The Crowding Out Effect of Local Government Debt: Micro- and Macro-Estimates

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Motivation

- Government debt may adversely affect private sector via **financial crowding out effect**

$$\boxed{\frac{\partial \text{ Output}}{\partial \text{ Gvt debt}}} = \boxed{\text{Effect if no constraint on financing supply}} - \boxed{\textbf{Crowding out}}$$

Debt-financed multiplier

$\uparrow$ government debt demand
$\Rightarrow \downarrow$ supply of corporate debt
$\Rightarrow \downarrow$ corporate investment & output

- Challenges to empirical quantification:
  - Government debt: (1) is **endogenous**; (2) affects firms via **multiple channels**

- **This paper:** Quantify **crowding out effect** of **local government bank debt** on corporate credit, investment and output
  - Local government bank debt is large and growing:
    - Over 1990-2019, local government debt-to-GDP $\uparrow$ from **12%** to **22%** (G20 countries)
    - **80%** of local government debt = bank debt
  - Identification strategy to isolate financial crowding out

Methodology

Data: French credit registry over 2006-2018

1. **Identification:** causal reduced-form evidence
   - $\uparrow$ Local government borrowing from a given bank
     - $\Rightarrow$ $\downarrow$ Corporate loans by that bank?
     - $\Rightarrow$ $\downarrow$ Investment for that bank's borrowers?

   $\rightarrow$ Isolate crowding out

2. **Aggregation:** model
   - Estimated cross-sectional effects $\Rightarrow$ Aggregate output loss?

Main findings

1. **Existence:** Local government loans crowd out corporate loans

2. **Quantification:** $\uparrow$ €1 local government loans $\Rightarrow$ $\downarrow$ **€0.2** aggregate output

3. **Determinants:** More severe when borrowing from more **constrained banks**

   $\rightarrow$ Mode of financing of government debt matters

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Debt-financed multiplier | What we know ($\approx$1.5) | **0.2**