Deregulation, Competition and Consumer Welfare in Banking Market: Evidence from Hong Kong

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Summary

Governments of many industrialized economies deregulated banking industries in recent decades in an attempt to improve productivity and efficiency of banks, and promote consumer welfare. I examine the effects on market structure and consumer welfare of banking deregulation in a small open economy, Hong Kong, in order to better understand the effects of policy changes in which difficulty in reaching minimum efficient scale presents a natural barrier to entry and in which firms are subject to volatile strongly exogenous shocks.

My empirical strategy makes inference about market power based on observations on bank-level data from 23 commercial banks in the loan market during 1997-2004. I propose an oligopolistic framework in which banks, offering differentiated products and facing asymmetric costs, maximize profit by setting prices. Product differentiation is an important determinant of market power in that banks develop a wide range of products to create their market niches. I jointly estimate: (i) a differentiated product demand system based on utility maximization and (ii) first-order conditions derived from bank profit-maximizing behavior. Furthermore, the market structure is identified by the conduct parameters, which capture the interaction of price setting behaviors among banks. Finally, I utilize the structural model to analyze the impacts of banking deregulation on consumer welfare, profit margin and the dynamics of the market structure.

My structural approach is useful for policy makers because it provides a unified framework to study the market structure, product differentiation and consumer welfare. On the other hand, other often applied models of bank competition, such as the Panzar-Rosse and structure-performance models, typically only investigate the competition among banks, but are not able to examine the welfare implications on consumers. Therefore, the structural model employed in this paper is more capable for performing policy analysis.

In summary, my results indicate that the banking sector is characterized by the Nash-Bertrand equilibrium. There is significant product differentiation among commercial banks and thus the loan market is segmented. The empirical results show an intensification of competition following deregulation and an improvement in consumer welfare.