Can National Banking Systems Compete?

A Comment on the Paper by Hans-Werner Sinn

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Hans-Werner Sinn's paper raises important questions about the efficiency of international banking markets. His central proposition is that competition between systems of national bank regulation suffers from the same kind of market failure as the private banking market itself.

His basic argument is that good regulatory systems are expensive, but asymmetric information makes it hard to distinguish them from bad ones. Consequently, bad systems drive out the good in same way that bad products eliminate good ones in the well-known Akerlof (1970) model, resulting in an international race to the bottom. Sinn (2003) argues that this helps to explain the poor regulatory environment that precipitated the Asian banking crisis. However, in my view, his basic argument is not persuasive.

Financial products are credence goods: their quality is hard to discern both *ex ante* and *ex post*. To take the classic example, when an investment fund does well relative to the market, it is never entirely clear whether this is due to good management or good luck. In this situation, the well-known problems of adverse selection, moral hazard, and *ex post* state verification are inevitable. Banks are special in that the deposit contract can lead to excessive risktaking, bank runs, and systemic threats (Spencer, 2000).

Sinn's model represents an investment banking system, which raises funds through time deposits or loans and lends them on to borrowers. The number of banks is fixed, allowing them to make supernormal profits.[1] Each bank chooses the rate at which it lends these funds on to borrowers. As in the model

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1   There are problems with Sinn's model that would make me wary of using it for policy analysis. We are told that "there are a fixed number of competitive banks, which face an inelastic demand for funds" (Sinn 2003, p. 311–312). Surely what Sinn means is that banks act as pricetakers in the deposit market. Also, it is hard to see how changing the loan rate can affect the risk of lending and the expected return without affecting the quantity demanded by borrowers. This is certainly not consistent with adverse selection. It might result from moral hazard, yet we are also told (Sinn 2003, p. 311) that banks "possess the necessary information to monitor business firms and the power to enforce the efficient behavior of these firms." I do not find the arguments of footnote 12 convincing in this respect.

of Stiglitz and Weiss (1981), the expected probability of default increases with the loan rate. When the bank has limited liability, this gives it an incentive to undercapitalize and finance excessively risky projects. Bank regulation is designed to offset this tendency, by ensuring that banks are adequately capitalized.[2]

Depositors apparently cannot calculate the default probability of the individual bank, but can estimate the risk of the banking system as a whole and demand a premium rate that reflects this. This is a pooling equilibrium in which banks are indistinguishable and all face the same cost of funds, which reflects the reputation of the industry for quality.

As Sinn's equilibrium model makes clear, in the absence of regulation (and free entry to banking) these informational defects reduce producer rather than consumer surplus. There is a strong incentive towards self-regulation in this situation. If banks can use their expertise to eliminate their poorly capitalized fellows, this raises the quality and lowers the cost of funds, turning Akerlof's downward spiral into reverse (Spencer, 2000). Historically, studies of free (i.e., unregulated retail) banking systems suggest that banks could do this by restricting the membership of the clearing house. Interbank lending arguably plays a similar role in a modern system. Sinn's assumption that the number of banks is fixed suggests that producers have some means of regulating entry.

If depositors can assess bank default risk at the national level, Sinn shows that a bank capitalization rule can be used to replicate the optimum that obtains under unlimited liability. It does this by inducing the banks to set the loan rate at the level that obtains with unlimited liability, avoiding excessive risktaking. (Self-regulation would also help raise profits in this situation.) However, he goes on to argue that this scenario is not convincing because it contradicts the "Selection Principle": governments concentrate their regulatory efforts on markets that have failed. This is the crux of his argument.

The problem with this proposition is quite simply that regulators do not concentrate their efforts on the investment banking markets, which are the focus of Sinn's model. Wholesale depositors are normally left to look after themselves under *caveat emptor*. Indeed, the market that conforms most closely to the structure of Sinn's model is the Eurodollar market, which is

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2 However, this literature neglects the possibility of applying nonfinancial sanctions for bad performance. As Sinn (1983) puts it when he derives the gamble for resurrection: with unlimited liability and undercapitalization "you can't get blood out of a stone." Diamond (1984) shows that if nonfinancial penalties are available, then the moral hazard (and the *ex post* state verification) problem can be avoided even with zero capitalization. Diamond assumes, in contrast to Sinn, that loan risks are completely diversifiable. However, similar results have been obtained without this assumption by Bhattacharya and Thakor (1990) and others.

not regulated, or at best self-regulated. Regulators can admittedly set dedicated capital levels for the marketmaking and trading activities of investment banks, but these activities do not feature in his model.

In fact, governments focus their efforts on the *retail* banking market, which offers instant-access deposits and – some would argue – is prone to bank runs and systemic collapse if left unregulated. But Sinn does not claim to model such systems. Consequently, his "Selection Principle" does not tell us whether international bank lenders can assess risk at the national level. This remains an open and interesting question.

In addressing this issue, Sinn suggests that depositors could infer a country's default risk from its banking legislation (Sinn 2003, p. 321), and he shows that this would lead to an efficient equilibrium in systems competition. However, he is dismissive of this line of argument. He also notes (Sinn 2003, p. 309) that depositors could get "some idea of the frequency of bank failures in general and the amounts normally repaid in such events." This idea is built into his equilibrium model, determining the deposit rate in the pooling equilibrium. However, it is hardly a great leap of the imagination to suppose that investors could get an idea of the frequency of bank failures in a national system. Indeed, the rational-expectations hypothesis would dictate such an outcome in long-run equilibrium.

There is evidence that wholesale depositors can distinguish different regulatory systems, suggesting that regulators can avoid a race to the bottom. For example, the Eurodollar market is centered in London with its system of light self-regulation rather than centers like Grand Cayman with practically no regulation at all. That is not to say that the system is perfect. Evidently, there have been problems in Mexico, East Asia, and more recently Argentina. However, many would argue that these problems are primarily the result of the moral hazard in the international financial system that results from IMF bailouts, rather than an inability of international investors to assess risk differentials.

Modern retail banking systems are of course characterized by government deposit insurance, which lifts the risk from depositors and places it with the government. It is clearly in the government's interest to supervise these systems effectively, so Sinn's arguments about the ability of depositors to assess default risk are not relevant here. Whether or not governments can regulate these systems remains another open question. Arguably, the U.S. savings & loan debacle, which is mentioned in the paper (Sinn 2003, p. 309), was a failure of the retail deposit market and does not tell us much about the viability of the wholesale deposit markets. Moreover, because the taxpayer picks up the bill when things go wrong, this naturally pits the banks against the government and gives them a clear incentive to lobby for an easing of the regulatory burden (Sinn 2003, p. 320). An alternative explanation of this kind

of lobbying – to the extent that it occurs – is that the initial level of regulation could simply be too high: the London Eurodollar example suggests that in the absence of deposit insurance banks would not want zero regulation but light regulation.

It remains possible that Sinn is right in saying that international depositors do not have the expertise to distinguish between different banking systems. Then I would expect international banks to use their expertise to try and monitor their fellows and exclude them from the international banking markets, just as they did in free-banking systems. But in my view the jury is still out.

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