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Financial Markets, Banks' Cost of Funding, and Firms' Decisions: Lessons from Two Crises

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ABSTRACT

We test whether adverse changes to banks' market valuations during the financial and sovereign debt crises affected firms' real decisions. Using new data linking over 3,000 non-financial Italian firms to their bank(s), we find that increases in banks' CDS spreads, and decreases in their equity valuations, resulted in lower investment, employment, and bank debt for younger and smaller firms. These effects dominate those of banks' balance-sheet variables. Moreover, CDS spreads matter more than equity valuations. Finally, higher CDS spreads led to lower aggregate investment and employment, and to less efficient resource allocations, especially during the sovereign debt crisis.

JEL # E44, G01, E22, E24, G21

Keywords: Financial crisis, sovereign debt crisis, credit default swaps, investment, employment

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