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European Economic Review 47 (2003) 841–855

EUROPEAN
ECONOMIC
REVIEW

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Industrial loans and market structure

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Accepted 23 July 2002

Abstract

Based on the observation that financing is one of the main obstacles to create new firms, this paper deals with the interactions between the market structure of both the banking sector and the borrowing industries. We consider that firms' installation costs are financed by means of industrial loans from specialized banks. With endogenous entry in banking activity as well as in the borrowing industry, we find that a natural oligopoly emerges in both sectors if the entry cost in the industrial sector is small enough, relative to the banks' entry cost.

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JEL classification: G21; L10

Keywords: Banks; Industrial loans; Oligopoly

1. Introduction

It is usually claimed that financing is one of the main obstacles in the creation of new firms. In line with that observation, this paper studies the impact of industrial loans from banks on the market structure of both the banking sector and the borrowing industries. Specifically, our main aim is to deal with the limit configuration that emerges in both markets when the conventional conditions for perfect competition tend to prevail, that is, when the entry costs in both sectors converge to zero. In that context, our results suggest that a natural oligopoly may arise as the emerging limit configuration in both sectors.

In developing a model of industrial loans and market structure, we consider that the entrepreneurs borrow from specialized banks in order to build up their firms, and

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then the resulting active entities compete on the product market. This means that the entrepreneurs compete both to obtain loans from banks and to sell the output to consumers. As a consequence, in deciding on the amount of loans there are two opposite effects on any bank's payoff. First, there is a positive *market-share effect* according to which the bank is able to capture a larger market share by means of extra loans to entrepreneurs, hence providing the bank with a private incentive to perform aggressively in the loan market. Second, there is a negative *rent-extraction effect* because those extra loans imply more competition on the product market, which reduces each bank's ability to extract rents from its borrowing firms, and induces the banks to perform less aggressively in the loan market in order to ensure less competition among firms.

In a preliminary version of the model, we examine the case in which the number of banks is exogenous. This allows us to explore how a given configuration for the banking sector affects the equilibrium structure in the borrowing industry. We find that if the number of banks is small enough, relative to the degree of product differentiation, the rent-extraction effect dominates and the equilibrium structure in the product market mimics the configuration of the banking sector. By contrast, if the number of banks is high enough, relative to the degree of product differentiation, the market-share effect dominates and the subgame perfect Nash equilibrium (SPNE) leads to a number of loans that goes to infinity as the entry cost per firm tends to zero.

On the grounds of the baseline version of the model, we consider afterwards the number of specialized banks as endogenous. In particular, we assume that every bank must pay a fixed cost in order to enter the market of loans to a particular industry. In this part of the paper, we show that if the conventional conditions for the emergence of perfect competition tend to prevail, then the SPNE will in fact tend to one of the following outcomes: Perfect competition in both markets, natural oligopoly in the loan market with perfect competition in the product market, or a natural oligopoly in both markets, all of which depend on the relationship between the rate of convergence of both fixed costs to zero and on the degree of product differentiation. That is, the equilibrium market structure will depend on the relative rate at which the conventional conditions for perfect competition in both markets tend to emerge. Remarkably, when the two entry costs tend to zero but creating a bank is still relatively more costly than creating a firm (the fixed cost by firms converges to zero at a higher rate), then the SPNE converges to a natural oligopoly in *both* markets. The reason for this is that the market-share and rent-extraction effects create a discontinuity in the incentive to provide loans, so that the former effect dominates when the number of banks is beyond a given critical level. In consequence, the threat of triggering a large number of loans (associated to negative profits) if "excessive" entry occurs, can ensure that in fact a small number of banks enter and provide an amount of loans also small in number.

The current paper is closely related to the literature on the implications of finance on product market competition. This literature suggests that credit market competition affects lending relationships, so that the banking sector emerges as a key determinant in shaping the borrowing industries.¹ The current paper builds on this literature and

¹ For example, see Petersen and Rajan (1994, 1995). For an overview of the relationship between financial structure and product market competition, see Maksimovic (1995).

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