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Banks vs. Firms: Who Benefits from Credit Guarantees?

Many countries implemented large-scale programs to guarantee private credit in response to the outbreak of COVID-19. Yet the role of banks in allocating guarantees -- and thus in shaping their effects -- is not well understood. We study this role in an economy where entrepreneurial effort is crucial for efficiency but it is not contractible, giving rise to a debt overhang problem. In such an environment, credit guarantees increase efficiency to the extent that they allow firms to reduce their repayment obligations. We show that banks follow a pecking order when allocating guarantees, prioritizing highly-indebted captive firms, from whom they can extract all surplus, over solvent firms. This limits the effectiveness of guarantees in enhancing economic efficiency and raising output. We confirm the model's main predictions on the universe of all credit guarantees granted in Spain following the outbreak of COVID.