In the period since 2001 the Federal Reserve has lowered the Fed Funds rate dramatically and as a result interest rates in Hong Kong have fallen from around eight percentage points to their present levels of two-and-three-quarter percentage points – or by two-thirds. The question in this paper is what effect did this have on corporate finance in Hong Kong?

As the cost of borrowing falls below the expected return on marginal investment projects investment demand increases, and as firms become financially healthier their creditworthiness improves. Firms may seek more credit, or different types of credit available to premium borrowers. Bank borrowing, for example, may be replaced by finance raised through the sale of marketable debt or equity. Equally, short-term debt may be replaced by longer-term debt if short-term interest rates fall below the rates that are expected to prevail in the longer run. In addition, some types of firms may find that the credit constraints that they face on the supply side, from the markets and financial intermediaries, are relaxed. In this paper we seek to examine the implications of falling interest rates in an asymmetric information context where firms typically face borrowing constraints. Under low rates of interest, balance sheets improve and suppliers lend more freely, allowing previously constrained firms (or even firms that were totally excluded from the credit market) to borrow larger amounts on better terms.

A unique feature of Hong Kong is its heavy reliance on bank lending as a means of external finance for investment. This is typically a form of finance that is low in the pecking order, and firms that are able to access the financial markets usually substitute away from bank lending to some degree. Yet companies in Hong Kong are highly bank dependent compared to companies in other countries and only the largest companies obtain finance from non-bank sources such as bond and equity markets. In particular, the domestic bond market is small in comparison to other countries, on the basis of the market capitalisation to GDP and therefore the main alternative to bank finance is equity finance. Although we find evidence that borrowing of all types has increased, and that there has been a shift away from short-term debt towards long-term debt, the restrictions on the choice of financial options through the lack of a deep domestic bond market may have affected the response of firms to lower rates.