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Does judicial efficiency lower the cost of credit?

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Abstract

We investigate the effect of judicial efficiency on banks' lending spreads for a large cross-section of countries. We measure bank interest rate spreads for 106 countries at the country level and for 32 countries at the level of individual banks. We find that judicial efficiency and inflation rates are the main drivers of interest rate spreads across countries. Our results suggest that improvements in judicial efficiency and judicial enforcement of debt contracts are critical to lowering the cost of financial intermediation for households and firms.

JEL classification: D23; G21; G32; K42
Keywords: Interest rate spreads; Financial intermediation; Law and finance

1. Introduction

An efficient judiciary that enforces legal contracts is generally thought to enhance a country's investment climate, lead to lower interest rates, and thereby improve the performance of a country's economy. A transparent and efficient court system is likely to provide a better protection of creditors' rights and may improve the amount

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and speed of loan recovery. A larger amount of recovery and a shorter time to repossess collateral in the event of loan default allows banks to reduce lending rates and extend credit to previously rationed customers.

While prior research has found a positive correlation between judicial efficiency and the supply of external finance – both across countries (see, for example, La Porta et al., 1997; Demirguc-Kunt and Maksimovic, 1998; Galindo, 2001) and across states within countries (see, for example, Bianco et al., 2004; Castelar and Cabral, 2001; Cristini et al., 2001) – there exists mixed evidence of the effect of judicial reform on the cost of finance.

Theoretical research shows that the impact of judicial efficiency on lending spreads is ambiguous due to the presence of two countervailing effects. One is the positive effect of increased recovery in the event of default. The other is the negative impact of a composition effect as a result of which riskier and previously rationed bank customers may access bank credit (Bianco et al., 2004). The new cohort of risky customers will be charged higher interest rates that may offset the potential reduction in interest rates for existing borrowers. Banks with a dominant market position may also benefit from a more efficient courts by extracting higher rents from their borrowers.

On the empirical side, the evidence is mixed. Bianco et al. (2004) do not find significant effects of judicial efficiency on bank spreads in the Italian loan market, while Meador (1982) finds significant effects for the US mortgage market. Demirguc-Kunt and Huizinga (1999) find a significant relationship for a large number of countries between judicial efficiency and the ratio of banks' net interest income over total assets. Unfortunately, the latter association is not sufficient to infer the effect of judicial efficiency on the cost of credit because the ratio of banks' net interest income over total assets is an imperfect measure of the ex-ante cost of financial intermediation, and because this ratio may be affected by several asset composition effects. For example, a decrease in net interest income may derive from an increase in the share of fixed assets or government bonds relative to the share of loans in total assets. Another bias could arise from the inclusion of non-interest accruing non-performing loans in the calculation of total bank assets. In an analysis of the determinants of bank interest rate margins, Ho and Saunders (1981) and Saunders and Schumacher (2000) have tried to control for these factors using a two-stage regression procedure, but none of these studies focuses explicitly on the effects of judicial efficiency on lending spreads.

In this paper we use a measure of the ex-ante cost of bank credit – the spread between lending and deposit rates – to study the relationship between judicial efficiency and the cost of financial intermediation. We find that judicial efficiency is an important determinant of interest rate spreads across countries. Our results suggest that improvements in judicial efficiency and judicial enforcement of debt contracts are critical to lowering the cost of financial intermediation for households and firms.

By quantifying the relationship between judicial efficiency and the level of lending spreads, we can estimate the potential gains from increased protection of creditors' rights and reduced adverse selection in credit markets on the cost of financial