Financial Policies, Investment, and the Financial Crisis: Impaired Credit Channel or Diminished Demand for Capital?

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Abstract

Though much of the narrative of the financial crisis has focused on the impact of a bank credit supply shock, we show that such a shock cannot explain important features of the financial and investment policies of industrial firms. These features are consistent with a dominant role for the increase in risk and the reduction in demand for goods that occurred during the crisis. The net equity issuance of small firms and unrated firms is abnormally low throughout the crisis, whereas an impaired credit supply by itself would have encouraged these firms to increase their net equity issuance. After September 2008, firms increase their cash holdings rather than use them to mitigate the impact of the credit supply shock. Firms that are more bank-dependent before the crisis do not reduce their capital expenditures more than other firms during the crisis. Finally, the evidence is strongly supportive of theories that emphasize the importance of collateral and corporate net worth in financing and investment policies, as firms with stronger balance sheets reduce capital expenditures less after September 2008.

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