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Deposit Bank Market Power and Central Banking

Introduction

This chapter provides the analysis of two areas of significant regulation of banks. First, there are multiple mechanisms to restrict market power in banks. The main topics covered in various sections are market structure, entry, and market power. Second, government intervention in banking is proposed for stabilization of the economy. The main topics covered are the general principles of central banking, the transmission of monetary policy, inflation targeting, and the Lucas Critique and consistency of optimal plans. The text is completed with a brief summary.

Banking competition

The two fundamental welfare theorems cannot be applied directly to banking (Vives 2001). There are evident violations of the assumptions. Retail banking is characterized by frictions that create entry barriers, such as reputation, branch network, and switching costs. Corporate banking also creates entry barriers in established relationships and asymmetric information that provide advantage of information to bankers with long-established relations. These frictions permit the exercise of market power by banks. Vives argues that certain measure of rivalry is required in banking to promote innovation and efficiency. The rapid changes in banking resulting from deregulation and technological change require adaptation of competition and regulation. Vives finds dangers in both excessive competition and excessive market power. There are different levels of competition in banking, which is a multiproduct industry. Institutional characteristics of regulation and bank soundness influence the optimum level of competition. The continuing improvements in
processing information and in electronic transactions raise concern of frictions and market power, requiring active competition policy. There is intensive competition in global wholesale and investment banking suggesting natural oligopoly as the equilibrium market structure (Ibid). There may be a limited or no role for competition policy in wholesale and investment banking. The following subsections consider the critical issues of market structure, entry, market power, and the relation of concentration to financial stability.

**Market structure**

Early research on market structure and power is centered on the structure-conduct-performance paradigm (Berger et al. 2004a). More recent research considers the efficiency hypothesis. There are numerous references on the structure-conduct-performance approach.¹

There has been significant technological change affecting banks since 1980 (Berger 2003; Berger and Mester 2003). Banks and other financial institutions use information technology (IT) intensively both in the back office, in the form of processing transactions electronically at decreasing costs, and in the front office, in the form of providing faster services of higher quality to clients. In addition, banks develop and use financial technology intensively for their own risk management and product development and also for their clients. The measurement of bank productivity by the Bureau of Labor Statistics (BLS) consists of the ratio of numbers of transactions, an output, to labor, an input, which may not capture many effects of technological improvement (Berger 2003, 157–8; Berger and Mester 2003). The index does not state outputs that are intensive in the use of capital, where IT advances occurred. It does not accurately portray the business of banking because of the focus on transactions instead of on intermediation. The index may not include all the labor input because of outsourcing of services to credit bureaus and so on.

An enhanced measurement of productivity in banking is obtained by econometric research on cost and profit functions at the individual bank level (Berger 2003; Berger and Mester 2003). The typical banking cost function is as follows (Berger 2003, 158):

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\ln C = f_c(\ln w, \ln q, \ln z, \ln v) + \ln u + \ln \varepsilon
\]  

(3.1)

where \( C \) denotes variable costs, \( f_c \) is the log cost function corresponding to the best-practice frontier, business conditions are denoted by \( w \), variable input prices, \( q \), variable output quantities, \( z \), fixed input and output quantities and \( v \), environmental variables, \( u \) is an inefficiency factor