The Impact of Competition on Profitability in the Banking Industry －**A Dynamic Panel Data Analysis**

Lee, Chien-Chiang*

Hsieh, Meng-Fen

Yang, Li-Ching

Abstract

This article examines the impact of banking competition on profitability, using bank-level data with 61 countries from 1992 to 2006 and applying generalized-method-of-moments (GMM) techniques developed for dynamic panels. The main contribution is to explain whethr reducing banks' competition can improve their profits. Does the relationship between competition and profit change under different conditions? Using a wide array of measures of banks' comeptetion indicators, the empirical results demonstrate that banking competition plays an ambiguous role in influcencing to profitability. However, in consideration of the effects of broader factors, five conclusions are evidenced. First, going along with the change of market structure, the higher degree of activity restriction will enhance banks' profit. Next, restrictions on commercial banks' right to engage in securities, insurance, and other non-banking related, along with restrictions on entry restrictions on foreign banks will weaken the positive relationship. Thirdly, higher efficiency of the judicial system and investors' protection may weaken or do not impact the positive relationship. Fourthly, countries with a sound financial system or high level income may weaken the positive relationship. Finally, the higher the scale of non-banking industry, the higher competition pressure that banks will take and may reduce or have no

Date submitted: September 16, 2008 Date accepted: July 7, 2009

* Lee, Chien-Chiang, Associate Professor, Department of Finance, National Sun Yat-sen University. Email: cclee@cm.nsysu.edu.tw (C.-C. Lee); Hsieh, Meng-Fen, Associate Professor, Department of Finance, National Taichung Institute of Technology; Yang, Li-Ching, Graduated Master Student, Department of Applied Economics, National Chung Hsing University.

impact on the profit.

Keywords: Banking competition, Bank profitability, Panzar-Rosse, Generalized method of moments, Dynamic panel data model.