Switching Cost and Deposit Demand in China

Chun-Yu Ho
Shanghai Jiao Tong University
Hong Kong Institute for Monetary Research

March 2014

Summary

Bank pricing has become a key issue for Chinese banks, as intermediation services play an increasingly important role for Chinese banks. In the early 2000s, only approximately 10% of the bank income in China was contributed by non-interest income, which was far below the corresponding figure (which was approximately 30-40%) for banks in Europe and the U.S. Since 2004, the Chinese government has reduced the interest rate margin by deregulating the deposit interest rate and requesting that banks raise the contribution of non-interest income to their total income. However, there has not been much discussion of bank pricing when consumers in the banking market face a switching cost.

This paper develops and estimates a dynamic model of consumer demand for deposits in which banks provide differentiated products and product characteristics that evolve over time. Existing consumers are forward-looking and incur a fixed cost for switching banks, whereas incoming consumers are forward-looking but do not incur any cost for joining a bank. The main finding is that consumers prefer banks with more employees and branches. The switching cost is approximately 0.8% of the deposit's value, which leads the static model to bias the demand estimates. The dynamic model shows that the price elasticity over a long time horizon is substantially larger than the same elasticity over a short time horizon.

Counterfactual experiments with a dynamic monopoly show that reducing the switching cost has a comparable competitive effect on bank pricing as a result of reducing the dominant position of the monopoly. Supplying this discussion provides insights to practitioners for pricing their services and to policy makers for evaluating the competitiveness of bank pricing when consumers face different levels of switching cost.