Government Banks, Competition and Interventions in Credit Markets*

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November 10, 2021

JOB MARKET PAPER

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 state owned banks. Theoretically, we show that this type of policy can be beneficial if adverse selection prevents financing of safer firms, or harmful if public banks finance riskier firms. We answer whether or not the policy is associated with an increase in the amount of loans to productive firms using confidential credit registry data to document a series of empirical facts. 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 substantial worsening of default risk. In particular, government banks subsidize more levered firms, and loans to indebted firms explain borrower default differences between public and private banks. Moreover, neither the increase in total credit or the reduction in interest rates of private banks has effects on GDP and employment growth. These findings are inconsistent with the notion that the increase in credit led to more loans to safer firms, and instead suggest that the expansion was associated with credit misallocation.

Keywords: Credit Market Interventions, Credit Misallocation, Government Banks

JEL Classification: E44, E65, G21, L44

*We thank José Scheinkman, Martin Uribe and Olivier Darmouni for invaluable guidance and support; as well as Matthieu Gomez, Rodrigo Gonzalez, Martina Jasova, Dario Romero, Silvio Ravaioli and seminar participants at Columbia University and the Central Bank of Brazil for comments and suggestions. **The views expressed herein are those of the authors and do not indicate concurrence by the Federal Reserve Bank of Boston, the principals of the Board of Governors, or the Federal Reserve System. The views expressed herein do not necessarily reflect those of the Banco Central do Brasil.**

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