Competition and credit procyclicality in European banking

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Abstract

This paper empirically assesses the effects of competition in the financial sector on credit procyclicality by estimating both an interacted panel VAR (IPVAR) model using macroeconomic data and a single-equation model with bank-level data. The findings of these two empirical approaches highlight that an exogenous deviation of actual GDP from potential GDP leads to greater credit fluctuation in economies where competition among banks is weak. According to the financial accelerator theory, if lower competition strengthens the cyclical behavior of financial intermediaries, it follows that these "endogenous developments in credit markets work to amplify and propagate shocks to the macroeconomy" (Bernanke et al., 1999). Furthermore, since credit booms are closely associated with future financial crises (Reinhart and Rogoff, 2009; Schularick and Taylor, 2012; Gourinchas and Obstfeld, 2012), our results can also be read as evidence that greater competition in the financial sphere reduces financial instability, which is in line with the competition-stability view denying the existence of a trade-off between competition and stability.

JEL Codes: E32, E51, G20, D40, C33

Keywords: credit cycle; business cycle; bank competition; interacted panel VAR

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