

How to Respond to a Sudden Stop in Firm Financing--- Government or Market? Lessons from the Pandemic-Era Policies

Abstract: Using administrative data of the universe of Chilean firms, we test the role of a new credit line from the Central Bank and of government-backed credit guarantees on firms' financing during the onset of COVID. Our identification rests on regression discontinuity design, where eligible firms increased their debt from domestic lenders relative to foreign lenders. By reducing the cost of local currency debt vis-a-vis the foreign currency debt, from domestic lenders, policies reduced the UIP premium of firms eligible for guarantees. An open economy model of heterogeneous firms with financial frictions accounts for these facts. An increase in the external debt default risk leads to a higher mass of firms demanding credit from domestic lenders, who are risk averse and lower their credit supply. The model shows how government policies complement each other to fully offset these demand and supply side costs. Government guarantees loosen firms' domestic collateral constraints and reduce banks' risk aversion, while the Central Bank credit facility increases the aggregate supply of credit in the economy.