TUTORIAL #23: THEORY OF THE FIRM & MARKET STRUCTURE

Question 2: Banks have to merge to reap economies of scale

a) Identify the type of economies of scale Deputy Prime Minister stated in the extract.

Internal economies of scale.

b) Define the type of economies you have identified in question 1.

It is a fall in unit costs when the firm increases its scale of production.

c) Explain how bigger banks can enjoy cost savings.

i. Explain two examples of economies of scale that might occur in banking.
Reminder: Link to the banking context.

Any two of the following:
Technical Economies (Indivisibility of capital): Banks and customers have become increasingly reliant on new and expensive technologies e.g. Cash Deposit Machines, mobile telephony, online banking etc. The costs of such machines can be spread over a large number of customers when the bank increases its scale of operation. (2m)

Note: Banks usually do not do R&D. Instead they buy the latest technology to improve their productivity and thus lowering costs.

Marketing Economies: Through large scale advertising - for large firms, although the advertising expenditure may be substantial, the advertising cost per unit because of the larger output level. (2m)

Administrative & Managerial Economies: Generally, administrative costs will not rise in proportion to the size of an order. For instance, after the banks merged, one human resource manager can oversee more staff and thus unit cost falls. (2m)

ii. Explain rationalisation in the banking industry.
Note: You have not learnt about this concept so do find out more about it.

Rationalisation: the reorganising of production so as to cut waste and duplication and generally to reduce costs. Some mergers do result in closing down of branches and layoffs. However, many banks reduce their staff largely through attrition to ease the transition (e.g. 40% annual turnover rates are not unusual among tellers.)

d) Explain how bigger banks can enjoy revenue advantages.

- *A large bank is able to generate more revenue because it can receive more deposits and give out more loans as compared to a smaller bank. Also they are more likely to offer a broader array of services.*
- *A merger of two banks with different expertise can result in a combination more to the liking of customers looking for a one-stop banking services. Hence, enabling them to capture a greater market share.*
- *A large bank is able to set aside a bigger budget for advertising. A successful advertising campaign establishes a strong brand name, increases services awareness and fosters consumer loyalty. The demand for the bank's services increases and becomes more price inelastic.*

Hence, a large bank is ensured of high profit (due to barriers to entry) and thus has the avenue to do R&D and will be able to improve the quality of its services and thus compete better than a small bank.

In the banking scene, most banks are moving from retail banking to investment banking and thus revenue advantages are of real importance for them to compete better. Banks need the revenue to maintain a high profile and reputation to attract consumers especially from overseas.

e)

i. **Explain diseconomies of scale.**

A large bank may incur higher unit cost if disEOS sets in due to lack of co-ordination in the different departments of a large business, increasing complexity of the organisation creating communication barriers between management, staff and customers, low morale of individual workers due to lack of identity and at leads to low productivity.

ii. **Comment whether diseconomies of scale will outweigh the internal economies of scale the big banks enjoy. *Hint: Compare the customers of Singapore's five banks and that of the largest international bank in the extract.***

iDOS is mainly due to the managerial diseconomies/complexities associated with running a very large organization/large bureaucracy with many branches/outlets/divisions/departments and large number of employees.
Instead of cost savings, unit cost rises because of organizational inefficiencies such as the problem of control, co-ordination and communication.

According to the extract, the largest international bank had an estimated 100 million customers but the largest of Singapore's five banks had just five million customers. So in terms of size, our merged banks still cannot match to our bigger foreign counterparts. Also, it will take years and much effort for Singapore's banks to gain high or worldwide recognition/reputation to that of Citibank, HSBC or Stanchart. Thus, we may not have reached our MES yet.

In practice, despite their enormous size many large organization are run efficiently.
Why? Talented CEOs and better technology

f)

i. **Explain X-inefficiency in the banking industry.**
Note: You have not learnt about this concept so do find out more about it.

A large bank may experience X-inefficiency which leads to higher cost - without competitive pressures on profit margins, cost controls may become lax. The result may be overstaffing and spending on prestige buildings and equipment, as well as less effort to keep technology up to date, scrap old machines, research new services/products, or develop new domestic and export markets.

ii. Comment if X-inefficiency really takes place in the banks.

In such a competitive industry, banks will try to minimise unnecessary costs which means they most likely won't experience X-inefficiency as they cannot afford to use outdated technology or offer 'old' services. Staff hoarding will also be minimised through rationalisation. To stay competitive, they have to minimise mismanagement and thus reduce costs.

Also, in Singapore, the presence of a large number of foreign banks makes the market "contestable", hence our local banks have incentives to keep X-inefficiency to a minimum in the presence of potential competition.

Note: The above structured questions are steps to answer the following essay question:
Discuss whether it is always true that bigger banks can compete better. [15]
Since it is a discursive essay, you need to take a final stand whether you agree bigger banks can compete better and justify your stand.