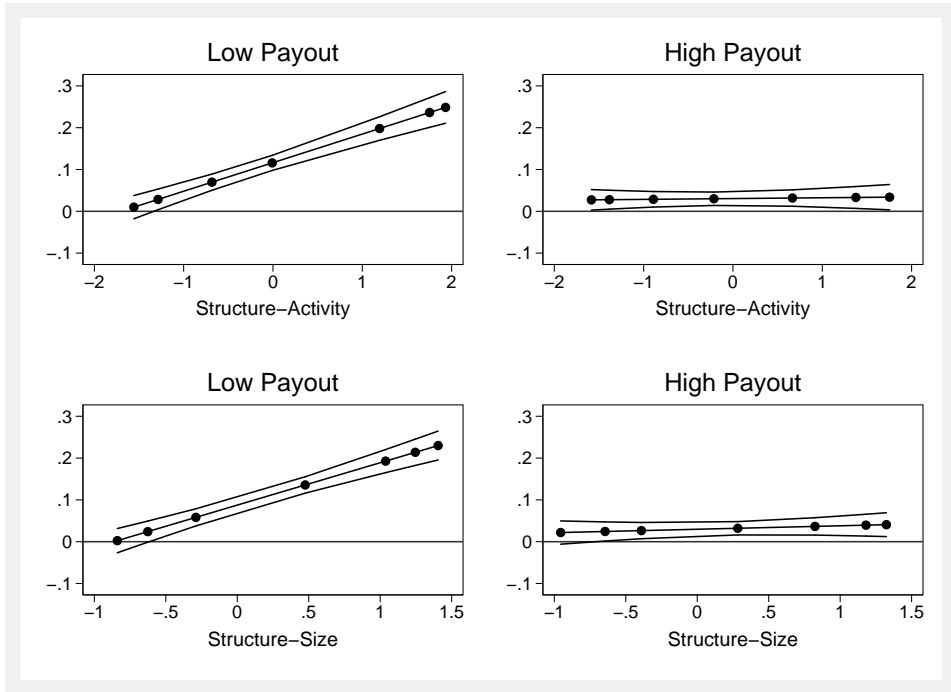


Figure 2: Cash flow sensitivity of  $\Delta CashHoldings$  by payout ratio groups.