gie Mellon University, one can characterise the evolution of corporate financing needs and strategy, and implicitly the growth of capital markets in developing economies, as follows: In the earliest stages of economic development, firms finance investment by building up savings from internally generated funds. Self-funding is supplemented by loans from close relatives, extended family members, friends in the community and the like. Such "inside" funding overcomes information and credibility problems, and provides an incentive for owners to use the funds energetically, as promised. The borrower is bonded by its close relationship to family and community. Indeed, close relationships monitor the borrower's behaviour and can enforce discipline on the borrower if need be.

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As an economy develops, self-funding and inside funding become insufficient to finance firms that must manage complex production processes and serve broader markets. Firms must attract additional financing from external sources. Banks arise to provide information-intensive external funding, and, in effect, recreate the kind of information, bonding and monitoring that come with family relationship lending, only with more funding.

The cost of external funding through banks involves credit evaluation, loan monitoring, and a component to allow for the risk of default and the cost of managing a default if it occurs. These costs of external finance create an external finance premium that a borrower must pay over and above the opportunity cost of self-funding or funding from close associates.

Too much reliance on bank loans or direct bond finance, however, exposes a firm to excessive risk of bankruptcy in the event of default. Hence, in developed economies firms have come to rely on a portfolio of external finance that usually includes substantial equity, as well as bond and bank loan finance. Equity finance gives a firm financial flexibility in the choice of the payment of dividends -- flexibility that a firm can utilise to avoid default on bank loans or bonds.

Outside equity, however, involves a cost of its own: too much of it blunts the incentive of managers to run a firm efficiently because external ownership allows managers to retain only a fraction of every dollar of value they create for the firm above revenue needed to pay off fixed obligations, which include debt and fixed salaries. Therefore, equity, bank loans, and bonds generally co-exist in the capital structure of modern corporate borrowers.

At a more practical level, taxation would bias the financing choice towards debt if, for example, corporate income is taxed but interest payments are tax deductible. This is an important factor in developed economies but much less so in developing ones. A much more relevant issue in countries like Bangladesh and India is that in emerging markets with strong family ownership ties, the issue of control may play a larger role, causing firms to defer issuing equity to avoid diluting control.

Agarwal and Mohtadi (2004) examine the financing choice of firms by focusing on the determinants of the debt-equity ratios of firms in 21 developing countries for a period of 18 years (1980-1997). They find that find that:

- Stock market development reduces leverage in favor of equity, while reliance on bank borrowing increases it.
- Using foreign direct investments as a measure of capital inflows, they find that such inflows improve the debt-equity ratio (reduce it) over the short run, but surprisingly have no significant effects on this ratio in the long run.

The results show that stock market development as measured by market capitalisation is significantly and negatively associated with the firms' debt levels relative to their equity position, while banking sector variables (especially bank deposits) are significantly and positively associated with debt equity ratio.

The issue around appropriate leverage in listed companies will become increasingly important, as has been the case in more