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Abstract

We investigate the impact of fiscal expansions on firm investment by exploiting firms that have multiple banking relationships. Further, we conduct a localized RDD approach and compare the lending behavior of banks that barely met and missed the criteria of being a primary dealer, as well as barely winners and losers at government auctions. Our results indicate that a 1 percentage point increase in banks’ bonds-to-assets ratio decreases loans by up to 0.4%, which leads to significant declines in firm investment, profits and wages. Our findings are grounded in a quantitative model with financial and real sectors with which we undertake a welfare analysis and compute the cost of government borrowing on the overall economy.