Public Borrowing and the Crowding Out of Corporate Credit: Evidence from Chile

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Motivation

Understanding whether public borrowing reduces the availability of credit to the private sector—commonly referred to as financial crowding out—is central to evaluating the broader economic effects of government debt. When firms, particularly small and medium-sized enterprises (SMEs), face credit constraints, a reduction in credit supply can lead to lower investment, slower employment growth, and ultimately, reduced output. These risks are especially pronounced in developing countries like Chile, where financial markets are less diversified, firms rely heavily on bank lending, and the public sector often competes directly with private borrowers for domestic credit.

Recent work by Pinardon-Touati (2023) demonstrates that local government borrowing from banks in France leads to a substantial crowding out of corporate credit, with measurable declines in firm investment and aggregate output. While her study focuses on a developed economy with a deep and relatively elastic financial market, she highlights that local government borrowing from banks is both large and expanding globally. Between 1990 and 2019, the local government debt-to-GDP ratio doubled from 11% to 22% across developed and emerging economies, with approximately 80% of this debt held in the form of bank loans.

Chile offers an ideal empirical setting for extending this framework. As of March 2024, Chile's gross central government debt reached $119.5 billion (de Hacienda de Chile, 2024). A significant share of this debt consists of obligations to the Central Bank, reflecting legacy commitments and monetary stabilization efforts. However, the government also finances itself through domestic debt issuance—selling bonds in local markets that are often purchased by banks, AFPs (Pension Fund Administrators), and insurance companies. When banks purchase government securities, they may reduce their exposure to private lending—especially to SMEs, which are more credit-constrained. In this context, crowding out may emerge not only through direct loans to the public sector but also through the portfolio choices of banks operating under capital and liquidity constraints.

This research aims to adapt Pinardon-Touati's identification strategy to the Chilean context by leveraging regional variation in government borrowing and firm-bank lending relationships. The objective is to measure whether an increase in government bond holdings by banks is associated with reduced credit to firms and to quantify the resulting impact on firm-level investment and productivity.

Research Question

Does domestic government borrowing—either directly through loans or indirectly through bond sales to banks—crowd out private credit to firms in Chile? What are the real effects of this mechanism on corporate investment and output?

Potential Contribution

This paper would be among the first to rigorously document financial crowding out in a Latin American emerging market. It would provide new evidence on the interaction between public borrowing and private credit allocation in a partially segmented financial system. The results may inform policy debates about the fiscal-monetary interface, debt management strategies, and SME access to finance.

Methodology Overview

- I plan to use credit registry data from Chile (from the CMF or SBIF), linking firm-bank relationships with data on government bond and loan issuances. This data is not publicly available, so access may be challenging, but it is potentially attainable.
- I can exploit both spatial and temporal variation in banks' exposure to public debt—driven by factors like portfolio shifts, bank balance sheet constraints, or geographic lending patterns—following the identification strategy used by Pinardon-Touati (2023).
- To isolate credit supply effects from demand-side variation, I would implement a within-firm estimator, following the methodology of Khwaja and Mian (2008).
- Finally, I would aim to build a simple model of the Chilean economy that allows me to use the estimated micro effects to evaluate macro-level impacts on credit volumes, interest rates, investment, employment, and output. This approach follows the spirit of combining micro and macro estimates as in Pinardon-Touati (2023).

Limitations and Challenges

Testing the crowding out hypothesis in Chile faces several challenges. Identification relies on exogenous variation in public borrowing, but if debt issuance responds to local conditions, confounding is a concern. Measuring crowding out also requires that the government borrows from institutions that would otherwise lend to firms; if AFPs or foreign investors absorb most of the debt, the effect may be muted. Finally, while Chile has rich regulatory data, access is limited. Implementing the strategy would require credit registry and bond holding data from the CMF, which may involve institutional barriers.

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