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Competition in markets with dominant firms: A note on the evidence from the Italian banking industry

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Abstract

In this paper we consider the Italian banking industry, where the eight largest firms operate at a national level, manage about a half of total loans, and have a notably larger dimension than the other competitors. We estimate a structural model containing a behavioural parameter, in order to assess the market conduct of the largest banks for the period 1988–2000. Our finding is that, in spite of their noteworthy size and significant market share, these banks have been characterised by a more competitive conduct than the Bertrand–Nash outcome: this is in line with the results of the latest literature of the field, for which in the banking industry there is often no conflict between competition and concentration.
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1. Introduction

In the past two decades, European banking markets have been subjected to structural changes, due to modifications occurred in the external environment: particularly, the liberalisation of capital flows and the prospect of a common market have influenced the policy of the domestic banks. This has pushed them to search for more

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efficient organisational solutions, greater variety of the offered services and stronger exploitation of scale economies. The last of these phenomena has taken place especially thanks to an increasing consolidation, and has led to a fall in the number of banks.

It is crucial to assess whether such modifications have had an impact on the degree of competition characterising the banking industry, because of the potential for monopoly power that the consolidation process could produce. This paper aims to evaluate the degree of competition of the eight Italian largest banks (the only operating throughout the whole country, and also involved in many mergers and acquisitions) during the period 1988–2000, and thus shed light on the possibility that few important banks use their dimension and market leadership to act as colluding oligopolists.

Section 2 gives a brief picture of the structural evolution of the Italian banking industry over the recent years, and presents our conjectural variation model. Section 3 describes the sample characteristics and discusses the estimation results. Some conclusions are given in Section 4.

2. A conjectural variation model of competition for the Italian banking market

Over the last fifteen years, a profound process of consolidation occurred in the Italian banking industry, giving rise to significant transformations. Commercial banks have been forced to search for scale and scope economies, with the aim of increasing their efficiency. As a consequence, from 1988 to 2000 the number of commercial banks dropped from 1100 to 841. Moreover, in the decade 1990–2000 there were 356 mergers or acquisitions. The belief of the Central Bank of Italy is that in the national banking industry (characterised by a prevalence of small-scale banks) there is room for exploiting wide scale economies, without prejudice to the market niches of local little banks. At the same time, mergers and acquisitions are considered as a beneficial solution compared to the closure of inefficient banks, since their exit is expected to involve economic and social costs.

In spite of the outlined changes, commercial banks have been able to maintain their outstanding role in the Italian financial system: actually, the reduction in the number of banks has been balanced by a remarkable increase in the number of branches. Such transformations have also amplified the concern that the reorganisation may have adverse consequences on competition, as a result of the bigger market power gained by leading banks through mergers, so casting doubts on the possibility that a competitive conduct among Italian banks is still possible. [1] The above point emphasises the major role that an empirical investigation could play in assessing

[1] This fear derives from the structure–conduct–performance (SCP) paradigm, where the degree of competition in a market is a direct function of the number of firms and an inverse function of the average market share. However, the occurrence of certain conditions can lead to alternative results, like contestability. For details on the above theories, see Stigler (1964) and Baumol et al. (1982).

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