

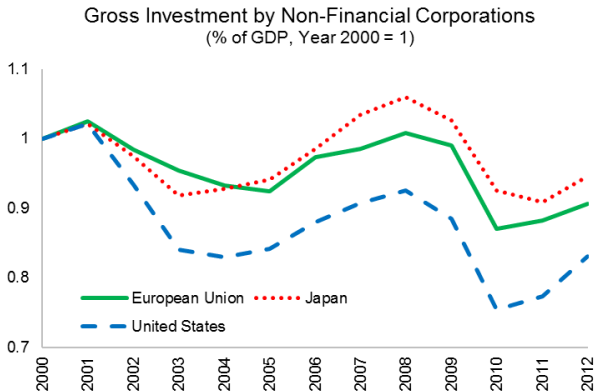
# Financial Frictions and Sources of Finance for European Firms

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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.

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

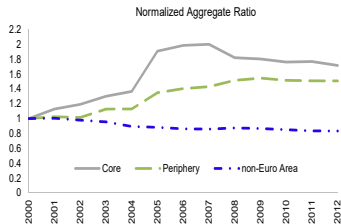
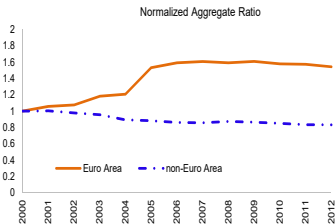
- Too much debt on firms' balance sheet: **debt overhang** problem  
⇒ Even strong banks will not lend ⇒ **Low Investment**
- Too much short term debt: rollover risk ⇒ worse under low demand/uncertainty ⇒ **Low Investment**
- Too little equity financing: endangers cross-border equity ownership  
⇒ reduces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