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Have Capital Markets Aided Growth in China and India?

Financing to the private sector in China and India has expanded much less than aggregate measures of financial depth suggest

Among the most notable developments in the global economy over the past 20 years has been the rise of China and India as world economic powers. Along with high overall growth in these economies has come an increase in their financial activity. But how much have different types of firms used capital markets and benefited from their expansion?

Didier and Schmukler study this question in a new paper by assembling a unique and comprehensive data set on domestic and international capital raising activity and the performance of the publicly listed Chinese and Indian firms. They compile transaction-level information on equity and bond issues, then match these data with annual firm-level balance sheet information. Their matched data cover 2,458 firms in China and 4,305 in India.

The authors show that the expansion of financing to the private sector in China and India has been much more subdued than the aggregate measures of financial depth suggest. Although capital raising activity in equity and bond markets expanded substantially in 2005–10, it remained relatively small. Importantly, this expansion was not associated with widespread use of capital markets by firms. For example, while the amount of capital raised through equity issues in domestic markets in China doubled (from 0.5 to 1 percent of GDP a year) between 2000–04 and 2005–10, the number of firms using these markets to raise capital per year increased by only 20 percent (from 87 to 105 among 1,621 listed firms). Similar patterns, though on a smaller scale, apply to the use of foreign markets.

Not only have few firms made recurrent use of equity and bond markets; even fewer firms have captured the bulk of the capital market financing. For example, the top 10 firms in China and India captured between 43 and 62 percent of the amount raised in 2005–10. Thus the authors' findings suggest that capital markets have not been a significant source of financing across firms. This contrasts with the perception in the literature that equity markets in the two countries, particularly in India, are relatively well developed.

The authors also show that firms that use equity or bond markets are very different from—and behave differently than—those that do not do so. While nonissuing firms in both China and India grew at about the same rate as the overall economy, issuing firms grew twice as fast in 2004–11. Indeed, firms that raise capital through equity or bonds are typically larger than nonissuing firms initially and become even larger after raising capital. Firms grow faster the year before and the year in which they raise capital. Moreover, firms that use capital markets have ex ante a longer liability maturity structure and more capital expenditures, and the differences relative to the firms that do not use capital markets

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become more accentuated ex post. Notably, all the differences between users and nonusers are associated with the probability of raising capital.

The evidence on firm size and growth has important implications for the firm size distribution of listed firms. Quantile regressions show that the distribution of issuing firms is tilted to the right and shifts more over time than the distribution of nonissuing firms, suggesting no convergence in firm size; if anything, the distributions seem to diverge.

The findings suggest that finance matters, but in more nuanced ways than previously thought. Even though the financial markets in China and India arguably are not yet fully developed, the firms that are able to raise capital do appear to benefit from it, particularly in their overall expansion. In other words, at least part of the high growth in these countries seems to come from the firms that are able to raise new funds from the markets.

Moreover, the findings suggest that even large firms appear to be partly financially constrained. The difference in performance observed between users and nonusers of capital market financing suggests that for the group of publicly listed firms that issue securities, performance is sensitive to the external capital raised. That firms perform differently and expand when they raise capital also implies that they had investment opportunities ex ante that they could not realize. While the authors show that capital raising activity is related to changes in firm dynamics, they do not analyze to what extent the effects are driven by the supply side (capital markets) or the demand side (firms). Doing so requires further research.

In recent decades many emerging economies have undertaken large efforts to increase the scope and depth of their capital markets and to liberalize their financial sectors as a way to complete and increase the provision of financial services. But expanding capital markets might tend to directly benefit the largest firms—those able to reach some minimum threshold size for issuance. More widespread direct and indirect effects are more difficult to elucidate.

Tatiana Didier and Sergio L. Schmukler. 2013. "The Financing and Growth of Firms in China and India: Evidence from Capital Markets." Policy Research Working Paper 6401, World Bank, Washington, DC. *Also forthcoming in* Journal of International Money and Finance.

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The World Bank
1818 H Street, NW
Washington, DC 20433, USA

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