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The implication of banking competition: Evidence from African countries☆

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ABSTRACT

This paper examines how bank efficiency and stability are affected by the market power in Africa. Our results show that the higher degree of market power is associated with high level of efficiency and profitability. The banks with more market power operating are able to be in command of the price and hence improve their profit. The market power has a benefit in both stability and risk. Hence, gain in market will increase the stability and reduce the risk for banking system. Our findings do not support the argument that competition should not be based on a "quiet life hypothesis".

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1. Introduction

Over the past two decades, the economic authorities over the world have taken the steps to liberalize the banking sector, through the deregulation of the interest, the opening of the sector to the foreign competition, among others. These structural changes have changed the structure and the competition in banking sector which bear a significant implication on the efficiency and the stability of the sector.

Competition in banking sector has been and still widely debated, especially after the financial crises 2007–2009. Current debate regarding the impact of competition on banking efficiency and stability has been emerged.

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Nevertheless, there is a less intention by academician to study the degree of influence of banking structure market on efficiency and there is no consensus on whether the competition leads to financial stability. Indeed, competition can be harmful to economy through the erosion of franchise value and incentive banks to take excessive risk (Keeley, 1990). However, recent strand of literature shows that competition fosters financial stability (Boyd et al., 2006; Boyd and De Nicolo, 2005). In other hand, research which examine simultaneously the impact of competition on efficiency and stability are few (Schaeck et al., 2009; Turk, 2010).

In this context, the aim of this paper is to investigate the implications of market power on issues of bank efficiency and stability in the African Banking system where capital markets are relatively underdeveloped, and banks represent the main providers of credit to the economy. Banking systems face different challenges in the region. The African banking is characterized by the dominance of state banks which are burdened with inefficiencies and unprofitability. The banking system is relatively high concentrated, suffering of low intermediation and size[1]. Despite the effort and progress made by countries to improve the quality of the banking system, it is still underdeveloped.

This paper contributes literature on financial development by two aspects. First, to our knowledge, we provide the first cross country study on the relationship between bank efficiency and market structure dedicated to the region of Africa. Existing studies use either cross-country samples covering a mix of developed and developing countries, or samples covering developing economies of different regions (Turk, 2010). This paper addresses this gap in the literature.

Studying Africa is of particular interest for policy purposes. Following multiple episodes of banking crises during the 1980's and the 1990's, most African countries implemented reforms to align their practices with international standards with the expectation that this will enhance banking system efficiency and stability and consequently promote economic development. Largely as a result of these reforms, fragility in African banking systems subsided. Yet African countries are increasingly criticized for preventing the continent from delivering greater financial development and inclusion because of their conservative approach to regulation. Therefore, it is important to empirically examine whether competition is associated to better efficiency outcomes and stability in the African context to inform future reforms and help the continent reap off the growth enhancing effects stemming from well-functioning banking systems. The results could also be useful to inform policy makers in other developing regions facing similar challenges to Africa.

Second, we propose the Simar and Wilson's (2007) parametric regression bootstrap to study the implication of competition on efficiency. This method overcomes the problem of the existence of correlation of efficiency scores.

Our results show that banks with more market power operating are able to command the price and hence improve their performance. This positive relation between efficiency and market power does not support the quiet life hypothesis.

In addition, our findings support the argument that competition erodes the stability where higher power market is associated with bank stability.

The remainder of the paper is structured as follow. Section 2 summarizes the relevant literature for our paper while Section 3 describes the data. Section 4 represents research methodology while Section 5 discusses the empirical results of the suggested model. The article ends up with concluding remarks given in Section 6.

2. Literature review

2.1. Market power

Market structure (power) refers to the capacity of the bank to determine the price of their products or services above their marginal cost. The literature on the measurement of the competition can be divided in two main streams, known as structural and non-structural approach. The structural approach includes the structure-conduct-performance paradigm (SCP, Bain, 1956). In SCP model, the

[1] For more detail, Beck and Cull (2013): Banking in Africa. Center for the Study of African Economies. University of Oxford.

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