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How do bank competition, regulation, and institutions shape the real effect of banking crises? International evidence

Ana I. Fernández [a,1], Francisco González [a,2], Nuria Suárez [b,*]

[a] University of Oviedo, School of Economics and Business, Avda. Del Cristo s/n, 33071 Oviedo, Spain
[b] Public University of Navarre, School of Business and Economics, Arrosadía Campus, 31006 Pamplona, Spain

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ABSTRACT

This paper studies the influence of bank competition on the real effect of 36 systemic banking crises in 30 countries over the 1980–2000 period and how this influence varies across countries depending on bank regulation and institutions. We find that bank market power is not average useful for mitigating the negative real effect of a systemic banking crisis. Market power promotes higher growth during normal times in industries that are more dependent on external finance but induces a bigger reduction in growth during systemic banking crises. We also find a country-specific effect depending on bank regulation and institutions. Stringent capital requirements and poor protection of creditor rights increase the benefits of bank market power for mitigating the negative real effect of a systemic banking crisis because bank market power has a positive effect on economic growth during both crisis and non-crisis periods in these environments.

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1. Introduction

The current global financial crisis highlights the relevance of reducing the negative real effect of a systemic banking crisis. The empirical evidence on the variables that explain the real effect of banking

* Corresponding author. Tel.: +34 948 166 085; fax: +34 948 169 404.
E-mail addresses: afernan@uniovi.es (A.I. Fernández), fgonzale@uniovi.es (F. González), nuria.suarez@unavarra.es (N. Suárez).
[1] Tel.: +34 985 103 690; fax: +34 985 103 600.
[2] Tel.: +34 985 103 798; fax: +34 985 103 600.

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crises is scarce and limited to studies of the role of industries' external dependence, countries' financial development, and the size of the banking crisis. Dell'Ariccia et al. (2008) find that the industrial sectors that are highly dependent on external finance tend to experience a substantially greater contraction of value added during a banking crisis. Krozsner et al. (2007) go further and show that the negative effect on the growth of highly financially dependent industries is much greater in countries with deeper financial systems. Serwa (2010) suggests that is the size of the crisis that matters for economic growth.

There is, however, no empirical evidence on how bank competition shapes the real effect of banking crises and how its influence depends on bank regulation and institutions in the country. Our paper attempts to fill this gap by linking the literature on the impact of bank competition on economic growth with the Law and Finance literature and the literature that analyzes the real effects of banking crises.

Cetorelli and Gambera (2001) find a general depressing effect on growth associated with a concentrated banking industry. However, this general effect varies across sectors because bank concentration promotes economic growth in the industrial sectors that are most in need of external finance by facilitating credit access to younger firms. They argue that in such industries bank market concentration facilitates the formation of close lending relationships between banks and firms, which, in turn, have an enhancing effect on firms' growth. Claessens and Laeven (2004) find similar results using direct measures of bank competition.

There are also a number of recent cross-country studies highlighting the importance of bank regulation and supervision for the functioning and development of banking systems. Barth et al. (2004) analyze the relationship between specific regulatory and supervisory practices and banking-sector development. They show the more beneficial effects of policies that force accurate information disclosure and foster incentives for private agents to exert corporate control in promoting bank development. They also show that policies that rely excessively on official supervision and restrictions on bank activities are worse for financial development and stability. Beck et al. (2006) find that bank concentration increases financial stability after controlling for countries' regulation and institutions.

Our paper extends the above literature by analyzing the influence of bank market competition on the real effect of systemic banking crises. We analyze 36 systemic banking crises in 30 developed and developing countries over the 1980–2000 period. We use data for 28 industries in each country and a direct measure of bank competition (Lerner index). We use cross-country differences in bank regulation and institutions to assess the robustness of the influence of bank market competition and whether the regulatory and institutional environment shapes this influence. Thus, our research differentiates between the direct effect of regulatory and institutional variables on economic growth and the indirect effect that these variables may have by influencing the role of bank competition during banking crises.

We control for potential endogeneity of bank competition, regulation, and institutions using instrumental variables. The Law and Finance literature suggests that legal origins and cultural variables are the ultimate determinants of regulation and institutions across countries (La Porta et al., 2008) Moreover, regulation on, for instance, bank entry or antitrust legislation may affect bank market competition (Barth et al., 2004). So bank competition, regulation, and institutions may share ultimate determinants and be affected by endogeneity problems leading to correlations among them that would bias the results. To separate specific effects, we consider the three sets of variables and focus on the exogenous component of each one using instruments. This procedure allows us to interact and simultaneously analyze bank competition with, respectively, bank regulation and institutions.

The results suggest that bank market power is not on average useful for mitigating the negative real effect of a systemic banking crisis. External financially dependent sectors where market power promotes higher (lower) growth during normal periods also suffer on average a higher (lower) reduction in growth during a systemic banking crisis. This finding is consistent with market power enhancing lending relationship in normal times and the existence of switching costs for firms in changing lenders during a systemic banking crisis. We also find a country-specific effect for bank market power depending on bank regulation and institutions. Bank market power has a positive effect on economic growth during both crisis and non-crisis periods in countries with stringent capital requirements and poor protection of creditor rights. The positive effect of bank market power during non-crisis periods does not remain during a systemic banking crisis for other characteristics of bank

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