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Do more competitive banks have less market power? The evidence from Central and Eastern Europe

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A B S T R A C T

Studies that have explored the competitive behaviour of banks frequently arrive at divergent conclusions because they use different measures of competition. This study first discusses these various measures of competition and their divergence from a theoretical perspective and then employs them to measure the competitiveness of Central and Eastern European banks and to investigate whether more competitive banks really have less market power. We find that these banks increase their market power when there is low banking concentration and do not necessarily become less competitive. Moreover, a more concentrated banking market does not enhance the market power of banks and does not make them less competitive, and more competitive banks do not necessarily have less market power. This latter outcome ensues because revenue and production reactions to cost evolution are either positively related – or completely unrelated – to the competitive behaviour of banks.

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1. Introduction

Bank regulators and researchers in banking have made many attempts to assess banks' competitive behaviour. This issue is important because of the role of bank competitiveness in economic development, because of banks' reactions to deposit-insurance requirements and prudential regulations, and because of the effects of banks' competitive behaviour on their performance and on the stability of the

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banking system, among other reasons. A higher level of competition might encourage banks to engage in higher levels of risk-taking behaviour (Salas and Saurina, 2003), particularly because of prudential constraints (Bolt and Tieman, 2004) that modify the market power effects of banks and their risk-taking behaviour (Lapteacru, 2008). Competition in the banking sector might improve bank efficiency, according to the Structure-Conduct-Performance (SCP) paradigm (Bain, 1951), or competition might have a negative effect on bank performance because of losses linked to excessive risk-taking behaviour (Lapteacru and Nys, 2011). The structure of the banking sector, in conjunction with risk-taking behaviour, is likely to affect the stability of the banking system: tougher competition among banks might increase the likelihood of bank failure (Fungáčová and Weill, 2013), and a crisis is less likely to occur in countries with a concentrated banking sector (Beck et al., 2006). However, fierce bank competition might also imply stronger economic growth (Smith, 1998).

Despite the importance of the various banking competition measures, there is much confusion in the literature about what a given competition measure captures, which has resulted in the interchangeable usage of several distinct banking competition measures, such as the Herfindahl-Hirschman index (which measures concentration in the banking market), the Lerner index (which measures the market power of banks), and the H-statistic (which measures bank competition). The aim of this paper is to assess and explicate the differences among these competition measures, and to further explain what each describes and why none of these measures can be used in place of another.

Probably because of this confusion, there is no consensus among academics and regulators in banking about the most reliable measure of bank competition. Bank regulators typically employ the Herfindahl-Hirschman (HH) concentration index to gauge the level of competition among banks. The SCP paradigm justifies the application of the HH concentration index, because a concentrated market facilitates uncompetitive behaviour and allows banks to over-price their products and services. However, economists mostly use measures that stem from economic explanations of bank behaviour; in particular, they use the Panzar and Rosse H-statistic[1] and the Lerner (1934) index. The H-statistic measures competitive behaviour by the reaction of bank revenue to the evolution of input prices. Banks manifest perfectly competitive behaviour if they completely adjust the variation of input prices with their revenue. As for the Lerner index, it is a measure of the market power of banks. In a perfectly competitive market, the price of a bank's product is equal to the bank's marginal cost, and the banking institution therefore has no market power.

Despite the relationships between these competitive measures – a more concentrated market encourages less competition (Bikker and Haaf, 2002) and more market power for banks – the conclusions of numerous studies are often divergent and, therefore, controversial. A more concentrated market is not necessarily less competitive if it is contestable (Baumol, 1982; Baumol et al., 1982). Claessens and Laeven (2004) found no evidence that competitiveness – as assessed by the H-statistic – positively relates to market concentration, and the authors suggest that contestability determines the effectiveness of competition. A sizeable empirical banking literature suggests that concentration is not a reliable measure of competition (Shaffer, 1999, 2002; Shaffer and DiSalvo, 1994; Claessens and Laeven, 2004).

The H-statistic and the Lerner index are subject to certain constraints with respect to the characterisation of competition. The reaction of bank revenue to the modification of bank costs characterises the H-statistic measure of competition. The estimation of the Lerner index is subject to profit maximisation strategies and to the condition of price invariability to changes related to bank production.

The absence of consensus in the banking literature regarding these three measures of competition leads this study to explore whether more competitive banks have less market power (as certain theoretical paradigms imply), or whether there is no relationship between competition and market power (as certain empirical results suggest). Focusing on the Central and Eastern European (CEE) context, this study explores the origins of the relationship between competition and market power and reveals certain important factors; specifically, it examines the relationships between the concentration of the banking market (HH index), competitive behaviour (H-statistic) and market power (Lerner index).

[1] See Panzar and Rosse (1982, 1987).

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