Discussion of

"Bank Competition and Credit Booms: Can Finance be Too Much, Too Cheap?"

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Summary of the paper

The paper contains two main parts:

1. A stylized theoretical model of ‘credit boom’
   - Not subject to risk-shifting problem (when bank is ‘close to the water line’)
   - But “there can still be excessive risk-taking as a result of bank competition”
   - Persistent credit boom could then occur as a result of co-ordination failure
   - The indeterminacy of the finance-neutral rate of interest indicates practical limits to using monetary policy to deal with financial stability
2. Three supporting observations
   - Larger credit boom tend to have a stronger association with financial crises.
   - Even if monetary policy was consistent with the Taylor rule, there is no guarantee that financial stability would have been ensured.
   - “Mini episode of credit boom” in Thailand during 2011-2013 is due to greater bank competition.

- In concluding section, “The theoretical result also argues in favor of promoting a level playing field in the regulatory policy.”

On credit boom: When more is better and when it is not?

- Generally, two different strands of literature
  - On the one hand, higher credit to GDP is seen as an indicator for financial development/deepening which tends to have positive effects on growth
  - On the other hand, 'excessive' credit expansion relative to GDP often end in crises

<u>Question</u>: What generates the fragility in the model?

- In the context of this theoretical model, there are two suspects

1. Increased riskiness of loan portfolio
2. Intense competition leading to higher risk-taking
   - As noted in the paper, a measure of bank competition (parameter *d*) 'could also be served as a rough proxy for degree of risk appetite'

On credit boom: When more is better and when it is not?

- These two points above implies
  - A <u>closely monitoring by CB</u>
  - The <u>need to measure degree of competition</u> (as a proxy for bank's risk taking)
- Both are not an easy job for CB!
  - Judgments on part of the regulator
  - Estimation errors

- Why not using other 'simple indicators' for warning sign?
  - For example, leverage ratios on part of the bank/firm/household
  - In general, some key financial ratios would be more straightforward

Competition vs Stability: Is there a trade-off?

- Higher bank competition could undermine financial stability
- But, when looking at microeconomic point of view, more competition would improve efficiency

<u>Questions</u>: How to balance these micro vs macro objectives?

- Note that both theoretical and empirical literature on this cannot give clear-cut answer

Competition vs Stability: Is there a trade-off?

The Economist

June 1st 2011 - June 13th 2011

Banking

This house believes that more competition makes banking more dangerous.

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Yes

Franklin Allen

Nippon Life Professor of Finance and Economics, Wharton School, University of Pennsylvania

No

Thorsten Beck

Professor of Economics and Chairman of the European Banking Center

Moderator

Jonathan Rosenthal

Banking editor, The Economist

Competition vs Stability: Is there a trade-off?

The Economist

Opening statements

Yes

Franklin Allen

Nippon Life Professor of Finance and Economics, Wharton School, University of Pennsylvania

While there are many historical examples of stable financial systems with limited competition such as Canada, there seem to be relatively few examples of highly competitive stable banking systems.

No

Thorsten Beck

Professor of Economics and Chairman of the European Banking Center

Competition in banking is not dangerous per se; it is the regulatory framework in which banks operate and which sets their risk-taking incentives that drives stability or fragility of banking.

Policy implications

- Very nice section on the ‘limiting role’ of monetary policy in dealing with excessive risk-taking on part of the lender
- The paper takes the view that macro-prudential policy is needed

Suggestions for future research

1. Need to explicitly analyze how macro-prudential measures could help in preventing inefficient credit boom equilibrium
2. Alternatively, could ‘moral suasion’ by CB be thought of a (practical) way to help co-ordinating expectations of bankers?
    1. Or, formally modeling strategic game between bankers vs regulator
3. Central bank communication as policy tool? For example, CB gives ‘public signal’ on financial imbalances