Negative Impacts of Capital Injection Policies on the Capital Crunch

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This paper empirically investigates the effects of capital injections into Japanese banks, which were based on the Financial Function Stabilization Law and the Early Strengthening Law, on the capital crunch. We demonstrated the possibility that capital injection policies have both positive and negative effects on capital crunch, and then examined which effects have been observed in the Japanese banking sector. Using financial panel data for all Japanese commercial banks, we estimated the dynamic panel models.

The main contributions of this paper are threefold. First, we found that capital injections had a negative impact on capital crunch. Though the capital injections were expected to free banks from capital regulatory constraint, Japanese banks that had received capital injections became more sensitive about their capital adequacy ratios, and reduced their loans; the exception was the domestic banks that got capital injection based on the Early Strengthening Law.

Second, we found asymmetric effects of the Early Strengthening Law on international and domestic banks. Unlike the international capital-injected banks, domestic banks which received injections based on this law became less sensitive about their own capital adequacy ratios and increased their loans: both Total and SME Loans. This means that the capital injections had positive effects on their capital crunch.

These two findings tell us that capital injections do not necessarily prevent capital crunch. What is the difference between success and failure? We found that this has a lot to do with the difference in the frameworks of capital injection policies. This third finding suggests that the manner of conducting capital injection policies is a very crucial matter and the careful design of capital injection policies is very important.

We demonstrated that capital injection policies could not ease, but, in fact, plagued banks with capital crunch, which may have been the cause of a prolonged depression in Japan. What was and will be needed is a greater appreciation of the potential adverse effects that capital injection policies can have on the economy.