Discussion of:

Firm Quality Dynamics and the Slippery Slope of Credit Intervention

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Should we bailout the productive sector during crises?

- Frequent and large credit interventions by ECB, BoJ, FED, fiscal authorities...

  ✓ **Preserve production capacity** — unlike private funding, government funding is unconstrained by firms' collateral value

  X **Dampen the "cleansing effect" of crises** — in a bailout low-quality firms are subsidized by non-discriminatory pricing, i.e. high-quality firms pay a relative premium for govt funding

  ⇒ "Quality-quantity" trade-off determines the optimal size of the (credit?) intervention

Should we bailout the productive sector during crises?

1) **Policy distortions are self-perpetuating** — a lower quality productive sector necessitates interventions of greater scale in the future
2) **Bailouts cause moral hazard for low quality firms** — low quality firms over-invest in normal times expecting (mispriced) credit support in an eventual future crisis
3) **More distortion in a low-interest rate environment** — High-quality firms save less causing the firm quality distribution to worsen $\rightarrow$ greater intervention needed in a crisis
   - This result likely not first order in the data and somewhat distracts from the core of the model

Mispricing by the government

- **Mispricing as the government does not differentiate high- from low-productivity firms**

  Key friction motivated by:
  - Productivity not easily observable
  - Political considerations against discriminating among firms
  - Speedy implementation might make credit pricing unfeasible

- Intuitive (and common sense) limitation of government interventions during crises

- **Is this one the key distortion in the data?**
  - This paper: productive firms pay a relative premium for government funding
  - There is no "congestion externality" (Caballero et al., 2008) caused by too many unproductive firms or too much production relative to a laissez-faire benchmark

Nature of the shock

- A crisis is a suddenly binding financial constraint for a subset of firms that reduce investment below the level implied by their Tobin's Q (firms rush to rebuild capital)
  - The model resembles a natural disaster or a localized cyberattack

- Difficult to interpret this setup as a "crisis" where demand drops
  - *"The destruction of capital can be interpreted as a decline of product demand, disruptions in supply chains, or government mandatory shut downs"*
  - The permanent vs temporary nature of the shock should be a key component of the trade-off (bailing out gyms and restaurants vs bailing out commercial real estate)

Funding the government bailout

- The government finances lending with lump-sum taxes on deep-pocket households and transfers the instantaneous repayments to households
  - Other government funding arrangements possible?
  - What distortions? Think of aggregate demand post-COVID in the US
  - Is the government becoming an equity holder?

Two suggestions

1) Model predicts a correlation between bailout size and change in firm quality distribution
   - Can be tested in the data across industries, countries, or crises episodes
   - Can the model be used to *detect* "Fed put" distortions?

2) The paper is already rich, not sure whether analysis on low interest rate environment and extensions on banks and firms' precautionary savings belong to the main body

Overall

- Intuitive and elegant model
- Gives a much needed structure to the growing empirical literature on the “Fed put”
- Important insights on the dynamic effects of bailouts (slippery slope)

- Two main comments:
  - Government mispricing in the model vs. congestion externalities in the data
  - Shock to capital in the model vs. COVID-19/financial crises/natural disasters in the data