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The Italian banking industry: efficiency, market power, role in the local economies

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ABSTRACT

In the last twenty years the banking sector of many countries has undergone a period of consolidation and restructuring. This has raised concerns about the welfare implications of larger credit institutions, given that the banking industry is vital for the whole economic system.

From a theoretical point of view, one should expect two "direct" effects from these structural transformations. First of all, consolidation may allow banks to achieve a higher level of efficiency thanks to the exploitation of scale and scope economies. Secondly, mergers and acquisitions among credit institutions could lead to an increase in local market concentration and thus, as maintained by the Structure-Conduct Performance (SCP) paradigm, to an increase in banks' market power.

In turn, market power in banking is the channel through which the consolidation process could have some "indirect effects" on other economic phenomena. Indeed, as shown by recent empirical works, the degree of competition in banking markets is a key explanatory variable of banks' X-efficiency, as well as credit availability for small firms, relationship banking, economic growth and financial stability.

In this dissertation we empirically explore some of the consequences of the consolidation process, focusing on the Italian banking industry. More precisely, *Chapter One* studies the effect on banks' cost efficiency. Starting from a Multi-output Symmetric Generalized McFadden cost function, we estimate a system of factor demand equations in order to assess the degree of scale and scope economies of Italian banks in the period 1992-2007. We find evidence of slight economies of scale and significant economies of scope. Our main conclusion is that the efficiency gains coming from merger and acquisition operations could be an explanation of the consolidation process; at the same time, they could translate into beneficial effects for consumers and firms, provided that they are not offset by an increased market power.

In the following chapters we turn to the possible indirect effects of banking consolidation. The focus of *Chapter Two* is on the impact of banks' monopoly power on their X-efficiency. Particularly, we test the so-called "quite life" hypothesis (QLH), according to which firms with market power are less efficient. Using data for the period 1992-2007, we apply a two-step procedure. First, we estimate bank-level cost efficiency scores and Lerner indices. Then we use the estimated market power measures, as well

as a vector of control variables, to explain cost efficiency. Unlike the existing literature on the subject, to this end we employ a logistic regression that, in our opinion, is better suited to model cost efficiency scores. Our empirical evidence supports the QLH, although the impact of market power on efficiency is not particularly remarkable in magnitude.

Finally, in *Chapter Three* we assess the impact of banks' market power, and other structural variables characterizing banking markets, on local economic growth. Using a dataset on the Italian provinces for the period 1999-2006, as well as banks' balance sheets data, we estimate a dynamic panel data model, also taking into account the possible spatial dependence among observations. This is a novelty in the empirical literature on the finance-growth nexus. Moreover, the use of data on local economies, allows us to control more easily for heterogeneity. Our results show a positive and statistically significant relationship between banks' market power and economic growth, thus supporting the view according to which competition in banking can be detrimental to growth because it tends to reduce credit availability for informationally opaque firms. This evidence can have important implications on the Italian economy, where the presence of small (usually more opaque) firms is quite relevant. Besides, when spatial interactions are accounted for, the impact of local financial development disappears, and provincial growth is positively linked to how fast contiguous provinces grow.

Although the three chapters, as explained above, are to some extent linked, they have been organized and written as self-contained works.