

Government Banks and Interventions in Credit Markets*

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Abstract

We study a large scale intervention in the Brazilian banking sector, characterized by a sudden increase in the supply of credit provided by commercial government banks. Theoretically, the effects of this type of policy are ambiguous: the policy can be beneficial if credit is inefficiently low, or harmful if public banks finance riskier firms with unproductive projects. We use confidential credit registry data to document a series of empirical facts and test if the policy alleviates inefficient underprovision of credit. We show that while the policy leads to a reduction in private banks interest rates and to an increase in total credit, public banks experience worsening of loan default risk. In particular, government banks subsidize more levered firms, and loans to indebted firms explain differences in loan default between public and private banks. Moreover, neither the increase in total credit nor the reduction in interest rates of private banks has effects on GDP and employment growth. These findings suggest the policy did not ameliorate inefficiently low credit, but rather was associated with credit misallocation.

Keywords: Credit Market Interventions, Credit Misallocation, Government Banks

JEL Classification: E44, E65, G21, L44

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1. INTRODUCTION

It is well known that credit markets are prone to government intervention, and that one of the tools that can be used to implement financial market policies are state owned banks.¹ These policies targeting financial markets can address problems caused by adverse selection or excessive market power by private banks, which can lead to inefficient credit rationing. However, interventions that lead to a larger role of the state in financial markets often have harmful effects such as credit misallocation.² Importantly, despite government ownership of banks being common in many countries, little is known about the effects of an increase in lending by public banks, and what are the underlying mechanisms causing these effects, since most of the empirical evidence studying the use of government owned banks comes from crisis episodes.³ Consequently, it is unclear if more credit by public banks alleviates inefficient underprovision of loans, or if loans issued increase credit misallocation, and how do private banks respond to an increase in lending by state owned banks.

In this paper we address these questions in a novel setting studying a large scale credit market intervention in Brazil. In 2012, the Brazilian government announced the use two of its large commercial public banks to increase credit at low interest rates, pursuing a reduction in private banks' interest rates and an increase credit access. Using administrative data, we explore the increase in total credit and the differences in interest rates of private and public banks to assess if the credit expansion allowed safer or riskier firms to obtain more funds, and if that is connected to adverse selection. We find evidence that the policy led to more loans to riskier firms. Private banks reduce interest rates in response to the policy, but the credit expansion entailed more loans to levered firms, which are riskier, and has no effects on employment or output growth. Our results suggest that the credit expansion had limited benefits and came at a cost of increased loan default risk and credit misallocation.

One important challenge faced by studies of credit market policies is to isolate the specific

¹Throughout this paper we use the expressions *State Owned Banks*, *Government Banks* and *Public Banks* interchangeably. They refer to banks whose majority shareholder is a local or federal government, which allow governments to provide credit directly to households and firms.

²Papers highlighting a beneficial view of government interventions in financial markets include [Stiglitz \(1994\)](#), [Tirole \(2012\)](#) and [Philippon and Skreta \(2012\)](#), whereas papers that document a negative role for the state include [Bertrand, Schoar and Thesmar \(2007\)](#), [Acharya et al. \(2020\)](#) and [Acharya et al. \(2021\)](#).

³Examples of countries with government owned banks include Brazil, Chile, Argentina, Spain, Germany and China.

mechanisms affecting equilibrium credit allocation and firm outcomes. This is particularly true for interventions employed during financial crisis, when banks can face shocks to bank capital and borrower quality in addition to being affected by credit market policies. More generally, banks can change loan contracts in response to changes in the demand for loans rather than in response to credit market policies, which can bias the estimates of the effects of these interventions. To overcome these challenges, we rely on the unique nature of our experiment, a large intervention outside a financial crisis episode, where the financial sector is not subject any other systematic shocks that would affect private and public banks differently. Moreover, our very detailed data allows us to include a variety of time varying regional and industry specific fixed effects, which absorb any demand shocks stemming from banks' different regional and industry exposures. This strategy allow us to directly link changes in private bank lending and firm outcomes to the increase in credit provided by public banks.

The first step in our analysis is to describe the economic context and the details of the intervention. In the year prior to the implementation of the policy, the Brazilian government implemented a series of policies to foster economic growth, including expansionary monetary policy. Importantly, the government had the belief that high loan interest rates inhibited economic growth. Consequently, in late March 2012, it announced the use of the two largest commercial state owned banks in the country - *Banco do Brasil* and *Caixa Economica Federal*, to increase the supply of credit at low interest rates. This included changes in loans to both households and firms, and was accompanied by wide advertising of the low interest rates and of the increase in loan availability. However, despite this widespread promotion of the program, few details about the implementation, loan approval requirements or the duration of the policy were disclosed.

To understand situations in which economic stimulus through an increase in credit by public banks can be beneficial, we develop a simple theoretical framework. Theoretical models predict that credit market interventions can be beneficial or harmful depending on the economic fundamentals that influence equilibrium credit allocation. We incorporate these two distinct views of the effectiveness of government provided credit in our model. Our starting point is a scenario where firms with productive and unproductive projects obtain credit from banks to finance their investment projects. We incorporate public banks in

this context by allowing the government to provide credit at low interest rates, but subject to a capacity constraint, which implies not all borrowers who want to borrow from the government are able to do so. We then incorporate two different mechanisms that have different implications about welfare. Specifically, in the presence of adverse selection, an increase in public credit is welfare improving, as it allows for more firms with productive projects to obtain financing in equilibrium. However, absent any form of selection, the effects of an increase in public credit depend on the average quality of firms borrowing from public banks. In particular, if we allow for the credit expansion to increase the riskiness of firms that borrow from government banks, then an increase in public credit is welfare decreasing.

Having our illustrative theoretical framework, we begin our empirical analysis documenting a series of facts about lending activity of government and private banks. We restrict our attention to working capital loans, which are term loans that can be use for any corporate purpose and represent one of the main sources of funding for firms in the Brazilian economy. We first document that state owned banks lend at lower interest rates both before and after the intervention, but that the policy is not characterized by reductions in the interest rates of working capital loans by public banks. Instead, there is a sudden increase in the supply of credit by public banks, which grows by more than three times after the policy is announced. We then turn to the response of private banks, relying on the fact that the intervention was unexpected, and that no other systematic events that could cause changes in the behavior of private banks took place when the policy was implemented. While private banks' interest rates were falling at a faster pace than public banks' interest rates prior to the beginning of the policy, there is a large drop in the spread between interest rates of private and public banks after the policy. In other words, private banks respond to the increase in the supply of public credit by reducing loan interest rates, with the spread between interest rates of public and private banks falling 4 percentage points, a reduction of a third of the difference prior to the intervention.

The second step in our empirical analysis is to compare riskiness of borrowers of private and public banks. The fact that public banks charge lower interest rates than private banks in similar loans to comparable firms gives us an unique opportunity to test if markets are characterized by adverse selection, since we can test if different firm willingness to pay correlates with unobserved default risk. In the presence of adverse selection an increase in

the provision of public credit is beneficial since it allows for more productive firms to obtain funding for their projects. Alternatively, public banks can subsidize levered borrowers, as in zombie lending situations, in which case government banks would be financing unproductive firms that would default more on their loans. Importantly, these different mechanisms connected to borrower risk have different implications for the desirability of the policy, as illustrated by in our model.⁴ We analyze firm ex-post default risk by tracking loan delinquency at the firm level after the origination month. Riskier firms are those who are more likely to not repay their loans in full, as captured by our delinquency measure.

The trajectory of private and government banks loan risk reveals two important patterns. First, delinquency rates prior to the intervention are very similar for both types of banks. Second, the policy is associated with a worsening of the quality of public banks' borrowers relative to the quality of borrowers of private banks. In particular, after the policy the average probability that a firm borrowing from a public bank became delinquent is about 100 basis points higher than the probability of a firm borrowing from private banks becoming delinquent, which corresponds to approximately 20% higher probability of delinquency for firms borrowing from public banks in comparison to firms borrowing from private banks. Importantly, the fact that public banks lend to firms with similar default risk before, and firms with higher default risk after the intervention, casts doubt on the idea that adverse selection drives borrower riskiness in our context, but is consistent with the idea that public banks directed loans to unproductive indebted firms, as in zombie lending contexts.⁵ Nevertheless, the observed differences in average borrower riskiness between private and public banks are also consistent with uniformly lower screening standards by public banks during the policy. Finally, taken in isolation, the evidence post intervention is also consistent with potential advantageous selection, with riskier borrowers being attracted by low interest rates.

⁴Another possibility is that lower interest rates riskier borrowers, such as in advantageous selection models (De Meza and Webb (1987), Mahoney and Weyl (2017)). Similarly, lower interest rates can have a causal effect on borrower risk, as in moral hazard models, indicating lower risk for public bank borrowers (Boyd and De Nicoló (2005), Martinez-Miera and Repullo (2010)). Finally, public banks might have lower screening standards and attract riskier borrowers even in the absence of selection (Jiménez et al. (2019)). Our empirical evidence rule out these alternative mechanisms as well.

⁵While it is challenging to characterize zombie lending, literature suggests zombies can be identified when banks issue subsidized loans to unproductive firms (Caballero, Hoshi and Kashyap (2008)). In our context the cheaper interest rates for higher leverage firms along with ex-post higher delinquency rates, are consistent with the zombie lending view.

To uncover the exact mechanisms that explain differences in loan risk for government and private banks, we first compare loans to levered borrowers with loans to unlevered borrowers. If differences in riskiness are caused by specific subsidies provided by public banks to levered firms, we would expect *unlevered* borrowers of private and public banks to have *similar* risk, whereas *levered* borrowers would be *riskier*. However, if differences in riskiness are caused by public banks having lower screening standards, which might have become more lax after the intervention, then *both* levered *and* unlevered borrowers of public banks would be *riskier*. We document that while private banks charge lower interest rates when lending to borrowers with no outstanding debt, public banks charge lower interest rates when lending to older, levered borrowers, rather than subsidizing lending to new customers with no debt outstanding. However, new clients of public and private banks have comparable risk both before *and* after the intervention, contradicting the idea of uniformly lower screening standards by public banks. Risk differences for public and private banks arise from loans to levered firms, with the difference between loan risk for public and private banks increasing monotonically in firm leverage. Moreover, firms borrowing from public banks have higher debt outstanding and become more levered after the intervention. This is consistent with the idea that public banks extended credit to more indebted firms as part of the policy, allowing such firms to become more levered and riskier.

We also perform one additional test to rule out the possibility that any form of selection is driving our results by comparing old and new firms. If differences in riskiness were to be explained by some sort of selection, we would expect *new* borrowers of private banks to be *safer/riskier* if there is *adverse/advantageous* selection. Intuitively, these borrowers are expected to have lower propensity to borrow on average, since they only obtain loans when facing ex-post lower interest rates. We find that, conditional on having no outstanding debt, old and new borrowers have similar risk, which contradicts the hypothesis that new borrowers who would be attracted by lower interest rates would be safer/riskier, as in adverse/advantageous selection models. This indicates that selection is not causing the differences in borrower risk, and lends support to the idea that public banks' loans to indebted firms and the increase in leverage caused the deterioration in credit quality.

A final exercise to evaluate whether the policy increased credit primarily to unproductive firms is to assess if the increase in credit led to output and employment growth. If

government banks financed mostly unproductive levered firms, then we should see no output difference between areas more and less exposed to public banks. Alternatively, locations with more exposure to state owned banks would experience larger economic growth if these funds were used to finance productive projects. We answer this question by comparing municipalities with only public or private bank branches. Locations with only government banks face larger credit growth after the intervention compared to locations with only private banks. However, cities with only public banks do not experience statistically significant differences in output growth relative to cities with only private banks. Finally, we also test for differences in employment of firms who borrow from public banks and firms who borrow from private banks. The latter group benefits from larger interest rate reductions after the intervention and, according to theories that highlight the role of credit constraints in preventing firm investment, should respond by investing more. However, we find that both types of firms have comparable employment dynamics. In summary, the empirical evidence is consistent with the idea that, despite causing a reduction in the interest rates of private banks, the policy led to an increase in the number of less productive firms that were able to obtain more loans, decreased loan quality through an increase in firm leverage, and had limited positive effects on employment and growth.

The remainder of the paper is as follows: Section 2 reviews the related literature. Section 3 presents the data and relevant institutional details of the Brazilian economy. Section 4 presents the illustrative theoretical framework. Section 5 presents evidence of the effects of the intervention on public and private banks' credit variables. Section 6 documents lending patterns to levered and unlevered firms and risk differences for these firms. Section 7 assess the real effects of the policy. Section 8 concludes.

2. RELATED LITERATURE

Our paper adds to the broad literature that studies government interventions in financial markets. [Bertrand, Schoar and Thesmar \(2007\)](#) shows that a removal of government regulations in France led to productivity gains, and that by ceasing to provide subsidized loans to unproductive firms allowed such firms to restructure, overall improving credit allocation. More recently, given the increase in government interventions in financial markets, more studies analyzed how these interventions can lead to credit misallocation. Recent examples

include [Acharya et al. \(2021\)](#), who show how guarantees provided by European governments distorted lending incentives of banks, which ultimately engaged in zombie lending. Moreover, [Acharya et al. \(2020\)](#) argues that such zombie lending is associated to disinflation and productivity loss that is currently observed in Europe⁶. Close to our paper, [Jiménez et al. \(2019\)](#) use a small loan facility implemented using a state owned bank in Spain, and argue that despite public banks attracting worse quality borrowers, the social value of such interventions during a crisis is still positive. By exploring an unique setting in which a large intervention occurs outside a financial crisis episode, we are able to isolate the mechanisms affecting private banks' behavior, borrower risk and output and employment outcomes. We add to the literature by showing that public led credit expansions outside economic downturns have limited benefits despite increased costs due to higher loan default, and cannot rule out the idea that the policy led to credit misallocation.

The paper is also related to studies of asymmetric information in credit markets. Theoretical papers predict that the effectiveness of interventions in credit markets depends on the existence of adverse or advantageous selection ([Stiglitz and Weiss \(1981\)](#), [De Meza and Webb \(1987\)](#), [Tirole \(2012\)](#), [Philippon and Skreta \(2012\)](#), [Mahoney and Weyl \(2017\)](#) and [Biswas and Koufopoulos \(2019\)](#)). Empirical studies usually rely on measures of exogenous variation in borrowers' propensity to borrow/insure to test if such propensity is correlated with unobserved borrower risk, as in [Chiappori and Salanié \(2000\)](#). This is the case in [Gupta and Hansman \(2021\)](#), who study the importance of adverse selection and moral hazard in household mortgage exploring variation induced by interest rate indices used in different contracts, and [Defusco, Tang and Yannelis \(2021\)](#), who estimate welfare losses from asymmetric information in the market for online consumer credit. Alternatively, [Crawford, Pavanini and Schivardi \(2018\)](#) isolate the unobserved variation in demand for credit and the unobserved variation in risk to test for adverse selection, also showing that market power can alleviate the negative effects of increased adverse selection. We take a different approach by exploring the different interest rates charged by public and private banks, which would attract borrowers with different willingness to borrow. That allows us to test if the variations in borrower risk not explained by observables is in line with the predictions of selection models. This adds to the literature by providing a reduced form way to explore

⁶Focusing in the US, [Veronesi and Zingales \(2010\)](#), shows that interventions during the Great Financial Crisis were costly to tax payers, while benefiting bank debtholders

implications of asymmetric information models by testing if the predictions of these models hold in equilibrium.

This paper is also related to the literature that studies the Brazilian banking sector.⁷ Several papers study the use of these institutions during the Great Recession to prevent a credit crunch, such as [Coleman and Feler \(2015\)](#) and [Cortes, Silva and Van Doornik \(2019\)](#). [Ponticelli and Alencar \(2016\)](#) shows how the Brazilian bankruptcy reform had heterogeneous local effects reflecting differences in court enforcement. Additionally, two papers focus on the same policy explored by our project. First, [Garber et al. \(2021\)](#), shows that the expansion led to an increase in household debt that ultimately led to smaller consumption during the economic downturn in 2014-2016. Additionally, [Schmitz \(2020\)](#) documents differences in ex-ante risk between public, foreign and private national banks at the regional level. Our project complements these studies by showing that the expansion led to a reduction in private banks' loan interest rates, connecting the increase in credit supply to a worsening of public banks' borrower quality and showing that this worsening of default probabilities is associated with loans to levered firms. Importantly, despite focusing on different loan types, both our study and [Garber et al. \(2021\)](#) convey the idea that public bank credit expansions have drawbacks linked to increased borrower leverage.

Finally, our project adds to the literature studying state owned banks. Many studies connect misallocation to the existence of public banks, such as [La Porta, Lopez-De-Silanes and Shleifer \(2002\)](#), which studies cross country differences in government ownership and connects it to financial development. Similarly, [Dinç \(2005\)](#) documents how credit provided by state owned banks is influenced by political cycles. Focusing on Italy, [Sapienza \(2004\)](#) shows that public banks provide cheaper credit than private banks, and connects the cheaper loans by government banks to political factors. More recently, [Carvalho \(2014\)](#) shows that political capture can lead to misallocation problems connected to the misuse of the a large Brazilian development bank. On the other hand, some projects show that government banks have less procyclical, as argued by [Bertay, Demirgüç-Kunt and Huizinga \(2015\)](#), which can be beneficial during financial crises.⁸ Our paper complements this literature by documenting a response of private banks by lowering interest rates, which is consistent with the view

⁷Many papers explore different aspects of the Brazilian banking sector, such as [Bustos, Garber and Ponticelli \(2020\)](#), [Lazzarini et al. \(2015\)](#) and [Coelho, De Mello and Funchal \(2012\)](#).

⁸Other papers that study government ownership of banks include [Iannotta, Nocera and Sironi \(2013\)](#), [Assuncao, Mityakov and Townsend \(2012\)](#) and [Ru \(2018\)](#)

that these banks compete against public banks. This contrasts with [Coelho, De Mello and Rezende \(2013\)](#), who suggests that private banks do not compete with public banks, and [Sanches, Silva Junior and Srisuma \(2018\)](#), who shows that public banks generate positive spillovers to private banks. Additionally, we show that the reduction in the interest rates of private banks in response to more credit by public banks is *larger* for smaller firms and for firms without previous relationships with public or private banks.⁹

3. DATA AND INSTITUTIONAL SETUP

3.1. Data

Our main sources of data comes from two sources: (i) Confidential credit registry data from the Brazilian Central Bank SCR database;¹⁰ (ii) labor contracts data from the *Annual Review of Social Information - RAIS* database. We complement the confidential data with publicly available data from various sources as outlined below.

SCR Credit Registry Banks are required to disclose details of loans originated with amounts above a specific threshold, allowing us to observe the near universe of loans to firms in Brazil.¹¹ The database includes basic information about loan contracts, such as the type of credit, interest rates, amount, maturity, borrower tax id and collateral. Most information from the credit registry is available to the banks in Brazil, being one of the main sources of credit history information available to banks.¹² We construct a time series of loan origination by looking at all loans in each month which have a positive amount outstanding at the end of that month. While we lose very short term loans in the process, the majority of the corporate loans have maturities of more than one month. We also use the outstanding amounts to track firms credit history prior to the month in which they contract a loan, so we

⁹This is in line with the literature studying the how competition in the banking sector benefits small firms ([Rice and Strahan \(2010\)](#) and [Ryan, O'Toole and McCann \(2014\)](#)), and empirical studies of relationship lending ([Degryse and Ongena \(2005\)](#), [Ioannidou and Ongena \(2010\)](#)), suggesting that lending relationships allow banks to extract rents from smaller firms.

¹⁰Several papers studying the Brazilian economy use the SCR as their main source of data. Examples include [Fonseca and Van Doornik \(2021\)](#), [Joaquim, Gustavo; Van Doornik \(2019\)](#) and [Cortes, Silva and Van Doornik \(2019\)](#)

¹¹BRL 5,000.00 (around \$2,500) until December 2011, 1,000.00 (around \$ 500.00) from January 2012 onward.

¹²Some information available to us is not available to banks. For example, banks do not observe interest rates negotiated between clients and other banks.

can track firms' past relationships with specific banks.

The credit registry data also allows us to track loan delinquency since it also has information about outstanding amounts past due date. However, loan identifiers are not constant across time, which means we cannot track individual loans. We address this issue by tracking the delinquency information at the firm-month-loan type-bank dimension, up to one year after origination. This means we can identify firms which become delinquent in a loan within a certain loan type that they have borrowed from a certain bank in a specific month. Since our definition of borrower quality reflects borrower information and since many firms are smaller firms with only one origination in the same month, our approach for obtaining delinquency information is comprehensive despite the constraints. Additionally, it allow us to identify firms with a bad credit history at the moment in which they originate a loan.¹³

Finally, the SCR credit registry contains information about the funding sources for each loan originated, differentiating between banks' own funds and external funding. This distinction is important since subsidized credit from development banks, for example, are accounted for as loans with external sources of funding in the SCR. By restricting ourselves to loans using banks' own resources we restrict the analysis to loans whose liability counterparts are banks' deposits and capital, rather than onlending from development banks, which are likely different than regular loans from a competition perspective.

Annual Review of Social Information - RAIS We use the *RAIS* database to collect employment information about consumers and firms. Brazilian firms are required to inform their annual employee headcount, along with individual labor contract information, which includes detailed information such as hiring dates, employer and employee tax ids and average yearly wages. We use the RAIS data to obtain income and employer information about consumers, and to construct size proxies for firms based on number of employees and payroll costs, by matching the unique firm tax IDs from the SCR and the RAIS datasets.¹⁴

Both datasets may contain firm ids without a correspondent in the other dataset. While this is expected in the case of RAIS (since not all firms have access to credit and/or decide

¹³Following [Jiménez et al. \(2014\)](#), we include only loans past due date for more than 90 days in the construction of our delinquency variable. We follow the same rule when identifying firms with negative credit history in a certain month, where we track a firm's credit history for 12 months prior to origination.

¹⁴Although we do not observe balance sheet and income statement information for all firms, we estimate firm revenue based on average 3 digit information from surveys of commerce, industry and services. The procedure is detailed in [C](#).

to borrow in a given year), this is less obvious for SCR. Firms which do not have employees do not have to fill the annual RAIS information, which means these are firms which are not in the RAIS dataset. These can be individual entrepreneurs or holdings of other corporate entities which use the holding id to obtain loans. Since these firms represent less than 15% of the total amount originated by public banks as part of the policy, we do not include such firms in our sample.

Auxiliary Data We also collect information from public sources, including bank balance sheet, bank branches and municipality characteristics. Bank balance sheet, income statement and regulatory capital information for all financial institutions in the country is available at quarterly frequency in the [IF data website](#). Branch balance sheet information containing detailed information about assets and liabilities at branch level is available at monthly frequency from the [ESTBAN database](#). The database also includes the municipality of location for each branch, and allows for the identification of entry/exit of banks in each municipality. Finally, the *Brazilian Institute of Geography and Statistics (IBGE)* provides economic data at municipality level, including a breakdown of GDP and its individual components from the expenditure perspective. The institute also performs three large surveys that we use to complement our firm data information. The *PIA - Annual Industry Survey*, the *PAC - Annual Commerce Survey* and the *PAS - Annual Services Survey*, which contain two and three digit aggregated income statement information about firms in these macro sectors.

There are five types of corporate loans that most commercial banks provide using their own funding sources, which does not include loans from development entities: working capital, discounted receivables (loans in which firms anticipate the receipt of cash flows from sales and other accounts receivables), auto loans, credit cards and overdraft accounts. We focus on working capital loans since they were one of the types covered during the policy, and since they have longer maturity, which allows us to track borrower delinquency over time more accurately.¹⁵ Appendix C contains the details of the construction of the main dataset used in our analysis. Table 1 shows borrower summary statistics from our data:

¹⁵Importantly, such loans are also one of the primary source of funds for firms, as can be seen in Appendix A.

Table 1: Summary Statistics

Variable	Mean	Median	SD	Min	Max
Panel A - Loans					
Amount (R\$)	77,611	35,121	129,873	5,037	4,000,000
Maturity (months)	18.38	18	11.13	1	60
Interest Rate (% Yr)	33.84	30.29	15.59	10.03	111.9
Panel B - Firms					
Num. of Employees	12.24	4	90.85	1	13,981
Payroll Costs (R\$ per Month)	15,716	3,659	204,450	540	1,701,000

Note: This table reports summary statistics for the main variables in our dataset. There are $N_{obs} = 3,285,824$ observations and $N_{firms} = 941,597$ firms in the matched sample,

3.2. Economic Context

The Brazilian banking sector has an oligopolistic structure that has consolidated as a result of privatization processes and other restructurings in the banking sector that took place as part of several financial reforms employed in the late 90s and early 2000s. Most states had their financial institutions by that time, which were sold to private national and foreign banks as part of an effort to stabilize state fiscal deficits and modernize the financial sector. While large national banks, such as Itau, Bradesco and Unibanco, acquired some of these regional state banks, the intense privatization process also allowed foreign banks to gain access to Brazilian credit markets, with Santander, ABN Amro and HSBC engaging in important acquisitions during the period. Bank consolidation would further advance with the merger of Itau and Unibanco, and the sale of ABN Amro's operations in the country to the Spanish conglomerate Santander.¹⁶

Despite the large scale privatization process described above, state owned banks remained an important part of the financial sector in Brazil. In particular, the federal government has direct control of two large commercial banks: *Banco do Brasil* (from now on BB) and *Caixa Economica Federal* (from now on CEF), with BB being the largest bank in Brazil by asset value. In addition to regular corporate and retail products, BB is a major provider of agricultural credit. The bank is under direct control of the Brazilian government as the majority

¹⁶We distinguish between public, private national and private foreign banks using Central Bank's UNICAD database.

shareholder is the Ministry of the Economy, through the Brazilian National Treasury. In contrast, CEF was originally created as a savings bank, focusing mainly on savings accounts and retail products throughout its history, and is the main provider of real estate credit in Brazil. Contrary to BB, it does not have shares traded in public markets. In both cases, however, the Ministry of the Economy is responsible for nominating the CEO of both banks. Effectively, this implies both institutions are under control of the Brazilian government and are actively used as means to implement credit policies.¹⁷

In addition to the two, large commercial banks mentioned above, the Brazilian government also controls three other institutions: the *Banco Nacional de Desenvolvimento Social* (BNDES), the *Banco do Nordeste* and the *Banco da Amazonia*. BNDES is the largest development bank in the country and provides subsidized lending to firms and financing for local government infrastructure projects. As with BB and CEF, BNDES is also extensively used as a mean to implement credit policies in the country. *Banco do Nordeste* and *Banco da Amazonia* are smaller commercial banks which operate within specific regions.

3.3. The Intervention

After the early years of the Great Recession, the Brazilian economy experienced fast economic recovery, with the Brazilian GDP growing 7.5% in 2010 and 4.3% in 2011. Importantly, in 2011 former president Dilma Rousseff began her presidential mandate, which increased the number of policies geared towards fostering economic growth. In particular, in August 2011, the government announced the *Plano Brasil Maior*, an economic plan which was geared towards increasing the competitiveness of the Brazilian economy. The plan included tax incentives for investments and exports of specific sectors, along with other economic measures.¹⁸ These policies were implemented as the government became worried about a potential economic slowdown. In the same direction, monetary policy was loosed, with the SELIC target, the main reference interest rate in the economy, going from 12.50% in July 2011 to 7.25% in October 2012.

Interest rates for consumers and firms were particularly high even when compare to other

¹⁷These government owned commercial banks were nevertheless profitable, with their ROA above the average of OECD countries between 2010 and 2012, as can be seen in Appendix F Figure F.4.

¹⁸For more on the plan, see <https://www.forbes.com/sites/ricardogeromel/2011/08/03/bigger-brazil-plan-16-billion-in-taxes-breaks-to-fight-against-cheap-imports-from-china-and-surgings-real/?sh=1673094a29e6> and Zanatta (2012)

developing countries. The bank lending deposit spread in 2011 was 32.9% in Brazil, compared to 3.4% in Argentina and 3.7% in Mexico, for example.¹⁹ Consequently, the Brazilian government increased the number of interventions in the Brazilian banking sector, which included capital injections and regulatory changes in loans to households (Torres (2016)). Furthermore, in March 2012 the government announced the use of BB and CEF to promote credit supply increases for several types of loans, both to consumers and firms, at subsidized interest rates. These actions were part of two governmental programs, “*Bom pra todos*”, which was implemented by BB, and “*Caixa Melhor Credito*”, implemented by CEF.²⁰ The reasoning behind the implementation of the policy was that by increasing the amount of credit provided by government banks and charging lower interest rates the government would successfully increase competitive pressure on private banks. Facing additional competition, private banks would be forced to reduce loan interest rates in order to avoid losing customers. Achieving lower interest rates was a fundamental goal for economic policymakers in Brazil, who held the belief that lower interest rates were necessary for sustainable economic growth and would prevent a slowdown of economic activity.²¹

While the policy was widely advertised after its announcement, specific details about its implementation, coverage and duration were imprecise. Initially, each of the two banks indicated that minimum interest rates would be reduced for loan categories included in the program, along with funding amounts which were to be directed to the policy. However, it was not clear which borrowers would have access to the lowest interest rates, or if there were specific requirements to obtain public credit after the intervention.

4. THEORETICAL FRAMEWORK

The nature of the intervention is such that public banks were charging lower interest rates than private banks in similar products, while having a lower market share before the in-

¹⁹Source: IMF International Financial Statistics, available at <https://data.imf.org/regular.aspx?key=61545855>

²⁰The two programs were funded through a combination of equity and deposits, with total growing by about 10% for BB and 23% for CEF between 2012 and 2013, as can be seen in Appendix F Figure F.3.

²¹The former Brazilian President Dilma Roussef was particularly dissatisfied with high interest rates spreads - the difference between interest rates charged by banks and the base interest rate in the economy. In her labor day's speech, which took place after the intervention, she says "*The Brazilian economy will only be completely competitive when our interest rates (...) match the interest rates employed in international markets (...) It is unacceptable that Brazil, which has one of the most stable and profitable financial sectors in the world, continue to have one of the highest interest rates (...) Government owned banks proved that it is possible to reduce interest rates in loan operations, credit cards and even payroll loans. It is important that Private Banks follow suit*".

tervention. Given that the sudden increase in the amount of credit originated by public banks right at the beginning of the intervention was not accompanied by a decrease in average loan interest rates, this suggests public banks operate with a fixed supply of credit and ration some of their applicants.

The second important feature of the intervention is the differential between interest rates of private and public banks, and the emphasis on the attempted reduction of interest rates by private banks via competitive pressure by government banks. A long strand of the literature focused on credit markets assumes interest rates and borrower risk are connected. In particular, adverse selection models such as [Stiglitz and Weiss \(1981\)](#) and moral hazard models such as [Boyd and De Nicoló \(2005\)](#) and [Martinez-Miera and Repullo \(2010\)](#) incorporate the idea that lower interest rates *reduce* borrower risk. A different, less common approach is to assume that interest rates and borrower risk are negatively related ([De Meza and Webb \(1987\)](#), [Biswas and Koufopoulos \(2019\)](#)), in which case higher interest rates are associated with safer borrowers. These different approaches have important implications for the study of interventions in credit markets since they lead to different conclusions about the optimal amount of credit in the economy ([Mahoney and Weyl \(2017\)](#)).

We incorporate one view that lends support to the idea that, through an increase in public credit, governments can address problems related to inefficient provision of credit due to adverse selection problems. Then, we show that if the adverse selection hypothesis is relaxed, then government interventions are no longer welfare improving. Moreover, if we allow for the government banks to attract riskier firms, then interventions become welfare decreasing.

Adverse Selection The economy consists firms that want to finance investments and can be of two types: good and bad firms. Firms borrow to finance an investment with unit cost. If successful, good firms obtain a return Y_i , and bad firms obtain a return Y_B , which is fixed for all bad firms. We assume that $Y_B \geq Y_i \forall i$. While bad firms have greater return if they succeed, their probability of success is lower. In particular, we use p^B and p^G to denote the probability of failure of bad and good firms, respectively, and assume that $p^B > p^G$. Each firm knows its type, but a firm's type is unknown to either of the banks in the economy. There is a fraction γ of bad firms in the economy, which is public knowledge. We assume

that $p_G Y_i \geq c > p_B Y_B$ for all i , where c is the cost of funds for any banks in the economy. In other words, good projects have positive NPV and should be financed, while bad projects have negative NPV and should not be financed.

Notice that our assumption that bad firms have a higher return to their investment opportunities means bad firms will always obtain financing if credit is greater than zero in equilibrium. In other words, markets are characterized by *adverse selection*, with good borrowers having a lower propensity to borrow. In this economy more credit will always be welfare improving, since more credit increases the proportion of good borrowers which are able to finance their projects.

In the first stage, a public bank sets interest rates R_G and quantity \bar{q} . The demand faced by the public bank is given by:

$$\gamma + (1 - \gamma)P(Y_i \geq R_G) \geq R_G \quad (1)$$

We assume that the demand for loans from public banks is larger than \bar{q} . In other words, public banks will have to ration their applicants. We assume that public banks randomly select firms to have their applications accepted, until their capacity is met. Therefore, the probability of a firm that applies for credit from a government bank of having their application accepted is given by:

$$\pi_G(\bar{q}) \equiv \frac{\bar{q}}{\gamma + (1 - \gamma)P(Y_i \geq R_G)} \quad (2)$$

In the second stage, private banks provide credit for the remaining firms which did not obtained credit from public banks. Their residual demand for a given interest rate R is given by the share of bad, good and levered firms which are not able to obtain public funding *and* are willing to pay interest rates R . In particular, we have the following:

- Bad firms: For a given interest rate $R \geq R_G$, the residual demand of bad firms is given by $\gamma(1 - \pi_G(\bar{q}))$ if $Y_B \geq R$.
- Good firms: For a given interest rate $R \geq R_G$, the residual demand of good firms is given by $(1 - \gamma)(1 - \pi_G(\bar{q}))\text{Prob}(Y_i \geq R)$

Private banks face a cost fixed c when providing credit. Let $P(R) \equiv \frac{\gamma p_B + (1 - \gamma)p_G \text{Prob}(Y_i \geq R)}{\gamma + (1 - \gamma)\text{Prob}(Y_i \geq R)}$

denote the average probability of default faced by private banks when they charge interest R . One can show that $\frac{\partial p}{\partial R} > 0$, that is, the average probability of default faced by private banks is *increasing* in the interest rate R . This formalizes the adverse selection mechanism, whereby safer borrowers are attracted by lower interest rates.

In this case, one can show the following result:

Lemma 1. *If public banks randomly select firms to have their applications approved, then R , the equilibrium interest rate charged by public banks, is insensitive to \bar{q} .*

Proof: Appendix B

In other words, the optimal R *does not* depend on \bar{q} in this case, which means an increase in public quantities would not affect private banks' interest rates. Intuitively, since an increase in \bar{q} does not change the distribution of borrowers willing to pay a certain interest rate R , the interest rate that maximizes private banks' profit remains the same. Importantly, despite the fact that interest rates are not sensitive to \bar{q} , an increase in \bar{q} would still lead to an increase in welfare. In particular, we can show the following result:

Lemma 2. *In the presence of adverse selection an increase in \bar{q} increases the fraction of good firms which are able to obtain funding in equilibrium. In other words, an increase in \bar{q} is welfare increasing.*

Proof: Appendix B

This lemma illustrates that, in markets characterized by adverse selection, government interventions that lead to an increase in total credit are welfare improving since they allow more firms with positive NPV projects to finance themselves. In this context, total credit increases since the crowding out effect of an increase in \bar{q} is smaller than the increase in \bar{q} itself. Thus, there is an increase in total credit, which expands the amount of funding obtained by productive firms, allowing for more NPV positive projects to be financed.

Importantly, this result hinges on the idea that markets are characterized by a severe adverse selection problem, with the very riskiest firms always being financed whenever a good firm is financed. We now show that, if one relax this assumption then the welfare implications of an increase in public credit become sensitive to the average quality of firms borrowing from government banks in equilibrium.

No Selection In models with adverse selection government actions that allow for a larger number of firms to obtain credit are welfare increasing because the less productive firms always obtain credit in equilibrium. That way, an increase in the provision of credit will increase the amount of resources available for productive firms to finance their project, thereby increasing surplus. However, absent adverse selection, the implications for surplus are no longer straightforward.

Assume that bad borrowers have the same distribution of returns as good borrowers. In other words, letting Y_i^G and Y_j^B denote the returns of good and bad firms, respectively, we assume that $P(Y_i^G \geq R) = P(Y_j^B \geq R)$ for all R . In other words, for any interest rate R charged by private banks, the fraction of good and bad firms that obtains funding for their projects remains constant. Therefore the average probability of default faced by private banks is constant and given by $p \equiv \gamma p_B + (1 - \gamma)p_G$.

We continue to assume that the government bank will intervene in the market by increasing \bar{q} , that is, the provision of public credit, and keep interest rates R_G constant. As before, one can show that, in response to a change in \bar{q} , the interest rate charged by private banks remains constant. However, such an increase no longer necessarily leads to an increase in welfare. In particular, letting $F(i)$ denote the CDF of the returns of good and bad firms, we can show the following result:

Lemma 3. *Absent adverse selection, an increase in \bar{q} is welfare increasing if and only if $\int_{i(R_G)}^{i(R)} (p_B \gamma Y_i^B + p_G(1 - \gamma)Y_i^G - c) dF(i) > 0$. Moreover, for a sufficiently large $\gamma \in (0, 1)$, the intervention is welfare decreasing.*

Proof: Appendix B

Lemma 3 shows that when there is no selection, the effect of an increase in public credit depends on the sign of $\int_{i(R_G)}^{i(R)} (p_B \gamma Y_i^B + p_G(1 - \gamma)Y_i^G - c)$, that is, the average net present value of the firms who apply for public banks only. Moreover, if the fraction of bad firms is sufficiently large, then the average net present value of firms applying to government credit only is negative.²² Finally, the model also predicts that, in the case of adverse selection, public banks will finance *safer* firms, whereas without selection public and private banks finance firms which have similar risk. This is because the share of government credit that

²²Importantly, the lower the interest rate, the smaller the average NPV of firms who finance their projects with public credit, since the return of firms with a lower propensity to borrow is smaller.

is used to finance good firms is larger than the share of private credit used to finance good firms when there is adverse selection. Thus, average probability of default faced by the public bank is smaller. This is a testable implication that we investigate in our empirical analysis that follows.

5. THE EFFECTS OF THE INTERVENTION ON EQUILIBRIUM CREDIT

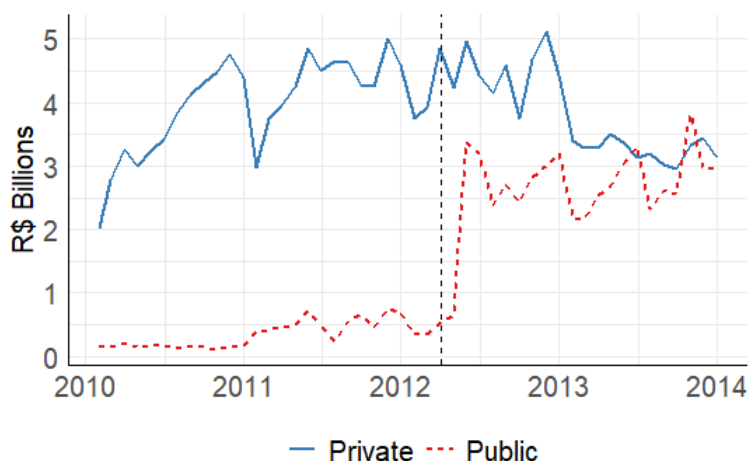
The intervention was designed to cause private banks to react to the increase in government provided credit, leveraging on the fact that the largest private and public banks were competing in similar locations. However, it is unclear how such policy affected private banks and which contract margins these institutions adjust. Moreover, theory suggest that the effectiveness of the intervention depends on economic forces that determine borrower risk. In this section we study how the intervention affected credit markets, looking at the aggregate effect on total credit, the response of private banks' interest rates and the trajectory of average borrower quality before and after the policy.

5.1. Aggregate Loan Amounts and Average Interest Rates

We start our empirical analysis investigating how credit originated by public and private banks behaved before and after the intervention. First, this is important for us to understand whether or not public banks successfully increase their lending, since additional supply by these government institutions would have to be met by borrowers in need of funds. Second, this analysis will also indicate the extent to which there was crowding out of private credit in response to the intervention. On the one hand, we might observe firms who borrow from private banks switching to public banks, leading to a decrease in the amount of credit supplied by private banks. On the other hand, private banks might adjust other contract characteristics, such as interest rates, to accommodate the increase in competition arising due to the policy implementation. Figure 1 shows the total amount of credit private and public banks lend per month:

The striking feature of Figure 1 is that, despite a sudden and large increase in public banks' lending right after the announcement of the intervention, this does not trigger an

Figure 1: Total Amount of Credit



Note: This figure shows the total sum of the contract amount of working capital loans originated by private and public banks each month. Source: SCR Database.

immediate reduction in loans originated by private banks, which is stable throughout most of 2012. Despite the fact that government banks had small market share prior to the intervention, state owned banks are able to rapidly increase their lending, without a large effect on the amount of credit provided by private banks or in their customer base. In particular, Appendix E Table E.1 shows that in response to a 1% increase in public banks' credit at the municipality level, private banks' credit falls by 0.02%. This translates into a 4% crowding out of private credit in response to the increase in supply of public banks during the intervention. Moreover, despite the increase in the availability of cheaper credit, very few firms switch from private to public banks.²³ This is in line with the idea that lending relationships are sticky and characterized by hold up issues (Petersen and Rajan (1994)).

One possibility is that public banks worked with a fixed credit supply and were rationing their applicants, which would explain how these banks were able to suddenly increase their loan origination. Additionally, to the extent that public banks can also internalize social benefits of lending, they can charge lower interest rates than private banks, thus facing larger demand for loans. This can help explain why borrowers who potentially were being rationed by public banks would not obtain loans from private banks.²⁴

²³Conditional on borrowing from private banks before the intervention, less than 10% of the firms borrow from public banks exclusively after the policy.

²⁴In terms of size distribution, firms borrowing from both private and public banks are usually micro and small firms, as can be seen in Appendix D Figure D.2.

The lack of effects of the policy in private credit amounts suggests that private banks adjusted other margins to compensate for the increase in competition, with one important margin being interest rates. To assess whether or not there are meaningful differences between pricing by private and public banks, we analyze average loan interest rates. The behavior of interest rates is relevant not only because it can provide additional evidence of credit rationing by public banks before the policy, but also because loan rates are a fundamental aspect of the policy. The reasoning supporting the implementation of the policy was that, by charging lower interest rates and increasing credit supply, public banks would increase competitive pressure on private banks, forcing these banks to respond by lowering their interest rates. Figure 2 shows the average interest rates of working capital loans of public and private banks:

Figure 2: Average Loan Interest Rates



Note: This figure shows the average yearly interest rates of uncollateralized working capital loans originated by private and public banks. Source: SCR Database.

The notion that public banks are able to provide loans at lower interest rates is evident in Figure 2. We can see that government banks provide substantially cheaper credit than private banks, both before and after the intervention. Moreover, the policy is followed by a large decrease in the interest rates of private banks. Despite such reduction, the difference in interest rates of private and public banks remains large after the intervention, with private loans on average 12.8pp more expensive before the intervention, and 7.4pp more expensive after the policy.²⁵ One possibility is that private banks are changing other margins of their

²⁵That difference is more pronounced in loans for small and micro firms, as can be seen in Appendix D

loan contracts, such as maturity and loan amounts. For example, private banks might offer loans at shorter maturities than they were prior to the intervention, and the overall effect of smaller interest rates would be reduced. Similarly, private banks can also extend loans with smaller amounts to their borrowers, which would also limit the extent to which the policy benefits firms who borrow from private banks. Appendix D Figure D.7 and Figure D.6 illustrate that there are no substantial differences in the distribution of maturities and loan size for private banks in the post period relative to the period prior to the intervention. This confirms that the main margin that private banks adjusted in response to the policy were loan interest rates.

While the aggregate evidence suggests private banks responded by reducing interest rates, there are many limitations to this aggregate analysis. Loan contracts have other characteristics that banks and firms agree on, and might justify higher interest rates by private banks. For example, private banks might provide longer maturity but demand higher interest rates. Another possibility is that, in order to access loans from public banks, firms have to provide collateral, or other guarantees which are might not be available for smaller firms. Finally, public banks might attract applicants with lower ex-ante risk (such as larger, consolidated firms), which are able to borrow at particularly low interest rates. In other words, in order to evaluate the effectiveness of the policy in forcing a reduction in private banks' interest rates, we have to focus on comparable loans, which we do next by exploring the details of our data.

5.2. Are Private Banks Reducing Loan Interest Rates?

At the core of the intervention is the government belief that private banks would respond to the additional competition by their public counterparts by reducing interest rates on their loans. The aggregate evidence in Figure 2 indicates that there was a reduction, but it was not enough to bring the difference between public and private banks' interest rates to zero. Importantly, these aggregate differences can reflect borrower or loan contract characteristics among which private and public banks differ in their lending decisions. To account for this possibility we leverage on the detailed structure of our data, which allows us to look at individual loan issuance, and compare loans issued by private and public banks before and

Figure D.3.

after the intervention, while controlling for firm and contract specific features and a broad range of fixed effects.

Our setup resembles a differences-in-differences specification, but with both types of banks being *treated* by the policy. This poses an additional challenge of isolating changes in such difference that arise because of the intervention, since in general average differences between interest rates of public and private banks, even for comparable borrowers using comparable contracts, can indicate changes that are not associated with the policy. However, the context of our analysis allow us to confidently state that there are no other systematic shocks that could cause meaningful changes in the difference between private and public interest rates. In particular, there are no large mergers, bank failures or other macroprudential policies which would differently affect different banks. Furthermore, the absence of financial crisis means we do not have to worry about the different behavior of private and public banks during such episodes, which could also explain observed changes in the difference between interest rates. Therefore our identification hypothesis is that, given the absence any systematic shocks that differently hit private and public banks, changes in the difference between private and public banks' interest rates are caused by the intervention. Formally, we estimate Equation 3:

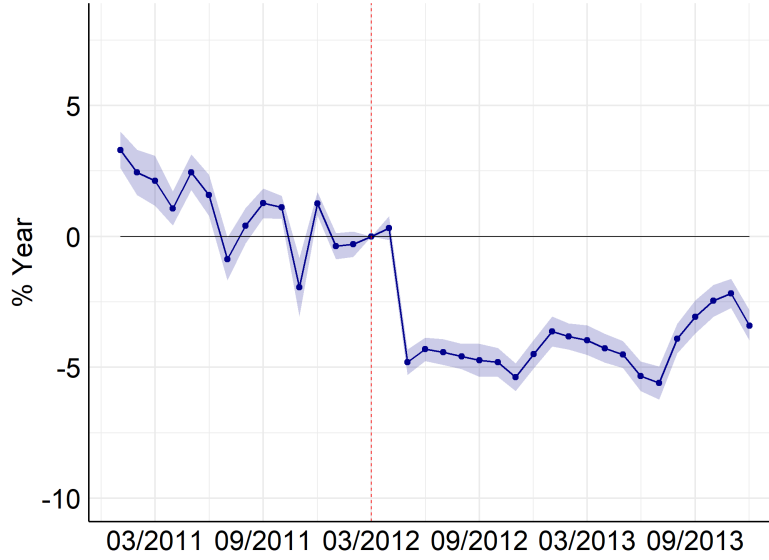
$$i_{jtmf} = \sum_{\tau=1}^m \delta_{-\tau} \times Private_b + \sum_{\tau=1}^q \delta_{\tau} \times Private_b + \alpha_{mti} + \alpha_{bank} + \alpha_{t,j(maturity)} + \alpha_{t,f(size)} + \varepsilon_{jtmf} \quad (3)$$

Where i_{jtmf} denotes the interest rate of a loan issued in month t , municipality m , by bank b to firm f , $Private_b$ is a dummy equal to 1 if bank b is a private bank, and α_{mit} , α_b , $\alpha_{t,j(maturity)}$ and $\alpha_{t,f(size)}$ are fixed effects. The use of a broad range of fixed effects guarantees that we are comparing loans in the same region, month and for firms of the same industry, and that bank specific characteristics are also accounted for. Additionally, time-maturity and time-size fixed effects guarantee we are comparing loans with the same maturity for firms with the same size. In summary, this specification guarantees our results are also not capturing portfolio re-balancing changes in response to the policy.²⁶ The results are shown

²⁶Since there were very few operations in 2010 for uncollateralized loans originated by public banks, we chose to restrict the delinquency analysis to 2011 onward. This still gives us more than one year prior to the intervention and allows us to understand trends for public and private banks before the policy was implemented.

in Figure 3:

Figure 3: Differences in Differences - Interest Rates



Note: Regression estimates for δ_t from equation 3 at the loan level, with March 2012 as the reference month, weighted by loan amount. Dependent variable i_{jtmfb} is the interest rate of a loan j issued in municipality m , month t , from bank b to firm f . Standard errors clustered at bank-municipality level. Coefficients include 95% confidence interval.

The results in Figure 3 indicate that, despite a linear trend prior to the intervention, interest rates of private banks fall sharply relative to the interest rates of public banks after the policy. The large reduction in November 2011 can be associated with industry specific trends in sectors that rely on working capital loans to pay for end of year wage expenses. In particular, in Appendix D Figure D.8, we show that if one adds time, municipality and industry fixed effects *separately* in Equation 3, the coefficient associated with November 2011 falls by half, without any meaningful changes in our coefficients of interest after March 2012. Appendix E Figure E.2 shows that the spread between public and private banks' interest rates falls around 5 percentage points, a reduction of about 33% of the pre-policy interest rate spread between private and public interest rates. The results are also robust to the inclusion of a private bank specific linear trend, as shown in Appendix D Figure D.9, and indicate that the competition shock caused by the increase in supply by public banks

caused a reduction in private banks' interest rates.²⁷

The results so far indicate that private banks responded to the increase in competition generated by the policy by reducing their loan interest rates, although a large spread between average loan rates of public and private banks persisted even after the intervention. Additionally, given the magnitude of the increase in government provided credit, one might expect changes in average borrower quality as a result of the intervention. One hypothesis is that, by targeting certain types of borrowers, public banks distort optimal allocation of credit and subsidize risky borrowers after the intervention. Alternatively, theoretical models predict that, in the presence of some form of selection, differences in interest rates would lead to differences in the quality of the borrowers of each type of bank. A final possibility is that public banks have worse screening standards, leading them to finance firms which are less productive and riskier than firms financed by private banks both before and after the intervention. In particular, if public banks absorb riskier firms, this would also allow for interest rate reductions by private banks, as private banks would be lending to an overall safer pool of borrowers.

5.3. Public Banks and Private Banks Borrower Risk

We have seen that private banks charge higher interest rates than public banks, both before and after the intervention, and that the policy led to an expansion in the number of firms with access to working capital loans. Both characteristics - differences in interest rates, along with expansion credit supply by public banks - can lead to changes in the risk that banks bear in their loan portfolio. Differences in borrower risk can be a result of different economic mechanisms, which have different implications regarding the desirability of the policy. One possibility is that public banks use the intervention to subsidize levered firms with whom they have relationships. Importantly, if these are unproductive firms which can only stay afloat by relying on funds obtained during the intervention, this would lead to a deterioration of loan portfolio quality for public banks once the policy ends. Alternatively, worse borrower quality for public banks can also be caused because these banks are less efficient in their screening process than private banks. Consequently, expand credit

²⁷Appendix E Table E.4 shows that interest rates reductions occurred even in locations with only private bank branches, and that micro and small firms face larger reductions than medium and large firms.

using these banks would further increase problems associated with allocating credit through government controlled institutions. In both cases the intervention is undesirable, since it allows unproductive firms to obtain funds that would otherwise be better allocated to other, more productive firms.

A different possibility is that markets are be characterized by the presence of adverse selection, in which case there is not enough credit in equilibrium. Importantly, given the differences in interest rates between public and private banks, one would expect public banks to attract safer borrowers than private banks, both before and after the intervention. Intuitively, borrowers with low propensity to borrow would be interested in borrowing only from public banks, which charge lower interest rates. To the extent that such propensity to borrow is correlated with unobserved risk, as in adverse and advantageous selection models, we expect borrowers of private and public banks to have different risk. Importantly, in adverse selection models, the intervention is desirable since it increases the fraction of productive firms that receive credit in equilibrium, and by reducing overall loan portfolio risk since it causes private banks to reduce their interest rates.

The first step to understand how the intervention affected risk is to compare the trajectory of borrower risk for public and private banks, before and after the policy. To do that, we rely on information about loan delinquency which we obtain from the credit registry data. In particular, we say a firm which borrowed in a particular month with a certain bank is delinquent if either of the loans to that firm in that particular month became delinquent for more than 90 days withing a year after origination.²⁸ For example, if a firm obtains a loan in May 2012, we track that firm's delinquency amounts until May 2013. If such a firm fails to pay its loan instalments for at least 90 days, we define such firm as a delinquent for loans it contracted in May 2012.

It is worth pausing for a moment to understand the implications for our measure of risk. Since we track loans for a period of one year, loans originated in different months will be exposed to different economic shocks that will likely reflect higher or lower default. For example, a loan issued in March 2013 will be exposed to economic shocks happening in early 2014, while the same is not true for a loan issued in March 2011. Thus, differences in delinquency trajectories will also reflect different shocks affecting firms over time. For that

²⁸The choice of 90 day cutoff follows other papers in the literature, such as [Jiménez et al. \(2014\)](#) and [Jiménez et al. \(2019\)](#)

reason in our analysis of delinquency we jointly analyze public and private banks, since borrowers of both types of banks will be subject to the same systematic shocks, conditional on borrowing on the same month.

We first analyze the individual average delinquency over time for private and public banks, in order to evaluate parallel trends and to understand how private and public banks' borrower quality evolves over time. Formally, we estimate the following specification:

$$I_{tmf}^D = \alpha_{mj} + \alpha_b + \sum_{\tau=1}^m \delta_{-\tau} + \sum_{\tau=1}^q \delta_{\tau} + \varepsilon_{tmf} \quad (4)$$

Where I_{tmf}^D is a dummy equal to 1 if a loan originated by firm f located in municipality m in month t borrowed from bank b becomes delinquent within one year after origination, α_{tmj} and α_b are time-municipality-industry and bank fixed effects and δ_{τ} is a dummy equal to 1 in month τ . Each δ_{τ} indicates the average delinquency probability relative to March 2012, our baseline date. We estimate equation 4 for public and private banks separately, and show the specific time coefficients δ_{τ} with standard errors in Figure 4. Interestingly, prior to the intervention public and private banks have very similar delinquency trajectories, despite large differences in the average interest rate of their borrowers. However, after the intervention public banks experience a deterioration of their loan portfolio, while private banks' borrower quality remains mostly stable.²⁹

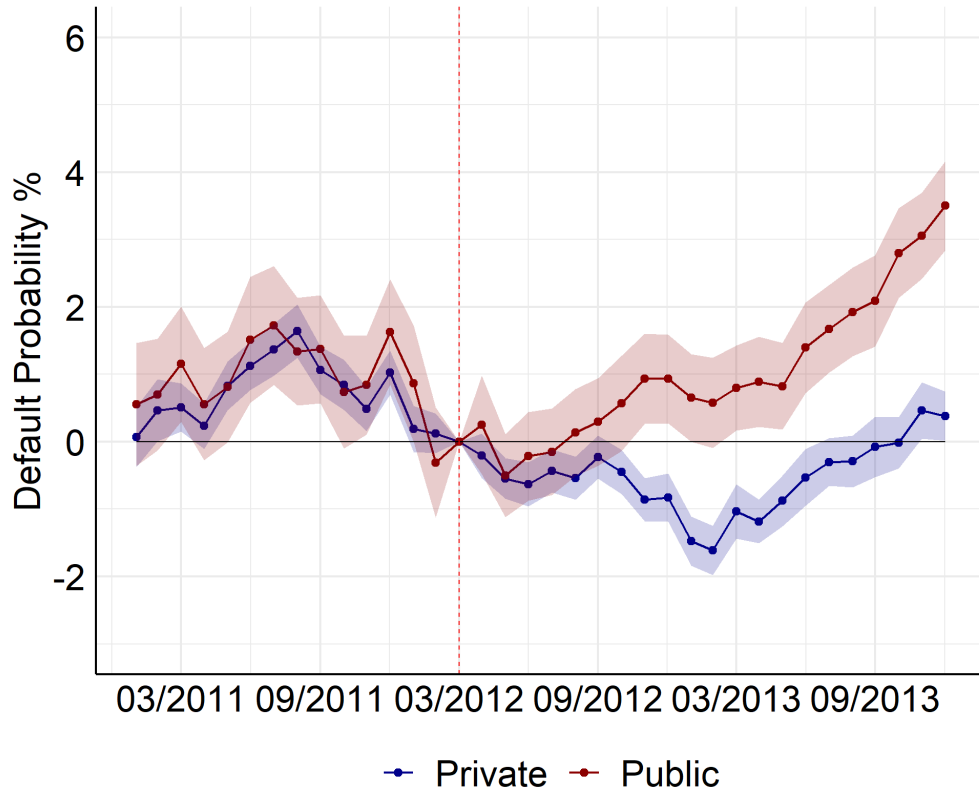
To formally test average delinquency differences between private and public banks for comparable borrowers obtaining loans in the same month, we estimate the following specification:

$$I_{tmf}^D = \alpha_{mti} + \alpha_b + \sum_{\tau=1}^m \delta_{-\tau} \times Public_b + \sum_{\tau=1}^q \delta_{\tau} \times Public_b + \varepsilon_{tmf} \quad (5)$$

Where I_{tmf}^D is a dummy equal to 1 if a loan originated by firm f located in municipality m in month t borrowed from bank b becomes delinquent within one year after origination, α_{tmj} and α_b are time-municipality-industry and bank fixed effects, $Public_b$ is a dummy equal to 1 if bank b is a public bank, δ_{τ} is a dummy equal to 1 in month τ . Importantly, the use of time-municipality-industry fixed effects guarantees that the differences in delinquency not

²⁹As the intervention was widely advertised within the country, it is possible that it helped raise awareness about the low interest rates of private banks, ultimately attracting more borrowers with lower propensity to borrow to public banks.

Figure 4: Differences in Average Borrower Delinquency



Notes: Results for the δ_τ from the estimation of Equation 4 for public and private banks separately. Dependent variable I_{tmf}^D is a dummy equal to 1 if a loan originated by firm f located in municipality m in month t borrowed from bank b becomes delinquent within one year after origination. Coefficients include 95% confidence interval. Standard errors are clustered at the bank-municipality level.

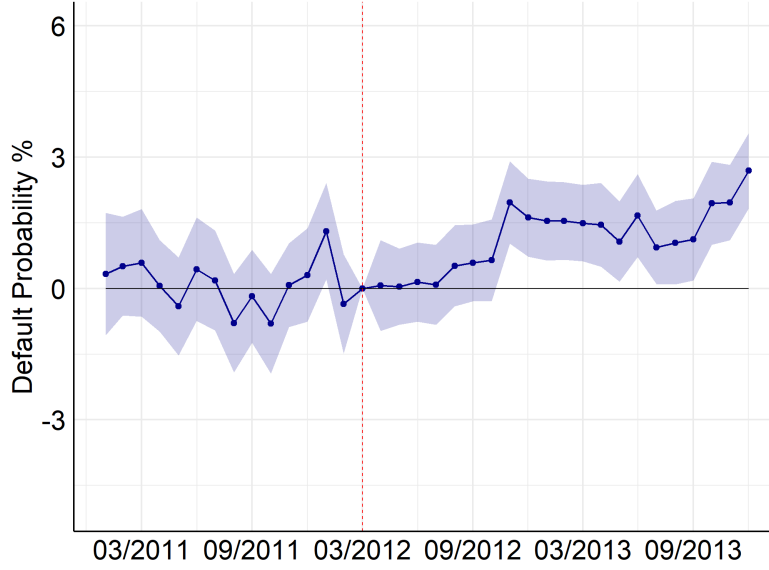
explained by shocks that affect firms in the same location, that operate in similar industry, in the same month.³⁰ The results are shown in Figure 5:

Relative to private banks, public banks experience *higher* delinquency rates after the intervention, despite the fact that private banks charge substantially larger interest rates across all years in the sample. In particular, after the policy, loans originated by public banks had between 130 and 70 basis points higher probability of becoming delinquent relative to loans originated by private banks, as shown in Table E.3 in Appendix E.

The evidence obtained from average borrower delinquency for public and private banks

³⁰One implication of the use of these controls is that our results are not explained, for example, by the fact that public banks entered many new locations during the policy.

Figure 5: Differences in Differences: Borrower Delinquency



Notes: Results for the δ_τ from the estimation of Equation 5. Dependent variable I_{tmbf}^D is a dummy equal to 1 if a loan originated by firm f located in municipality m in month t borrowed from bank b becomes delinquent within one year after origination. Coefficients include 95% confidence interval. Standard errors are clustered at the bank-municipality level.

casts doubt on the idea that an asymmetric information mechanism that generates a negative relationship between interest rates and borrower quality is at play. In particular, despite lower interest rates, government banks attract borrowers with similar risk as private banks' borrowers after the intervention, and experience a deterioration of their borrower quality after the policy started. This can also indicate that the policy was associated with a relaxation of lending standards by government banks.³¹

6. INTERVENTION DRIVEN INCREASES IN RISK

The results so far are consistent with the idea that public banks financed riskier borrowers after the intervention, but are not necessarily less efficient than private banks when it comes to borrower screening since delinquency rates are comparable pre-policy. Moreover, to the

³¹This is similar to evidence from Jiménez et al. (2019) studying a similar policy implemented in Spain, where public banks accepted applications from borrowers with a lower credit score than did private banks.

extent that the average propensity to borrow of firms who borrow from public banks is lower than the average propensity to borrow of firms who borrow from private banks, the trajectory of borrower risk observed after the intervention is hard to reconcile with adverse selection, since public banks lend to worse borrowers despite charging lower interest rates.

However, it is not clear whether or not public banks adopted lower lending standards as part of the intervention, or if they engaged in zombie lending by lending to levered firms which eventually fail to pay loans that help them stay afloat. [Jiménez et al. \(2019\)](#), for example, document that public banks accept applications from borrowers with worse credit scores in a similar intervention implemented in Spain, and that the intervention was nevertheless efficient from a social welfare perspective. Another possibility is that markets are characterized by advantageous selection, where worse borrowers have lower propensity to borrow, and the differences only became apparent after public credit became large relative to total credit. Finally, one cannot rule out the possibility that loan markets in Brazil are still characterized by adverse selection, but with public banks less effective at screening and ultimately attracting knowingly riskier applicants. To rule out these alternative explanations we explore the details of our dataset, which allows us to track borrowers over time and divide firms according to their past relationships.

6.1. Are Public Banks Subsidizing Specific Firms?

The results in table [E.3](#) suggest that debt plays a significant role in explaining delinquency. Thus, we start by dividing firms between levered and unlevered, and investigate whether or not banks price discriminate between these different types of firms. We define a firm as a levered firm if that firm has positive debt outstanding at the beginning of the month in which it borrows.³² Therefore bank loans are the only source of external debt for most firms in our sample. The division between levered and unlevered firms allows us to draw connections to the literature that studies zombie lending, where zombies defined as inefficient, less productive firms which borrow at subsidized interest rates, such as in [Acharya et al. \(2020\)](#). In our context, if public banks engage in zombie lending, they will subsidize levered firms by charging lower interest rates than what they charge from unlevered firms. Importantly,

³²This definition incorporates the notion that the vast majority of Brazilian firms, including firms in our sample, does not have access to capital markets to finance themselves.

this is an additional advantage for these firms, since as we have seen before state owned commercial banks charge lower interest rates than private banks in comparable loans.

One important aspect to keep in mind is that, since the majority of the unlevered firms in our sample are new borrowers who have no previous lending relationship with banks, differences between levered and unlevered borrowers might reflect differences between new and old firms. The relationship lending literature ([Ioannidou and Ongena \(2010\)](#)) indicates that old borrowers might pay large interest rates than new borrowers, and that can potentially bias our results. Therefore, to understand the extent to which banks discriminate between new and old borrowers, we divide unlevered firms between new and old, and test for pricing differences for these clients as well. Since firms can be more or less levered, we also compare, within the subset of levered firms, the interest rates paid by more levered firms relative to less levered firms. Finally, we also analyze differences between firms with bad credit history and other firms.

Formally, we estimate the following regression separately for public and private banks to investigate if the intervention is associated with different pricing strategies for these institutions:

$$i_{tmbf} = \alpha_{tim} + \alpha_b + \beta_0 \times Type + \beta_1 Post_t \times Type + \Gamma_1 \mathbf{X}_{tmbf} + \varepsilon_{tmbf} \quad (6)$$

Where $Type$ is either of the two options in each pair $\{levered, unlevered\}$ and $\{old, new\}$, or the relative debt over payroll quintile of firm f . We estimate the regression in equation 6 for public and private banks separately. We include a series of time-varying loan and firm specific controls to isolate the differences in pricing due to the individual characteristics we are testing. The results are shown in Table 2:

Column (1) in Table 2 shows that the reduction in interest rates of private banks caused by the policy is 1.2 pp. larger for unlevered firms after the intervention. In other words, unlevered firms pay *smaller* interest rates than levered firms when borrowing from private banks after the policy. Column (2) shows that firms with pre-existing relationships with private banks experience smaller reduction in their loan interest rates after the intervention. These results are consistent with the idea that old, levered firms are expected to pay higher interest rates in equilibrium, and that the increase in competition faced by private banks leads to larger gains for new borrowers. To the extent that lending relationships are sticky,

Table 2: Interest Rate Sensitivity - Private Banks

	Private Banks		Public Banks	
	(1)	(2)	(3)	(4)
Debt	0.511*** (0.0838)		0.0354 (0.139)	
Post × Debt	1.246*** (0.0663)		0.00558 (0.148)	
Old		-0.621 (0.350)		0.162 (0.825)
Post × Old		1.541*** (0.371)		-0.768 (0.924)
Firm Group	All	Unlevered	All	Unlevered
Time × Ind × Mun FE	✓	✓	✓	✓
Bank FE	✓	✓	✓	✓
R ²	0.581	0.627	0.514	0.680
Observations	1725178	330369	787623	38880

Standard errors in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Notes: This table shows the results of the estimation of Equation 6 including loans issued by private banks only. Controls \mathbf{X}_{tm} include: Maturity Categories, Rating, firm ownership dummies, log of number of employees, log of estimated revenue. Standard errors are clustered at the bank-municipality level.

private banks had to adjust interest rates for older customers less after the policy. The results are different for loans issued by public banks. Columns (3) and (4) indicate that public banks do not price discriminate between firms with positive debt outstanding and unlevered firms, or firms with existing relationships and new firms.

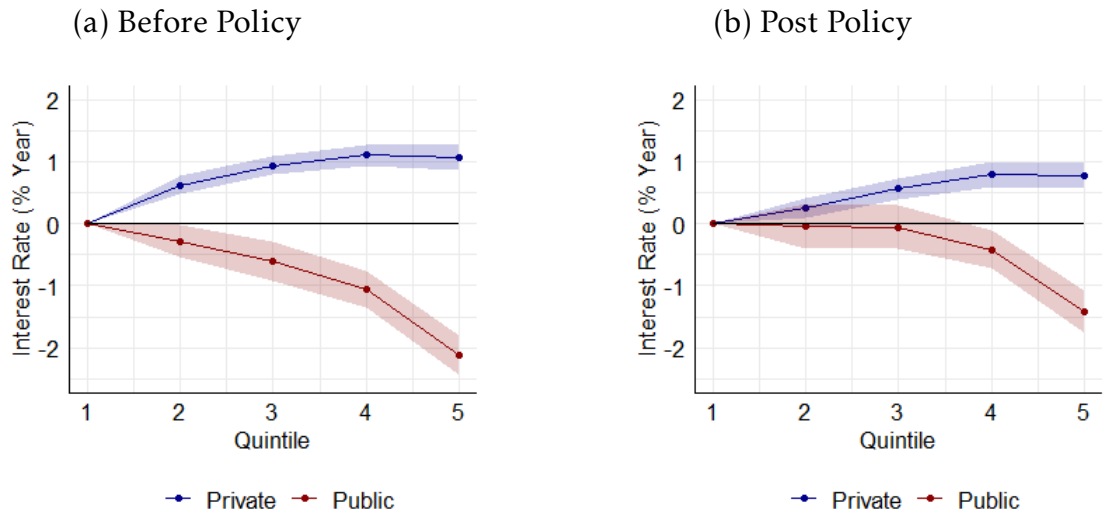
While the results in Table 2 suggest levered firms would benefit from comparatively lower interest rates when borrowing from public banks due to the lack of discrimination between levered and unlevered firms in loans issued by government institutions, we can further explore how differences in leverage are priced by these banks. We do so by dividing our sample into quintiles of our leverage proxy, the ratio of total outstanding debt to payroll costs. We then estimate the following regression:

$$i_{tmbf} = \alpha_{tim} + \alpha_b + \sum_l \beta_l \times Ind_f^l + \Gamma_1 \mathbf{X}_{tmbf} + \varepsilon_{tmbf} \quad (7)$$

Where Ind_f^l are dummy variables equal to 1 if firm f belongs to the l quintile, where $l \in \{2, 3, 4, 5\}$. The coefficient β_l in equation 7 captures the average difference in the interest

rates between firms in the bottom quintile of the leverage proxy distribution and firms in the l quintile of the same distribution. This informs us if banks charge different interest rates for firms based on how levered they are. We estimate the specification above separately for private and public banks, and both before and after the intervention, to capture potential changes that were caused by the policy. We add firm and loan level controls to minimize the possibility that we capture variation related to a different variable. The results are show in Figure fig:int_{leverage} :

Figure 6: Delinquency Trends By Borrower Type

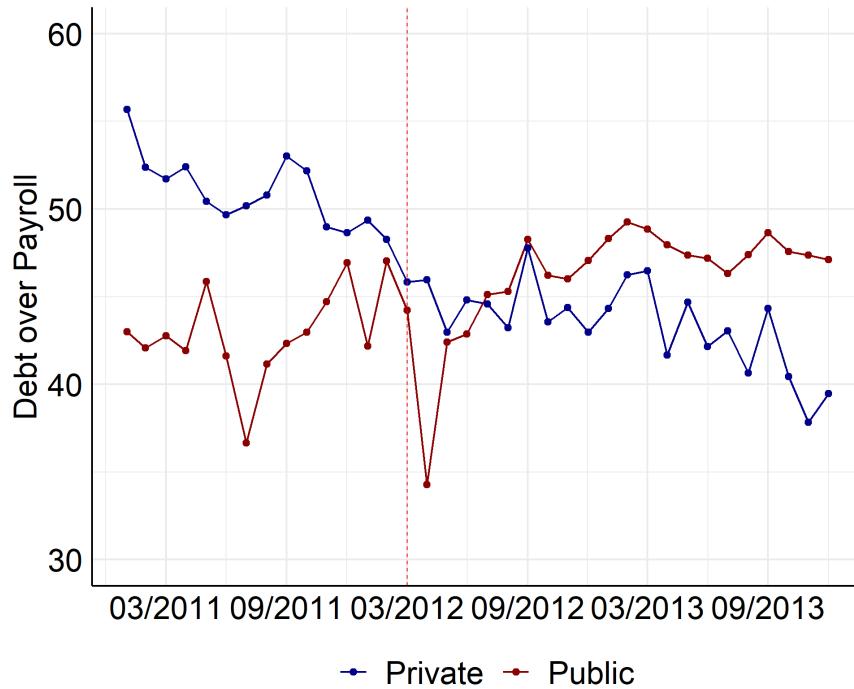


Notes: Results for the β_l from the estimation of Equation 7 for public and private banks separately. Controls X_{tmf} include: Maturity categories, rating, firm ownership dummies, log of number of employees, log of estimated revenue. Standard errors are clustered at the bank-municipality level.

A related question is whether or not the subsidies provided by government banks to levered firms leads to an increase in average firm leverage after the intervention. Another possibility is that the policy also led to a change in the composition of government banks' loan portfolio towards levered firms. To answer the first question, we use a leverage proxy, given by total debt outstanding divided by total payroll costs. Firms with more assets are more likely to have more payroll costs, and our measure should capture changes in leverage over time. Figure 7 shows the ratio of debt outstanding over payroll costs for public and private banks during the implementation of the policy:

While firms who borrow from private banks are in general more levered than firms who borrow from government banks prior to the policy, there is a clear shift in the composition

Figure 7: Debt Over Payroll Costs - Public and Private Borrowers

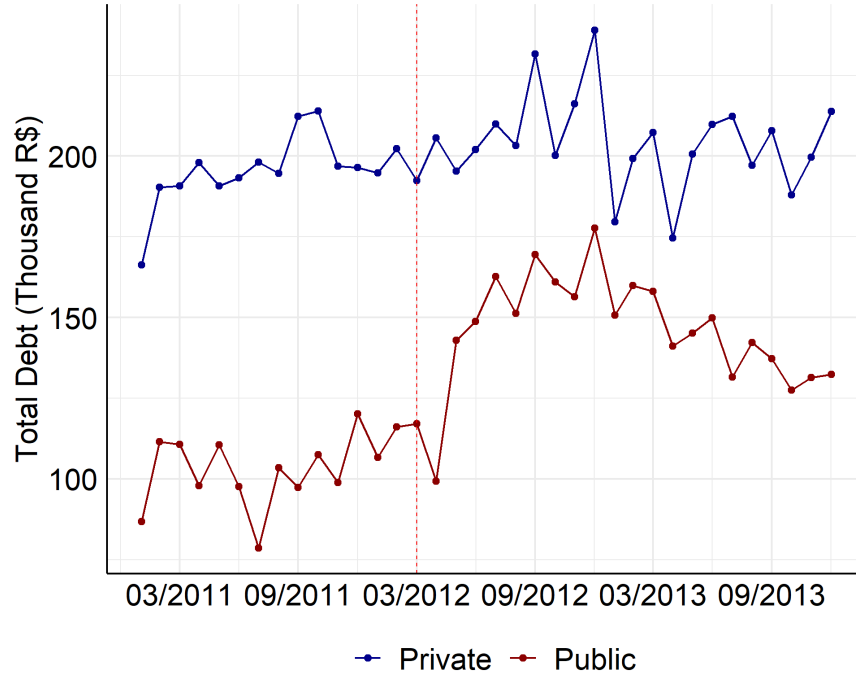


Note: This figure shows the average total amount of debt outstanding over total payroll costs for firms that borrow from public and private banks. Source: SCR Dataset and RAIS Dataset.

of public banks' loan portfolio after the beginning of the policy. Firms borrowing from public banks have a debt over payroll costs ratio 7% larger after the intervention relative to prior to the intervention. To answer the second question, of whether or not there is some portfolio changes by public banks towards more levered firms, we study the amount of debt outstanding for other types of credit of firms borrowing from private and public banks. We focus on other types of credit to avoid a mechanic relationship between loan origination and debt outstanding. This analysis indicates that public banks shift the composition of their loans portfolio towards firms with more debt outstanding in other types of loans excluding working capital, as can be seen in Figure 8:

Overall, the evidence is consistent with public banks providing subsidies for levered borrowers, which became more levered after the intervention. Our main hypothesis is that this change in the loan portfolio of public banks towards more levered firms, along with an increase in the leverage of such firms, led to an increase in riskiness that ultimately can

Figure 8: Total Debt Outstanding - Other Types of Credit



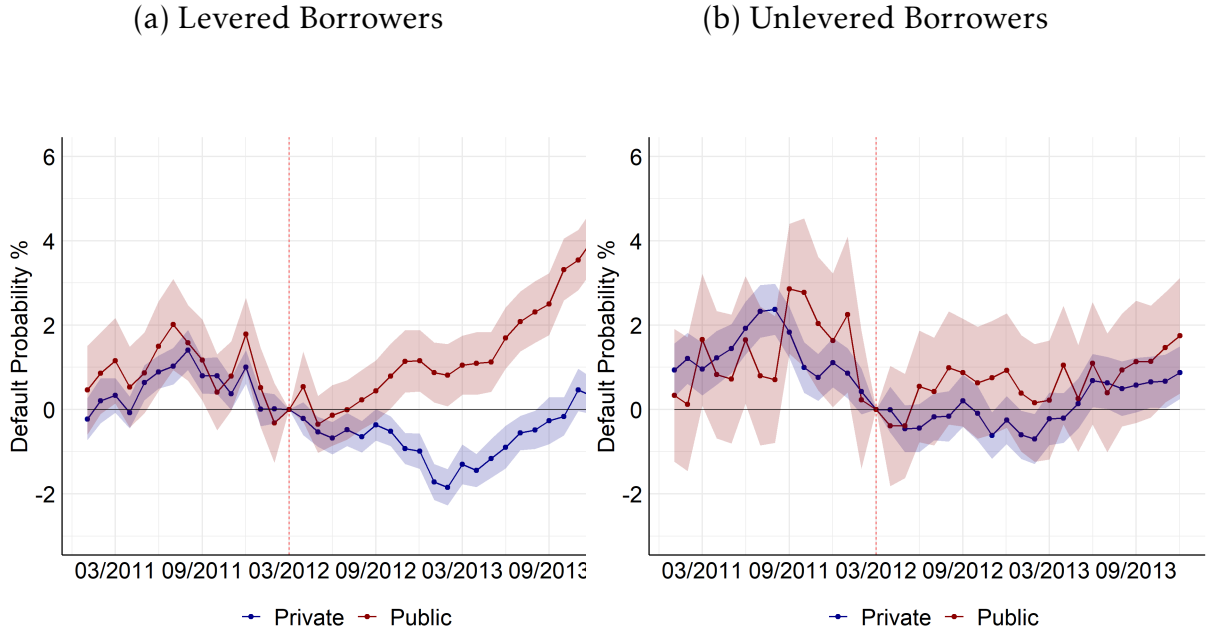
Note: This figure shows the total amount of debt outstanding in other types of credit for firms borrowing from private and public banks over time. Source: SCR Dataset.

explain the patterns observed in Figure 4. We explore risk differences for levered and unlevered firms in the next section.

6.2. Levered and Unlevered Firm Risk

Our hypothesis that government banks subsidized riskier firms after the intervention requires levered firms to bear more risk than unlevered firms when borrowing from such banks. Alternatively, if public banks have lower screening standards or are clearing the market for private banks by absorbing riskier firms, both types of firms will have worse quality relative to private bank borrowers after the policy. We redo our analysis of public and private banks' borrower quality over time, estimating equation 4 for each group separately. The estimates for the coefficients δ_t and the respective standard errors are shown in Figure 9:

Figure 9: Delinquency Averages By Borrower Type



Notes: Results for the δ_τ from the estimation of Equation 4 for public and private banks separately. Each panel estimates the regression for levered and unlevered borrowers separately. Dependent variable I_{tmbf}^D is a dummy equal to 1 if a loan originated by firm f located in municipality m in month t borrowed from bank b becomes delinquent within one year after origination. Coefficients include 95% confident interval. Standard errors are clustered at the bank-municipality level.

Figure 9 Panel (a) that levered borrowers of state owned banks become delinquent more often than those of private banks after the policy. In contrast, Panel (b) shows that new borrowers of public and private banks have comparable risk, both before and after the policy. This indicates that levered firms which obtain government provided credit during the intervention have worse quality than levered firms who borrow from private banks. Furthermore, we can rule out the hypothesis that government banks relaxed their credit standards for all borrowers as part of the policy, since new borrowers of both public and private banks have similar risk.

Our working hypothesis is that, by providing loans to firms with positive debt outstanding, public banks exposed themselves to more borrower delinquency risk. This view incorporates the notion that more levered firms are more likely to become delinquent. To understand whether or not this is indeed the case, we test if our leverage proxy measure, total debt outstanding divided by total payroll costs, affect borrower delinquency. In par-

ticular, we divide firms in 5 bins according to their position in the distribution of leverage, and estimate the following regression:

$$I_{tmbf}^D = \alpha_{tim} + \alpha_b + \sum_l \beta_l \times Ind_f^l + \varepsilon_{tmbf} \quad (8)$$

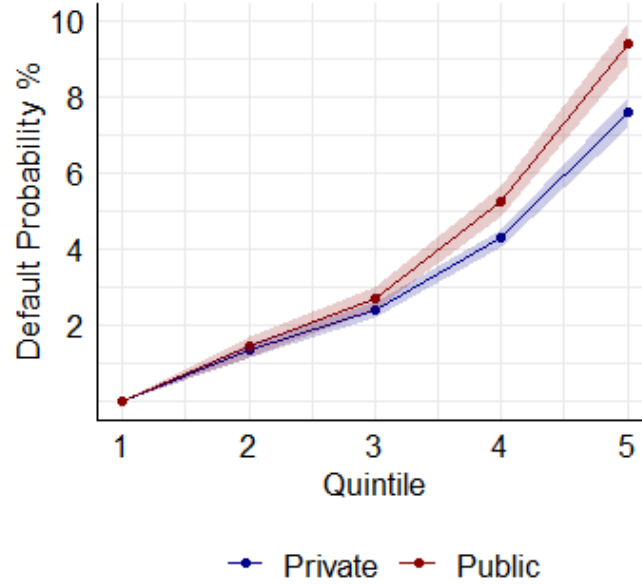
Where Ind_f^l are dummy variables equal to 1 if firm f belongs to the l quintile, where $l \in \{2, 3, 4, 5\}$. Therefore the coefficient β in equation 8 captures the average delinquency difference between firms in the bottom quintile of the leverage proxy distribution and firms in the upper quintiles of the same distribution. Importantly, we restrict this analysis to firms with positive leverage, so our results are not contaminated by differences in riskiness of levered and unlevered firms, and focus only on the post intervention period. The results are shown in Figure 10. We can see that delinquency increases monotonically in leverage quintiles, indicating that firms with more leverage are more likely to become delinquent, with the difference being economically significant. In particular, firms in the bottom quintile of leverage are 8.5% more likely to become delinquent than firms in the bottom quintile. Furthermore, this effect is larger for public banks than for private banks, which indicates that leverage plays a central role in explaining the relative differences between public and private banks' borrower default risk.

Finally, to further rule out potential adverse or advantageous selection, we test for delinquency differences between new and old borrowers. In particular, we know from Table 2 that private banks charge lower interest rates from new borrowers relative to old borrowers which are unlevered. If risk differences are explained by adverse/advantageous selection, new borrowers would be *safer/riskier* since these borrowers are more likely to have low propensity to borrow. However, if leverage is the main factor contributing to risk differences, these borrowers would have comparable risk since we condition on borrowers without debt outstanding. We test this hypothesis by estimating the following regression:

$$I_{tmbf}^D = \alpha_{tim} + \alpha_b + \beta_0 Old + \varepsilon_{tmbf} \quad (9)$$

Where I_{tmbf}^D is a dummy equal to 1 if the firm f in municipality m becomes delinquent in a loan issued at time t from bank b , and Old is a dummy equal to 1 for old borrowers. The results are shown in Table 3. Importantly, there are no meaningful differences in the risk of

Figure 10: Delinquency Differences - Leverage



Note: This figure shows the coefficients of regression 8. Dependent variable I_{tmf}^D is a dummy equal to 1 if a loan originated by firm f located in municipality m in month t borrowed from bank b becomes delinquent within one year after origination. The leverage proxy is calculated using firm outstanding debt at the beginning of month t divided by the firms' total payroll cost in that month. Coefficients include 95% confidence interval. Standard errors are clustered at the bank-municipality level.

new and old borrowers. To the extent that old and new borrowers have different propensities to borrow since they face exogenously different interest rates, this indicates that borrowers with different propensities to borrow do not have different unobserved risk, going against the idea that adverse or advantageous selection can explain differences between riskiness of public and private banks.

All in all, our results indicate that by subsidizing lending by levered firms, government banks increased the riskness of their loan portfolio, which led to a deterioration of their credit quality over time. This is consistent with the idea that public banks, when facing a relaxation of their capacity constraints, provided more loans to unproductive indebted firms, which became more levered and, consequently, more likely to default on their debt obligations. Importantly, our results are also consistent with the hypothesis that state owned banks engaged in zombie lending during the policy.

Table 3: Delinquency Differences - Old and New Borrowers

	Private	Public
Old Borrowers	-0.000290 (0.00307)	-0.00215 (0.00323)
Time \times Ind \times Mun FE	✓	✓
Bank FE	✓	✓
R ²	0.219	0.272
Observations	152593	91648

Standard errors in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Notes: Results from the estimation of equation 9. Dependent variable I_{tmbf}^D is a dummy equal to 1 if a loan originated by firm f located in municipality m in month t borrowed from bank b becomes delinquent within one year after origination. Coefficients include 95% confidence interval. Standard errors are clustered at the bank-municipality level.

7. REAL EFFECTS OF THE INTERVENTION

Our results so far indicate that, by increasing credit supply during the intervention, government banks subsidized levered firms which eventually became delinquent and led to a deterioration in these banks' loan portfolio. If indeed these firms are zombies and are not using the funds they acquire to finance productive investments, we would expect limited real effects from the increase in credit supply. Conversely, if these are ex-ante riskier firms with productive investment opportunities, one would expect to see differences in output where the expansion of government credit was the largest. In other words, the policy might have caused real effects such as GDP or employment growth due to an *extensive* margin associated with more credit to new borrowers and borrowers without access to working capital loans prior to the intervention. Importantly, the policy could also lead to real effects through an *intensive* margin, whereas firms borrowing from private banks experienced a reduction in their interest rates that is *not* explained by other economic shocks to their ability to generate cash flows, such as regional or industry specific shocks. This exogenous reduction in interest rates can lead to more investment if such firms are constrained by the interest rates they pay in their loans. In other words, there are two margins through which the policy could have had real effects in the Brazilian economy, which we explore below.

7.1. Extensive Margin of Credit

To understand how the intervention might have had real effects, we ask whether or not the increases in public credit that were part of the policy led to more economic growth. A natural way to approach this question is to compare municipalities with different levels of exposure to the intervention and compare the trajectory of GDP in these locations. The challenge is to obtain a plausibly exogenous variation in exposure to the policy that takes into account the potential endogeneity of credit allocation by public banks. In particular, one cannot simply regress municipality GDP on public credit, for example, since public banks might be targeting municipalities where growth prospects are particularly weak. In this case, our regressions would be downward biased and more likely point out to a lack of real effects of the credit expansion.

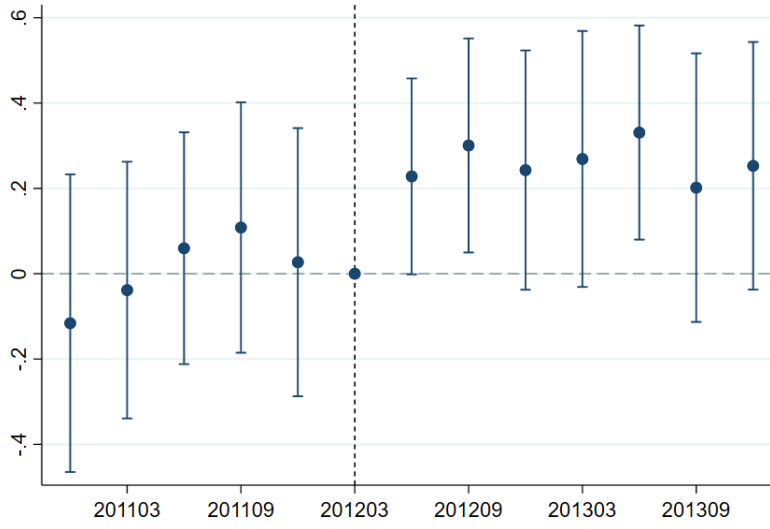
To address these concerns, we explore institutional features of the Brazilian banking sector. Specifically, we leverage on the fact that most municipalities that had only private or only public banks by 2010 were the result of privatization processes that took place several years before. In other words, the entry decision of public and private banks took place several years before the intervention took place. This alleviates concerns that we are capturing banks location decisions that might be correlated with other contemporaneous economic shocks. First, we estimate the following regression:

$$\Delta credit_{tmr} = \alpha_m + \alpha_{tr} + \sum_{-1}^m \delta_\tau Pub_m + \sum_1^q \delta_\tau Pub_m + \varepsilon_{tmr} \quad (10)$$

Where $\Delta credit_{tmr}$ denotes log of total working capital loans originated in municipality m , quarter t and micro region r , α_m and α_{tr} are municipality and micro region-time fixed effects and Pub_m is a dummy equal to 1 if a certain location has only government bank branches. We limit our analysis to municipalities that have branches of only one bank - either a public bank, or a private bank. Equation 10 can be seen as a first stage analysis where we test whether or not credit in public versus private monopolies was comparable before the policy, and whether places with only government banks experience higher credit growth after the intervention. The results are shown in Figure 11:

One can see that the trajectory of corporate credit before the intervention is similar in both types of municipalities, and changes suddenly in the quarters after the policy begins.

Figure 11: Public and Private Monopolies - Credit



Notes: Results from the estimation of Equation 10. Dependent variable $\Delta credit_{tmr}$ denotes log of total working capital loans originated in municipality m , quarter t and micro region r . Coefficients include 95% standard errors. Standard errors are clustered at the municipality level.

This indicates that we can compare municipalities with only private or public banks to evaluate whether the increase in credit associated with the policy has real effects. We do so by estimating a difference-in-differences specification using local GDP and its individual components as the dependent variables:

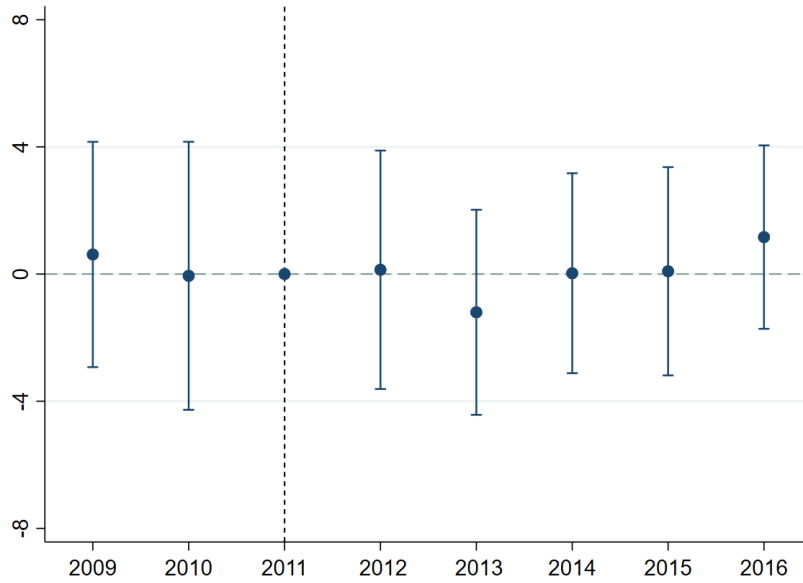
$$\Delta y_{tmr} = \alpha_m + \alpha_{tr} + \sum_{-1}^m \delta_{\tau} Pub_m + \sum_1^q \delta_{\tau} Pub_m + \varepsilon_{tmr} \quad (11)$$

Where Δy_{tmr} denotes local GDP growth in municipality m , year t and micro region r , α_m and α_{tr} are municipality and micro region-time fixed effects. The coefficients of interest are the δ_{τ} , which indicate the GDP growth in a treatment location relative to a control location in year τ , relative to the difference in growth in 2011, our baseline year. The results for GDP growth are shown in Figure 12:

The results show in Figure 12 show that, despite the large difference in credit in municipalities with only public banks, there is no difference in GDP growth between these locations and cities with only private banks after the policy.³³ The evidence suggests that

³³There is, however, one important caveat to this comparison. The reduction in interest rates of private banks also happens in locations where there are no public bank branches, and to the extent that this intensive margin of credit supply can also have real effects, our coefficients would be downward biased.

Figure 12: Extensive Margin Effects - Local GDP



Note: This figure shows the results from regression 11. Dependent variable Δy_{tmr} denotes local GDP growth in municipality m , year t and micro region r , α_m and α_{tr} are municipality and micro region-time fixed effects.. Standard errors clustered at municipality level. Coefficients include 95% confidence intervals. Source: IBGE municipality data and ESTBAN dataset.

that the extensive margin of credit - the increase the total amount of credit - does not lead to larger GDP growth, which is in line with the idea that government banks were not financing productive projects in these municipalities. Importantly, we cannot reject the hypothesis that credit provided by state owned banks was mainly used to finance unproductive zombie firms.

7.2. Intensive Margin of Credit

We have seen that the increase in public credit during the intervention led to a reduction in interest rates of private banks, one of the main objectives of the Brazilian government when implementing the policy. Importantly, if high interest rates were preventing these firms from investing at optimal levels, this reduction can lead to an increase in output through an increase in investment by firms who borrow from private banks.

To isolate this effect, we rely on two characteristics of our context that allows us to isolate firms which benefit the most from interest rate reductions. First, to ensure we are not capturing any extensive margin effects (namely, firms which started borrowing from private

or public banks *after* the intervention only), we focus on firms which were borrowing from these banks prior to the policy. Second, since existing clients that borrow from public banks experience smaller reduction in interest rates after the intervention, and since interest rates they accessed were already smaller, we conjecture that such firms would benefit *less* from any intensive margin effects. In other words, we compare firms borrowing from private banks before and after the policy with firms borrowing from public banks before and after the policy.

To measure these potential effects, we rely on our employment level data, which allows us to track firm employment over time. One interpretation is that if firms invest more, they would require more workers if their production function has capital and labor as complements (such as in standard Cobb-Douglas functions). Another interpretation is that since firms can use working capital loans to finance their wage expenditures, reducing the cost of such loans would allow for more hiring by these firms. Overall, the comparison of labor over time should indicate whether or not the intensive margin of credit had real effects on firms.

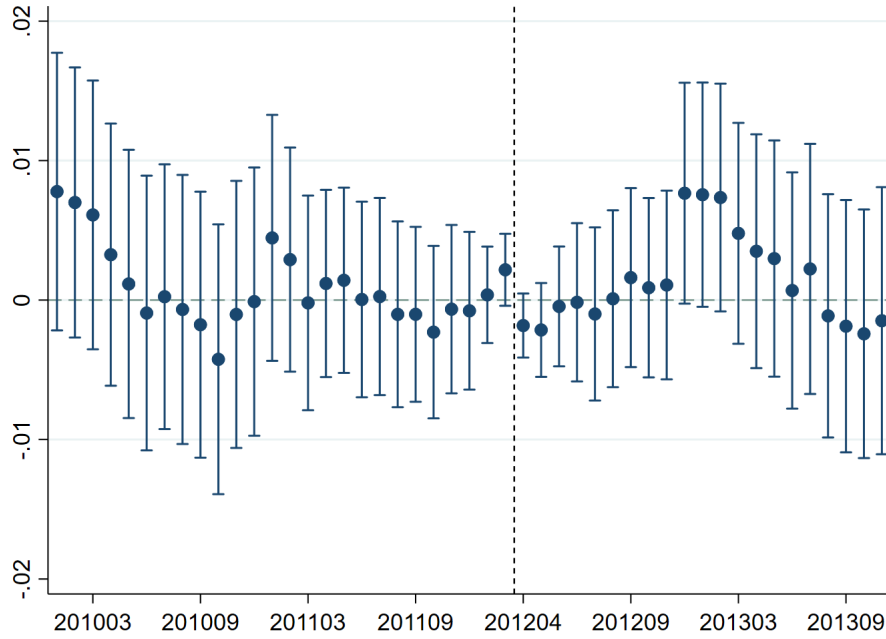
We test this by comparing employment of firms with exclusive relationships with private and public banks. We focus on firms with exclusive relationships since firms borrowing from both types of banks are usually larger, and also have access to cheaper sources of funding. Specifically, we test if firms with relationships with private banks hire more workers:

$$\text{Log}(emp)_{tmf} = \alpha_{tmj} + \sum_{-1}^m \delta_{\tau} \text{Private}_b + \sum_1^q \delta_{\tau} \text{Private}_b + \varepsilon_{tmf} \quad (12)$$

Where $\text{Log}(emp)_{tmf}$ is the log of firm f employment in month t , α_{tmj} are time-region-municipality fixed effects, which capture region and industry specific shocks, and Private_b is a dummy equal to 1 if the bank with which firm f has exclusive relationships, bank b , is a private bank. The coefficients of interest δ_{τ} capture the employment differences between firms borrowing from private and public banks in month τ . We normalize these coefficients by the value in March 2012, the beginning of the intervention. The results are shown in Figure 13:

Importantly, while firms that borrow from private banks seem to employ more workers in late 2012 and early 2013, the effects are short lived and not statistically significant. Overall,

Figure 13: Intensive Margin Effects - Firm Employment



Note: This figure shows the coefficients δ_t from regression 12. Standard errors clustered at municipality level. Coefficients include 95% confidence intervals. Source: SCR Dataset and RAIS Dataset.

there are almost no differences in employment levels of firms borrowing from private or public banks stemming from the policy. Since the subset of firms is kept constant - namely, firms with exclusive relationships with either private or public banks, that had access to working capital loans prior to the intervention - our lack of results speaks directly to the notion that the intensive margin of credit could have led to employment growth. Instead, the reduction in interest rates by private banks does not translate into more employment, and suggests such firms were not constrained by the interest rates they paid prior to the policy.

The fact that most loans originated by public banks during the policy went to indebted firms begs the question of whether there was an insufficient number of new borrowers demanding credit or if public banks rationed new applicants. While answering this question is beyond the scope of our project, the stylized facts we have uncovered suggest public banks might have faced operating capacity constraints to process working capital loans. If banks face operating capacity constraints, these institutions would provide more refinancing credit at the expense of new credit, as shown by [Choi, Choi and Kim \(2021\)](#). In our context, state owned banks had a small market share of working capital loans, and rapidly expand credit

at the onset of the intervention. If loan officers faced operating constraints, it is possible that they would favor firms with existing relationships, allowing banks to expand credit faster. Importantly, regardless of the exact force behind the increase in public bank loans to levered firms during the policy, our results indicate that public led credit expansions outside crisis episodes can lead to increased loan default and potential credit misallocation, while providing limited benefits stemming from reduced interest rates.

8. CONCLUSION

The use of tools to affect equilibrium in credit markets is a common policy implemented by governments which are trying to address problems related to financial crisis. Outside crisis episodes, theory suggests that such interventions can be beneficial if they address problems such as adverse selection or excessive monopoly power, but they can also be harmful if they increase the share of credit that is directed to less profitable projects. In this paper we study a credit market intervention implemented by the Brazilian government using public commercial banks, which is characterized by a large increase in the supply of credit to firms at subsidized interest rates. We document that while the policy was effective in forcing private banks to reduce the interest rates, it was also associated with a deterioration in credit quality that potentially led to credit misallocation. Loans issued by public banks during the intervention were around 1 pp. more likely to default than comparable loans issued by private banks, and such deterioration in the loan portfolio quality of government banks is connected to loans issued to levered firms.

In particular, the policy had public banks subsidizing loans to firms with positive debt outstanding with whom they had previous relationships, shifting the composition of their loan portfolio towards firms with more debt outstanding and higher debt over payroll costs, suggesting these firms were more levered. We showed that lending to more levered firms cause the worsening of borrower quality experienced by public banks, and that such worsening is not observed in loans to new borrowers. By doing so we rule out alternative explanations as to why the intervention is characterized by the worsening in credit quality, such as selection or poor screening by public banks. This findings have important implications for papers highlighting the role of asymmetric information mechanisms linked to interest rates. Our analysis suggests these forces are not sufficiently strong to generate meaningful

variations in borrower risk.

Finally, we cannot rule out the hypothesis that the increase in credit was not used to finance productive projects, as despite a larger increase in loan amounts in public monopolies relative to private monopolies, these locations do not have better economic growth in the years following the policy. Moreover, the reduction in the interest rates of private banks is also not able to generate variations in output, casting doubt on the idea that the policy was effective at addressing inefficient credit rationing problems. Importantly, while a proper characterization of zombie firms is challenging, our results are consistent with the a zombie lending view of the policy, where public banks provided loans to unproductive firms.

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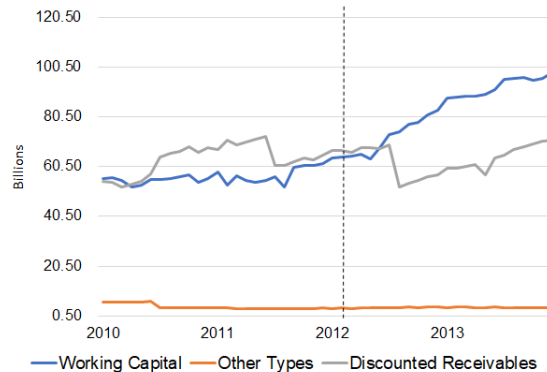
Appendix

A. CORPORATE BORROWING IN BRAZIL

In this appendix we overview the basic patterns of corporate lending in Brazil, the market share of public and private banks, and the trajectory of outstanding amounts in the loan portfolio of each type of bank for different types of loans.

We start by comparing the outstanding amount of different types of credit - namely, working capital loans, discounted receivables and other categories - to identify which categories were subject to larger credit supply increases:

Figure A.1: Total Amount Outstanding - Public Banks



Note: This figure shows the total amount outstanding for different types of loans for public banks. Source: SCR Dataset.

Figure A.1 shows that, relative to working capital loans and other types of credit, discounted receivables represent a smaller share of public banks' loan portfolio. Additionally, the amount outstanding of working capital loans grows substantially after the intervention, with an increase of 52.3% between March 2012 and December 2013. On the other hand, discounted receivables and other types of credit experience smaller growth of 7.1% and 9.6%, respectively.

B. PROOFS AND DERIVATIONS

B.1. Lemma 1

Proof. We can write private banks' profit when charging interest R as:

$$Q_P(R, \bar{q})[R(1 - P(R)) - c] \quad (13)$$

Where $Q_P(R, \bar{q}) \equiv (1 - \pi_G(\bar{q}))[\gamma + (1 - \gamma)Prob(Y_i \geq R)]$ is private banks' residual demand. First order conditions for R are:

$$Q'_P(R, \bar{q})[R(1 - P(R)) - c] + Q_P(R)(1 - P(R)) - Q_P(R)RP'(R) = 0 \quad (14)$$

Importantly, since $Q_P = (1 - \pi_G(\bar{q}))[\gamma + (1 - \gamma)Prob(Y_i \geq R)]$, then $Q'_P(R, \bar{q}) = (1 - \pi_G(\bar{q}))(1 - \gamma)\frac{\partial Prob(Y_i \geq R)}{\partial R}$, and we can write the first order condition as:

$$\begin{aligned} & Q'_P(R, \bar{q})[R(1 - P(R)) - c] + Q_P(R)(1 - P(R)) - Q_P(R)RP'(R) = 0 \\ \iff & (1 - \pi_G(\bar{q})) \left[(1 - \gamma) \frac{\partial Prob(Y_i \geq R)}{\partial R} (R(1 - P(R)) - c) + (\gamma + (1 - \gamma)Prob(Y_i \geq R)) \left((1 - P(R)) - R \frac{\partial P}{\partial R} \right) \right] = 0 \\ \iff & (1 - \gamma) \frac{\partial Prob(Y_i \geq R)}{\partial R} (R(1 - P(R)) - c) + (\gamma + (1 - \gamma)Prob(Y_i \geq R)) \left((1 - P(R)) - R \frac{\partial P}{\partial R} \right) = 0 \end{aligned}$$

■

B.2. Lemma 2

Proof. First, notice that:

$$\begin{aligned} \frac{\partial Q_P}{\partial \bar{q}} &= -\frac{\partial \pi_G(\bar{q})}{\partial \bar{q}} [\gamma + (1 - \gamma)Prob(Y_i \geq R)] \\ &= -\frac{1}{[\gamma + (1 - \gamma)Prob(Y_i \geq R_G)]} [\gamma + (1 - \gamma)Prob(Y_i \geq R)] \\ &> -1 \end{aligned}$$

Where the last inequality comes from $R_G < R$. Therefore, the effect of an increase in \bar{q} in total credit $Q = Q_P + \bar{q}$ is positive. Since that bad firms always borrow if equilibrium credit is greater than zero, as their propensity to borrow is higher than all good firms, then an increase in \bar{q} is welfare improving in the presence of adverse selection. To see why, notice that we can write the total function as:

$$SW(R, \bar{q}, R_G) = \gamma(p_B Y_B - c) + \int_{i(R)}^1 (p_G Y_i - c) dF(i) + \int_{i(R_G)}^{i(R)} (p_G Y_i - c) \pi(\bar{q}) dF(i) \quad (15)$$

Since $\pi'_G(\bar{q}) > 0$ and $\int_{i(R_G)}^{i(R)} (p_G Y_i - c) > 0$, then $\frac{\partial SW(R, \bar{q}, R_G)}{\partial \bar{q}} > 0$, that is, social welfare is increasing in the amount of public credit. ■

B.3. Lemma 3

Proof. As before, we know that an increase in \bar{q} leads to an increase in total credit. Then, we can write social surplus as:

$$SW(R, \bar{q}, R_G) = \int_{i(R)}^1 (p_B \gamma Y_i^B + p_G (1 - \gamma) Y_i^G - c) dF(i) + \int_{i(R_G)}^{i(R)} (p_B \gamma Y_i^B + p_G (1 - \gamma) Y_i^G - c) \pi(\bar{q}) dF(i) \quad (16)$$

In this case $\frac{\partial SW}{\partial \bar{q}} \leq 0 \iff \int_{i(R_G)}^{i(R)} (p_B \gamma Y_i^B + p_G (1 - \gamma) Y_i^G - c) \leq 0$. In particular, for a sufficiently large γ , $\int_{i(R_G)}^{i(R)} (p_B \gamma Y_i^B + p_G (1 - \gamma) Y_i^G - c) < 0$, meaning an increase in government credit becomes welfare decreasing. ■

C. DATA APPENDIX

The starting point in the construction of our main dataset is to collect loan origination information for working capital loans on a monthly basis. We focus on loans with fixed interest rates which are financed by banks' own capital. We then perform the following exclusions:

- Drop firms from utilities and public industries (CNAE 2 digit industry codes 33-39 and 84);
- Drop loans with annual interest rates smaller than 5%, which are likely miss classified as fixed interest loans;
- Drop loans with credit scoring worse than D, which include only renegotiations;
- Include only limited liability, corporations and sole proprietors firms;

We winsorize loan amounts, maturity and interest rates at the 1% in each tail. We then merge this dataset with a monthly employment dataset constructed based on RAIS Annual files. We only include firm observations for firms with a RAIS registry, which corresponds to more than two thirds of our data.

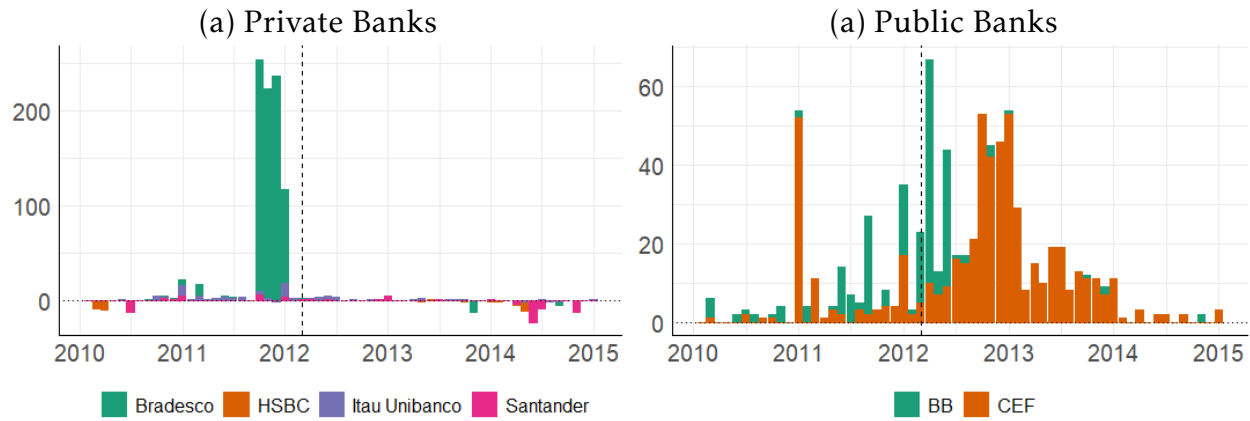
We use employment headcount to construct our firm size measures. In particular, we follow the classification by SEBRAE. In particular, we define:

- *Micro Firms*: Firms with less than 10 employees in the service/commerce sectors, or less than 20 employees in industry sectors.
- *Small Firms*: Firms with more than 10 and less than 50 employees in the service/commerce sectors, or more than 20 and less than 100 employees in industry sectors.
- *Medium Firms*: Firms with more than 50 and less than 100 employees in the service/commerce sectors, or more than 100 and less than 500 employees in industry sectors.
- *Large Firms*: Firms with more than 100 employees in the service/commerce sectors, or more than 500 employees in industry sectors.

The monthly employment panel is constructed using hiring and termination dates for each employee in the RAIS dataset. We aggregate such information at the firm-month level.

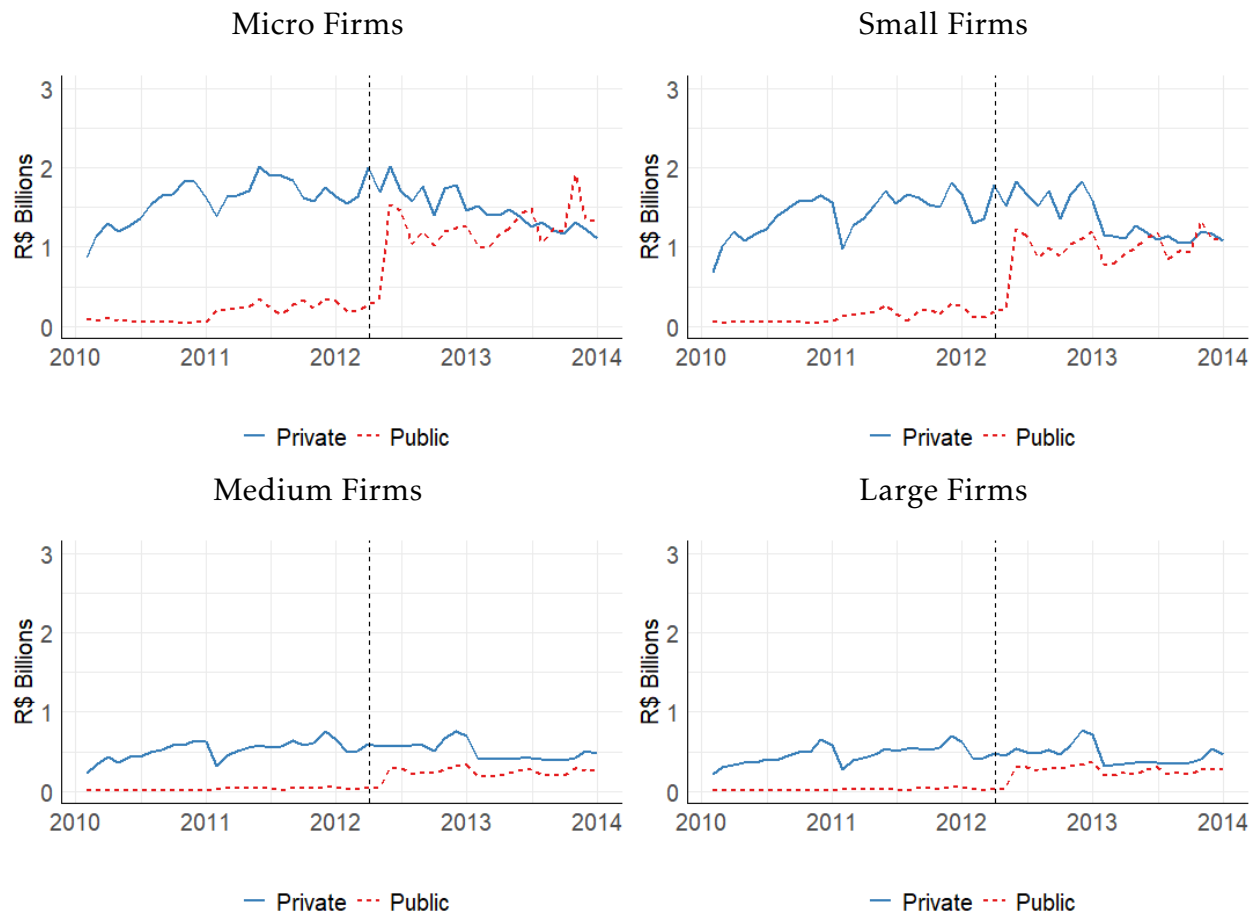
D. ADDITIONAL FIGURES

Figure D.1: Bank Entry



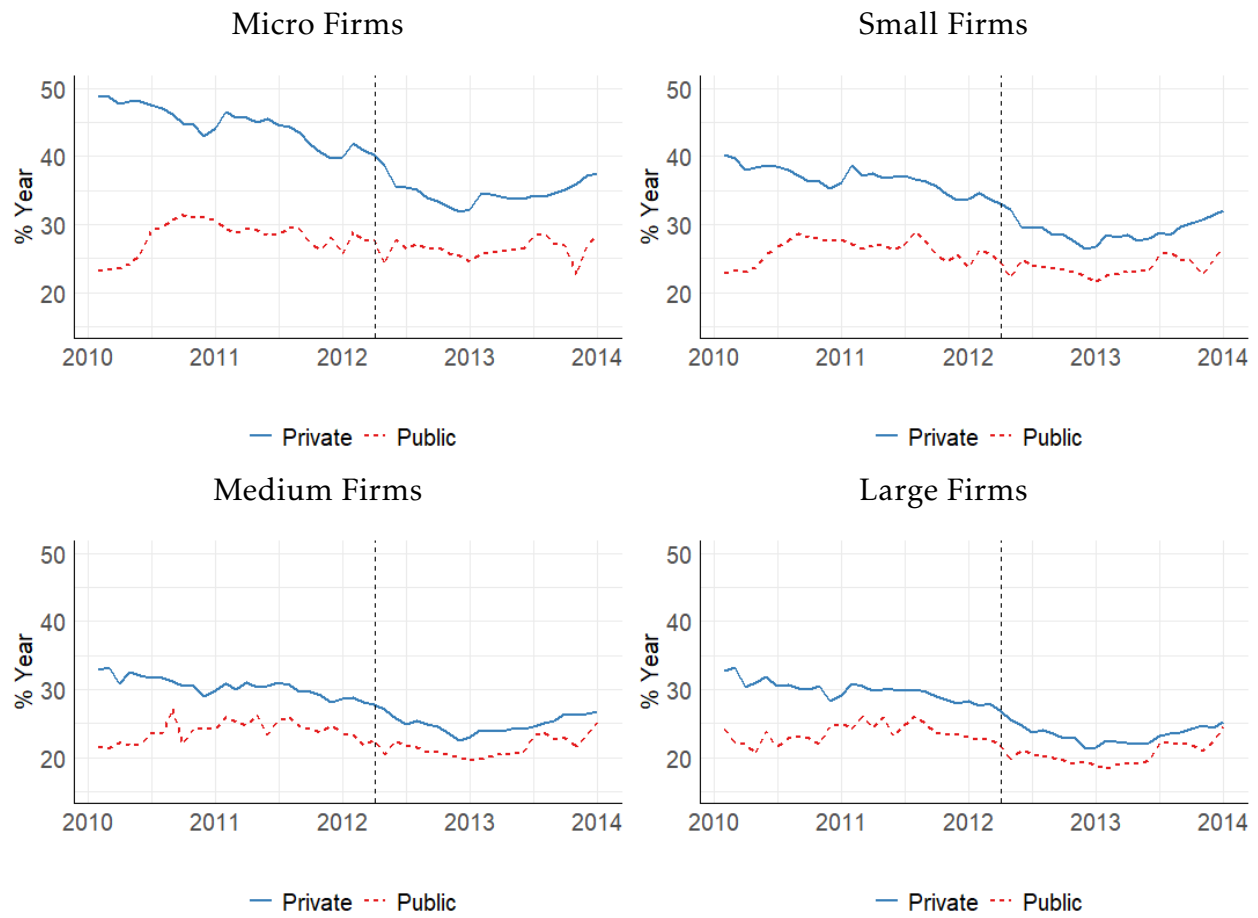
Notes: Entry is defined by a bank opening a branch in location where it had no previous presence. Source: ESTBAN Dataset, available at <https://www4.bcb.gov.br/fis/cosif/estban.asp?frame=1>

Figure D.2: Total Loan Amount by Firm Size



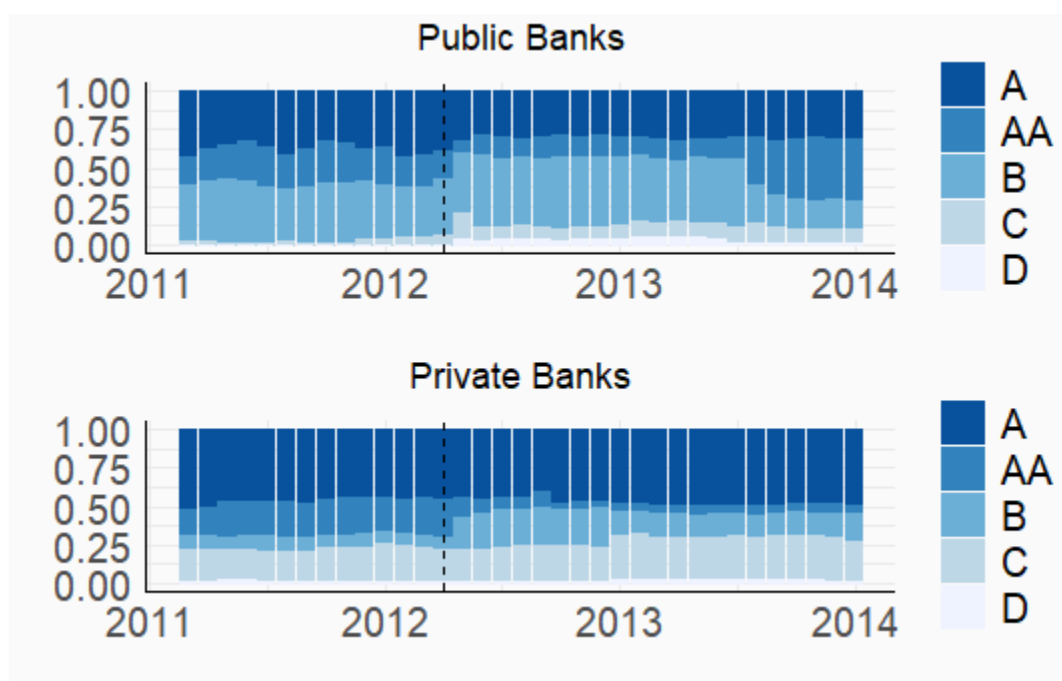
Notes: Total loan amount for public and private banks for firms of different size. Source SCR dataset and RAIS dataset.

Figure D.3: Loan Interest Rates by Firm Size



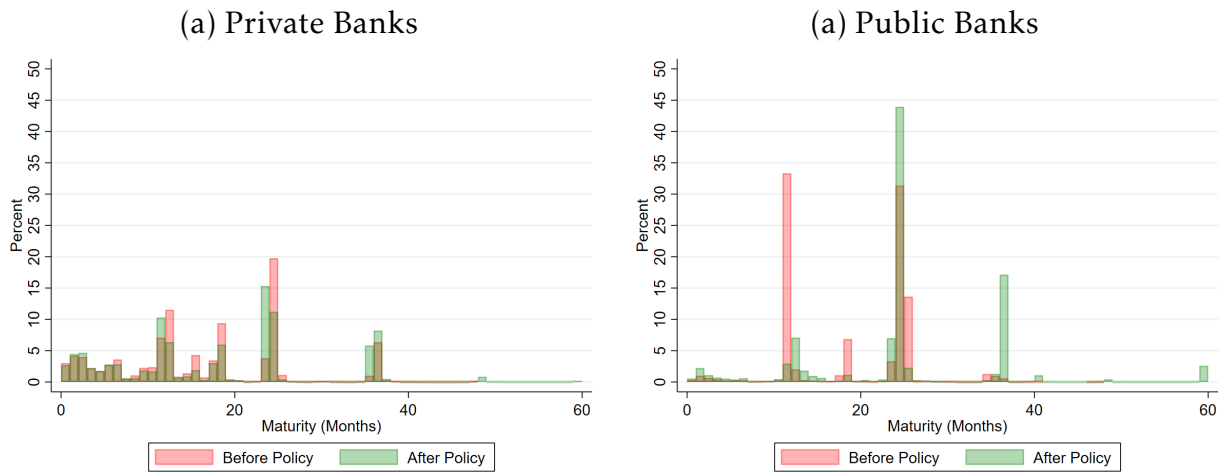
Notes: Average interest rate differences for firms of different size. Source SCR dataset and RAIS dataset.

Figure D.4: Credit Rating Distribution: Public and Private Banks



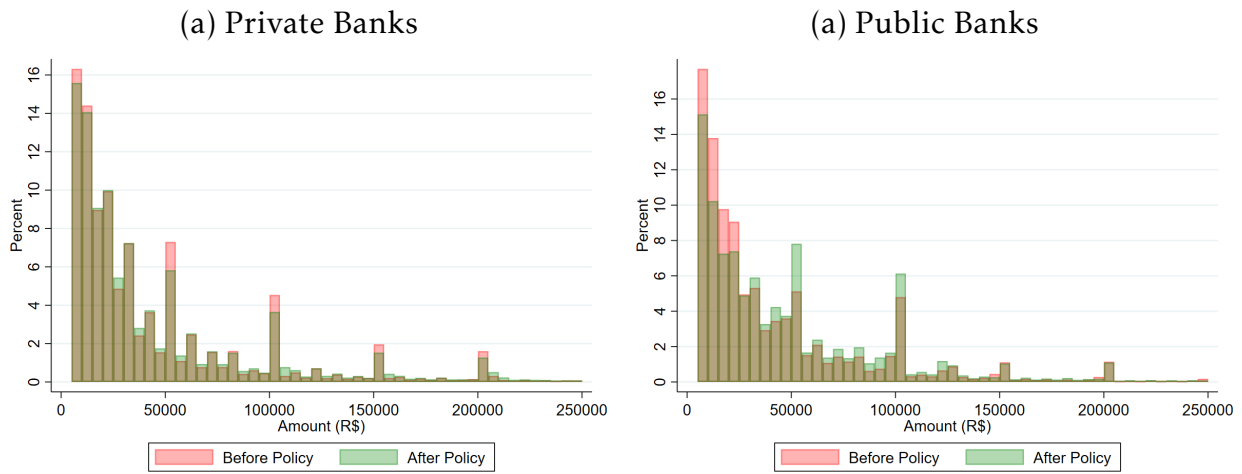
Note: This figure shows the distribution of credit rating for loans originated by public and private banks. Source: SCR Dataset.

Figure D.5: Loan Maturity Distribution: Public and Private Banks



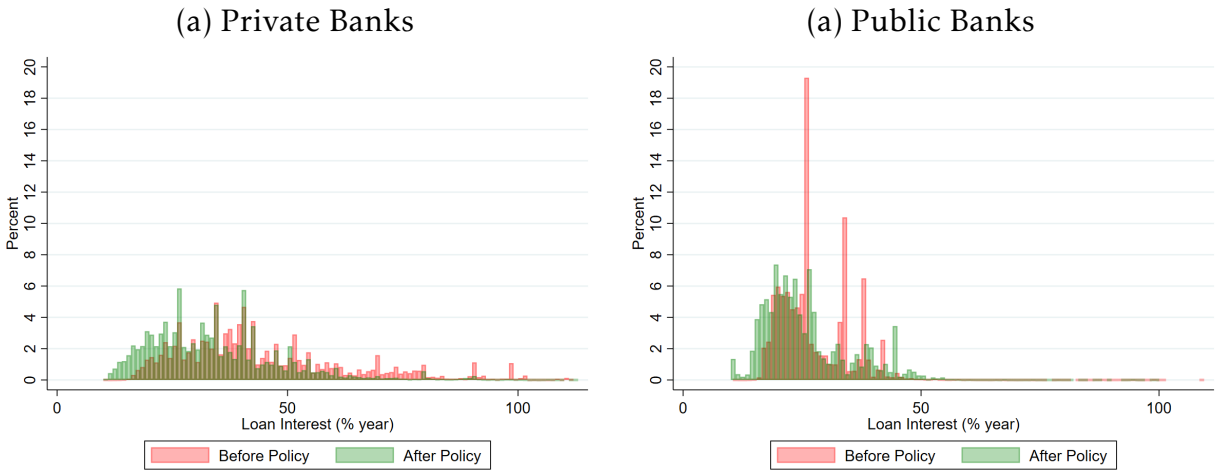
Note: This figure shows the distribution of loan maturity for loans originated by public and private banks.
Source: SCR Dataset.

Figure D.6: Loan Amount Distribution: Public and Private Banks



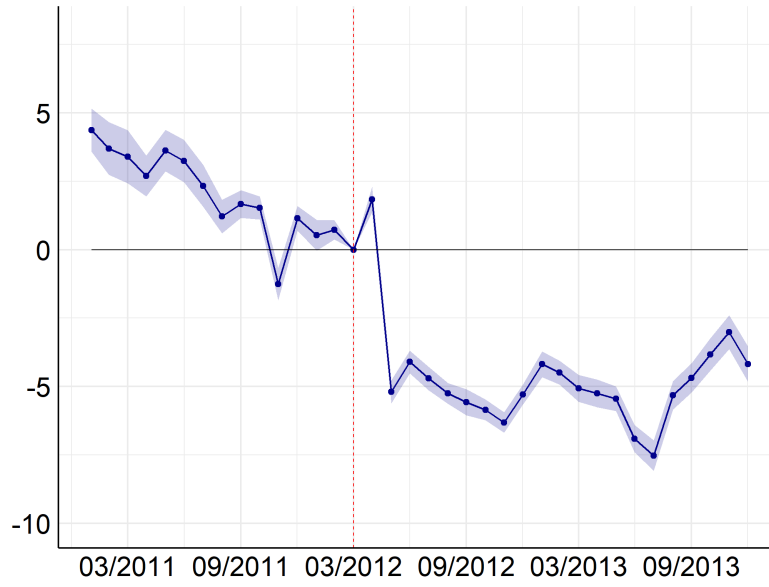
Note: This figure shows the distribution of loan amount for loans originated by public and private banks.
Source: SCR Dataset.

Figure D.7: Loan Interest Rates Distribution: Public and Private Banks



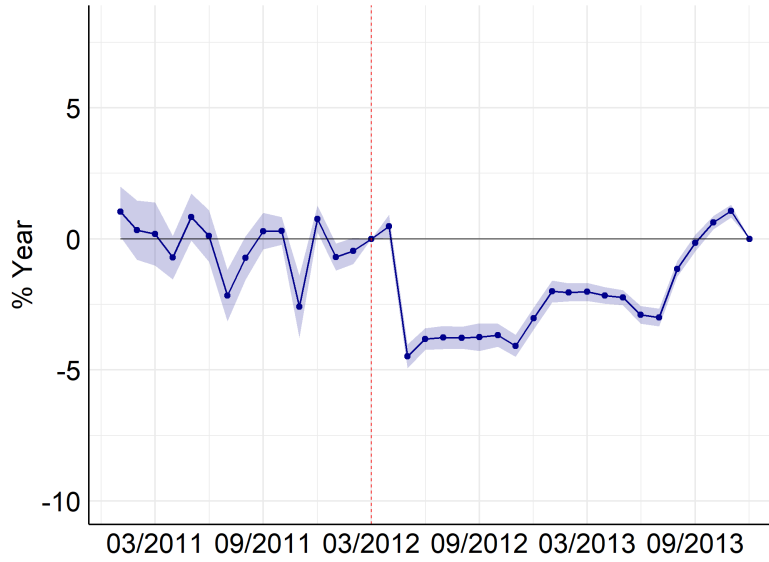
Note: This figure shows the distribution of loan interest rates for loans originated by public and private banks.
Source: SCR Dataset.

Figure D.8: Differences in Differences - Interest Rates with separated fixed effects



Note: Regression estimates from equation 3 at the loan level weighted by loan amount, with March 2012 as the reference month, but with time-municipality-industry fixed effects *not interacted*. Dependent variable $i_{jtm\text{b}f}$ is the interest rate of a loan j issued in municipality m , month t , from bank b to firm f . Standard errors clustered at bank-municipality level. Coefficients include 95% confidence interval.

Figure D.9: Differences in Differences - Interest Rates with Private Linear Trend



Note: Regression estimates from equation 3 at the loan level weighted by loan amount, with March 2012 as the reference month and adding a private specific linear trend. Dependent variable i_{jtmf} is the interest rate of a loan j issued in municipality m , month t , from bank b to firm f . Standard errors clustered at bank-municipality level. Coefficients include 95% confidence interval.

E. ADDITIONAL TABLES

Table E.1: Crowding Out Regressions

	(1)	(2)	(3)	(4)
$\Delta Credit^{Public}(\%)$	-0.0281*** (0.00468)	-0.0114** (0.00574)	-0.00858 (0.00728)	-0.0162** (0.00801)
R ²	0.00963	0.0486	0.0950	0.230
N. Munic.	3649	2755	1327	1315
Municipality Controls		✓	✓	✓
Local Branch Controls			✓	✓
Region FE				✓

Standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Notes: Results from a regression of private credit in public credit and controls at municipality level. Standard errors clustered at municipality level.

Table E.2: Differences in Differences: Interest Rates

	(1)	(2)	(3)
Public	-12.80** (0.186)		
Public \times Post	5.131*** (0.636)	7.123*** (0.470)	5.324*** (0.353)
Time \times Ind \times Mun FE	✓	✓	✓
Bank FE		✓	✓
Firm FE			✓
Adjusted R ²	0.545	0.528	0.753
Observations	3448110	2640349	2325626

Standard errors in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Notes: Results from a DiD regression using interest rates as the dependent variable. Standard errors clustered at bank level.

Table E.3: Differences in Differences: Borrower Delinquency

	(1)	(2)	(3)
Public \times Post	0.0107*** (0.00230)	0.00721** (0.00224)	0.0134*** (0.00239)
Debt		0.0270*** (0.000801)	0.0280*** (0.000830)
Time \times Municipality \times Industry FE	✓	✓	✓
Bank FE	✓	✓	✓
Weighted by Num. Loans			✓
R ²	0.158	0.159	0.173
Observations	1818371	1818371	1818371

Standard errors in parentheses

* $p < 0.01$, ** $p < 0.05$, *** $p < 0.01$

Notes: This table shows the results of the estimation of a difference in differences regression using delinquency as the dependent variable. Standard errors are clustered at the bank-municipality level.

Table E.4: Differences in Interest Rates - Relationship Borrowers

	Private Banks			Public Banks		
	(1)	(2)	(3)	(4)	(5)	(6)
Post	-1.840*** (0.0857)	-1.844*** (0.0873)	-2.271*** (0.107)	-0.395*** (0.0776)	-0.430*** (0.0785)	-0.157 (0.0868)
Post \times Monopoly		-1.047 (0.787)			0.535* (0.266)	
Small			-0.613*** (0.0893)			0.490*** (0.0854)
Medium			-0.944*** (0.190)			0.527** (0.186)
Large			-0.818** (0.257)			0.985** (0.321)
Post \times Small			1.093*** (0.0943)			-0.663*** (0.0789)
Post \times Medium			2.034*** (0.153)			-0.397* (0.172)
Post \times Large			1.757*** (0.225)			-0.986*** (0.213)
Ind \times Mun FE						
Bank \times Firm FE	✓	✓	✓	✓	✓	✓
R ²	0.745	0.745	0.746	0.676	0.675	0.676
Observations	1622503	1586269	1622503	840496	821345	840496

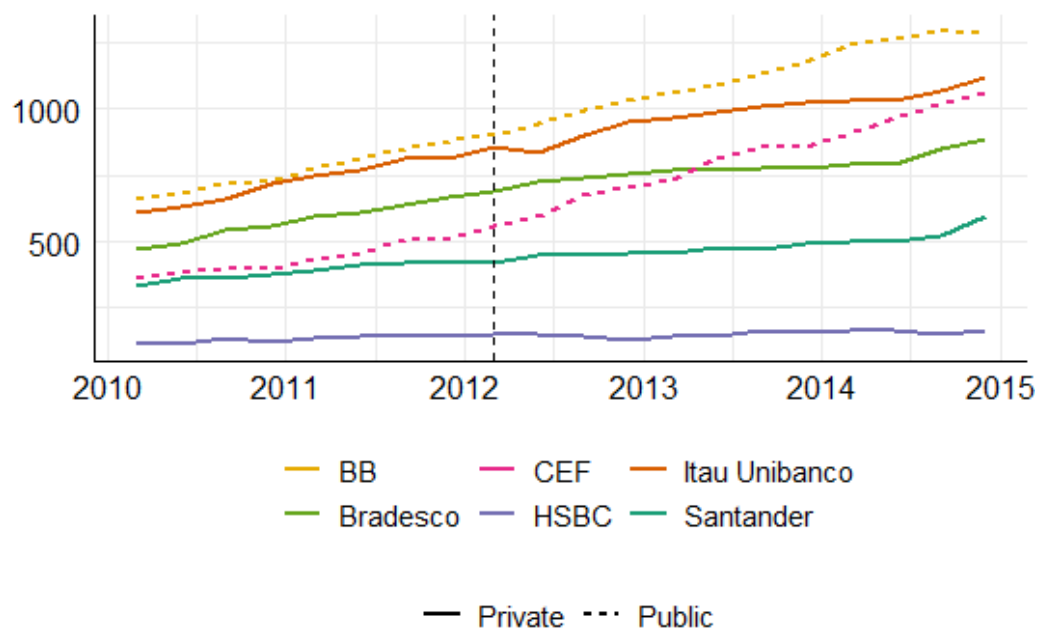
Standard errors in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Notes: Results from the regression specification in Equation $i_{tmbf} = \alpha_{tim} + \alpha_b + \beta_0 Type + \beta_1 Post_t \times Type + \Gamma_1 \mathbf{X}_{tmbf}$ for firm credit. Controls \mathbf{X}_{tm} include: Maturity Categories, Loan Amount and Rating Categories, Firm Ownership dummies, log of number of employees, log of estimated revenue. Standard errors clustered at bank level.

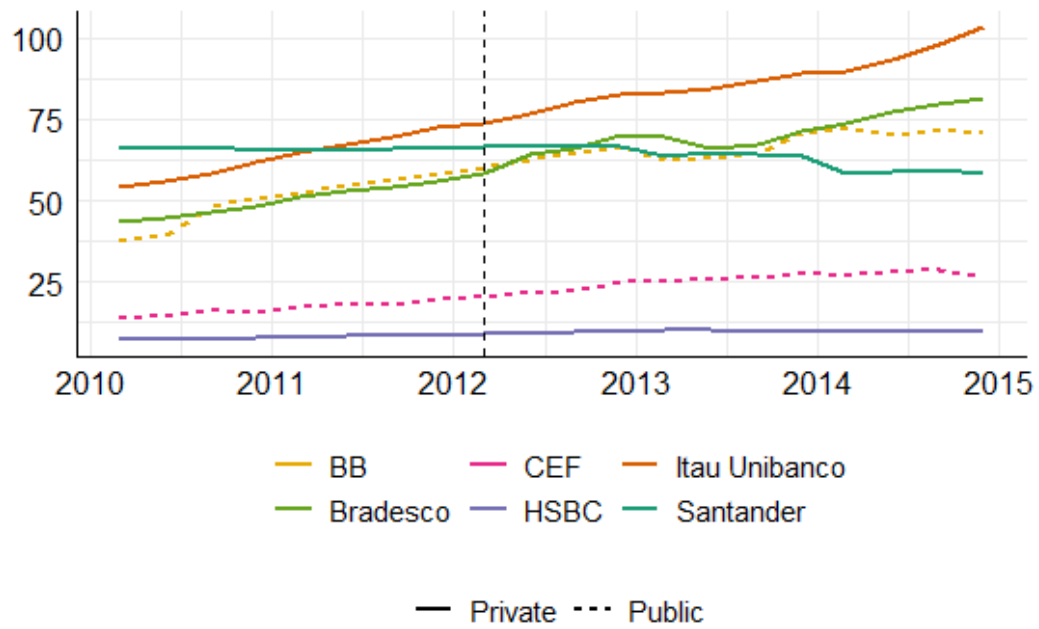
F. BANK LEVEL ANALYSIS

Figure F.1: Total Assets



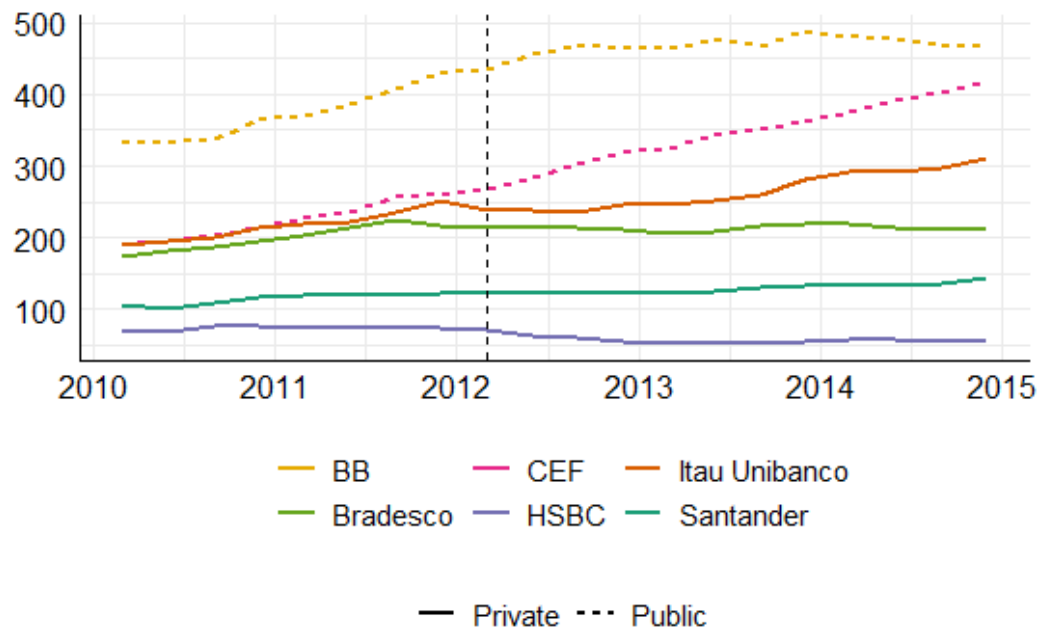
Notes: Total Bank Assets, including loan portfolio, securities, repo and others. Source: IF Data, available at <https://www3.bcb.gov.br/ifdata/>

Figure F.2: Equity



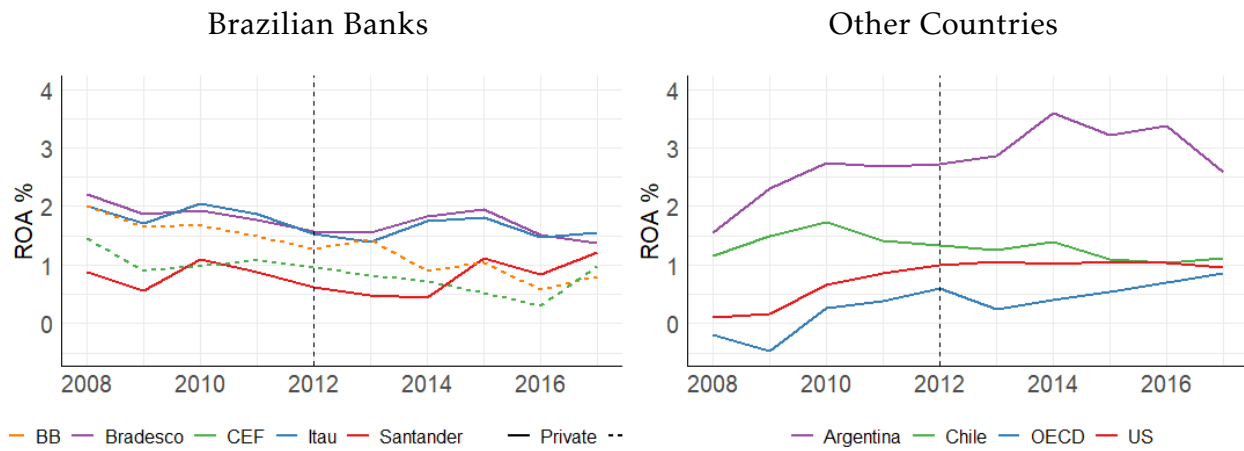
Notes: Total Bank Equity. Source: IF Data, available at <https://www3.bcb.gov.br/ifdata/>

Figure F.3: Total Deposits



Notes: Total Deposits include Savings, Demand and Time Deposits. Source: IF Data, available at <https://www3.bcb.gov.br/ifdata/>

Figure F.4: Return Over Assets



Notes: Return Over Assets Defined as Net Income divided by Total Assets. Data for plot (a) obtained using IF Data, available at <https://www3.bcb.gov.br/ifdata/> Data for plot B available at the IMF's Global Financial Development database.