

A Potential Pitfall in Estimating a Nonlinear Function of Bank Lending: A Critical Evaluation of “Unnatural Selection”*

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Abstract

We critically evaluate the mechanism of “unnatural selection”, suggested by Peek and Rosengren (2005), in terms of specification of the forbearance lending. We demonstrate that their estimation results, which are based on the random effect probit specification, would imply that, in the late 1990s (from years 1994 to 1999), Japanese banks lend more credits to firms with lower profitability irrespective of whether they are capitalized or lowly capitalized. Our finding suggests that the forbearance lending to low-quality firms would prevail in the Japanese banking system.

Keywords: interaction effect, nonlinear specification, probit model, forbearance lending.
JEL classification: G01, G21, G28.

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