How stock market's 'spare tire' keeps economy churning during banking crises

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Stories about corrupt CEOs raiding the corporate piggy bank would appear to be the best argument for shareholder protection laws known as "anti-self-dealing laws." But there's another bonus. A new study finds in countries with strong legislation to prevent fraudulent corporate behavior, banking crises have a less severe impact on firms and the economy in general.

The study, "How the stock market can play this critical role is the subject of "Spare Tire? Stock Markets, Banking Crises, and Economic Recoveries," forthcoming in the *Journal of Financial Economics*, is the first assessment of the role of shareholder protection laws in shaping firms' response to a banking crisis.

Co-authored by Prof. Ross Levine, the Willis H. Booth Chair in Banking and Finance at UC Berkeley's Haas School of Business; Chen Lin, the Stelux Professor of Finance at the University of Hong Kong; and Wensi Xie, Assistant Professor at the Chinese University of Hong Kong; the paper is forthcoming in the *Journal of Financial Economics*.

During a similarly sized banking crisis, firms in countries with strong shareholder protection laws raised more money through stock sales, performed better in terms of profits and investment efficiency, and terminated fewer employees than similar firms in countries with weaker shareholder protection laws.

Banking crises make it harder for firms to obtain loans, threatening their profitability and survival. That's when the stock market can act like a "spare tire" —by allowing firms to issue equity to keep capital moving so firms can remain solvent and avert further damage to the economy. But strong shareholder protection laws must already be in place, according to Prof. Levine who studies the effects of regulation on the finance industry and how they impact ordinary people.

"This isn't just about trading and profits," says Levine. "Much of the population may not know anything about the stock market, but an economic crisis could cause people to lose their homes or jobs."

The study builds upon a conjecture by Alan Greenspan, former chairman of the Federal Reserve. In 1999, Greenspan argued that the banking crisis in Japan and East Asia would have been less severe had those countries built a legal infrastructure to allow stock markets to provide corporate financing when the banks could not.

"A spare tire is an alternative source of external financing during a crisis. If everything is ok, we wouldn't put the spare tire on. But if you get a flat, you're glad that you have a spare," says Levine.

The researchers compiled data on over 3,600 firms across 36 countries that experienced at least one systemic banking crisis from1990 through 2011. They also factored in shareholder protections in the sample countries, firm profitability, and the duration of the banking crises. By examining what happened to many firms over two decades, the researchers were able to rule out many other potential explanations for why firms in different countries respond differently to crises, such as differences in the size of the crisis; the level of economic development; the sophistication of financial markets; the potential role of other laws; and accounting protocols.

No matter how they cut the data, the evidence indicated that the ability to access stock markets when the banks go flat has a big effect on businesses and, more important, on the lives of ordinary workers.

"The mechanisms are clear," says Levine. "When a country has stronger shareholder protection laws, people are more enthusiastic about buying shares in firms because corporate insiders are less able to take advantage of small investors and this enthusiasm translates into more money for firms, allowing them to weather banking crises more effectively."

More information: See full study: faculty.haas.berkeley.edu/ross … _tire_26june2015.pdf

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