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Bank Capital Pressures, Loan Substitutability, and Nonfinancial Employment

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Abstract

We exploit the cross-state, cross-time variation in bank tangible capital ratios—brought about by bank branch deregulation on a state-by-state basis—to identify the effects of bank capital pressures on employment and firm dynamics over two waves of changes in bank capital regulation. We show that stronger capital pressures temporarily slowed down growth in employment in industries that depend on external finance, retarding growth in the average size of firms rather than in the number of firms. Such effects were particularly strong for smaller firms that may not have access to national capital and bank loan markets. Our findings indicate that a tightening of capital requirements may have significant real effects, in part, because of the lack of substitutes for bank loans.

JEL CLASSIFICATION: G21, G28, G30, J20, L25

KEYWORDS: bank capital ratios, bank capital regulation, loan substitutability, employment, firm dynamics.

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