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Abstract

1
2 How does government debt affect long-run economic growth? A prominent strand of the-
3 oretical literature suggests that government debt has a negative effect on growth. Another
4 strand argues that government debt can foster growth by enhancing the supply of liquid assets
5 or collateral. We empirically investigate the liquidity channel of government debt and apply
6 the difference-in-differences methodology of Rajan and Zingales (1998) on a sample of 28 man-
7 ufacturing industries across 39 developing and developed countries. We provide evidence that
8 industries with greater liquidity needs tend to grow disproportionately faster in countries with
9 higher levels of government debt. The positive liquidity effect of government debt on industry
10 growth stems from domestic debt, not external debt. We perform a battery of robustness checks
11 and show that our results are robust to using instrumental variables and controlling for many
12 competing channels.

13
14 *JEL classification : H63, D92, O16, G21*

1 *Keywords: Government Debt, Growth, Liquidity, Non-linearity*

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