Government Subsidies, Credit Allocation and the Investment Cycle

Errol D'Souza & Jay Surti

Discussant: Kaushalendra Kishore (CAFRAL)

CAFRAL World Bank Conference, 2020

February 26, 2020

Summary

- Summary of the NPA problem after 2008 crisis
- Builds a model to explain zombie loans, low productivity and investment

Model

Static Model:

- Key Assumption: Government bailout of PSB
  - Specific form: the government pays back the principal in case of default
- Subsidy $\Rightarrow$ PSB can afford to give loans to low productivity borrowers
- PVB only give loan to high productivity borrowers
- Competitive market for lending $\Rightarrow$ zero profits for banks

Comments:

- Low type must be negative NPV. So there is inefficient lending.

Zombie lending

- Failing project turns into zombies
- Assumption: Government subsidy only if loan given to zombies
- PSBs prefer to lend to zombies than new loans. PVBs lend to high productivity firms

Comments:

- Why government subsidies only when lending to zombie loans. Why not to any loan as in static model. It will result in increase in welfare.
- What is special about zombie firms?

Dynamic Model

- Fraction of zombie loans keeps increasing
- Average productivity declines
- High productivity firms may get crowded out

Comment: No steady state in the model. Should there be some countervailing force which finally prevents zombie lending?

Discussion

Comment 1: What is the motivation for the bailout?

- Bailout in the model is exogenous. What is the regulators objective function? Why bailout banks?
- Gorton and Huang (2004): Bailout necessary for *ex ante* efficient investments
- What was special in 2008? Government guarantees always exist.

Comment 2: Why only bailout zombie firms?

- Jaskowski (2015): Zombie lending may be efficient as it prevents fire sales *ex post* and leads to higher lending *ex ante*
- But in the model there is no difference between low productivity firms and zombie firms (apart from productivity)

Comment 3: Other forms of intervention

- This paper: Government pays back the principal in case of default
- Phillipon and Schnabl (2012): Analyze exogenously given policy measures (Asset buyback, capital injection)
  - Different policy has different implication
- Llobet (2014): Policy design to preventing zombie lending. Why can't be used by regulators in Indian context? Discuss.

Comment 4: Comparison with Stiglitz and Weiss (1981)

- Stiglitz and Weiss (1981): Projects vary in s.s.d
- Different from this paper
- What will be the impact of bailout in Stiglitz model? How it is different from this paper?

Conclusion

- Enjoyed reading the paper
- Interesting model and results
- Need to discuss/motivate the assumptions more (or endogenize them)
- Relate more to theoretical literature on bailouts and zombie lending