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Financial liberalization, market structure and credit penetration

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ABSTRACT

This paper shows that the effects of financial liberalization on the credit market of a small and capital constrained economy depend on the market structure of domestic banks prior to liberalization. Specifically, under perfect competition in the domestic credit market prior to liberalization, liberalization leads to lower domestic interest rates, in turn leading to increased credit penetration. However, when the initial market structure is one of imperfect competition, liberalization can lead to the exclusion of less wealthy entrepreneurs from the credit market. This provides a rationale for the mixed empirical evidence concerning the effects of liberalization on access to credit in developing markets. Moreover, the analysis provides new insights into the consequences of foreign lenders' entry into developing economies.

1. Introduction

The last three decades have witnessed a wave of financial liberalization that has increased less developed countries' access to international capital markets and to foreign financial banks. Financial liberalization was regarded as a means to foster competition in the financial sector, increasing access to credit for firms. As a result, an increased growth rate was expected. In some countries this was observed (Claessens et al., 2001; Micco et al., 2007). In others, while the access and conditions faced by larger firms improved, the effects on smaller firms have been mixed or negative. For example, focusing on a specific type of liberalization, i.e., the entry of foreign banks, the study of Gormley (2010) for India

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showed a reduction in lending to small and medium enterprises after financial liberalization. What could explain this wide divergence in the results of financial liberalization? We suggest that one possible explanation for this contradictory evidence is that the impact of financial liberalization depends on the market structure of the domestic banking system prior to liberalization.

Assume that financial liberalization is defined as the entry of foreign banks coupled to improved access to international capital markets. We show that if the domestic banking market is competitive, financial liberalization leads to the expected positive results. On the other hand, when markets are initially non-competitive, liberalization can lead to the exclusion of smaller (or weaker) businesses from the credit market, while the stronger companies are served by international banks. Thus, we show that the *ex ante* competitive situation in the financial market can explain the diverging observations on the effects of financial liberalization.

The proponents of financial liberalization have argued that the entry of foreign banks would reduce costs by the use of improved financial technology; because they would demand improved financial regulation; and because they would be less corrupt and would not lend to related firms in banking conglomerates. Opponents of liberalization pointed out that foreign entrants are at a disadvantage because they have less information about clients and the domestic legal system, and because their lobbying capacity is lower than that of domestic banks. One of the implications of the informational disadvantages is that for foreign banks, the *entrepreneurial rent* received by entrepreneurs should be higher, *ceteris paribus*, than for domestic banks. Since increased competition by foreign banks will weaken domestic banks and reduce their lending, these two effects could combine to reduce total lending in the economy post-liberalization.

This combination of advantages and weaknesses suggests that foreign banks tend to cherry pick firms with good internal accounting systems, solid financial positions and therefore a low probability of default. Given their better technology and lower loan origination costs, they can outcompete the domestic banks for these clients, leaving the riskier and more information-demanding clients for domestic banks, which can apply their relatively better monitoring ability. In these conditions, each type of bank specializes in the type of firm in which it has a comparative advantage, and this should lead to an increase in efficient lending. However, this conclusion rests on the assumption that the entry of foreign banks reduces or does not alter the cost of funds for domestic banks. If the entry of foreign banks were to raise the cost of funds for domestic banks, the effects of entry would be different. In particular, if the domestic banking system is imperfectly competitive, and the cost of funds is initially kept artificially low due to the lack of alternatives for savers, post-liberalization, the increased access to the international financial markets and the increased competition for domestic funds by foreign banks leads to an increase in the cost of funds for local banks. This may lead to a reduction in lending to the riskiest clients.

There is empirical evidence for these effects. Rashid (2011), using data from 81 developing and emerging countries for the period 1995–2009, shows that foreign banks compete for deposits with the domestic banking system, and that this leads to an increase in the reliance on costlier (and more volatile) non-deposit funds by domestic banks. Moreover, the author presents evidence that increases in the share of deposits by foreign banks leads to a decline in credit to the private sector. Another paper, by Detriagache et al. (2008), uses data from the banking sector of 62 low income countries. They show that increased foreign bank penetration is associated with lower access to credit by the private sector and that foreign banks have a safer (less risky) loan portfolio.[1]

Why would foreign banks lend to a less risky loan portfolio than domestic banks in emerging economies? One possibility is that there are costs associated to operating in countries in environments that are different, with legal systems that are often inefficient or corrupt. In this regard, Mian (2006) has

[1] In this regard, it is interesting to note that similar effects were observed by Berger et al. (1995, pp. 73–80, 91–93), who review the effects of deregulation in the banking industry in the US. The authors show that following the liberalization of bank deposit rates, funding costs for banks rose and profitability fell, and that domestic bank lending fell. According to the authors, foreign banks more than offset the decline in US bank lending, but this lending was restricted to highly rated corporations, which received lower rates than the average customer of domestic banks. Small businesses were more likely to borrow from local banks and faced a steep decrease in lending. Lending fell by 34.8% and 41.9% for small and very small borrowers, respectively, in the period 1989–1994.