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Government ownership of banks, institutions, and financial development☆

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Abstract

Using a suitably modified locational model of banking, we examine the influence of institutions, such as deposit contract enforcement, in explaining the share of government owned banks in the banking system. We present cross-country evidence suggesting that institutional factors are relatively more important determinants of the share of state banks than political or historical ones. We argue that rather than privatizing or subsidizing state banks governments in developing countries should build institutions that foster the development of private banking.

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1. Introduction

It is now widely accepted that well functioning financial systems can help promote economic growth, especially in middle income countries (Rioja and Valev, 2004; Demetriades and Andrianova, 2004). However, the policies that could advance financial development remain elusive for many developing countries. Importantly, financial liberalization, widely considered critical in delivering a more efficient and competitive banking system, has frequently been followed by financial instability, especially where institutions such as rule-of-law and regulation were weak (Demirgüç-Kunt and Detragiache, 1999; Kaminsky and Reinhart, 1999; Arestis and Demetriades, 1999). Surprisingly, even though financial liberalization policies have been widely adopted, government ownership of banks remains prevalent in many countries (Barth et al., 2000). Could this stylized fact to some extent explain why financial development has not taken off in some countries, or, indeed why financial liberalization has been followed by financial instability? An important recent paper by La Porta, Lopez-de-Silanes and Shleifer (2002) suggests that this may indeed be the case. The authors report a number of cross-country correlations that suggest that the degree of government ownership in the banking system is negatively related to subsequent financial development and economic growth, and positively associated with financial instability. If these relationships are causal, as indeed is implied by the authors, then large-scale privatizations of banking systems around the world could generate enormous benefits in terms of both financial development and economic growth.[1] However, if the relationships observed in the cross-country data reflect reverse causality or are driven by other factors, then it is essential to know what factors determine the presence of government owned banks and what the likely implications of their privatization might be.

A careful analysis of government ownership of banks needs to explain why state banks exist in the first place. Is it purely driven by political motives, as postulated by the "political view" of state banking, or is it a response to institutional deficiency?[2] Stylized facts, as well as empirical studies, provide credence to both possibilities. For example, the evidence from Russia suggests that mistrust of banks by the general public means that most savings are not in the financial system and that 70% of retail bank deposits are controlled by Sberbank, the largest state savings bank.[3] Additionally, the bi-variate cross country regressions reported in La Porta et al. (2002), suggest that government ownership of banks is negatively correlated with property rights protection and other institutional quality indicators, as well as with political rights or democracy.[4]

In order to advance our understanding of the determinants of the share of state (government owned) banks in the banking system, this paper offers a theoretical analysis of depositors' behavior, when they have a choice between private and state banks. We postulate a plausible trade-off between the two types of bank, the nature of which is affected by institutional quality. Specifically, while private banks are assumed to be more efficient than the government owned bank, some private banks are assumed to be opportunistic. Under weak institutional quality, the presence of opportunistic banks may create a preference for the less efficient but safer state bank

[1] The estimated effects in La Porta et al. (2002) are quite large: a 10 percentage points rise in the share of government ownership of banks reduces the growth rate by approximately 0.25% per annum.

[2] Stiglitz (2002), pp. 54–59 and 157–160, provides a vivid illustration of the risks associated with premature privatization in both developing and transition economies. See also Perotti (2001), who discusses the Russian experience.

[3] CSI (Coalition of Service Industries) Background Paper on Russian Banking Services (22 May 2002).

[4] It should be noted, however, that the bi-variate nature of the regressions reported in Table III in La Porta et al. (2002) makes it impossible to establish which determinants of government ownership of banks are the statistically significant ones.