Don't privatize banks too soon

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The research, led by Professor Panicos Demetriades of the University of Leicester, suggests that privatising government owned banks without having an effective system of regulation in place can result in a collapse of depositors' confidence in banking. This can not only undermine the ability of the banking system to finance economic growth but it can also trigger bank runs and financial instability.

The work, which is published in the *Journal of Development Economics*, shows that if financial regulation is ineffective depositors may prefer to place their money in government owned banks, which are frequently more trusted than private banks.

Professor Demetriades, of the Department of Economics at the University of Leicester, said: "If government owned banks are privatised prematurely, depositors will shift their funds not to private banks but to alternative assets that are deemed safer, such as domestic or foreign currency or real assets (e.g. houses, gold or consumer durables). This, in turn, means that the ability of the banking system to provide credit to businesses and households will be impaired.

"Moreover, rapid outflows of funds from one bank can create panic and may cause more widespread bank runs due to insufficient information and lack of confidence in regulation."

Professor Demetriades added that, naturally, there are concerns that governments may be unable to run nationalised banks efficiently. He states: "If so, this can well have a negative impact on long run growth. In the words of Financial Times journalist Martin Wolf "…crisis ridden private banking is bad; government monopoly banking is still worse' ."

Follow on research by Professor Demetriades and his co-authors suggests that such concerns may be unwarranted. This research, published in the University of Leicester's Economics Discussion Papers, shows that in recent years government ownership of banks has, if anything, been robustly associated with higher long run growth rates. Specifically, the researchers, who utilise data from a large number of countries for 1995-2007, find that - other things equal - countries with high degrees of government ownership of banking have grown faster than countries with few or no government owned banks.

The researchers provide a novel political economy explanation for their findings. They suggest that politicians may actually prefer banks not to be in the public sector. When banks are in theory controlled by their shareholders, in practice they are more likely to be controlled by their top managers because shareholders are typically not well informed. Conditions of weak corporate governance in banks provide fertile ground for quick enrichment for both bankers and politicians - at the expense ultimately of the taxpayer. In such circumstances politicians can offer bankers a system of weak regulation in exchange for party political contributions, positions on the boards of banks or lucrative consultancies. Activities that are more likely to provide both sides with quick returns are the more speculative ones, especially if they are sufficiently opaque as not to be well understood by the shareholders e.g. 'financial engineering' including complex derivatives trading and securitization of sub-prime loans.

Government owned banks, on the other hand, have less freedom to engage in speculative strategies that result in quick enrichment for bank insiders and politicians. Moreover, politicians tend to be held accountable for wrongdoings or bad management in the public sector but are typically only indirectly blamed for the misdemeanours of private banks - it is the shareholders who are expected to prevent these but lack of transparency and weak governance stops them from doing so in practice. On the other hand, when it comes to banks that are in the public sector, democratic accountability of politicians is more likely to discourage them from engaging in mutually beneficial speculation. In such banks, top managers are more likely to be compelled to focus on the more mundane job of financing real businesses and economic growth.

More information:

Andrianova, S., Demetriades, P. and Shortland, A. "Government Ownership of Banks, Institutions and Financial Development", Journal of Development Economics, vol. 85, 218-252.

Andrianova, S., Demetriades, P. and Shortland, A. (2009), "Is Government Ownership of Banks Really Harmful to Growth?", University of Leicester Discussion Paper in Economics 09/11.

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