

# Commentary

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**D**oes credit market competition aid or hinder the formation of firm-creditor relationships? Economists have offered contradictory answers. In an insightful analysis, Mayer (1988) argued that in a world where contracts are incomplete, limited competition in the credit markets might allow creditors to take the long-term view. Intuitively, a certain degree of monopoly power can create the kind of rents *ex post* that allow the monopolist creditor to invest in nurturing young firms. Put another way, if the borrower cannot commit to stay with the lender via long-term contracts, but it is optimal for him to commit, he may be better off when the creditor is a monopolist because commitment is achieved *de facto*.

A number of assumptions are necessary for this result. First, for the relationship to start up, the lender has to make a fixed investment up front, regardless of whether he is a monopolist. Second, once the relationship starts up, there is little ongoing relationship-specific investment by either party during the course of the relationship. These two assumptions ensure the lender will have more of an incentive to make the required investment when he is faced with little competition *ex post* and that competition *ex ante* does not spur more investment.

Petersen and Rajan (1995) formalize this intuition in a model and take it to the data. One measure of a creditor's up-front investment in a relationship is his willingness to offer lower-than-market rates to start-up firms. They find that loan rates are indeed lower for young firms and higher for older firms in concentrated banking markets than for comparable firms in competitive banking markets. They also find a greater availability of credit for firms in concentrated markets.

Of course, if the upfront investment is discretionary, the potential monopolistic lender will have less of an incentive to make that investment if he knows that the borrower will be captive anyway.

(This assumes, of course, that the lender cannot appropriate all the surplus the borrower generates.) Similarly, if the relationship demands ongoing investment by the borrower, he may have less of an incentive to commit to that investment if he knows the lender will enjoy a monopoly regardless. A marriage where there is no possibility of divorce is one where neither party has the incentive to work very hard at keeping the marriage exciting. Thus the traditional effect of monopolies, that they distort the incentive to invest, can imply that firm-creditor relationships can be shallow and unsatisfying. (See, for example, Dinc, 2000, for a nice development of this point.)

This means that one cannot make a blanket assertion about whether credit market competition is good or bad for firm-creditor relationships—it depends, at the very least, on the nature of the investments that are required by either party. To test the theory, we have to go deeper into the data and look at the details of the theory—for example, the intertemporal loan rate smoothing observed by Petersen and Rajan (1995).

However, work has moved beyond testing the detailed implications of the theory to testing whether some of its predictions hold up. In particular, if firm-creditor relationships are stronger in more concentrated areas and if they especially benefit small and young firms who would otherwise have limited access to credit, we should see more entry by industrial firms in areas where there is more credit market concentration. (See Cetorelli's paper, as well as Black and Strahan, 2002.)

While exploring a link between credit market competition and entry is interesting, I am not sure we can attribute any finding solely to stronger (or weaker) firm-creditor relationships. There are at least two other explanations that have to be ruled out.

The first is a selection bias. For example, it could be that areas where there is little entry into banking (so that the banking sector is concentrated) are also areas where entry into industry is difficult. A correlation would then be seen between limited industrial entry and banking sector concentration; the cause would not be weak relationships, however, but a

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common explanatory omitted variable—poor incentives to enter industry or finance.

The omitted variable could also be political: Perhaps access to finance is used as an entry barrier. (See the negative correlation between the size of entry barriers in a country and the development of financial markets documented in Rajan and Zingales, forthcoming.) In areas with more concentrated finance, such barriers are easier to coordinate. Or, equivalently, concentrated finance might reflect the ascendancy of a small group of incumbents who prevent finance from becoming widely accessible.

These possibilities suggest that one has to be cautious about examining the relationship between entry and credit market competition and drawing strong conclusions about how the availability of finance to small- and medium-sized firms varies with credit market competition. For instance, a liberalization of credit markets is likely to occur in concert with a removal of other entry barriers for a variety of reasons.

This suggests that we need to move away from the broad implications of the theory (the correlation between competition and access to credit) to the more detailed implications of the theory in order to test it. One way that Cetorelli's paper suggests is to look at the differential impact of credit market

competition on firms of different ages or on firms at various stages of distress. I think this is promising, and if the predictions can be tied more closely to the theory (that is, what is the nature of the investment required at each stage), we will make progress.

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