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# The Effects of Lender of Last Resort on Financial Intermediation during the Great Depression in Japan[#]

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## Abstract

The interwar Japanese economy was unsettled by chronic banking instability, and yet the Bank of Japan (BOJ) restricted access to its liquidity provision to a select group of banks, i.e. BOJ correspondent banks, rather than making its loans widely available "to merchants, to minor bankers, to this man and to that man" as prescribed by Bagehot (1873). This historical episode provides us with a quasi-experimental setting to study the impact of Lender of Last Resort (LOLR) policies on financial intermediation. We find that the growth rate of deposits and loans was notably faster for BOJ correspondent banks than the other banks during the bank panic phase of the Great Depression from 1931-1932, whereas it was not faster before the bank panic phase. Furthermore, BOJ correspondent banks were less likely to be closed during the bank panics. To address possible selection bias, we also instrument a bank's corresponding relationship with the BOJ with its geographical proximity to the nearest branch or the headquarters of the BOJ, which was a major determinant of a bank's transaction relationship with the BOJ at the time. This instrumental variable specification yields qualitatively same results. Taken together, Japan's historical experience suggests that central banks' liquidity provisions play an important backstop role in supporting the essential financial intermediation services in time of financial stringency.

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