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The Response of Corporate Financing and Investment to Changes in the Supply of Credit

Michael Lemmon and Michael R. Roberts*

Abstract

We examine how shocks to the supply of credit impact corporate financing and investment using the collapse of Drexel Burnham Lambert, Inc.; the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; and regulatory changes in the insurance industry as an exogenous contraction in the supply of below-investment-grade credit after 1989. A difference-in-differences empirical strategy reveals that substitution to bank debt and alternative sources of capital (e.g., equity, cash balances, and trade credit) was limited, leading to an almost one-for-one decline in net investment with the decline in net debt issuances. Despite this sharp change in behavior, corporate leverage ratios remained relatively stable, a result of the contemporaneous decline in debt issuances and investment. Overall, our findings highlight how even large firms with access to public credit markets are susceptible to fluctuations in the supply of capital.

I. Introduction

Fluctuations in the supply of financial capital flowing to different sectors of the market can be extreme.[1] Coupled with the presence of financing frictions,

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