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Journal of International Money and Finance 27 (2008) 387–410

Journal of International Money and Finance

www.elsevier.com/locate/jimf

Credit, cronyism, and control: Evidence from the Americas

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Abstract

I examine the effects of corruption and government control of the banking system for 18 Western hemisphere countries on the sensitivity of commercial lending rates to changes in international financial conditions and find that most countries' lending rates are insensitive to these conditions. Only the least corrupt nations exhibit a significant positive relation between lending rates and international financial conditions. The responsiveness of these lending rates is nonlinearly related to corruption and government control of the banking sector. The findings suggest that both corruption and government control of banks need to be considered when analyzing international credit markets.

JEL classification: F3; F34; F37; G15; G21

Keywords: Credit allocation; Commercial banks; Corruption; Government Intervention; Empirical analysis; International

1. Introduction

The proper functioning of an economy's credit allocation mechanism is an integral part of a healthy, growing macroeconomy. Studies such as those reported in Demirgűç-Kunt and Levine's (2001) book on the linkage between financial system performance and macroeconomic growth confirm there is a significant positive relation between the depth and maturity of a nation's financial system and the health of its macroeconomy (as measured by economic growth,

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0261-5606/$ - see front matter
doi:10.1016/j.jimonfin.2008.01.010

productivity, inflation, etc.) regardless of whether a nation's financial system is "bank-based" or "market-based".[1,2] Thus, it is important to consider how a nation's banks allocate loans because the potential mis-allocation of commercial credit can have significant effects on the country's long-term macroeconomic performance.

In particular, I examine the sensitivity of a country's commercial lending rates to changes in international financial market conditions using the well-known Markowitz (1952) market model relation. Since the market model can be applied to any risky asset, the relation can be used to estimate the ex ante required returns on commercial bank loans. In addition, the choice of a country's domestic commercial lending rate is a suitable variable to study in terms of credit allocation because it represents an ex ante measure of the national price of commercial credit. Clearly, if this promised price is "incorrect" (i.e., sub-optimal) due to corruption, government control of the banking system, or other effects, then the price and quantity of credit allocated, as well as its distribution amongst national entrepreneurs, will also be distorted. Thus, the market model's application to ex ante lending rates provides a theoretically consistent and concise test of a country's credit allocation mechanism.

Once I have estimated the relation between a country's commercial lending rate and changes in international financial conditions, I test whether these sensitivities for a sample of countries can be explained by cross-sectional differences in national levels of corruption, government control of the banking system, as well as control variables such as the depth of banking market, the concentration of the banking industry, and the overall cost efficiency of the banking system. La Porta et al. (2002), Pagano (2002), Hannan and Berger (1991), and Brock and Suarez (2000) provide the theoretical and empirical basis for my choice of the above variables. In particular, La Porta et al. (2002) and Pagano (2002) show that there are significant economic effects associated with the level of government control of a nation's banking system and the level of corruption, respectively. For example, La Porta et al. (2002) reports that government control of a nation's banking system has negative effects on the nation's economic growth and productivity. Pagano (2002) finds that high levels of corruption explain the lack of sensitivity of commercial lending rates in East Asian countries during the 1997–1998 Asian financial crisis.

The empirical tests presented in this paper explore how commercial lending rates in 18 Western hemisphere countries were determined during 1978–2001.[3] The Western hemisphere countries of North, Central, and South America were chosen for this analysis because it is the most homogeneous (and large) geographic region in the world in terms of demographics, as well as economic, political, and legal systems. Thus, it provides the "cleanest" test of the model in terms of controlling for important country-specific differences. Further, Aizenman and Lothian (2003) cite the increasing relevance of Latin America's financial markets and financial institutions within the global financial arena. Edwards et al. (2003) also note that "concordance of cycles across markets has increased significantly over time, especially for Latin American countries after liberalization" during the late 1980s and early 1990s.

[1] See chapter 1 of this reference for an excellent overview of this linkage. Chapters 3–7 provide further details on specific aspects of the linkage between financial systems and macroeconomic activity.

[2] The distinction between "bank-based" and "market-based" financial systems centers on the overall reliance of corporations to use banks or financial markets for their financing needs. See Allen and Gale (2000) for a comparison of the two major types of financial market systems and their relative advantages and disadvantages.

[3] The 18 countries cover North, Central, and South America and are as follows: Argentina, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Panama, Paraguay, Peru, U.S., Uruguay, and Venezuela.