

# **Credit Crunch, Creditor Protection, and Asset Prices**

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August 2008

## **Summary**

In a Tobin's  $q$  model with productivity and liquidity shocks, we study the mechanism through which strong creditor protection increases the level and lowers the volatility of stock market prices. There are two channels at work: (1) the Tobin's  $q$  value under a credit crunch regime increases with creditor protection; and, (2) the probability of a credit crunch falls for given stochastic processes of underlying shocks when creditor protection improves.

We test these predictions by using cross-country panel regressions of the stock market price level and volatility, in 40 countries, over the period from 1984 to 2004, at annual frequency. We create indicators for liquidity shocks based on quantity and price measures. Estimated probabilities of big shocks to liquidity are used as forecasts of credit crunch. We find broad empirical support for the hypothesis that creditor protection increases the stock market price level and reduces its volatility directly and via its negative effect on the probability of credit crunch. Our empirical findings are robust to multiple specifications.