CENTRE FOR MACROECONOMICS

Economic and Social Research Council

[Banks, Credit Reallocation, and Creative Destruction]

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How do banks' lending decisions influence firm turnover and creative destruction? We develop a dynamic general equilibrium model in which banks restructure loans with high default risk, thereby releasing funds for new lending and forcing firms with poor prospects to close down. By reducing banks' reliance on external funds, loan restructuring lowers the equilibrium interest rate, which stimulates firm creation. We derive analytical and quantitative results from the model calibrated to German data: A lower cost of loan liquidation (e.g., improved insolvency laws) accelerates firm entry and exit, and boosts aggregate capital productivity mainly by incentivizing more active credit reallocation. Restructuring also complements policies that aim at stimulating firm creation (e.g., R&D subsidies) as it mitigates a crowding-out of entry via a higher interest rate.