

Rodriguez-Fuentes, Carlos J; Dow, Sheila C.

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Financial deregulation, banking competition and regional development: the Spanish experience

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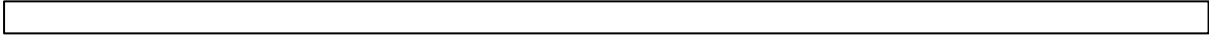
For presentation to the European Regional Science Association (ERSA) 39th Congress,
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**FINANCIAL DEREGULATION, BANKING COMPETITION
AND REGIONAL DEVELOPMENT:
THE SPANISH EXPERIENCE**

Carlos J Rodriguez-Fuentes
Department of Applied Economics
University of La Laguna
S/C de TENERIFE 38071

Sheila C Dow
Department of Economics
University of Stirling
STIRLING FK9 4LA

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I INTRODUCTION

The purpose of this paper is to consider the implications of European monetary integration for peripheral economies within Europe, with a particular focus on the experience of Spain. The view represented in the European Commission's own research is summarised as follows:

As regards the regional distribution of the impact [of EMU], which is relevant to the objective of longer-term convergence of economic performance, *there are no a priori grounds for predicting the pattern of relative gains and losses*. There are risks and opportunities of different types affecting both categories of regions. Policies are already at work to reduce locational disadvantages of the least favoured and geographically peripheral regions. However, the key to the catching-up process lies in obtaining synergies between Community and national efforts to upgrade the least favoured regional economies. The fixing of clear policy objectives, such as for the single market and EMU, are also highly relevant here for mobilizing such efforts (Commission for the European Communities, 1990, p12, emphasis added).

This paper will focus on the implications of EMU for the financial sector, and for its influence on peripheral regions. In particular the consequences of deregulation and increased competition will be considered: the currency unification and fiscal co-ordination features of EMU will not be addressed directly.

The premise of the argument to be developed is that credit creation is relevant to regional economic development. The process of credit creation is complex. It requires consideration not only of the supply side, and the possibilities of credit-rationing, but also of the demand-side, and firms' and households' preferred financial structure, with its implications for firms' propensity to invest and consumers' propensity to spend. Risk perception, is central to both the supply and demand sides. Given that risk may be assessed differently for different classes of borrowers in different regions, the resulting pattern of credit creation may in turn determine the industrial structure of each region. Further, different patterns of perceived risk in different regions can lead to a pattern of expenditure plans and portfolio selection which discourages credit allocation to peripheral regions. (See Dow and Rodriguez Fuentes, 1997 for a fuller account of this argument and how it relates to other arguments in the regional finance literature.) Thus, while banks have increasingly gained control over the volume of credit creation, they may still choose to ration credit in aggregate, and to particular classes of borrowers. The process of European monetary integration may thus set in train forces which exacerbate the credit availability problems of peripheral regions.

Given the significance to this approach of the potential for differences among different parties' risk perception, it is important to consider the structure of decision-making, ie the regional structure of the financial sector. We are thus concerned to examine the structure of the financial sector in Europe, and how it is likely to be affected by the aspects of EMU on which we are focussing here: increased competition, unified regulation, and a move to a unified institutional structure. We then proceed to the main contribution of this paper, which lies in assessing these arguments in relation to Spain.

II EUROPEAN FINANCIAL STRUCTURE

There are at least two views as to the likely structure to emerge in the European financial sector as a result of financial integration:

- The first is that increasing competition will lead to higher efficiency and reduced segmentation in financial markets. Therefore, higher financial efficiency may improve long run growth expectations in less developed regions in Europe since they must have been suffering some credit rationing in the past.
- The second view is that increased competition can also lead to higher concentration in the financial system, and this may not improve credit availability in some cases (due to regional differences in liquidity preference, access to finance sources other than bank credit, etc.), and may encourage excessive financial outflows from regional markets.

The European Commission (1990) research report supports the first view, suggesting that peripheral regions will benefit from improved cost and availability of credit as a result of the single European market:

With full monetary union local banks will lose (sic) [local] monopoly power assuming that borrowers will have direct access to foreign banks, either locally established or not, after the opening of the domestic financial market. Besides this credit availability effect, the borrowers in peripheral countries will also benefit from the level of interest rates which very likely will stay below those prevailing in the region before monetary unification. These two effects - availability and lower price - will represent a clear benefit for the borrowers of lagging regions.

However, local banks may be disrupted because foreign banks will rapidly seize the best segment of the market leaving the local banks with the less performing borrowers. Besides, the new and open financial market will develop in a context of tighter financial discipline and stricter rules for credit granting which may crowd out the (marginal) borrowers of the lagging regions. The net effect is ambiguous. Naturally, the situation will disappear once the local bank[s] ha[ve] recovered and adapted to the new conditions.

(Commission for the European Communities, 1990, p225)

This quotation involves several presumptions about the financial structure which is likely to pertain in an integrated European financial system:

1. increased competition in which small local banks will initially be disadvantaged;
2. an eventual resumption of balance between large national and multi-national banks and regenerated local banks;

the eventual consequences being:

3. increased efficiency resulting in lower interest rates in peripheral regions;
4. reduced credit rationing, but lesser availability for high-risk borrowers in remoter regions.

But this view is not borne out by the study of banking history, which suggests that the competition which characterises the opening of new markets eventually reverts to concentration. This was the experience for example of the Scottish and Canadian banking systems (see Dow and Smithin, 1992, and Dow, 1990, respectively).

A review of the literature on Europe in the 1980s and 1990s by Bisignano (1992) also suggests that concentration is the likely eventual outcome of European financial integration, although he predicts that fragmentation will persist for some time. Gentle and Marshall (1992) and Gentle (1993) identify a significant spatial element in the concentration in the financial services sector in the UK in the 1980s, which is anticipated to continue with further integration in the European financial sector.

The EC (1990) prediction of a competitive reassertion by small local banks draws support from Branson's predictions of the emergence in Europe of a two-tier banking structure whereby local markets will still be served by local banks operating alongside large multinational banks (a prediction shared by Goodhart, 1987). But what they seem to have in mind is local in the sense of national, which would still be compatible with concentration away from peripheral regions within nations. Further, the type of two-tier system they have in mind has much in common with that traditionally identified in the US (as analysed for example by Moore and Hill, 1982, Harrigan and McGregor, 1987 and Dow, 1987). Weisbrod (1991) explicitly uses the US case to argue that concentration will not occur in Europe. Yet financial liberalisation in the US has significantly increased the degree of concentration in banking, eroding the importance of the second tier of banking. But the concentration has not been spatial in the same way as the UK. Indeed, Santomero (1993) argues that the political and cost pressures which have led head offices to disperse operations spatially may well operate similarly in Europe. This could be to the advantage of peripheral regions in terms of employment and output although not necessarily in terms of credit availability.

Overall, then, the prediction that local banks will eventually regain their competitive position relative to the large national and multinational banks does not find much support from past experience or the balance of the relevant literature. But there is the suggestion of advantage to these regions in terms of more favourable terms for financial services. Certainly, *ceteris paribus*, increased competition and economies of scale in a multinational market would be expected to increase efficiency (see Bisignano, 1992). But Eckbo (1991) argues that efficiency gains will not necessarily be passed on, due to increased concentration in European banking.

In addition, the experience of Britain as an already-integrated financial market suggests that regional differentials may persist. McKillop and Hutchison (1990) identify two forms of segmentation present in the British banking sector: institutional and market segmentation. The first refers to the existence of local banks institutionally distinct from the national banks; the second refers to national banks having regionally distinct markets. As far as Europe is concerned the first would be the case anticipated by the EC, with the persistence of local banks. The second would be the case of concentration in large multinational banks.

In both cases, segmentation creates the opportunity for different interest rates and/or

charges. These latter are becoming an ever-more significant element in bank profits and may be a means more appealing to the banks to differentiate between markets than interest rates as such. In the case of institutional segmentation, small local banks have less ready access to funds than large banks, as well as some local monopoly power in terms of credit availability, both of which would explain higher interest rates in remote regions. The observation that this is the case is consistent with the theoretical literature with respect to a two-tier regional banking market in the US. In the case of market segmentation, Hutchison and McKillop identify the higher costs to national institutions of operating in remote regions: costs of acquiring information about borrowers in the region, transaction cost premiums for remote regions on trading in extra-regional assets, and differential attitudes towards risk. Again, the outcome for remote regions was identified to be higher interest and/or other charges. The implication for Europe is that, even if a two-tier banking system emerges, institutional segmentation can be expected to lead to higher charges in remote regions, just as would the alternative of a single-tier system with market segmentation. If market segmentation can persist within a nation state like Britain, then it is even more likely to persist in Europe. Montgomery's (1991) analysis, based on the experience within Italy, supports this view. Regional differences in interest rates and/or bank charges are therefore likely to persist even within a financially integrated Europe.

At the same time as the financial sector is undergoing spatial concentration, its overall structure is also undergoing evolution. Banks have over the last decade faced increased competition from non-banks, while the policy of financial liberalisation has progressively broken down many of the regulatory distinctions between banks and non-banks. This process has been termed market structural diffusion (see Gardener, 1988). Insofar as the large multinational banks have developed competitive strategies more quickly and successfully than small local banks in order to address the increased competition from non-banks, the tendency towards concentration in banking will be reinforced. The influence of financial liberalisation in Europe on credit creation in peripheral regions will thus be the outcome of two forces:

1. the spatial concentration of creators of credit.
2. the effects of non-bank competition on the preferences of banks with respect to the volume and distribution of credit.

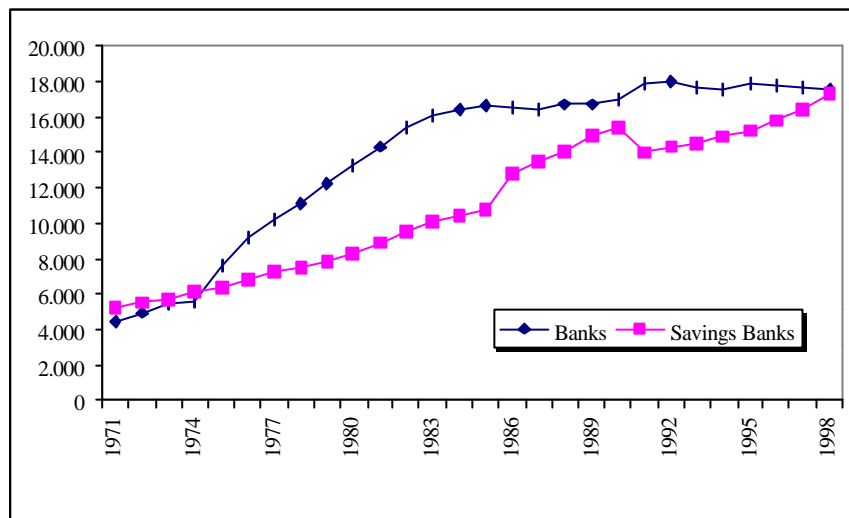
We examine these forces more closely in the evidence for the experience of the financial sector in Spain in the 1980s and 1990s.

III THE SPANISH EXPERIENCE

The Spanish financial system has experienced a rapid and intense process of deregulation in the eighties and nineties, leading to the current situation of strong competition which characterises most European banking systems. Most of these financial changes have had much to do with the membership of Spain to the EU (in year 1986), and with the advances registered during the eighties and nineties in the construction of the financial counterpart of the European single market: the Single European Financial Market.

The current situation of the Spanish financial system clearly contrasts with that of the sixties and seventies, which was characterised by the existence of virtually no competition among banks, both from an internal (among Spanish banks) and external (between Spanish and foreign institutions) point of view, and a close control both over interest rates and the allocation of financial resources channelled by the financial institutions. All these features started to be removed from the mid seventies, firstly by allowing banks to open more branches all over the country in 1974, a possibility which was extended much later (in 1989) to the savings banks. This explains the different trend followed by banks and savings banks in the opening of branches from mid seventies (figure 1).

FIGURE 1: *Expansion of banking branches in Spain, 1971-1998*

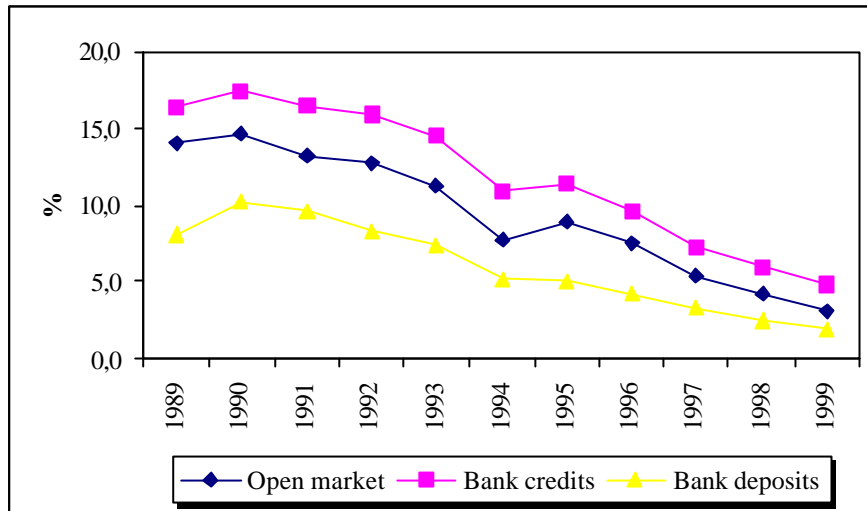


Source: Bank of Spain

Although foreign banks were allowed to operate in 1978, the “real” opening up of the national banking market wouldn’t really come until the late eighties (with the progressive adaptation of the Spanish financial regulation to that of the Second Banking Directive). Therefore, it was not until the nineties that foreign European banks started to compete on equal terms with the Spanish ones.¹ As regards the control on both interest rates and the allocation of credit, the process of complete liberalisation was completed by the end of eighties.

¹ Casado, Campoy and Chulia (1995) study the changes in the regulation of the Spanish financial system after the Spanish entry in the EU.

FIGURE 2: *Interest rates and financial costs in Spain*



Source: Bank of Spain

There is little doubt that the financial deregulation is responsible for the higher levels of financial efficiency achieved by the Spanish financial system in the last decades, if by efficiency we mean lower interest rates (figure 2). But apart from lower interest rates, financial liberalisation has also produced a strong increase in the degree of concentration within the banking sector, as banking history suggests (Dow, 1990, and Dow and Smithin, 1992). Concentration within the banking sector has clearly risen in the last decades (table 1) and it is likely that this trend will continue in the future since concentration within the Spanish banking system is still relatively low compared to other developed countries. Hence, the 5 larger banking institutions in Spain in 1995 had a market share of 48%, far below the level achieved in most developed countries: Sweden (86%), Holland (81%), Canada (78%), Finland (74%), Australia (67%), United Kingdom (57%), Belgium (59%), Noruega (58%), France (47%), Swiss (50%), Italy (29%), Japan (27%), Germany (17%) and USA (13%).²

² See Cebrian Carrasco (1997).

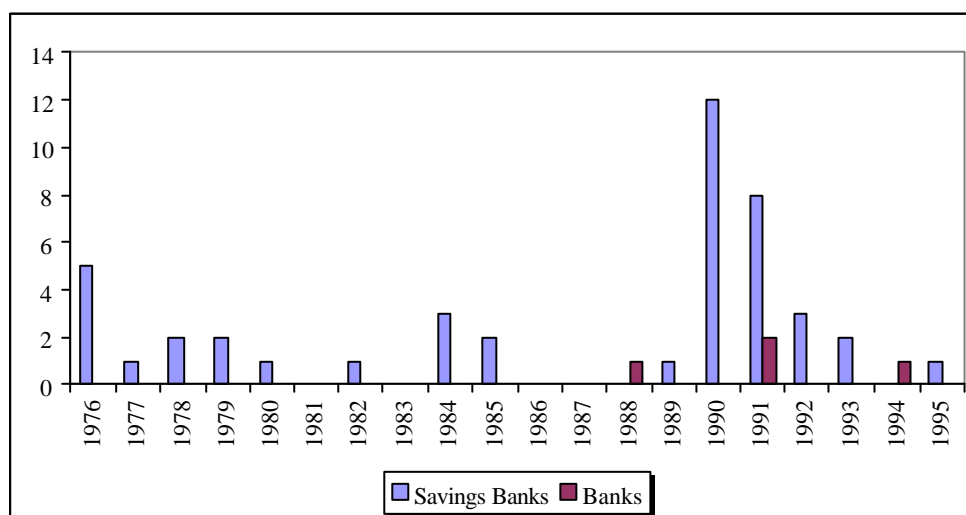
TABLE 1: Concentration in Spanish banking, 1987-1996

	BANKS		SAVINGS BANKS	
	ATM	NEE	ATM	NEE
HERFINDHAL-HIRSCHMAN				
1987	0,04620	21	0,04726	21
1996	0,07413	13	0,07131	14
HALL-TIDEMAN				
1987	0,02844	35	0,0309	32
1996	0,04725	21	0,0465	21
GINI				
1987	0,73020		0,5720	
1996	0,80210		0,5677	

Source: González Alcón (1998)

Financial deregulation has also fuelled mergers within the banking sector, and especially among savings banks during 1990 and 1991 (figure 3). Mergers have been important among those large Spanish banks which aim to play an active role in the European banking market. However, mergers among savings banks have had a very different purpose since they have been aimed to reinforce their competitive position within their local/regional markets; that's why mergers among savings banks have only involved institutions operating within the same market (region).

FIGURE 3: Mergers in the Spanish banking system, 1976-1995

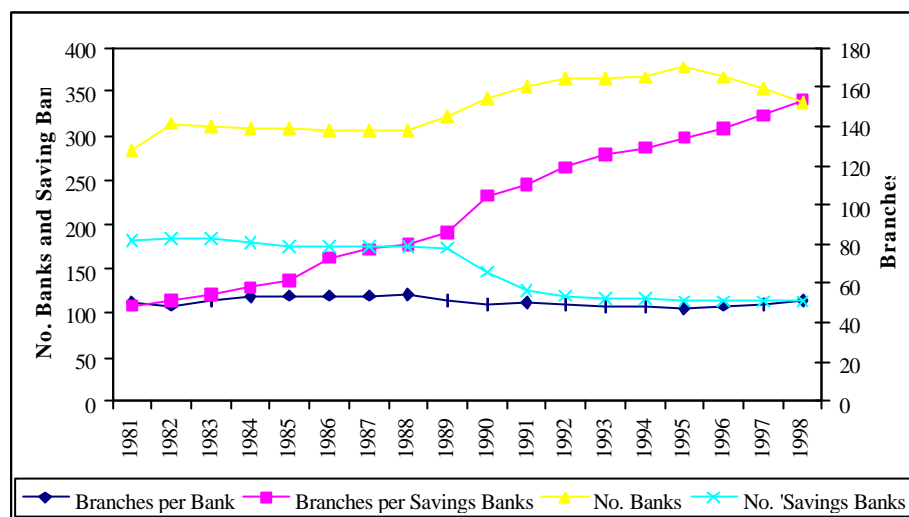


Source: Ontiveros and Valero (1997)

The increase in the number of banks in the nineties (figure 4) reflects the entry of both “small specialised” banks and foreign-EU banks, most of them have focussed their business on certain markets (personal and merchant banking, etc.). In contrast to the banks, the number of savings banks has gone down as a consequence of mergers within the sector. However, savings banks have also been increasing their average number of branches whereas banks

seem to have stabilised. This different pattern evidences the nation-wide expansion of the two major Spanish savings banks.

FIGURE 4: *Banks and Savings Banks expansion, 1981-1998*



Source: Bank of Spain

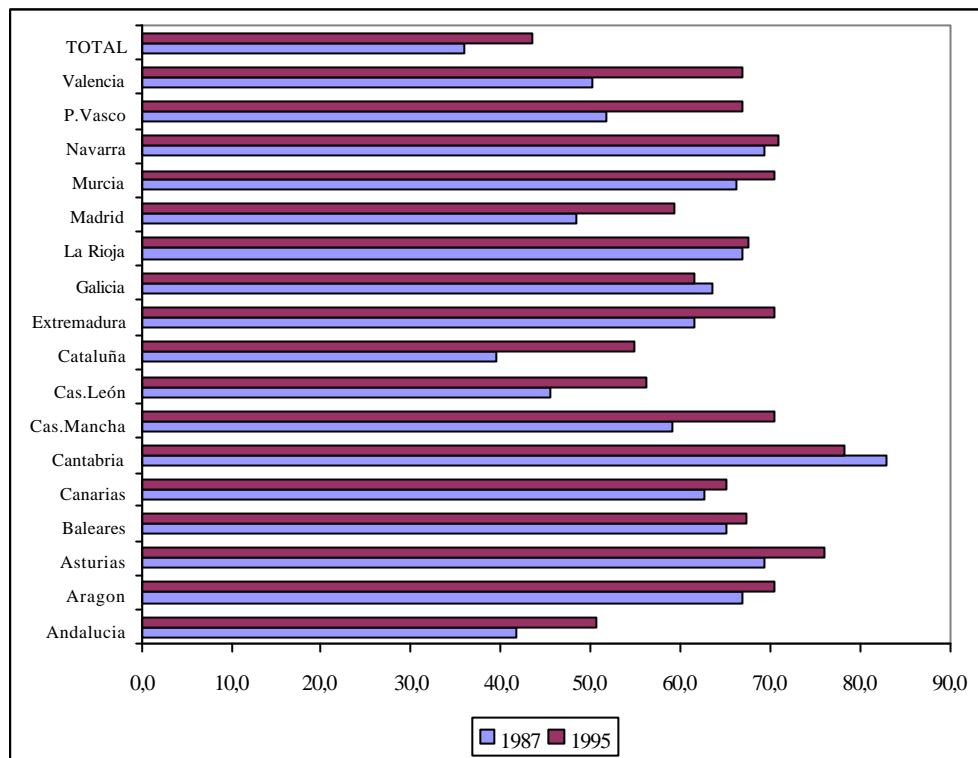
Financial deregulation in Spain seems to have reinforced the relevance of some local/regional financial intermediaries.³ Actually, the fact that only a very few saving banks (the two larger ones) have extended their branches all over the country, and that mergers in this sector have been restricted to the local/regional boundaries, has reinforced the regional dimension of the savings banks. However, this shouldn't be seen as a negative outcome *per se*, since there is some evidence which also suggest that bank credit in Spain is better distributed among regions (lower concentration) thanks to the existence of these local/regional intermediaries (mostly, savings banks which only operate regionally).⁴

The Spanish banking system may be characterised by the emergence of a “three-tier-system”. In the first tier were institutions operating nation-wide (all large banks and only a very few savings banks). The second level would be made up by some saving banks which operate in more than one region. The third tier would include both those small new specialised banks which operate in certain markets (personal banking, merchant banks, etc.) and the savings banks which only operate within one region. The emergence of such a banking structure may contradict the theoretical argument that financial liberalisation always leads to a higher degree of market integration. Actually, the Spanish experience shows that financial liberalisation has effectively removed the “institutional segmentation” existing within the banking sector in the sixties and seventies; but it has also reinforced what is called “market segmentation”. Furthermore, higher financial competition has led to an increased concentration within the Spanish banking system, while there are important regional differences in terms financial concentration (figure 5).

³ See Garcia Roa (1999), Garcia Sanz (1998) and Fuentelsaz and Gomez (1998).

⁴ Garcia and Cuesta (1999).

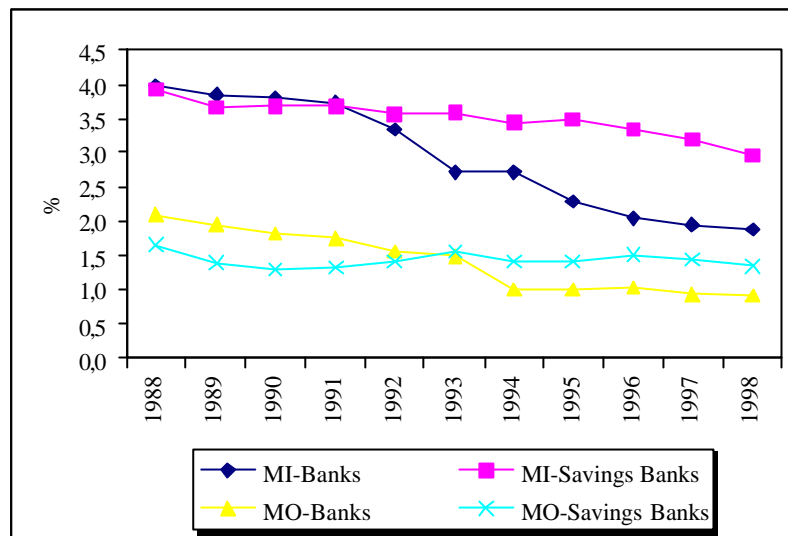
FIGURE 5: *Banking concentration: market share (%) of 5 larger institution*



Source: Cebrian Carrasco (1997)

It is impossible to know whether this segmentation might lead to the existence of interregional differences in terms of interest rates because there is no statistical information in this regard. However, it wouldn't be too risky to say that this could be the case since there seem to exist some differences among banks and savings banks in terms of financial margins and interest rates (figure 6). However, it must be noted that these are only the consequences of what it is called "institutional segmentation", and that even without existing institutional segmentation there could be "market segmentation" when nation-wide institutions applied different credit policies between regions. Unfortunately, the official statistics do not allow us to investigate this possibility further.

FIGURE 6: *Financial margins in Banks and Savings Banks*

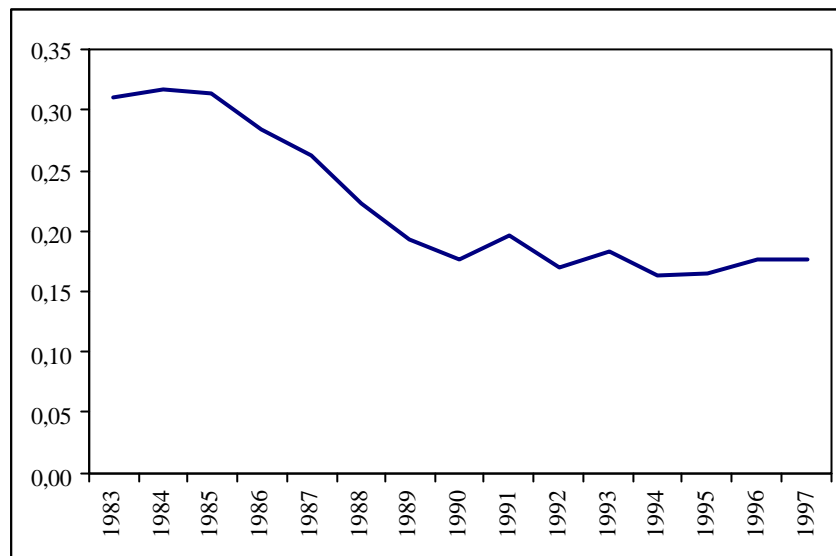


Source: Bank of Spain

So far we have tried to offer some descriptive evidence to show that financial liberalisation has notably affected the structure of the Spanish banking system. But the main purpose of this paper is to explore the potential effects that financial deregulation might have produced for regional credit creation and, particularly, whether higher banking concentration might have exacerbated the credit availability problems of peripheral regions in Spain.

According to the official view (sustained by the European Commission of the EU), financial liberalisation should lead, among other things, to a better functioning of the credit markets in peripheral regions. This argument seems to be supported by the Spanish experience (figure 7), since the calculated Gini index value for the regional concentration of bank credit in Spain has been going down at the same time that the financial system was being almost totally deregulated.

FIGURE 7: *Regional credit concentration in Spain, 1983-1997*



Source: Bank of Spain and BBV

However, it is not clear at all whether this secular trend towards a lower concentration in the regional distribution of banking credit in Spain is due exclusively to the deregulation of the financial sector. Actually, it might be that the improvement (and worsening) in credit concentration were just explained by business cycles movements which, in turn, might have affected both banks' and borrowers' liquidity preference in certain regions. Actually, the evolution of credit concentration in Spain seems to follow a pattern which matches with economic ups and downs since 1983. From 1983-1985 (recession) it increases and, starting in 1985 it turns into a sharp decreasing trend of credit concentration which matches with the expansionary period (from 1985 up to 1989). Finally this decreasing pattern ends in year 1990. From that year on the regional credit concentration seems to stabilise, coinciding with the last economic recession (1990-1993). However, it must be noted that from 1994 there is an increase in concentration despite economic expansion.

Contrary to what the European Commission of the EU sustains, our explanation for the reduction in credit concentration lies in the changes operated by financial agents' behaviour according to the different phases of the business cycle. Our argument is that banking competition and economic optimism may increase both supply and demand for credit in remoter markets during economic expansions because of the existence of a lower liquidity preference in that phase of the cycle. The lower concentration in credit during expansions could be explained by both the strong banking competition (which may lead nation-wide financial institutions to look for new investment opportunities in peripheral markets) and the relatively lower liquidity preference which characterises economic upturns. Therefore, higher rates of growth of credit in peripheral market wouldn't be simply explained by the removal of the monopoly power that local banks might have had before they were open to competition. If this were the case then credit expansion was much stronger in peripheral regions during expansions, whereas the contrary would apply for the downturns, the final result being a more unstable pattern in credit creation in peripheral regions than in the developed ones. This argument seems to apply to the recent Spanish experience. Hence, Rodriguez-Fuentes (1998)

has found that there existed a negative relationship at the regional level between the Gross Domestic Product per capita and the rate of growth of credit among the 17 Spanish regions during the expansion of 1985-1990, whereas for the recession of the nineties (1991-1993) this relationship turned out to be positive. Cuesta and Garcia (1998) have also offered some evidence in the same line of reasoning. In fact, they have found that the dispersion of bank credit among Spanish regions has gone down from 1986, although they also pointed out that this decreasing pattern is strongly correlated to the soundness of the business cycle (the greatest drop is achieved during the expansion 1986-1990).

If the former argument were valid, ie that the improvement in regional credit availability were mostly due to changes in the regional pattern of liquidity preferences over the business cycles, then it would be necessary to investigate further the underlying forces of such changes and its potential regional implications. However, it is a difficult task to address this question from an empirical point of view because of the lack of statistical information in this regard. However, there are some general tendencies that can provide illumination.

Over the last years we have been experiencing a notable reduction in interest rates in Spain. Lower interest rates have expanded the demand for credit, but have also driven household savings away from bank deposits (mainly to Investment Funds). Investment Funds⁵ have therefore achieved an important role within the financial preferences of households, but also within the whole Spanish economy (table 2).

TABLE 2: *Relevance of Investment funds in Spain (%)*

	GDP	M4	Deposits	Public Debt (a)
1991	7,3	7,1	10,7	17,9
1992	11,2	10,9	16,7	27,9
1993	17,6	16,4	24,9	33,1
1994	18,0	16,6	25,5	34,1
1995	18,1	16,4	25,8	33,7
1996	25,3	24,3	39,6	45,4
1997	34,9	33,0	56,7	51,3

(a) Public Debt included in the Investment Funds

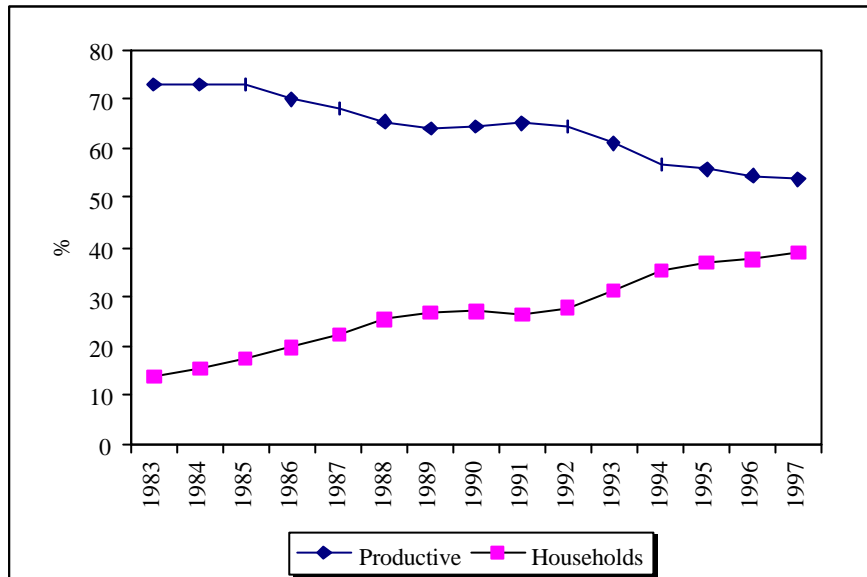
Source: Marcos Bermejo (1998)

Although bank credit has increased, it is also true that most of this increase have been driven into “non productive” activities, according to the own classification used by the Central Bank. In fact, figure 8 shows a sharp increase in the share of households in total credit, whereas the share corresponding to productive credit has been going down since 1983. The increasing role of non productive credit, which includes “home buying” funding, has very much to do with the fact that this is not only a highly profitable market for institutions, but also a more secure one. That is one of the ways through which financial regulation may have been affecting banks’ investment decisions, since in order to fulfil the capital adequacy ratios they

⁵ An *Investment Fund* is a financial asset in which the funds provided by private investors are customised by a Fund who acts in trust for the investors.

might have driven financial resources not only to the home buying market, but also to the public debt market since investment funds mostly invest their resources in these assets. There is no doubt that most changes in Spanish financial regulation have been reinforced by the financial harmonisation in Europe.

FIGURE 8: *Productive and “non productive” credit (% of total credit)*



Source: Bank of Spain

The increasing allocation of financial funds towards “Investment Funds” and “non productive” credit might have rationed business investment because firms have increased their self-financing thanks to the current economic expansion. However, it is difficult to say what could happen when the situation reverts, ie when the current expansion comes (sooner or later) to its end. In that case it might well happen that certain types of borrowers (mostly small business) may be rationed in credit markets since they depend more heavily on banking credit to finance their investments. But according to our analysis it is also likely that some banks (nation-wide) may decide to slow down their investment in certain (peripheral) markets due to the general rise in liquidity preference in those regions. Then, there could also be an “outflow of funds” that in other conditions (lower liquidity preference) would remain within the region. The final result would be a reduction in the availability of credit in some regional markets, and what is really important to note is that this credit-crunch might not now be compensated by the credit supplied by the “inefficient” local-regional intermediaries since they might have been removed from the market “thanks” to the increased competition and higher efficiency introduced by financial liberalisation. If this were so, then it wouldn’t be unlikely that the increasing concentration in the banking system in Spain may exacerbate, as we suggested before, the credit availability problems of peripheral regions in the near future, and particularly during times of economic uncertainty. But this could also be the case for Europe as a whole, since the European Monetary Union is producing a strong restructuring of the European financial system as well.

IV CONCLUSIONS

We started with two distinctive views about the likely outcome of financial integration in Europe. One was that increased competition would bring down borrowing costs and improve availability. The other was that this increased competition would be reversed in a process of concentration in the banking sector, with the consequence of credit availability problems for peripheral regions.

On the face of it, the evidence on the effect of financial integration in Spain appears to provide more support for the former view. We have seen that interest rates and financial margins have clearly been reduced. Further the regional distribution of credit has also improved, in the sense that it is now less concentrated from a regional point of view.

But we have noted other trends within the Spanish financial sector which leave open the possibility that the sector is still in a transitional stage, such that the outcome in a few years could be very different. The following conclusions suggest particular areas for study in order to understand the effect of financial liberalisation on the structure of banking in Spain, and the implications for the financing of business of different sizes and in different regions.

First, there is already evidence that financial liberalisation has led to an increased concentration within the banking sector; this is likely to continue in the future since the current level of concentration is still low (compared to most developed economies).

Second, although deregulation has tended to reduce regional segmentation in financial markets and so achieve lower levels of interest rates and higher credit availability in those segmented markets, the fact is that the Spanish banking system is still characterised by the existence of a certain degree of segmentation. All large banks and two savings banks operate nation-wide, but there are also some intermediaries whose natural markets are still local. Most savings banks only operate within their regions, or at best in some nearby regions; also there are many banks, for example merchant banks, which have focused on specific markets.

Third, another result of financial liberalisation has been the emergence of new investment opportunities for households and banks (primarily in the form of investment funds). These financial opportunities now compete (in terms of profitability and interest rates) with the business demand for credit (especially small sized business, since large ones can now benefit from opportunities “outside”). The Spanish experience shows that both households and banks have diverted funds towards these emerging markets. (Spanish banks controls around 70% of Investment Funds) The increasing allocation of funds towards these financial assets, together with the increasing credit channelled towards non-productive activities (primarily home buying), does not appear to have affected business financing in Spain yet. However, this might not be the case for small business once future poorer economic performances reduce their capacity for self-financing. Small businesses are the market segment which may be affected most by credit rationing in the future, together with, more generally, markets/regions which are considered by large banks as peripheral (more unstable, risky, etc.). The analysis here suggests that much of the “improvement” in the regional concentration of credit can be explained as much by changes in liquidity preference during the course of business cycles, as by the increased competition introduced with the financial reforms.

It is early days yet in the process of financial integration in Europe. What we have found for Spain is an outcome which characterises the early stages of a process of opening up financial markets to competition. The more telling evidence will emerge over the next decade, during which it will become more clear whether the beneficial effects of enhanced competition will persist, or be eroded by a process of concentration in banking.

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