Comment on "Banking Competition, Housing Prices and Macroeconomic Stability"

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"Household Indebtedness, House Prices and the Economy"

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Macroeconomic Implications of Market Power in the Banking Sector

- NK with Banks (Christiano et. al (2007), Goodfriend and McCallum (2007), Meh and Moran (2007)...)

Imperfect Competition in the Banking Sector

- RBC with Imperfect Competition in Banking (Smith (1998), Aliaga-Diaz and Olivero (2007) and Mendelman (2006))

monetary policy shocks, housing investment, collateral constraints, frictions (production for rental services, capital adjustment costs...)

Main Results: Fostering banking competition increases total output and consumption + increases macroeconomic volatility

$\Longrightarrow$ trade-off between long run level of economic activity and its stability at the business cycle frequencies.

$\Longrightarrow$ reducing market power in banking doesn't necessarily deliver a better outcome!

On the Trade-Off

- Banks derive mkt power ex-ante from their relative proximity to the borrowing agents $\Longrightarrow$ mark-up for the intermediary (lending margins) $\Longrightarrow$ distortion in the model

weaker market power $\Longrightarrow$ lower margins $\Longrightarrow$ minimization of the distortion in financial intermediation

Minimization of a distortion/mark-up (not required by the structure of the model) $\Longrightarrow$ agents better off !

- higher long run level of consumption $\Longrightarrow$ improves welfare

- larger response to shocks $\Longrightarrow$ not necessarily welfare reducing

Is there any Trade-off?

Minimizing a distortion is welfare improving unless it exacerbate the consequences of alternative distortions present in the model

How does the reduction in banks market power affect the cost of other distortions?

Does the reduction of market power in banking generate a trade-off?

Other main distortions:

Nominal rigidities: $\Longrightarrow$ cost of price dispersion.

Debt contracts in nominal terms: source of private risk generated by the unnecessary redistribution of wealth between borrowers and lenders as a result of unexpected changes in debt repayment. $\Longrightarrow$ variability of debt services

On the Results: Business Cycle Implications

R. Todd Smith "Banking Competition and Macroeconomic Performance" (JMCB 98)

(1). In the presence of imperfect information in credit markets "Increased bank competition raises the level of income and reduces the severity of business cycles"

(2). As in Diamond (RES1984) "less competition in the banking system enables banks to turn the efficiency gains into bank profitability" $\Longrightarrow$ imperfect competition can have much more negative impact on macroeconomic performance than the presence of imperfect information in credit markets itself.

(1). shared by Aliaga-Diaz and Olivero (2007) and Mendelman (2006)

Andres and Arce (2008):

$\uparrow Z \implies \uparrow$ borrowing ability $(\uparrow$ housing value$, Q)$ and interest payment $(\downarrow \pi) \implies$ first effect dominate and the economy reacts more to shocks.

calibration? assumption?

- sticky prices vs flex prices

- **form of collateral constraints + always binding**

- different assumption about the origin of imperfect competition in banking: distance vs switching costs vs imperfect information

- perfect info (vs info problems)

sensitivity analysis?

On the Assumptions: Banking Sector

Market for deposit: perfectly competitive

- deposit rate = policy rate

Market for Loans

1. Only bank-intermediated credit available

2. Monopolistic Competition a la' Salop (79): product differentiation is generated by transportation costs.

$\Longrightarrow$ Active banking sector: set loans rates taking the deposit rate and the demand for loans as given and equating the amount of loans to the available deposit.

Loans:

- 1-period contract

- riskless (no risk of default (probability of default=0)

- no information problems

but collateral requirement: *Why?*

Results mainly related:

- (procyclical.) housing prices in the collateral constraint

- always binding constraints

alternative assumption on the collateral requirement?

Bank Competition and Availability of Credit

higher competition $\Longrightarrow$ lower lending rates $\Longrightarrow$ increase in the availability of credit (endogenous effect)

$\Longrightarrow$ *what about direct changes in lending standards?*

- the lender offer a menu of loan contracts $\left\{C_j, R_j\right\}$

- where the repayment R_j depends on the amount of the collateral $(C_j = \alpha_j EqH)$ that the borrower decides to give

$\Longrightarrow$ effects of market power on two channels: the cost and availability of external finance

Effects bank competition on the loan rate and the availability of credit for firms

- non-linear relation: under market power lasting relationship with clients though it doesn't necessarily generate benefits in terms of lower cost of finance, does favour access to finance or requires the client to offer fewer assets in guarantee

- Petersen and Rajan (QJE 1995) document that some firms in more concentrated markets obtain greater relationship benefits (lower loan rates and easier access to bank credit) than firms in more competitive markets.

Model abstract from any "lending relationship" and information problems

$\Longrightarrow$ history doesn't affect current relation between borrowing and lenders

Good first step in modelling market power in banking and monetary policy

- think in terms of distortions and welfare vs economic performance

- alternative assumption on the form of the borrowing constraint

- lending relationships and a deeper characterization of the market power in banking