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# Competition, contestability and market structure in European banking sectors on the eve of EMU <sup>☆</sup>

Olivier De Bandt <sup>a,\*</sup>, E. Philip Davis <sup>b,c,d,e</sup>

<sup>a</sup> *Banque of France, Research Department, 41-1376 SEMEF, 39 rue Croix des Petits Champs, 75049 Paris Cedex 01, France*

<sup>b</sup> *Bank of England, Financial Stability Wing, London, UK*

<sup>c</sup> *London School of Economics Financial Markets Group, London, UK*

<sup>d</sup> *Royal Institute of International Affairs, London, UK*

<sup>e</sup> *Pensions Institute at Birbeck College, London, UK*

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## Abstract

In order to assess the effect of EMU on market conditions for banks based in countries which adopt the Single Currency, we use the *H* indicator suggested by Panzar and Rosse (Panzar, J.C., Rosse, J.N., 1987. *Journal of Industrial Economics* 35, 443–456). Our contribution is to assess results separately for large and small banks, and for interest income and total income as a dependent variable. From a panel of banks over the period 1992–1996, we provide evidence that the behavior of large banks was not fully competitive as compared to the US. Regarding small banks, the level of compe-

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\*Corresponding author. Tel.: +33-1-42926531; fax: +33-1-42922766.

*E-mail address:* odebandt@banque-france.fr (O. De Bandt).

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## 1. Introduction

It is widely agreed that EMU will significantly affect the degree of competition in the banking sectors of countries adopting the Single Currency, due inter alia to heightened disintermediation and increased actual and potential cross-border competition. These tendencies are expected to put European banks' profitability under significant downward pressure and enhance forces leading to restructuring and consolidation. In this context, our aim is to cast light on recent levels of banking market competition and to provide a benchmark against which the effects of EMU may be assessed. To confirm the relevance of our analysis we also provide comparative evidence on US banks, which operate in a largely deregulated and continental banking system – potentially akin to EMU. The methodology involves the estimation of revenue functions and consideration of the so-called  $H$  statistic, which is the sum of elasticities of revenue to the components of expenditure. One innovation of the paper is that competitive conditions are estimated both in terms of interest income and total income. This is considered to be highly relevant given that banks are seeking non-interest revenue as a supplement to declining interest income as deregulation and structural change proceeds. For example, OECD data show that non-interest income has accounted in recent years for 20–40% of total net income in the countries studied. Moreover, we assess results separately for large and small banks, which may face different competitive conditions.

The paper is structured as follows: in Section 2 we seek briefly to motivate the analysis by considering how the structural changes triggered by EMU may affect banks. In Section 3 we provide details of the methodology of the paper. Section 4 describes the data sources employed, and Section 5 gives the main results. Section 6 draws conclusions.

## 2. Underlying trends and the consequences of EMU

In many OECD countries, the banking industry has for some time been in a state of change, with banks facing heightened competition both within and outside the industry. This has in turn had an impact on banking behavior and

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