Essays in Financial Economics

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To

My parents, Ebrahim and Kheiri, and my brother, Majid

Foreword

This volume is the result of a research project carried out at the Finance Department at the Stockholm School of Economics (SSE). This volume is submitted as a doctorate's thesis at SSE. In keeping with the policies of SSE, the author has been entirely free to conduct and present his research in the manner of his choosing as an expression of his own ideas. SSE is grateful for the financial support provided by Bankforskninginstitutet which has made it possible to fulfill the project.

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Special thanks go to my cohort in the PhD program, whose support and friendship made my life much easier and enjoyable during the past 5 years. They had a crucial role in diminishing the cultural shock of living in Sweden. Who other than Patrick Augustin could have accompanied me to buy the first bottle of wine in my life and to run 12km so I become lame for one week? Jan Schnitzler was my first ski instructor and he was so good that I learned skiing in a few hours and could ski (fall) down from the World Cup slope in Finland! Johannes Breckenfelder was my travelmate in several unforgettable journeys not to mention our sophisticated discussions at the philisopher's corner at SHoF with Jan. Mustafa Yildirim was my officemate and a close friend who left us after the second year. It was a big loss.

Part of this thesis was written when I was a visiting scholar at Olin Business School at the University of Washington in St Louis. I thank the Olin Finance Department and in particular my faculty sponsor Professor Anjan Thakor for his guidance and the kind hospitality shown to me. Without them St. Louis as a city would have not tolerable for me.

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Stockholm, June 7, 2013
Hamid Boustanifar

Contents

Introduction

This doctoral thesis consists of four independent papers in Financial Economics. The papers are self-contained and each written with the purpose of eventually being published as a separate article in academic journals.

The first paper, *Personal Bankruptcy Reform, Credit Availability, and Financial Distress*, explores the impact of increased credit availability on households' borrowing and its consequences. Economic theory does not provide an unambiguous answer to this question. While it can mitigate financial hardship through the possibility of consumption smoothing, credit access may exacerbate distress among certain group of borrowers because of over-borrowing.

To identify the impact of a credit expansion, the paper exploits Bankruptcy Abuse Prevention and Consumer Protection Act. The Act increased creditor rights in personal bankruptcy and led to a dramatic increase of credit supply to households. Households with high leverage increased their leverage following the Act, spent more on medical cares, and there is no evidence that they are defaulting more ex post. This is consistent with a relaxation of financial constraints at the household level following the reform. However, households with low education and those with self-reported self-control problem also took on much more debt, but spent mainly on apparel and recreational activities, and face a much larger level of financial and economic difficulty ex post. This part of evidence supports the models that highlight suboptimal borrowing choices due to financial illiteracy and cognitive biases as well as the models of self-control problem. The heterogeneous impact on different types of borrowers found in this paper explains the conflicting result of the previous literature on the impact of credit availability on household's financial well-being. Overall, the results stress the adverse impact of credit availability for specific groups of borrowers and highlight the importance of addressing borrowers' heterogeneity in this context.

The second paper, *Finance and Employment: Evidence from US Banking Deregulation*, investigates the relation between financial constraints and labor market outcomes. While the relation between financial constraints and corporate investment has been studies extensively, very little is known about the role that financial constraints play in determining the level of employment and wages. Testing for a causal effect of finance on employment is, however, complicated by identification concerns of endogeneity. As such, I exploit the U.S. banking deregulation as a quasi-natural experiment. Removal of restrictions on geographic expansion came with better efficiency and pricing of banking services. The simultaneous existence of cross-sectional and over-time variation concerning individual states' timing of reforms represents a unique opportunity for identifying and assessing the causal impact of a positive shock to the financial

intermediation environment on the labor market outcomes in non-financial industries. The results suggest that while having no effect on average wages, banking deregulation increased employment growth substantially. The paper also explores the potential channels between finance and employment. Two channels are found. First, relaxing financial constraints leads to a higher level of investment by firms and therefore increases employment due to complementarity between capital and labor. Second, as labor is not a pure variable cost of production, easier access to finance increases employment even after controlling for investment. The results of this paper, therefore, improve our understanding of the interaction between financial and labor markets, the literature that has received little attention so far.

The third paper, *Banking Deregulation and Relative Wages in Finance*, addresses the impact of banking deregulation on wages in Finance relative to other private non-farm industries. Although the substantial increase of wages in the finance industry during the past few decades has been a source of debate among policymakers as well as academics, there is little consensus about what caused this phenomenon. Using similar identification strategy as in the second paper, this paper investigates the causal impact of each of the three types of banking deregulation on relative wages in Finance. I document that relative wages in Finance began to rise in early 1980s in all states including those that deregulated before 1970 and those that deregulated in late 1990s. Consistently, after controlling for aggregate macro shocks that affected both treatment and control states, there is NO evidence that relative finance wages increased more following any type of deregulation. If anything, I find a small decline of relative Finance wages following bank branching deregulation. These results together with the previous literature that uses aggregate data and finds a positive correlation between measures of financial deregulation and relative wages in Finance calls for a better understanding of the dynamics of wages in the finance industry.

The last paper, *Information Acquisition, Foreign Bank Entry, and Credit Allocation*, explores theoretically the impact of foreign bank entry on the access to credit for small and opaque firms. although all the theoretical studies support the cherry-picking behavior of entrants, the empirical literature regarding this issue is inconclusive and has failed to establish a consistent inference regarding credit allocation of entrants towards SMEs. This paper presents a theoretical framework to understand the observed inconsistent behavior of entrants towards opaque and small firms. I show that the level of information asymmetries, resulting from previous relations of the incumbent, can potentially lead to equilibrium in which entrants have comparative advantage in funding opaque firms. Specifically, when only less opaque firms are distinguishable costlessly to incumbents due to past relationships, entrants can offer a more attractive pooling contract to opaque firms due to their cost of funds advantage. This is a situation where entrants focus on funding of opaque firms and the model implies that this equilibrium occurs when the pool of firms in the economy (industry) is not lower than a threshold. The model, thus, provides insights to reconcile the contradictory results of the previous literature regarding the impact of foreign banks on credit allocation.

The remainder of this thesis consists of four papers introduced above, each of which makes out a separate chapter.