Bank Credit, Liquidity Shocks and Firm Performance: Evidence from the Financial Crisis of 2007-2009*

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Abstract

This paper provides evidence about the transmission of banking sector problems to the real sector, and examines the impact of bank credit supply frictions on firm performance. I exploit differences in the composition of banks' liabilities structure during the financial crisis of 2007-2009 as a source of exogenous variation in the availability of bank credit to nonfinancial firms, in order to identify the causal relationship between bank credit supply and firm performance, measured by firms' stock returns. My evidence indicates that banking relationships are important for firms. Firms whose banks relied more on core deposit financing had a lower decline in bank credit during the crisis than those whose banks were mainly financed by noncore sources of funding. I document a positive relationship between changes in bank credit and firms' stock returns during the crisis: a one standard deviation decline in bank credit to a firm causes a stock return reduction of 3.5 percentage points, while firms that had lending relationships with healthier banks had a lower decline in bank credit and thereby lower reductions in their stock returns during the crisis.

Key words: Bank credit, bank liquidity shock, financial crisis, relationship lending, firm financial constraints, firm performance

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