

Privatization in Commercial Banking

Lecture 6

8 April 2025

Objectives of the Lecture

- The objectives of this chapter are to:
- understand why state ownership of commercial banks have been so prevalent.
- explain the theoretical base for state ownership of banks.
- identify the reasons why governments launch mass privatization programs for commercial banking in the 1990s.

- During the past 15 years, over 250 commercial banks have been fully or partially privatized by governments of 59 countries, either publicly through public offerings of shares or privately through an asset sale.
- In many countries, this shift represented a break from past development strategies centered on state-led banking systems.
- As a first step in determining why governments are privatizing banks, we examine why these banks became state-owned in the first place and then ask what caused societies to decide that state-owned banking was not a good idea.

Why Has State Ownership of Commercial Banks Been So Prevalent Historically?

- Commercial banking is the most basic industry in a modern economy because of its central role in allocating capital and monitoring corporate borrowers.
- Banks tend to perform three basic functions in any economic system.
 - 1 They play a central role in the country's payments system and also serve as a clearinghouse for payments.
 - 2 They transform claims issued by borrowers into other claims that depositors, creditors, or owners are willing to hold.
 - 3 Banks provide a mechanism for evaluating, pricing, and monitoring credit extension in an economy.
- Efficiency and transparency concerns have proven more complex in state-dominated systems.

The Theoretical Case for State Ownership of Banks

- During the modern era, proponents of state ownership have justified government control of business in three principal ways.
- 1 Business enterprises balance social and economic objectives, rather than focusing exclusively on profit maximization.
 - 2 State ownership has been motivated as a response to significant market failures and as a way to address production externalities such as pollution.
 - 3 Public ownership can be justified under certain conditions involving informational asymmetries between principal (the public) and agent (the producer), where complete contracts cannot be written and enforced.

The Theoretical Case for State Ownership of Banks

- State ownership of banking grew as a result of the post–World War II trend toward state ownership but was also driven by industry-specific factors.
- “Benevolent” reasons include:
 - ① a perceived lack of private capital with sufficient risk tolerance to finance growth;
 - ② inadequate funding to sectors and groups with low financial but high social returns;
 - ③ a desire to promote industrialization and development at a pace more rapid than private financing would allow;
 - ④ and a desire to maintain domestic control over a nation’s financial system.
- In postcolonial and ideological contexts, banks were also tools for political power and redistribution.

Why Have Governments Launched Bank Privatization Programs?

- There are important factors:
- ① State ownership was not working as planned.
- ② Financial system development promoted economic growth.
- ③ Governments increasingly viewed share issue privatizations as a way to develop capital markets.
- ④ Expanding stock market participation enhances financial intermediation and investor confidence.
- ⑤ Privatizations created large, liquid firms that served as anchors for domestic stock exchanges.
- ⑥ Share offerings also helped to foster a broader base of individual shareholders and institutional investors.

Financial Market Development and Privatization

- Governments often pursue privatization not only to raise revenue but also to stimulate national stock market development.
- Successful public share offerings (Share Issue Privatizations) promote investor participation and financial deepening.
- Capital markets are increasingly preferred over banks for corporate financing, especially in developed and emerging economies.

Impact of Share Issue Privatizations on Capital Markets

- Share Issue Privatizations have played a significant role in expanding market capitalization and trading volume globally.
- From 1983 to 1999, global market capitalization increased over tenfold, with trading volumes rising over thirtyfold.
- Privatized firms often represent the largest and most liquid stocks in their national markets.

Empirical Findings on Market Liquidity

- Boutchkova and Megginson (2000) show that each privatization deal increases national market turnover ratio.
- Liquidity (measured by turnover) is a robust predictor of long-run economic growth.
- Example: A major offering in Portugal led to a significant rise in Lisbon Stock Exchange trading.

Expansion of Share Ownership

- Share Issue Privatizations have significantly expanded individual and institutional share ownership.
- Privatized firms have statistically higher numbers of shareholders compared to similar private-sector firms.
- Many countries use Share Issue Privatizations to cultivate an equity culture and broaden the base of citizen investors.

Empirical Evidence on Banking Privatization

- Studies show that privatized banks usually become more profitable, efficient, and better at giving loans.
- Foreign ownership of banks often leads to even stronger performance, especially in developing countries.
- Bonin, Hasan, and Wachtel (2005) find that private banks in Central and Eastern Europe perform significantly better than state-owned banks.
- La Porta, Lopez-de-Silanes, and Shleifer (2002) show that government-owned banks are linked with lower growth and less financial development.
- Barth, Caprio, and Levine (2004) find that higher state ownership of banks is associated with lower bank efficiency and weaker bank supervision.
- These studies provide strong evidence that keeping banks under government control often limits the financial sector's contribution to economic growth.

Historical Trends in Bank Privatization

- Mass privatization began in the late 1980s, peaking in the 1990s.
- France, Italy, and Spain significantly reduced state banking by the end of the decade.
- Over \$142 billion raised through more than 280 privatization transactions globally (1985–2003), including asset sales and share issue privatizations.

Country-Level Case: France

- The Chirac government in 1986–87 executed four major share issue privatizations including Banque Paribas and Crédit Commercial de France.
- The Banque Paribas sale alone raised \$2.74 billion and created 3.7 million shareholders.
- These actions marked a turning point in Western European banking privatization.

- Evidence suggests state ownership in banking is linked to inefficiency and politicization.
- Privatization has contributed to stronger bank performance and financial market development.
- Future policies should emphasize transparency, regulation, and the selective role of the state.