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Costly information, entry, and credit access

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Abstract

Using a theoretical model that incorporates asymmetric information and differing comparative advantages among lenders, this paper analyzes the impact of lender entry on credit access and aggregate net output. The model shows that lender entry has the potential to create a segmented market that increases credit access for those firms targeted by the new lenders but potentially reduces credit access for all other firms. The overall impact on net output depends on the distribution of firms, the relative costs of lenders, and the cost of acquiring information. The model provides new insights into the evidence regarding foreign lenders' entry into emerging markets.

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1. Introduction

By allowing financial institutions in developed countries to lend directly to firms in less developed countries (LDCs), open capital markets are generally thought to alleviate domestic liquidity constraints, to improve the allocation of credit, and hence to increase aggregate net output. As a result of these potential benefits, many LDCs opened their capital markets in the 1980s and 1990s. These openings fostered foreign lenders' entry into their economies and changed the local competitive structure of their financial sectors. But, the assumption that opening capital

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markets is beneficial has recently come under serious doubt, as empirical studies have repeatedly failed to find a consistent relation between foreign lenders' entry, credit access, and net output in LDCs.¹ This lack of empirical evidence leads to this paper's central question: Why might the entry of new lenders, as experienced in many LDCs, *not* increase credit access and aggregate net output?

In this paper, I show that information asymmetries and competitive interactions between lenders with differing comparative advantages provide an answer. This paper presents a theoretical framework that explains how lender entry into an already competitive credit market can affect firms' access to credit when the entering lenders enjoy a different cost of capital and ability to acquire information about firms than incumbent lenders. Specifically, the model assumes entering lenders have a lower cost of capital but incumbent lenders determine firms' quality at a lower fixed screening cost per firm.² Within this framework, it is possible to derive a number of novel predictions.

First, new lender entry has the potential to induce a segmented credit market that reduces credit access for many firms. The intuition is straightforward. When the cost of acquiring information is sufficiently high, a competitive, closed-economy equilibrium may occur in which incumbent lenders pool all firms together with a uniform financial contract rather than invest in the costly screening technology. Relative to the first-best allocation without information asymmetries, a pooling equilibrium overfunds low-return firms and underfunds high-return firms. The entrance of new lenders may break this pooling equilibrium. Because of their lower cost of funds and the fixed nature of screening costs, entering lenders may find it worthwhile to acquire information about firms' types so as to offer more competitive contracts to high-return firms capable of profitably investing large amounts of capital—a practice commonly called “cream skimming”. While some firms benefit from cream skimming, the resulting separating equilibrium may reduce credit access for other firms by changing the set of financial contracts available to them.

This potential decline in credit access leads to the model's second implication: Additional lenders' entry has the potential to either increase or reduce net output. Cream skimming by entering lenders increases net output by eliminating the underfinancing of high-return firms capable of profitably investing large amounts of capital. The net output of all other firms, however, may decline. Because cream skimming reduces the average quality of firms that accept pooling contracts, these contracts may become more expensive, reducing the net output of firms that accept them. In some cases, the pooling contract will become unprofitable for lenders to offer, and the remaining firms will go unfunded entirely, further reducing net output, if neither the incumbent nor entering lenders find it cost-effective to acquire the information necessary to identify the remaining high-return firms.

The model thus provides a relatively simple explanation as to why open capital markets may not necessarily increase overall output in LDCs. In LDCs with significant information acquisition costs, the initial domestic allocation of credit may fail to achieve the first-best allocation because

¹ For example, Rodrik [46] and Edison, Levine, Ricci, and Słøk [23] find no effect of open capital markets and financial integration. See Eichengreen [25] for a more detailed review of this literature. More recent research focusing on the specific impact of foreign participation in domestic equity markets and foreign bank entry also reaches differing conclusions. For example, Bekaert, Harvey, and Lundblad [10] and Henry [34] find positive correlations between equity market liberalization and economic performance, whereas Detragiache, Tressel, and Gupta [22] and Gormley [30] find foreign bank entry to be negatively related to overall domestic credit.

² The comparative advantage of entering lenders—a higher cost of screening but lower marginal cost of funds—finds substantial support in both the theoretical and empirical literatures on foreign lender entry into LDCs (e.g., see Mian [39,40], Micco, Panizza, and Yañez [41], Stein [49]). This evidence is discussed in Section 7.1.

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