Heterogeneous Decision-Making and Market Power

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Abstract

We provide a structural model wherein the decision-makers are payoff maximizers in a general game theoretic setting in which heterogeneity is formally factored into the decisions of the players. The decision-makers are allowed to have different types; and parameters are the same within each type but they differ across types. Using insights from our treatment of heterogeneous and strategic decision-making, we estimate the conducts (market powers) of Eurozone banks for years 2002–2015. We find that Eurozone banks are fairly competitive. However, banks in peripheral countries have more market power compared to the core of Eurozone.

Keywords: Conduct parameter; Heterogeneity; Market power; Eurozone banks; Profit function

JEL Codes: C11; C18; D24; D40; G21
1 Introduction

Economic agents have different individual characteristics and strategies that are driven by these characteristics. Hence, a persistent feature of economic data is heterogeneity. Neglecting latent heterogeneity in the data can lead to inconsistent estimation and misleading inference. For panel data, a common way to handle heterogeneity is to allow the constant term to be individual specific and estimate a traditional fixed effects panel data model. These models rule out the possibility that the slope coefficients can be heterogenous. The homogeneity of slope parameters has been rejected in many empirical studies (e.g., Baltagi and Griffin, 1997; Phillips and Sul, 2007; Su and Chen, 2013; Kutlu et al., 2019, etc). For example, in the context of productive efficiency estimation, Kutlu et al. (2019) illustrate via simulations and an empirical example that ignoring heterogeneity may have serious negative implications for both parameter and productive efficiency estimation. Hence, it is essential to develop models that can properly address the heterogeneity problem across a range of possible model and heterogeneity specifications.

We aim in our paper to provide a methodology that addresses this concern in a structural framework where the players (e.g., firms) are payoff maximizers in a game theoretic setting. The players are allowed to belong to different groups; and parameters are the same within each group but they differ across groups. The players simultaneously choose their groups and strategy variables. For instance, the group identifier for the peers of a firm can be set by the technology that the firm uses in the production process. We identify unobserved groups of players by utilizing the behavioral implications of the structural game. For this purpose, we use the best response functions of players to deduce their groups and strategy choices. In our model, the parameters are heterogeneous across groups (i.e., they are group-specific), player group membership is unknown, and classification is determined empirically based on a game that describes behavioral characteristics of the players.

As an example, we consider an imperfect competition setting where the firms play a conduct parameter (i.e., conjectural variations) game. For detailed literature reviews for conduct parameter games see Bresnahan (1989) and Perloff et al. (2007).
game where the technology is chosen by the firms endogenously within the game. Our methodological approach contrasts with the standard conduct parameter approach that is used for estimating a conduct parameter game and estimates the best response functions rather than the standard first order conditions from firms’ profit maximization problem. The advantage of using the best response function approach is that it enables us to calculate the counterfactual profits of firms under different technology regimes. Therefore, we can identify the technology that is giving the best profit conditional on other firms’ strategies.

Compared to other industries, the market power of banks, which is the industry we study in our empirical illustration, is relatively more important than many industries as it affects many other key industries. If banks extract too much surplus, this would negatively affect investments in other industries via strong financial spillovers. A fragile banking industry is risks the health of the economy at large and has obvious and demonstrable contagion effects as well. If market power helps banks to be less fragile through decreasing their chances of insolvency, it may be desirable for banks to have some market power given that the extent of the market power is not excessive. Hence, for the banking industry, neither too low nor too much market power would be desirable. Using our methodology, we estimate the market powers of Eurozone banks over the period 2002–2015. This is a particularly important time period for Eurozone banks, especially after the 2008 debt crisis, which was a challenging environment for banks’ profitability that forced banks to seek remedies that included reducing their costs. One particular attempt by banks was to lower operating costs or expand into non-traditional areas of business by implementing organizational changes that modified their business model and thus their objectives. These changes included the manner in which banks generated profits, which customers they served, and the distribution channels that they used. Generally, small banks tended to be more active in retail banking while medium-sized and large banks tended to focus more on investment banking activities. Also, large banks are likely to hold a higher proportion of cash and available-for-sale assets, which generates liquidity. This is essential for those banks that provide wholesale activities as wholesale funds are more likely to be withdrawn prematurely. Hence, the business models may be considerably different among banks and the right choice of a business model may depend on the market and bank characteristics such as bank size.

In an environment where the banks implement structural changes in hopes of maximizing profits, the standard conduct parameter models may not capture the
extent of market power properly. Unobserved heterogeneity in this environment may be endogenously determined by the attempts of banks to maximize their profits. Assessing and comparing the market power of banks in the core of the Eurozone (Austria, Belgium, Finland, France, Germany, Luxembourg, Malta, and the Netherlands) and its periphery (Cyprus, Greece, Ireland, Italy, Portugal, and Spain) is a useful practice that would help us to better understand pre- and post-crisis conditions in Eurozone banking, which calls for a model that considers endogeneity in the latent heterogeneity.

We estimate the conducts of Eurozone banks using Bayesian methods. We conclude that there are two technology groups. We find that the periphery countries utilize different technologies more effectively compared to the core countries. That is, they change technology more frequently. In particular, the banks in periphery countries constitute 86.30% (100%) of banks that switched from group 1 (2) to group 2 (1). Although we conclude that both loans and other assets markets are fairly competitive, there remains market power in the provision of these two services. Moreover, the banks in periphery countries have considerably higher market power compared to the banks in core countries. The flexibility in technology switches may have helped the peripheral banks to gain market power through cost reductions. Moreover, for the core and the periphery countries 47.22% and 19.33% of the bank observations belong to technology group 1, respectively.

The average conducts of banks in the core countries slightly decreased after the crisis, i.e., between 2008 – 2015. In contrast to this, the average conducts of banks in the periphery countries increased considerably after the crisis. Note that conduct parameters measure the exercised market power rather than the potential market power. Hence, the increase in the average of conducts after the crisis may be both due to increased efforts in decreasing costs and banks’ attempts to increase exercised market power through either collusive and/or riskier behavior. If market power stems from expensive loans given to riskier borrowers, this risk passes to banks and increases their own probability of default.
2 A Brief Review of Models with Heterogeneity and Structural Models

As mentioned in the introduction, the homogeneity of slope parameters has been rejected in many empirical studies. One way to handle this issue is to modify the parametric form of the slope parameters and allow them to be random coefficients (e.g., Swamy, 1970; Tsionas, 2002; Hsiao and Pesaran, 2008). Cornwell et al. (1990) and Kuthu et al. (2019), among others, utilize individual effects models where only some of the slope coefficients are heterogeneous while other slope parameters are homogenous. Another way to handle this issue is to use models where individuals belong to a number of homogeneous groups within a heterogeneous population. In these models, the regression parameters are the same within each group but they differ across groups; and somehow we need to determine the number of groups and identify the membership of individuals. A convenient approach is assuming that group membership and/or the number of groups are known to the researcher (e.g., Ando and Bai, 2015; Bester and Hansen, 2016). For example, the individuals can be assigned to groups externally by using observable variables such as geographic location, industry group, or size.

For many applications, assuming a known group structure is not ideal. Among others, Wedel et al. (1993), Orea and Kumbhakar (2004), Greene (2005), and Greene and Hensher (2013) present latent class models where the group belonging is not known a priori. Lin and Ng (2012) and Sarafidis and Weber (2015) use modified K-means algorithms to estimate slope coefficients with latent group structure. Su et al. (2016) propose penalized profile likelihood and penalized GMM estimation methods where the regression parameters are heterogeneous across groups, individual group membership is unknown, and classification is to be determined empirically. Another way to model heterogeneity is to use threshold regression models. Hansen (1999, 2000) presents threshold regression models where individual observations can be divided into classes based on the value of an observed (threshold) variable. Hansen’s method is completely data driven and estimates the thresholds and number of groups using a bootstrap algorithm. One attractive feature of this method is that it allows firms to change their groups over time.

All these models described above are purely statistical and are not designed specifically to capture endogenous heterogeneity in a structural way. For ex-
ample, when estimating a model that involves firms with an objective such as profit maximization, these statistical models ignore the behavioral characteristics and categorize firms purely on statistical grounds. If, however, heterogeneity is determined endogenously, structural models would help to capture the heterogeneity in a way that is consistent with economic theory.

Lewbel (2005) and Reiss and Wolak (2007) provide excellent reviews of structural models. Reiss and Wolak (2007) stress the conventional definition of a structural model as a model that combines explicit economic theories. One of the earlier game theoretic structural papers that model competition is Porter (1983), which is based on a dynamic model of homogenous product markets. Porter (1983) models two regimes for firm conduct (cooperative and competitive) and identifies the conduct through distributional assumptions. Other earlier papers in this literature include Gollop and Roberts (1979), Applebaum (1982) and Spiller and Favaro (1984). A common point of conduct parameter studies, including our empirical model, is that they can estimate marginal cost without requiring total cost data. This requires certain functional form assumptions to point identify demand and marginal cost that in turn enables point identification of the conduct and marginal cost.\(^2\) Relatively more recent conduct parameter studies include: Corts (1999), Puller (2009), and Kutlu and Sickles (2012) (dynamic game); Reny et al. (2012) (tax incidence); Kutlu and Sickles (2017) (price discrimination); Ciliberto and Williams (2014) and Miller and Weinberg (2017) (differentiated product); Orea and Steinbuks (2018) and Karakaplan and Kutlu (2019) (observation-specific conduct parameters). Our novel contribution to the conduct parameter literature is that our model allows endogenous choice of production technology, which leads to endogenous heterogeneity.\(^3\)

Although the empirical structural games literature has progressed substantially, there are still important challenges that needs to be addressed. For example, when there are multiple equilibria, both estimation and counterfactual analysis do not necessarily provide meaningful out of sample inferences. Moreover, empirical structural games, by their nature, are often not non-parametrically identified; and those that are suffer from theoretical assumptions that are often not testable; and require informational and behavioral assumptions, which can often be quite strong. For instance, a typical assumption of incomplete infor-

\(^2\)Perloff et al. (2007) for identification conditions.

\(^3\)For more details about the conduct parameter models, we direct the interested reader to the surveys of Bresnahan (1989) and Perloff et al. (2007).
Information games is that a player’s beliefs about rivals’ behaviors is consistent with the equilibrium strategies of rivals. An obvious difficulty of multiple equilibria is that these models do not lead to unique predictions, which poses problems for a counterfactual analysis. The fundamental difficulty of multiple equilibria is that the model predicts multiple outcomes for a given input without providing the likelihood of each of these outcomes. Hence, the likelihood function, which would be used to estimate a model with multiple equilibria, needs to be carefully specified in order to avoid double counting. One potential solution is (e.g., Bresnahan and Reiss, 1991) defining the outcomes so that we do not have double counting, which leads to well-defined probability statements when calculating the likelihood. For example, in an entry game that accommodates at most one entrant, we may not know the identity of the entrant but can construct a well-defined likelihood function based on the number of entrants, which equals 0 or 1. Another approach, which is valid regardless of whether the model is point identified or not, is using bounds on probability statements (Ciliberto and Tamer, 2009). Finally, one can use an equilibrium selection criterion (e.g., Sweeting, 2009; Bajari, Hong, and Ryan, 2010; Grieco, 2014). Unlike these models we identify the equilibrium through estimating the best response functions and utilize different identifying assumptions, which we describe in the next section.

3 Endogenous Heterogeneity Model

We next present a model of endogenous heterogeneity where individuals choose their groups in a static game theoretical context. Although dynamic games provide a richer environment, technical difficulties such as multiple (infinite) equilibria makes such games intractable. Hence, we concentrate on static games and leave dynamic games for future studies. As an example, we provide a two-output conduct parameter model under linear demand and marginal cost assumptions.

Our model can be estimated by using a proper Bayesian estimation procedure or the generalized method of moments (GMM). In the empirical section, we estimate our model by Bayesian methods.
3.1 General Model

Our general model of endogenous heterogeneity allows individuals to choose their group from a finite set of alternatives when maximizing their payoff functions. Let \( g_i \in \{1, 2, ..., G\} \) be an index that is representing the group composed of individual \( i \in \{1, 2, ..., I\} \) and \( g = (g_1, g_2, ..., g_I)' \) be a vector of groups for all individuals. For each group state \( g \), the (expected) payoff of individual \( i \in \{1, 2, ..., I\} \) is given by:

\[
\Pi_i(g_i) (q_i, q_{-i}; x_i; \beta_{(g_i)}),
\]

where \( q_i = (q_{i1}^1, q_{i2}^2, ..., q_{iM}^M)' \in \mathbb{R}_+^M \) is the vector of continuous strategy variables for individual \( i \) other than their group; \( q_{-i} \in \mathbb{R}_+^M \times \mathbb{R}_+^{I-1} \) is the matrix of strategies of other individuals (strategy profile of others); \( x_i = (x_{i1}, x_{i2}, ..., x_{iK})' \in \mathbb{R}_+^K \) is the vector of variables that affect payoff; and \( \beta_{(g_i)} \) is the vector of parameters for group \( g_i \). We denote the vector of parameters by \( \beta = (\beta_{(1)}, \beta_{(2)}, ..., \beta_{(G)})' \).

Individuals choose their group and other strategies simultaneously. Basically, the group is a strategy variable that affects the parameters of the payoff function. Conditional on \( g_i \), we call the strategy with highest payoff the conditional best response. For a given group state \( g \), the first-order conditions for individual \( i \)'s payoff maximization problem are:

\[
\frac{\partial \Pi_i(g_i) (q_i, q_{-i}; x_i; \beta_{(g_i)})}{\partial q_i^m} = 0
\]

for \( m \in \{1, 2, ..., G\} \). For any given \( g_i \), the conditional best response of individual \( i \), \( q_i^*_{(g_i)} \), is given by the solution to the system of equations (2) as a function of \( q_{-i} \), \( x_i \), and \( \beta_{(g_i)} \). For each group \( g_i \in \{1, 2, ..., G\} \), we can obtain the corresponding vector of best response strategies and payoffs for individual \( i \).

Individuals choose the optimal group, \( g_i^* \), that maximizes their respective payoffs so that:

\[
\Pi_i(g_i) (q_i^*_{(g_i)}, q_{-i}; x_i; \beta_{(g_i)}) \leq \Pi_i(g_i') (q_i^*_{(g_i')}, q_{-i}; x_i; \beta_{(g_i')})
\]

for all \( g_i \in \{1, 2, ..., G\} \).

To achieve identification, we make the following assumptions:

A1) For any given \( g \), the payoffs and structure of the game are constructed so that conditional best response functions are uniquely defined single-valued functions.
- This assumption implies that the best responses are uniquely determined, i.e., best responses are functions rather than correspondences. For a given \( g \), the game structure is the same as those of standard games with continuous strategies. Hence, this assumption is satisfied for most of the games that are applied in modeling firm or individual behavior. For example, Cournot competition satisfy our assumption.\(^4\)

A2) The payoff function, \( \Pi_{i(g_i)} \), has a unique maximum, \( g^*_i \), with respect to \( g_i \in \{ 1, 2, ..., G \} \), which is determined from Equation (3).

- This assumption implies that the optimal group choice is uniquely determined. That is, we have \( \Pi_{i(g_i)} \left( q^*_{i(g_i)}, q_{-i}; x_i, \beta(g_i) \right) < \Pi_{i(g'_i)} \left( q^*_{i(g'_i)}, q_{-i}; x_i, \beta(g'_i) \right) \).
Moreover, we predict the group using the expected payoffs so that the payoff functions used in the calculation of groups do not involve error terms. Hence, conditional on \( q_{-i}, x_i, \beta \), and general form of payoff function \( \Pi_{i(g)} \), the optimal group, \( g^*_i \), can be calculated deterministically, which is a very useful assumption. Since there are finite number of groups the uniqueness is not a strong assumption. What makes this assumption a relatively strong one is that the group can be deterministically computed for given \( q_{-i}, x_i, \beta \), and \( \Pi_{i(g)} \). In practice, \( \beta \) is not known by the researcher and thus it must be estimated. Hence, the groups belonging must be estimated.

A3) There exists a parameter component that is different for all \( g_i \in \{ 1, 2, ..., G \} \), i.e., there exists \( k \) such that \( \beta_{k(i)} \neq \beta_{k(j)} \) for all \( i \neq j \).

- Using this assumption we can fix the group names by setting smaller group numbers for smaller values of this parameter component. In what follows, we re-order the constant terms for groups so that they are smaller for groups with smaller group numbers. That is, the constant term for \( g_1 \) is the smallest, the constant term for \( g_2 \) is the second smallest, etc.\(^5\)

A4) The best response strategy of individual \( i \) depends on another individual’s group only through \( q_{-i} \), i.e., the best response of individual \( i \) is invariant to groups of other individuals \( (g_{-i}) \).\(^6\)

- This important exclusion restriction implies that as long as \( q_{-i} \) is the same, individual \( i \) does not care about the groups of other individuals. This

\(^4\)Among others see Section 5.4. in Acemoglu and Jensen (2013) for a model where this assumption is satisfied. Although Acemoglu and Jensen (2013) consider a scenario where the technology (our case this corresponds to group) is a continuous strategy variable, for given technology levels, assumption A1 is satisfied.

\(^5\)See Geweke (2007) for a discussion for identification issues related to permutation of parameters.

\(^6\)The equilibrium would still depend on groups of other individuals.
assumption is satisfied in many economic contexts. For example, in a Cournot competition game, the best response of a firm would be the same as long as other firms choose the same total quantity. Hence, the best response depends on other firms’ cost structures only through their quantity choices. Of course, eventually, the quantity choices of other firms would depend on their own groups. But for the sake of finding the best response functions, this is not a relevant factor.\footnote{For example, Acemoglu and Jensen (2013) consider games in which oligopoly producers make technology and output choices where this assumption is satisfied, i.e., their assumptions imply A4.}

A5) For each group there is a sufficient number of observations to identify the parameters of the relevant group.\footnote{For example, if a group is assigned \( k \) parameters, we need at least \( k \) observations for that group to identify the parameters for this group.}

- This assumption is needed to identify group-specific parameter vectors.

One of the challenging identification issues is that for a specific observation of individual \( i \), we need to know to which region of the best response function this particular observation belongs. This is due to the fact that, for the best response functions, each group is represented by different parameters and thus functions. Given \( q_{-i} \), the observed quantity for individual \( i \) depends on the group of \( i \), which is not known. Hence, we do not know which one of \( \beta(1), \beta(2), ..., \beta(G) \) represents the relevant best response function for individual \( i \). However, by A4, we know that the best response function does not depend on groups of other individuals. Therefore, by Equation (3), we can infer the group of individual \( i \) conditional on parameters, \( \beta \), and other individuals’ strategies, \( q_{-i} \). In particular, for observation \( i \), \( \beta(g_i) \) defined in by Equation (3) would be the parameter vector that identifies a particular region of the best response function.

Another reasonable assumption would be that observed strategies are the equilibrium strategies of other individuals and thus that they are taken as given for individual \( i \). Hence, we can calculate the best response of individual \( i \) based on the observed strategies of others so that \( q^*_i(g_i) \) is found by solving the following system of equations:

\[
\frac{\partial \Pi_i(g_i)}{\partial q_i^m} (q_i, q^e_i, x_i, \beta(g_i)) = 0
\]

for all \( g_i \in \{1, 2, ..., G\} \) where \( q^e_i \in \mathbb{R}^M_+ \times \mathbb{R}_+^{L-1} \) is the matrix of observed strategies of other individuals. Let \( \Theta \) be the set of all relevant parameters including \( \beta \).\footnote{In the conjectural variations setting \( \Theta \) may include information about other parameters such as demand and conduct parameters. For now, we may assume that \( \Theta = \beta \).} We can estimate \( \Theta \) and \( g \) by minimizing the “distance” of observed
and calculated quantities and prices:
\[
\left( \Theta, \hat{g} \right) = \arg \min_{g} \| q^o - q(\Theta, g) \| ,
\]
(5)
where \( q^o \in \mathbb{R}_+^M \times \mathbb{R}_+^I \) is the matrix of observed strategies; and \( q(\Theta, g) \in \mathbb{R}_+^M \times \mathbb{R}_+^I \) is the matrix of best response strategies for given \( \Theta \) and \( g \). Since, \( q(\Theta, g) \) is the vector of best responses, an instrumental variable approach is needed. A potential set of instrumental variables for \( q(\Theta, g) \) is the averages of corresponding strategy variables (e.g., prices, quantities, etc) from other related markets. These instrumental variables would be valid if the strategies are independent across markets conditional on control variables such as time and individual-specific dummies along with other exogenous control variables. For example, in other contexts, Nevo (2001) uses the average prices of cereals from other cities as an instrumental variable for price of cereals and Kutlu and Sickles (2012) use the total number passengers in other routes as an instrumental variable for the number of passengers in a route. We can use Bayesian methods and the GMM to estimate the parameters and number of groups.

3.1.1 Two-Output Case with Linear Demand and Marginal Cost Functions

In line with our empirical study, we outline the model using a two-output technology: \( L \) and \( A \) with corresponding outputs \( q^L \) and \( q^A \) and prices \( P^L \) and \( P^A \).\(^{10}\) While it is possible to use other functional forms, this would require numerical solutions to the best responses of firms at each iteration, which is possible yet introduces computational complexities. Hence, we specify linear (in quantity) inverse demand and marginal cost functions, which are considered approximations to unknown demand and cost functions. The main advantage of the linear setting is that we can obtain closed form solutions. The inverse demand functions for outputs, \( L \) and \( A \), are:
\[
\begin{align*}
P^L &= \alpha_0^L (z^D) + \alpha_L^L (z^D) Q^L + \alpha_A^L (z^D) Q^A, \\
P^A &= \alpha_0^A (z^D) + \alpha_L^A (z^D) Q^L + \alpha_A^A (z^D) Q^A,
\end{align*}
\]
(6)
\(^{10}\)See Appendix for a general conduct parameter model and for more details about estimations.
\(^{11}\)In this section, we use notation consistent with our empirical model. In particular, here \( L \) and \( A \) stand for loans and other earning assets while the inputs capital (\( k \)), labor (\( l \)), and deposits (\( d \)); and \( w^k \), \( w^l \), and \( w^d \) are the input prices, respectively.
The optimal technology estimate, for all parameter vectors to differ by groups. The marginal cost functions for a given technology for given parameters. We allow the constant terms for group specific estimates from marginal cost functions would be sufficient to identify the best determining the best technology that is maximizing the profit so that parameter Therefore, without loss of generality, we can assume that all cost related variables including where is the vector of input prices; and is a vector of all cost related variables including , and 's are technology specific functions of . The constant term, in cost function is not technology specific. Therefore, without loss of generality, we can assume that when determining the best technology that is maximizing the profit so that parameter estimates from marginal cost functions would be sufficient to identify the best technology for given parameters. We allow the constant terms for group specific parameter vectors to differ by groups. The marginal cost functions for a given technology are given by:

where is the vector of demand related variables and 's are functions of . The cost function for a given technology is determined by:

**The optimal technology estimate, is determined by:**

**for all where is the vector of demand parameter estimates for output ; are the vectors of cost parameter estimates under technology and are the best response quantity vectors under technology and are the total of observed quantities of output for other firms in the market. The best response quantities are:**

\[ \mathbf{q}_{i(g_i)}^* = \mathbf{A}^{-1} \mathbf{r} \]
Let $s_i^m$ be the market share of $m = L, A$ for Bank $i$. If $\theta_i^m = \{0, 1, \frac{1}{N_i} \}$ for all $m = L, A$ and $i$, then the conducts are consistent with perfectly competition, Cournot competition, and joint profit maximization, respectively. The best response prices for firm $i$ for technology $g_i$ are calculated as:

\[
P_{i(g_i)}^L = \alpha_0^L (z^D) + \alpha_1^L (z^D) \left( Q_{-1}^L + q_{i(g_i)}^L \right) + \alpha_A^L (z^D) \left( Q_{-1}^A + q_{i(g_i)}^A \right)
\]

\[
P_{i(g_i)}^A = \alpha_0^A (z^D) + \alpha_1^A (z^D) \left( Q_{-1}^L + q_{i(g_i)}^L \right) + \alpha_A^A (z^D) \left( Q_{-1}^A + q_{i(g_i)}^A \right),
\]

where $Q_{-1}^L$ and $Q_{-1}^A$ are the corresponding total observed quantities for other firms in the market; and $P_{i(g_i)}^L$ and $P_{i(g_i)}^A$ are the corresponding best response output prices for the market when the technology for firm $i$ is $g_i$. The values of $q_{i(g_i)}^L$ and $q_{i(g_i)}^A$ from Equation (10) can be substituted into Equation (11) to obtain best response prices as a function of $Q_{-1}^L$ and $Q_{-1}^A$. Given the parameters, explanatory variables, observed quantities of other firms, and best response quantities and prices, the best response profits for each technology $g_i$ can be calculated. The technology that maximizes profit, $g_i^*$, is chosen as described earlier by Equation (9); and the corresponding best response quantities and output prices can be used for estimating model parameters. Hence, following system of equations is used to estimate the parameters of the model:

\[
y^o = y^* + \varepsilon_i,
\]

where $y^o = (q_i^L, q_i^A, P_i^L, P_i^A)^T$ is the vector of observed quantities and prices; $y^* = (q_{i(g_i^*)}^L, q_{i(g_i^*)}^A, P_{i(g_i^*)}^L, P_{i(g_i^*)}^A)^T$ is the vector of best response quantities and prices; and $\varepsilon_i$ is a vector error term.
4 Empirical Model: Eurozone Banking Industry

4.1 Market Power Measures for Banks

A typical market structure depends on various factors such as the nature of products, number of firms, market concentration, and the technology. The structure-conduct-performance (SCP) paradigm provides many of the stylized facts about firm behavior by describing the market structure through market concentration. The SCP postulates a more collusive firm conduct in highly concentrated markets, which results in higher prices. In line with the SCP paradigm, many banking studies use the Herfindahl-Hirschman index (HHI) as a proxy for market power. However, there are limitations of using HHI as a proxy for market power in banking markets.\textsuperscript{12} Although the HHI is informative about the market structure, it does not provide a full description of the market structure. For example, two markets with the same HHI value may have very different characteristics (e.g., risk involved, number of products, quality, etc.) that result in distinct market power levels. Moreover, HHI is a market-specific measure, which may not be satisfactory for addressing bank-specific questions because the characteristics of the whole market would not necessarily align with the characteristics of an individual bank.\textsuperscript{13} If the marginal cost and output price information are available, then the Lerner index can be used as a firm-specific market power measure. However, in many occasions cost data that enables estimation of marginal costs is not available. Even when the cost data is available, marginal cost needs to be estimated carefully. For example, in a setting where there are multiple technologies and the technology of a firm is unobserved, the standard single technology models that are used for calculating the Lerner index would not be applicable. The conduct parameter approach allows structural modeling of the market interactions, which can potentially describe the market structure better. Moreover, the conduct parameter may be considered as a price elasticity adjusted Lerner index (Corts, 1999). The markets with inelastic demand and less competition are distinguished by this demand elasticity adjustment.

\textsuperscript{12}See Berger et al. (2004), Bos et al. (2017), and the references therein for criticisms of HHI.

\textsuperscript{13}For example, a bank may have low market power even when the whole market is highly concentrated. Under quiet life hypothesis of Hicks (1935), this bank likely would be efficient even if the whole market is highly concentrated.
4.2 Eurozone Banking Industry

The Eurozone banking systems play an important role in the world economy and are examined in many studies (e.g., Allen and Rai, 1996; Altunbas et al., 2001; Lozano-Vivas et al., 2002; Maudos et al., 2002; Casu and Molyneux, 2003; Brissimis et al., 2010; and Mamatzakis et al., 2015). We contribute to this literature by estimating the market powers of Eurozone banks over the period 2002–2015. During this time period, the challenging environment for banks forced them to find ways to reduce their costs. The banks tried reducing their operating costs by implementing organizational changes. Especially, in such a time period, it would be more difficult to characterize the bank heterogeneity using reduced form models as the heterogeneity is endogenously determined through a variety of complicated factors including the other banks' strategies and conducts. A potential solution to this issue is to estimate the market powers of Eurozone banks by using a model that considers such endogeneity in heterogeneity. Based on the theoretical model that we described, we present such a model where the technologies of the banks are endogenously determined. In particular, we estimate the market powers of Eurozone banks under an imperfect competition setting where the banks play a conduct parameter game and choose the optimal technology from a finite set of available technologies. This is done by directly using the best responses of banks and infer the technology group of a bank based on these best response functions.

4.3 Data

We use Eurozone banking data obtained from IBCA-Bankscope database over the period 2002 – 2015, which is based on Mamatzakis et al. (2015). The countries included in the data set are divided into two groups: the core and the periphery. The core countries are Austria, Belgium, Finland, France, Germany, Luxembourg, Malta, and the Netherlands; and the periphery countries are Cyprus, Greece, Ireland, Italy, Portugal, and Spain. The main characteristic of periphery countries is that they received financial assistance from the EU and the IMF.

The data set includes commercial, cooperative, investment, real-estate, and savings banks. The sample covers the largest credit institutions in each country based on their balance sheet aggregates. The final unbalanced panel data set is obtained after dropping data for reporting errors and other inconsistencies. We
follow the financial intermediation approach (Sealey and Lindley, 1977), which assumes that banks collect funds, transform labor and capital into loans and other earning assets.

There are two outputs: loans \((q^L)\) and other earning assets \((q^A)\) and three inputs: capital, labor, and deposits. The price of labor \((w^L)\) is the ratio of personnel expenses to number of employees. The price of capital \((w^K)\) is the ratio of other administrative expenses to fixed assets. The price of deposits \((w^D)\) is the ratio of total interest expenses to total borrowed funds. The price of loans is \((P^L)\) the ratio of interest income to total loans and the price of other earning assets is \((P^A)\) the total non-interest income to total other earning assets.

Relevant quantity variables for loans and other earning assets as well as deposit price are assumed to be endogenous. The rest of the variables included in the model are used as instruments such as other input prices, (logarithm of) total assets \((TA)\), a time trend, real disposable income, etc. We also use the squares and interactions of the exogenous variables as instruments. Finally, we constructed two quantity related instrumental variables, which are the averages of the corresponding quantities in other markets (i.e., countries): \(Q^L_{IV}\) and \(Q^A_{IV}\). As we mentioned earlier, similar instrumental variables are used in a variety of contexts (Nevo, 2001; Kutlu and Sickles, 2012). Descriptive statistics of the data are provided in Table 1.

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>MEAN</th>
<th>STD. DEV.</th>
<th>MIN</th>
<th>MAX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price of Loans</td>
<td>0.053</td>
<td>0.012</td>
<td>0.036</td>
<td>0.073</td>
</tr>
<tr>
<td>Price of Other Earning Assets</td>
<td>0.038</td>
<td>0.023</td>
<td>0.016</td>
<td>0.091</td>
</tr>
<tr>
<td>Loans</td>
<td>1,594,909</td>
<td>2,396,045</td>
<td>62,202</td>
<td>7,700,000</td>
</tr>
<tr>
<td>Other Earning Assets</td>
<td>899,574</td>
<td>1,291,166</td>
<td>42,624</td>
<td>4,100,000</td>
</tr>
<tr>
<td>Deposit Price</td>
<td>0.019</td>
<td>0.008</td>
<td>0.004</td>
<td>0.032</td>
</tr>
<tr>
<td>Capital Price</td>
<td>1.282</td>
<td>1.188</td>
<td>0.997</td>
<td>4.250</td>
</tr>
<tr>
<td>Labor Price</td>
<td>1.188</td>
<td>1.195</td>
<td>0.541</td>
<td>4.498</td>
</tr>
<tr>
<td>Total Assets</td>
<td>2,921,072</td>
<td>4,356,429</td>
<td>129,103</td>
<td>1.40E+07</td>
</tr>
<tr>
<td>Z-score</td>
<td>4.125</td>
<td>3.802</td>
<td>0.251</td>
<td>11.593</td>
</tr>
</tbody>
</table>

Note: Number of observations 23,615 and the Eurozone includes the countries: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, and Spain.

4.4 Empirical Model

We provide the details of our empirical model that we use for estimating the market powers of Eurozone banks. We model the technology of intermediation services provided by banks with two outputs: loans \((q^L)\) and other earning assets \((q^A)\) with corresponding prices \(P^L\) and \(P^A\); and three inputs: capital \((k)\), labor \(l_2\) and deposits \(l_3\). The prices \(P^L\) and \(P^A\) are endogenous. The rest of the variables included in the model are used as instruments such as other input prices, (logarithm of) total assets \((TA)\), a time trend, real disposable income, etc. We also use the squares and interactions of the exogenous variables as instruments. Finally, we constructed two quantity related instrumental variables, which are the averages of the corresponding quantities in other markets (i.e., countries): \(Q^L_{IV}\) and \(Q^A_{IV}\). As we mentioned earlier, similar instrumental variables are used in a variety of contexts (Nevo, 2001; Kutlu and Sickles, 2012). Descriptive statistics of the data are provided in Table 1.

14 Recall that Nevo (2001) uses average prices in other cities and Kutlu and Sickles (2012) use total number of passengers in other routes.
(l), and deposits (d) with corresponding input prices \( w^k, w^l, \) and \( w^d \). We assume that the inverse demand functions for loans and other earning assets are given by:

\[
P^L = z^D \alpha_0^L + \left( \alpha_{1L}^L + \alpha_{2L}^L z_r \right) Q^L + \left( \alpha_{1A}^A + \alpha_{2A}^A z_r \right) Q^A
\]

\[
P^A = z^D \alpha_0^A + \left( \alpha_{1L}^A + \alpha_{2L}^A z_r \right) Q^L + \left( \alpha_{1A}^A + \alpha_{2A}^A z_r \right) Q^A,
\]

where \( z^D \) is a vector of demand related variables including deposit price, country specific real disposable income, country dummy variables, bank type dummy variables, country specific consumer price index, a time trend, a 2008 – 2015 dummy, bank’s total asset size, and \( z_r \) is the bank’s total asset size. The cost function for a given technology \( g_i \) is given by:

\[
C(g_i) = z^C \beta_0^i + \beta_{LL(g_i)} q_i^L \left( q_i^L \right)^2 + \frac{1}{2} \beta_{LL(g_i)} \left( q_i^L \right)^2 + \frac{1}{2} \beta_{AA(g_i)} \left( q_i^A \right)^2
\]

\[
+ (z_i^C \otimes q_i^L) \beta_{L(g_i)} + (z_i^C \otimes q_i^A) \beta_{A(g_i)},
\]

where \( w_i = (w_i^l, w_i^k, w_i^d)' \) is the vector of input prices; and \( z_i^C \) is a vector of all cost related variables including input prices, \( w_i \), the bank-specific z-scores, country dummy variables, bank type dummy variables, a time trend, a 2008 – 2015 dummy, and the bank’s total asset size. Finally, we model the conduct parameters for loan and other earning assets by:

\[
\theta_i^j \left( h_i \right) = \frac{\exp \left( h_i^j \gamma^j \right)}{1 + \exp \left( h_i^j \gamma^j \right)} \frac{1}{s_i^j} \text{ for } j = L, A,
\]

where \( h_i \) is a vector of variables that may affect the conduct and \( s_i^L \) and \( s_i^A \) are the market shares of loan and other earning assets for Bank \( i \). The normalization by market share assures that the conducts lie in their theoretical bounds.

### 4.5 Estimation Results

We estimate our model using Bayesian approaches based on Girolami and Calderhead’s (2001) Hamiltonian Monte Carlo approach with 30,000 iterations. In particular, for estimations we use Bayesian Exponentially Tilted Empirical Likelihood (BETEL).\(^{15}\) The first 10,000 of the iterations are discarded to mitigate possible start-up effects. Convergence is checked by Geweke’s (1992) approach. Marginal likelihood and Bayes factors are computed using the Laplace-

\(^{15}\)For technical details see the Appendix.
Metropolis estimator (DiCicio et al., 1997). Based on the Bayes factor criterion, we conclude that there are two groups.\textsuperscript{16} \textsuperscript{17} Our method allows the banks to switch technologies over the sample period. For the core and periphery countries, the percentage of banks starting with group 1 (2) that switched to group 2 (1) at some time period is 32.25 (4.16\%). The banks in periphery countries constitute most of these switches. In particular, the banks in periphery countries constitute 86.30\% of banks that switched from group 1 to group 2 and 100\% of banks that switched from group 2 to group 1. Hence, compared to the core countries, the periphery countries seem to utilize different technologies more effectively.

In Figure 1, we observe that a bank in a core country is most likely to be in group 1 and a bank periphery country is most to be likely in group 2. In Figure 2, we see that the banks in group 1 would likely to have smaller returns to scale and larger technical change values. Indeed, the technical change distribution for group 2 is centered around negative values. The returns to scale values for group 2 are close to 1 so they are close to exhausting their economies of scale. In Figure 3, we see that the distributions of demand elasticities suggest that group 2 has more elastic demand for both loans and other earning assets. Finally, in Figure 4, we see that the distributions of Lerner indices suggest that group 1 has higher Lerner index for loans and lower index in other earning assets. Based on these findings, we can say that banks in core and periphery countries are utilizing different technologies mostly.

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{chart.png}
\caption{Probability distributions for core and periphery banks.}
\end{figure}

\textsuperscript{16}We also estimate the model by CUE-GMM and MMSC-BIC criterion of Andrews and Lu (2001) chooses, which selected two groups as well.
\textsuperscript{17}For 95\% critical value, the over-identifying restrictions are rejected by CUE-GMM but not BETEL. Hence, accounting for parameter uncertainty as well as finite sample sizes, may be quite important in practice. See Appendix for details about overidentification test.
The demand parameter estimates are given in Table 2. The parameter estimates are in line with the low volatility nature of loans that can perform as a risk diversifier. The other coefficient estimates are consistent with our expectations as well.

Table 2. Demand Parameter Estimates

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Group 1</th>
<th>Group 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q^L</td>
<td>-0.332 (0.025)</td>
<td>0.188 (0.013)</td>
</tr>
<tr>
<td>Q^L*ln(TA)</td>
<td>-0.024 (0.009)</td>
<td>0.022 (0.007)</td>
</tr>
<tr>
<td>Q^A</td>
<td>0.144 (0.062)</td>
<td>-0.017 (0.022)</td>
</tr>
<tr>
<td>Q^A*ln(TA)</td>
<td>0.005 (0.003)</td>
<td>-0.055 (0.041)</td>
</tr>
<tr>
<td>ln(TA)</td>
<td>0.144 (0.023)</td>
<td>0.132 (0.017)</td>
</tr>
<tr>
<td>Deposit Price</td>
<td>0.181 (0.072)</td>
<td>0.260 (0.045)</td>
</tr>
<tr>
<td>Real Dep. Income</td>
<td>0.158 (0.044)</td>
<td>0.112 (0.042)</td>
</tr>
<tr>
<td>Consumer Price Index</td>
<td>0.235 (0.043)</td>
<td>0.288 (0.040)</td>
</tr>
<tr>
<td>Trend</td>
<td>0.001 (0.003)</td>
<td>0.003 (0.001)</td>
</tr>
<tr>
<td>2008-2015 dummy</td>
<td>-0.028 (0.016)</td>
<td>0.055 (0.010)</td>
</tr>
</tbody>
</table>

Notes: Posterior standard deviations are in parentheses. Estimates for country and bank type dummies are omitted to save space.

Table 3. Bayesian Supply Parameter Estimates

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Group 1</th>
<th>Group 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marginal Cost</td>
<td>L</td>
<td>A</td>
</tr>
<tr>
<td>Conduct</td>
<td>0.592 (0.062)</td>
<td>0.858 (0.063)</td>
</tr>
<tr>
<td>Marginal Cost</td>
<td>L</td>
<td>A</td>
</tr>
<tr>
<td>Conduct</td>
<td>0.266 (0.073)</td>
<td>0.852 (0.042)</td>
</tr>
<tr>
<td>Deposit Price</td>
<td>0.181 (0.046)</td>
<td>0.215 (0.032)</td>
</tr>
<tr>
<td>Capital Price</td>
<td>0.116 (0.033)</td>
<td>0.264 (0.017)</td>
</tr>
<tr>
<td>Labor Price</td>
<td>0.181 (0.039)</td>
<td>0.258 (0.032)</td>
</tr>
<tr>
<td>ln(TA)</td>
<td>-0.0020 (0.0014)</td>
<td>0.0011 (0.0012)</td>
</tr>
<tr>
<td>Z-score</td>
<td>0.003 (0.002)</td>
<td>0.003 (0.002)</td>
</tr>
<tr>
<td>Real Dep. Income</td>
<td>0.221 (0.011)</td>
<td>0.0027 (0.0011)</td>
</tr>
<tr>
<td>Trend</td>
<td>0.003 (0.001)</td>
<td>0.0000 (0.0001)</td>
</tr>
<tr>
<td>2008-2015 dummy</td>
<td>0.021 (0.002)</td>
<td>0.023 (0.003)</td>
</tr>
</tbody>
</table>

Notes: Posterior standard deviations are in parentheses. Estimates for country and bank type dummies are omitted to save space.

In Table 3, we present our marginal cost and conduct parameter estimates. The coefficient estimates for the marginal cost functions are reasonable and have the same signs for both group 1 and 2 except the coefficient of total assets variable. A striking observation is that input prices and output quantities lead to larger increases in marginal cost for group 2, which makes it a less attractive choice based on these factors. However, for the core and the periphery countries 47.22% and 19.33% of the bank observations belong to technology group 1, respectively. Hence, other factors may play important role in technology choice as well.
In Table 4, we present the means for conduct estimates. Both loans and other assets markets are fairly competitive (i.e., closer to 0 compared to 1) for the core countries. However, for the periphery countries both markets have considerable market power. To give some idea about the extent of market power in the periphery countries, in a Cournot competition the conduct equals 1. One potential reason for why the periphery countries have more market power is that in these countries the technology switches were more frequent, which may have helped the banks gain market power through cost reductions. While the market power levels for loans and other earning assets for the core countries are fairly close, the market power of the periphery countries for the other earning assets is somewhat higher compared to loans output. During and after a crisis we may observe relatively higher market power if the market concentration increases. Compared to the core countries, the banks in periphery countries show more dramatic changes after the crisis. This may be due to their need to fight financial struggles and success in reducing costs through technology adaptations. Risky loans may have contributed to the increase in conduct parameter as well. Hence, imbalances between the core and the periphery increased after the crisis. This poses an important obstacle for reaching a homogenous Eurozone banking system.

<table>
<thead>
<tr>
<th>Year</th>
<th>Core</th>
<th>Periphery</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>0.132</td>
<td>0.122</td>
</tr>
<tr>
<td>2003</td>
<td>0.133</td>
<td>0.133</td>
</tr>
<tr>
<td>2004</td>
<td>0.135</td>
<td>0.157</td>
</tr>
<tr>
<td>2005</td>
<td>0.146</td>
<td>0.161</td>
</tr>
<tr>
<td>2006</td>
<td>0.157</td>
<td>0.172</td>
</tr>
<tr>
<td>2007</td>
<td>0.166</td>
<td>0.165</td>
</tr>
<tr>
<td>2008</td>
<td>0.155</td>
<td>0.152</td>
</tr>
<tr>
<td>2009</td>
<td>0.111</td>
<td>0.148</td>
</tr>
<tr>
<td>2010</td>
<td>0.107</td>
<td>0.133</td>
</tr>
<tr>
<td>2011</td>
<td>0.102</td>
<td>0.125</td>
</tr>
<tr>
<td>2012</td>
<td>0.095</td>
<td>0.121</td>
</tr>
<tr>
<td>2013</td>
<td>0.081</td>
<td>0.118</td>
</tr>
<tr>
<td>2014</td>
<td>0.072</td>
<td>0.114</td>
</tr>
<tr>
<td>2015</td>
<td>0.077</td>
<td>0.113</td>
</tr>
</tbody>
</table>

5 Conclusion

A common feature of most models that aim to capture heterogeneity is that the heterogeneity is not modeled in a behavioral framework. In practice, many times the behavioral aspects of heterogeneity is ignored and dealt with by purely statistical methods. For example, neither fixed effects models nor latent class
models consider heterogeneity as an endogenously determined structural choice variable. If the underlying reason for the heterogeneity is behavioral, then using tools that assume an exogenous heterogeneity structure may lead to imprecise parameter estimates. We have provided a methodology that addresses this concern in a structural framework where the individual units are payoff maximizers in a game theoretical setting. One potential issue that may be improved is generalizing our setting to a dynamic framework. However, this is beyond the scope of this study and we left it as a subject of future research.

We applied this setting in a conduct parameter model where the firms are allowed to choose their technologies. In particular, we estimated the market powers of Eurozone banks over the period 2002 – 2015. This is a particularly important and special time period for the Eurozone banks as the challenging environment forced banks to seek ways to reduce their costs. Our estimates showed that this effect is present especially for the peripheral countries. The banks in these countries were more active in terms of their search for cost minimizing technologies. As a result their market powers turned out to be substantially higher than those of the core countries. A potential solution to this issue is to further enhance financial integration within the Eurozone.

References


6 Appendix

To test the over-identifying restrictions, we compute the Hansen-Sargan $J$ statistic (number of observations times the GMM objective) whose asymptotic distribution is $\chi^2_{m-k}$ where $m$ is the number of moment conditions and $k$ is the number of parameters. The $J$ statistic is computed for each MCMC draw so we can recover its finite sample distribution. The statistic $J^* = \frac{J}{m-k}$ should then follow, asymptotically a chi-square distribution with one degree of freedom.

First, we present the finite-sample distribution of $J^*$ along with the density of $\chi^2_1$ for comparison, panel (a). Second, in panel (b) we present the distribution of the same statistic, when we omit randomly $B$ banks from the sample, where $B \in \{1, \ldots, 10\}$ with equal probability. This is repeated 1,000 times and, therefore, the distribution of $J^*$-statistic resembles that of a bootstrap although, again, parameter uncertainty is accounted for, as we run MCMC for each of the sub-samples. In panel (c) we keep the same structure as in (b), but we also omit $\mu$ overidentifying restrictions at random, where $\mu \in \{1, \ldots, \lfloor \frac{m-k}{2} \rfloor \}$ with equal probability (here $\lfloor \cdot \rfloor$ denotes integer part. In panel (d) we follow the same methodology but this time we use CUE-GMM. Computational burden is much lower as we do not have to perform MCMC for each sub-sample and each $\mu$. 
Evidently, in panels (a), (b) and (c) the finite-sample distribution of the $J^*$-statistic is not $\chi^2_1$ but it has low probability in values exceeding the 95% critical value (the well-known 3.84). The finite-sample distribution of the $J^*$-statistic is multimodal showing that asymptotic approximations may not be valid in this application. Finally, in panel (d) where we use CUE-GMM, the finite-sample distribution of the $J^*$-statistic is, again, multimodal and has considerable probability in values greater than 3.84, suggesting rejection of certain over-identifying restrictions in a number of subsamples. The rejection of over-identifying restrictions by CUE-GMM but not by the Bayesian Exponentially Tilted Empirical Likelihood methods we employ in our empirical analysis, means that accounting for parameter uncertainty as well as finite sample sizes, may be quite important in practice.