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Competition in the banking sector: New evidence from a panel of emerging market economies and the financial crisis

Nicholas Apergis

Business School, Northumbria University, Newcastle upon Tyne, UK

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A B S T R A C T

This paper assesses competition across the banking systems in emerging market economies. The analysis employs the Panzar and Rosse (1987) methodology, spanning the period 2000–2012. The analysis emphasises the impact of the recent financial crisis on the extent of competition in these banking systems. The empirical findings are robust and consistent with those of previous studies, providing sufficient evidence in favour of monopolistic competition across all countries under investigation. The level of competition in these banking sectors seems to have undergone a significant decline after the recent financial crisis. This finding receives robust support from an alternative methodological approach.
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1. Introduction

There is a long-standing debate on the fact that the banking sector is exposed to instability and risks related to banking balance sheets. Due to high leverage levels and the lack of transparency on the asset side, banks usually take excessive risks, which are further exacerbated when they operate in a competitive environment. This increases the probability of bailouts and the risk of contagion when financial institutions fail. This approach is well known as the 'charter value hypothesis', according to which banks balance the gains from increased risk-taking with the losses of charter value, if they fail. Banks with higher market power have higher charter values, since they are able to charge higher rents. The increased charter values deter risk-taking

E-mail address: Nicholas.apergis@northumbria.ac.uk.

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behaviour because they increase the opportunity cost of bankruptcy. Therefore, increases in competition potentially reduce the value of bank charters, which is associated with increases in risk-taking. By contrast, lack of competition may lead to lower bank stability. As the lending market becomes more concentrated, banks use their market power to charge higher loan rates, leading to increases in their interest margins. Higher loan rates increase the probability of bankruptcy for borrowers who respond by undertaking riskier projects (Boyd and De Nikolo, 2005).

Banks in emerging markets have experienced significant restructuring in terms of ownership, as well as increased competition from foreign banks (Jeon et al., 2011; Wu et al., 2010). Williams (2012) provides evidence that increased foreign bank entry might have a negative effect on competition. Emerging market banking systems generally have proven to be more robust and less affected by the recent financial turmoil; still, their banking sectors have undergone significant changes (Takáts, 2010).

The goal of this study is to empirically assess, for the first time, and to the best of the authors' knowledge, the level of competition of the banking system in a panel of emerging market economies, through the non-structural methodology approach suggested by Panzar and Rosse (PR hereafter) (1987) and a unique panel dataset of commercial and savings banks, spanning the period 2000–2012. Additionally, the paper explores whether there is any changes in bank competition prior and after the recent financial crisis. This issue is substantially important given the negative spillovers of the crisis onto the economy as well as on how competition policies should be applied over a period of a systemic crisis.

Over the last decades, non-structural models of competitive behaviour measure competition and focus on the detailed competitive conduct of firms without using explicit information about the structure of the markets (Panzar and Rosse, 1987). They measure competitive conditions by estimating deviations from competitive pricing formally derived from profit maximising equilibrium conditions, which is their main advantage compared against structural measures (Bikker et al., 2012). PR (1987) provide the H-statistic metric, which is a quantitative assessment of the competitive nature of a market. A value below 0 denotes a collusive competition, a value below 1 denotes monopolistic competition, and a value equal to 1 characterises perfect competition. The advantage of this methodology is that it uses bank-level data and allows for bank-specific differences in production.

What separates this paper from the more recent empirical work is that it employs banking data from emerging markets, which allows us to use a large sample of public and private commercial banks, while the paper also benefits from the fact that it studies the pre-crisis and crisis periods and, thus, it uses the crisis as a quasi-natural experiment which provides solid results about the extent of competition across the two regimes. With respect to this approach, the results are expected to be substantially interesting to bank market participants, investors, and regulators who have expressed serious concerns about the extent of competition in the banking industry during and, mostly, after the crisis with respect to the recovery of the economy.

To foreshadow the empirical findings, the analysis documents that monopolistic banking competition prevails over any other market structure across the emerging market economies, while bank competition has declined after the recent financial crisis. These results survive a robust analysis that makes use of an alternative methodological approach. The remainder of this paper is structured as follows: Section 2 reviews the literature, while Section 3 discusses the data and the methodologies applied. Section 4 illustrates and evaluates the results of the empirical analysis. Finally, Section 5 concludes the paper and offers some policy recommendations.

2. Literature review

The majority of empirical studies (Bikker and Groeneveld, 2000; Bikker and Haaf, 2002; Claasens and Laeven, 2004; Casu and Girardone, 2006; Bikker et al., 2012) measure the level of banking competition by estimating the H-index across European Union countries. The World Bank also provides estimates for the H-statistic, albeit in a cross-sectional manner, while the H-statistic has been also estimated at the bank-level by Brissimis and Delis (2011). Andries and Capraru (2012) investigate competition in the banking sector across the EU-27 by estimating the mean value of the relevant H-indices for each member country.

The majority of the literature studies conclude that banks operate in monopolistic competitive environments (Beck et al., 2006; Claessens and Laeven, 2004; Gutierrez, 2007; Shaffer, 2002), while European banks seem to be less competitive than U.S. banks, with larger banks being more competitive than smaller

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