

# Are Local Banks Needed for Local Economic Growth? Evidence from Japan's Lost Decade

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## Abstract

This paper examines whether the failure of local banks has long-term causal effects on local economic growth, due to the increase in the costs of external finance to local firms. If it is true, then the more bank-dependent sectors should grow relatively less than the less bank-dependent sectors during the banking crisis. The evidence in this paper supports this view. Furthermore, the negative effect of bank failures is stronger in relatively lower-income prefectures, the prefectures with less development in their bank loan markets during “the lost decade” in Japan. The paper also shows that these results are unlikely to be driven by reverse causality, omitted variables or outliers. These results are consistent with the “lending view” – banks play a special role in corporate finances, and at least for some firms bank credit can not be easily replaced by other sources of finance. In addition, the findings in this paper may have relevance to other related fields of the lending view. In the context of the literature on relationship banking, this paper provides fresh evidence that the long-term relationship between local banks and firms has economic value: the loss of accumulated information on the quality of the borrower when a bank fails represses local growth over the long term. The paper also supports the segmentation hypothesis of Japanese bank loan markets, since the results indicate that local firms are not likely to be able to easily switch from a local bank to bank based in another prefecture.

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