PUBLIC BANKING IN SPAIN: GONE WITH THE WIND

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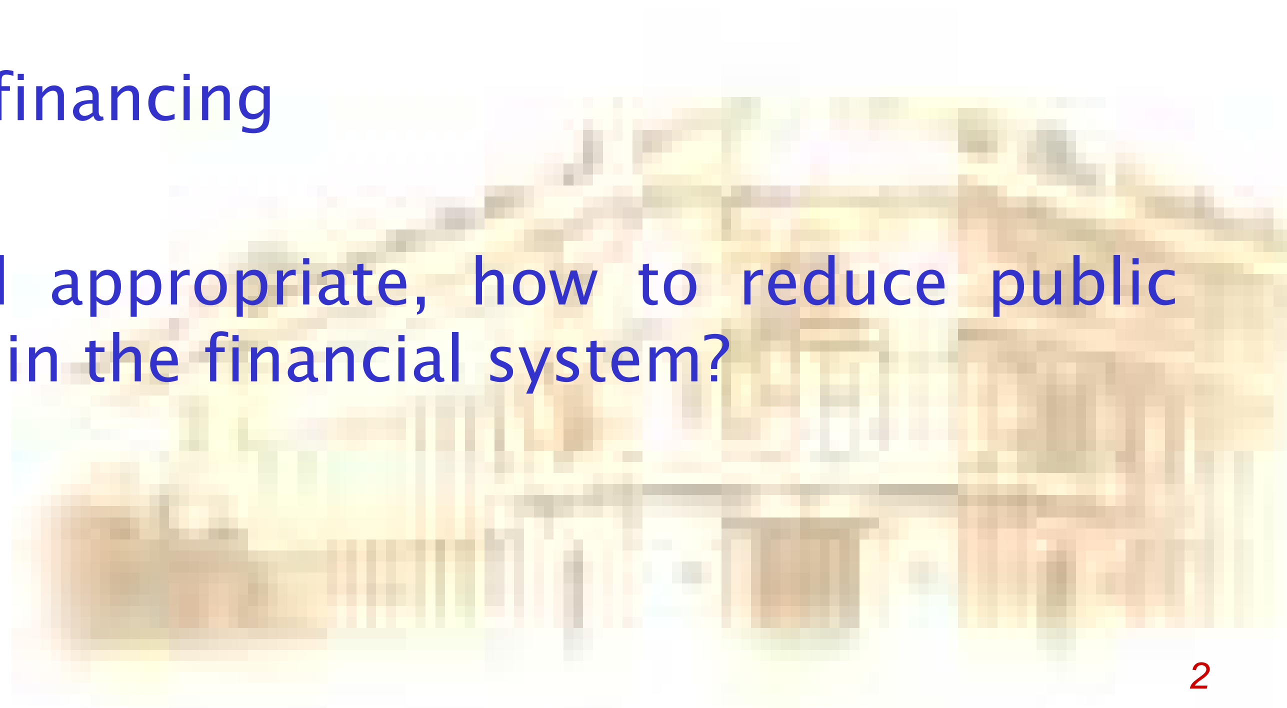
Outline of the presentation

Three key issues on public banking:

1. Appropriateness for promoting development and stability in the financial system?

2. Government financing

3. If considered appropriate, how to reduce public banks' share in the financial system?



1. Appropriateness for promoting development and stability

Important to distinguish between public commercial banks and development banks

1. Public commercial banks tend to be linked to:
   - Lower financial development and economic growth, reduced creditor's rigths protection
   - Higher bank spreads and reduced efficiency in intermediation.
- However, evidence not totally conclusive

2. Development banks are generally found useful if:
   - Market imperfections justify government intervention
   - Complements of private banks, not competitors
   - Good governance key

1. Appropriateness for promoting development and stability (Cont')

The **Spanish case** with public banking:

1. Nationalized in 1960s
   - 4 development banks for priority sectors
2. Financial liberalization from 1970s
   - Market principles introduced in public banks
   - Public credit complement not substitute for private credit
   - Increased competition between public and private banks
3. Full privatization in 1990s. At present only ICO:
   - More of an intermediary than a direct loan supplier

In any case:

- Small size of public banks: at its peak (1986) 10.7% of private credit, today 3.6% (excluding EIB).
- No evidence of contractionary effect on credit from privatization

2. Government financing

1. Public (commercial) banks more likely to finance the government:
   - The higher their size
   - The higher the fiscal deficit
   - The lower the alternatives for public financing

2. Consequences:
   - Crowding out
   - Excessive indebtedness if financing costs below equilibrium
   - Excessive exposure to sovereign risk, increasing the vulnerability of the financial system (relevant for EMEs)
   - Difficult to mitigate through regulation and supervision (moral suasion)

The Spanish case:

- Small size and sectoral specialization of public banks limited government financing (peak was in 1993 with 9.8% of total financing)
- For whole banking system crowding out in the past through liquidity coefficients and investment coefficients. No longer the case

3. How to reduce public banks' share in the financial system

If consensus that public (commercial) banks do not play a role in a country's financial system:

How can their share be reduced minimizing the transition costs?

3 choices:

1. After a **banking crisis**, if no will or no resources for recapitalization, privatize (e.g. C. and E. Europe)

2. In a process of **financial liberalization,** margins compressed: private banks enter into public banks' niches.

3. **Equal treatment** with private banks as regards regulation, supervision and accounting

3. How to reduce public banks' share in the financial system (Cont')

The Spanish case:

- Following liberalization, share of public banks reduced
- Same rules of the game introduced

- Importance of:
  - Gradualism
  - Consolidation before privatization to withstand competition

- Privatization was only one of the steps taken to modernise the Spanish financial system. Other crucial steps were:
  - Full liberalization: interest rates, tariffs, branches
  - Opening up to foreign competition
  - Introduction of same regulatory and supervisory rules for banks and savings banks
  - Internationalization of the domestic banking system

3. How to reduce public banks' share in the financial system (Cont')

Other related issues:

- Whom to privatize banks? Foreign banks vs domestic banks
  - Ownership should not determine choice but capital and business plans
  - Is it unavoidable to increase public banks' share as a consequence of a crisis?
  - Nationalization is specially appealing when banks are too big to fail. However
    - Openness to foreign ownership may reduce this argument
    - Fast but very costly way of recovering confidence and hard to reverse

3. How to reduce public banks' share in the financial system (Cont')

The Spanish case:

Bank crisis in 1978-1985 (thereafter Banesto 1993)

- Costs minimised: crisis affected half the banks (20% deposits), but cost was relatively mild (5% of GDP)
- Partial socialization of costs, but shareholders lost their capital, no bail-outs, and private banks contributed, particularly, with M&A's
- All in all, a successful experience: almost 100 institutions affected, but no further interventions

Conclusions

1. Consensus on limited role for public banks due to inefficiency and crowding out. Better intervention through regulation and supervision

2. BUT role for development banks if market imperfections
   (be careful about introducing government failures)

3. The Spanish experience endorses these conclusions:

   - Low share and reduced importance of public banks led to privatization
   - Private banks took up public banks' business: no reduction in credit
   - Despite low government financing, significant distorsions
   - Bank crisis resolved not through nationalization; no bailouts but some socialization of costs