Growing Like Germany: Local Public Debt, Local Banks, Low Private Investment

Mathias Hoffmann, University of Zurich
Iryna Stewen, JGU Mainz
Michael Stiefel [*], University of Zurich

April 15th, 2019
Preliminary. Do not quote.

Abstract

Germany's persistent current account surplus reflects to a large extent low domestic private investment. We argue that two factors—the local fragmentation of Germany's banking system and the role of local banks in local public finance—can help explain why investment is so low. Local public banks dominate lending to small and medium firms in many regions of Germany. At the same time, they are also important as lenders to local municipalities. Local banks in more indebted municipalities lend more to local government. This effect is particularly strong for local public banks, which are under the direct political control of municipalities. Local government debt yields very low returns, but because lending markets are geographically segmented, local banks can charge higher rates on their small and medium-sized enterprise (SME) customers to break even. Using a unique data set of more than 1m German firms over 2009-2016, we show that firms which depend on local banks pay higher interest rates on their loans if the local bank lends a lot to the local government. This considerably lowers firm investment. Hence, the reliance of municipalities on local banks for credit leads to the crowding out of private investment in geographically segmented banking markets.

[*]Mathias Hoffmann is Professor at the Department of Economics, University of Zurich. He is also affiliated with University of Zurich's Research Priority Program in Financial Market Regulation (URPP FinReg), the CESifo Munich and the Centre for Applied Macroeconomic Analysis (CAMA) at the Australian National University. E-mail: mathias.hoffmann@uzh.ch.
Iryna Stewen is Assistant Professor at Gutenberg School of Management and Economics, Johannes Gutenberg University Mainz, Jakob-Welder-Weg 4, D-55128 Mainz, Germany. She is also an affiliate researcher at the URPP FinReg. E-mail: iryna.stewen@uni-mainz.de
Michael Stiefel is PhD student at the Department of Economics, University of Zurich. He is grateful for a scholarship by the UBS Center of Economics in Society during his graduate studies. E-mail: michaelstiefel@outlook.com