

Discussion of Vázquez
by
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It is well known that higher interest rates affect real activity through a decrease in investment demand. This is the standard *money channel*. But the increase in interest rates may also affect the real economy through a drop in the supply of loans. This mechanism is known as the *lending channel* and works as follows. A rise in interest rates leads agents to decrease their bank deposits in favor of bond holdings. If banks are unable to perfectly substitute this drop in deposits by an increase in non-insured debt, the cost of raising such debt goes up. As a result, the supply of loans falls, causing a negative shock to real activity.

One would expect this lending channel to be important when capital markets are underdeveloped or when access to financial markets is limited. A weak regulatory framework or lack of transparency in accounting standards could further contribute to the problem by making investors more reluctant to buy non-insured bank debt. All of this points to banks in developing countries being more liable to this problem.

The paper by Francisco Vázquez uses data on banks in developing and developed countries to test for the existence of the lending channel. Exploiting the cross-sectional variation, he finds evidence consistent with the predictions: loan growth is more sensitive to interest rates for banks in emerging economies, for small banks, and for banks facing high costs of non-insured debt financing. These results are interesting, since previous work on the lending channel has been limited to the U.S. The use of a much richer data set, which includes banks in a wide cross-section of countries, is an important contribution to the literature.

Though admittedly not the point of the paper, I would like to elaborate on what these findings imply for policy. If the lending channel is due to inefficiencies in the market, then policy should be aimed at eliminating those inefficiencies. Without being exhaustive, we could think of further developing and deepening financial markets, and of increasing the transparency of accounting and regulatory standards. Further measures may include favoring large over small banks, and possibly foreign-owned over domestically-owned banks.

But can we be confident in making those policy recommendations? Probably not. The reason for my skepticism is simple: the empirical predictions of the *lending channel* in the paper by Francisco Vázquez cannot be distinguished from the predictions of the *balance sheet channel*. As described in Bernanke and Gertler (1995), a monetary shock, such as an increase in interest rates, tends to worsen the balance sheet of firms and banks. Because of the increased risk of non-performing loans, banks react by charging higher interest rates, causing a drop in the volume of loans. In addition, the worsening loan portfolio of banks leads investors to require higher returns on non-insured debt, thus widening interest rate spreads.

As with the lending channel, we would expect the balance sheet channel to be more important in developing countries. It is well known that the “better” firms in emerging economies finance themselves abroad at more favorable interest rates, leaving the “worse” firms as clients to the domestic banks. This adverse selection problem leads local banks to have a worse loan portfolio.

Suppose for a moment that we take this “specialization” as given. If banks in emerging economies tend to lend to firms with a higher probability of default, then it is not surprising that a monetary shock has a larger effect on the volume of loans and on interest rate spreads. Indeed, this is exactly what you would expect if financial markets function efficiently. This of course leads to very different policy implications. Contrary to the recommendations deriving from the paper by Francisco Vázquez, it suggests that policy makers need not worry about inefficient financial markets. Of course this is pushing the point somewhat, since we probably should not take adverse selection as given. This opens up the possibility for policy to mitigate the adverse selection problem. In as far as adverse selection has something to do with inefficient financial markets, the policy recommendations may end up being less different than at first appeared.

In any case, from a policy point of view it seems important to disentangle these two competing theories. Simplifying a little, the bank lending channel emphasizes differences between banks in their access to financial markets (banks in emerging economies have worse access), whereas the balance sheet channel emphasizes the relation between a bank’s characteristics and its loan portfolio (banks in developing countries have riskier loans). To understand which mechanism is at work, more detailed bank level data on the quality of loans could be used. Better data on the development of financial markets would help too. Proxying this by a country’s level of development, as in the paper by Francisco Vázquez, is not entirely satisfactory, as financial markets differ substantially across developing countries. These are just some loose ideas, but they suggest directions for future research.

This discussion has focused on an alternative theory --- the balance sheet channel --- which is consistent with some of the empirical predictions of the bank lending channel. As a closing comment, note that there may be more than just those two competing theories. For instance, there exists the notion that big banks are “too big to fail”. If true, large banks would be able to freely raise non-insured debt, since investors would not have to worry about increased risk. In that case, would it still hold, as suggested by the bank lending channel, that policy should favor big over small banks? Probably not, since from a welfare point of view “bigger” would not anymore imply “better”.

Reference

Bernanke, B. and Gertler, M., 1995. “Inside the Black Box: The Credit Channel of Monetary Policy Transmission,” *Journal of Economic Perspectives*, vol. 9, no. 4, 27-48.