Empirical Studies of Bank Privatization: An Overview

November, 2003

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I. Introduction

State ownership of large parts of the banking system is relatively rare in developed countries but widespread in less developed countries (Table 1). In 1999, the state owned controlling shares in banks with more than 30% of banking sector assets in only two -- 10% -- of the 20 developed countries for which we have data, compared to 25% of the 78 less developed countries for which we have information.

The importance of state owned banks in these developing countries contrasts worryingly with recent research findings that state ownership of banks has pernicious effects. Barth, Caprio, and Levine (2001) (BCL) find that state ownership is negatively associated with bank performance and overall financial sector development, and does not reduce the likelihood of financial crises. LaPorta, Lopez-de-Silanes, and Shleifer (2002) (LLS) find that greater state ownership in 1970 was associated in 1995 with less financial development, slower growth, and lower productivity.

Given its negative effects, one might expect governments to move quickly to phase out state ownership of banks. While some have done so in recent years, others have been reluctant, and the banking crises of the 1990s even led to re-nationalizations in some countries.

State ownership of banks varies widely by regions, according to data from the BCL surveys of banking (Figure 1). South Asian (SAR) countries have the highest share of banking sector assets held by government-controlled banks, followed by the transition countries of Europe and Central Asia (ECA), Africa (AFR), Latin America and the

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2 Figures 1-6 describe cross-country patterns in state ownership of banking and recent bank privatization activity, based on data from the BCL survey of regulators and supervisors first conducted in 1999, and then updated this year. One hundred thirty countries have state banking ownership data for either 1999 or 2002; eighty-one countries have reliable information for both years.
Caribbean (LAC), East Asia and the Pacific (EAP), the Middle East and North Africa (MENA), and finally, the OECD countries. The sample of countries from SAR is small and their remarkably high level of state ownership in banking is largely driven by India, Bangladesh, and Pakistan. The lower levels of state ownership in ECA and LAC are recent, the result of extensive bank privatization there in the early to mid-1990’s.

Some of the averages mask substantial intra-regional variation. For example, in MENA, Jordan has no government ownership while Egypt’s state-owned banks hold over two-thirds of sector assets. The MENA 1999 average is also misleadingly low because its country response rate to the survey. The addition of data on four new countries in 2003 raised MENA’s average level of state ownership to 30% – between that of Africa and ECA.

The extent of privatization of state-owned banks has also varied widely (Figure 2). From 1999 to 2002, Africa had the steepest reductions in state ownership of banks, again ignoring the extensive privatization in ECA and LAC earlier in the decade. East Asia and the OECD countries maintained their levels of state ownership, while South Asia and MENA showed slight increases in state ownership, partly because of state intervention in some troubled private sector banks.

Per capita income has a strong and significant negative association with the extent of state ownership of banks (first documented in World Bank (2001)). Lower income countries have substantially more state ownership (Figure 3), which probably accounts for their relatively greater share of recent privatization activity (Figure 4).

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3 The regional classifications are those used by the World Bank.
4 The income classification of countries is the one used by the World Bank, which is based primarily, but not solely, on the level of per capita income.
banking, some have resisted and as noted above the levels of state ownership remain high in some of the countries in Table 1.

To understand this reluctance we need to understand how bank privatization has progressed in individual countries and how politics has influenced privatization decisions. A large literature on privatization, summarized in section II, suggests that privatized firms generally outperform state owned enterprises, especially in competitive sectors. Much of the literature does not deal with banks, however. Recently bank privatization was studied in twelve countries -- Argentina, Brazil, Bulgaria, Croatia, Czech Republic, Egypt, Hungary, Mexico, Nigeria, Pakistan, Poland, and Romania -- chosen because they had high levels of state ownership at some point in the 1990s and undertook a relatively high number of privatizations. Some of the privatized banks were small, so the share of total banking sector assets privatized was also small in some cases. Nevertheless, the case study countries appear to have been well selected –they had a much higher share of state ownership in 1999 (35%) than the rest of the countries in the BCL sample (19%) (Figure 5), and they reduced the banking sector assets held by government controlled banks more than the other countries (Figure 6).

The case studies, summarized in section III, are based on detailed panel datasets for many -- in some cases all -- banks in each country. These data enable the authors to measure performance gains or losses much more precisely and to compare any improvements in privatized banks with trends for other banks in the country. The detailed studies also help to identify the political factors that determined the design and timing of privatization and which privatization characteristics were successful in improving the performance of the banks and the financial system. The regularities we observe in these
country cases form the basis for a set of policy conclusions, detailed in the final section of this paper.

Our policy conclusions are reinforced by cross-country analyses, also summarized in section III. By examining the cross-country variation in bank privatization one study directly tests the political and economic factors that lead governments to relinquish control of banks, complementing the political insights drawn from the case studies. Other cross-country studies allow us to draw policy conclusions about popular methods of bank privatization. One examines the effects of bank privatization via public share offerings, and another analyses the effect of share issue privatization (SIP) on the acquiring firms. These studies use event study methodology, benchmarking the share price of the acquired or acquiring bank against the market as a whole and other banks in a control group of banks that were not privatized.

II. Related Literature

A large theoretical and empirical literature, summarized in Shirley and Walsh, 2003, examines government ownership and privatization of state owned enterprises (SOEs). Much of the rationale for government ownership in this literature comes from the theoretical view that government is composed of well -- or even perfectly -- informed agents whose principal goal is to maximize social welfare. Under this assumption, government ownership reduces the cost of government intervention to correct market failures (Sappington and Stiglitz 1987) including natural monopolies (Millward 1983), reduce income inequality (Willner 1996), and undertake a host of other social goals (Choksi 1979). Seen in this light state ownership of banks could be justified as an efficient way to raise capital for projects with high social returns but low private returns.
or to provide finance to poorer borrowers that would be neglected by less well informed or motivated private bankers.

With the advent of public choice theory, this unrealistic assumption of a benevolent all-knowing government was discredited. Based on Buchanan 1969 and Niskanin 1971 and 1975, public choice theories postulated that government actors are politicians and bureaucrats who may be motivated to use state ownership to secure political office, accumulate power, or seek rents, and, as argued by Alchian 1965, may have less reason to monitor well than a profit motivated private owner. Theory further predicts that state actors will be most likely to act in self-interested ways in weak institutional settings where voters have less information and capacity to require good performance, in other words, in less developed countries.

Theories about why privatization might be beneficial to an economy are usually grounded in this public choice assumption that government consists of normal, fallible and self-interested individuals. These theories fit with the empirical findings that state-owned enterprises have been used in developing countries to finance politically motivated projects or provide subsidized finance to favored groups, and that they open too many offices and hire too many employees (for example, Jones 1985, Donahue 1989, Kikeri, Nellis, and Shirley 1992 and World Bank 1995).

Drawing on Shirley and Walsh 2003, we group the privatization literature around three main themes: competition, political intervention, and corporate governance. The competition argument assumes that privatization will improve the operation of the firm and the allocation of resources in the economy if it expands competition. There are two reasons why a private firm might face a more competitive market than the same firm
under government ownership. First, self-interested politicians may use SOEs to pursue political goals, such as expanding patronage jobs or providing subsidies to favored constituents (Shapiro and Willig 1990; Jones 1985; Vickers and Yarrow 1991). Under these circumstances state owned enterprises cannot compete effectively with profit maximizing firms and will run deficits in competitive markets that have to be covered by subsidies from the government treasury or by government guaranteed debt. Politicians and bureaucrats have a strong incentive to reduce the fiscal drain of such subsidies by giving SOEs monopolies, erecting barriers to entry or trade in SOE markets, or preventing competition with SOEs in other ways, all with adverse effects on efficiency (Shleifer and Vishny 1994 and Boycko, Shleifer, and Vishny 1996). Another reason why SOEs face less competition than private firms is that a subsidized SOE can undercut private rivals who have to make a profit to survive (Sappington and Sidak 1999). For example, a state owned bank might have more branches, higher deposit rates, and lower lending rates than its rivals because its excess costs are covered by government subsidy. In this case, instead of a competitive market improving SOE performance, the SOE hampers market performance. There is supportive empirical evidence for both protection of SOEs, SOE market power, and subsidies (see Jones 1985; Kikeri, Nellis, and Shirley 1992; and World Bank 1995).

Even without changing market structure privatization could improve efficiency if it hinders interventions by politicians or bureaucrats intent on using SOEs to further their political or personal goals. Political actors can also try to influence private firms to hire or subsidize their constituents, but this is harder to hide and private owners have stronger incentives and capabilities than SOE managers to oppose such interventions (Shleifer and
Vishny 1994, Galal 1991; Shirley and Nellis 1991, World Bank 1995). For example, the profit oriented owners of a private bank, especially one that must answer to foreign owners, would be more strongly motivated to protect its prudential lending policies or costs minimization rules from government interventions than an SOE. Privatization could also prevent SOE employees and other interest groups from “capturing” the government body charged with monitoring the state enterprise (Borcherding, Bush, and Spann 1977; Borcherding et al 1982) or bribing corrupt politicians to protect their interests (Shleifer and Vishny 1994). Capture or corruption could also occur with private firms, but the assumption is that the direct ownership link, by making the government an employer as well as a regulator, increases the likelihood of capture and corruption. The argument that SOEs are more subject to intervention and will receive larger subsidies than private firms is substantiated by empirical observations (Shirley and Nellis 1991; World Bank 1995; Claessens and Peters 1997; Djankov 1999).

The third group of studies argues that corporate governance will be weaker in SOEs than in private firms because of agency problems. SOEs have multiple objectives and many principals who have no clear responsibility for monitoring (Alchian 1965). Large private corporations can also have many small shareholders, information asymmetries between owners and managers, and problems defining goals and holding management accountable. Yet even private firms with highly diffuse ownership will be better governed than SOEs according to these studies. Alchian 1965 argues that since all citizens can be considered SOE owners, an SOE’s ownership is more widely distributed than a private firm’s ever could be. Since there is no way for any single owner to sell shares of an SOE, public owners stand to gain or lose less from firm performance than
private owners who can sell their shares, so public owners will monitor performance less (ibid). Without a market for ownership, information on firm performance will be scarce and non-comparable (Vickers and Yarrow 1991; Lin, Cai and Li 1998). Alternatively, Yarrow 1996 considers government to be the sole, concentrated owner. The government owner is free to pursue inefficient goals without the checking influence of smaller owners and with lower motivation to monitor than a private owner (Vickers and Yarrow 1991; Boardman and Vining 1992). Another reason why SOEs might have poorer corporate governance is weak incentives for managers to perform efficiently. SOE managers do not face a market for their skills or a credible threat of losing their job for non-performance, and bankruptcy, liquidation or hostile take over are not credible threats for state owned firms (Berglof and Roland 1998; Dewatripont and Maskin 1995; Schmidt 1996; Sheshinski and Lopez-Calva 1999; Vickers and Yarrow 1989; 1991).

Less competition, greater political intervention and weaker corporate governance are strong theoretical arguments against state ownership, but it does not necessarily follow that privatization will cure these ills. The same government actors responsible for the poor performance of SOEs are responsible for the design and execution of the privatization program. Political objectives, poor information, and principal/agent problems can compromise the privatized firm in ways that keep it from performing as well as a de novo private enterprise.

Does this mean that a privatized firm will perform better, the same or worse than it would under state ownership? There are many critics of privatization on the grounds that privatized firms do not perfectly mimic private firms – for example, Stiglitz 1999a and 1999b; Cook, Kirkpatrick 1997; Caves 1990; Kay, Thompson 1986. But this criticism is
misguided if privatized firms still outperform SOEs. Some authors go so far as to argue that if the root cause of poor SOE performance was an institutional environment that hampered voters from holding politicians accountable, then privatization will be as prone to error as SOE management (Stiglitz 1999a; 1999b). Others believe that underdeveloped capital markets, weak court systems, inadequate procedures for bankruptcy or takeover will all prevent privatized firms from performing efficiently, especially in developing countries where these market and institutional failures are common (Adam, Cavendish, and Mistry 1992; Caves 1990; Commander and Killick 1988; Cook and Kirkpatrick 1988; 1997; Stiglitz 1999a). Privatized firms in transitional economies will be less efficient if they were sold to their managers and workers since this may prevent necessary restructuring and limit capital infusion (Earle et. al. 1995; Frydman, Gray et. al. 1998; Barberis et al 1996; Havarylyshyn and McGettigan 1999; Kane 1999; Dyck 1999; Claessens and Djankov 1999; and Nellis 1999).

The empirical evidence suggests that, while privatized firms may not be identical to private firms, they are usually superior to state-owned enterprises (see studies reviewed in Millward 1982; Millward and Parker 1983; Borcherding et. al. 1982; Boardman and Vining 1989; D’Souza and Megginson 1999a; and Megginson and Netter 2000; 2001). The most important exceptions to this conclusion are firms sold to incumbent managers and employees in the former Soviet Union, especially Russia in 1992-93. When majority shareholdings were sold to outsiders, especially to foreigners, performance does improve there as well (Bornstein 1994, John Earle 1998, John Earle and Saul Estrin 1998, and Bernard Black, Reinier Kraakman and Anna Tarassova 2000). Exceptions
notwithstanding, the usual effect of privatization has been to improve efficiency (Megginson and Netter 2001).

III. The Effect of Privatization on Bank Performance

The privatization literature provides good reasons to assume that bank privatization will be beneficial under many circumstances, but few studies deal explicitly with privatization in the financial sector. The cross country studies we cited earlier show that state ownership of banks has serious negative consequences, but once again the question is whether and under what circumstances privatization of banks will improve performance over continued state ownership. To answer this question we turn first to the country case studies.

Prior to the studies described below there was relatively little published on bank privatization and most of it did not rigorously examine performance effects. Some studies describe the technical process of privatization (Arabanell and Bonin 1997 for Poland; Unal and Navarro 2001 for Mexico; Meyendorff and Snyder 1997 for the transition countries). Others are narrative accounts that also describe in addition to technical aspects of privatization, the political and economic environment that precipitated the sale and some post-privatization developments (Bonin and Wachtel (2000) for Czech Republic, Hungary, and Poland; Baer and Nazmi (2000), Makler (2000), and Ness (2000) on Brazil; and Brock (2000) on Chile). More rare are studies that use financial ratios to assess the effects of privatization (Clarke and Cull (1999) for Argentina; Othcere and Chan (2003) for Australia; and Verbrugge, Megginson, and Owens (1999) for share privatizations, mostly in developing countries). Comparing share
price movements for the privatized banks with those of their competitors, one of these studies assesses the competitive effects of privatization (Othcere and Chan 2003). Finally, aside from the studies on political economy described below, we know of no others that use econometric analysis to test what factors lead governments to privatize their banks.

Variations across countries and across privatized banks within the same country notwithstanding, there is evidence of post-privatization performance improvements for many of the case study countries. These results are mixed, but they are not random. Where bank performance did not improve after privatization, we can identify the specific reasons, including: the ownership share retained by the government, the type of transaction -- direct sale to a foreign investor or via a share offering-- and the extent to which foreign ownership was permitted. We organize our discussion of the cases around the three major themes identified in Shirley and Walsh (2003) for the broader literature on privatization: governance and performance, political economy, and the competitive environment.

A. Governance and Performance

The effects of privatization on governance in our cases varied depending on the extent to which: (1) government retained an ownership stake; (2) shares were divested widely or sold to a strategic investor; and (3) foreign owners were allowed to participate. As we have seen the broader privatization literature suggests that state ownership creates agency problems, and some cases explore if these can continue even after divesture if government retains ownership shares. The corporate finance literature leads us to expect that the method of sale and the type of buyer might also affect governance.

Privatization produced few or no performance benefits in cases where the government retained majority control or even a sizable minority ownership stake in the bank, as we can see in Table 2. The vertical axis in Table 2 indicates the extent to which the government relinquished its ownership stake and the horizontal dimension captures the extent of any post-privatization performance improvements. Although our judgments about performance are somewhat subjective, it is relatively obvious in the cases studied here whether performance improvements were small, large, or non-existent.

The same conclusion emerges when we compare the first unsuccessful round of privatization in the Czech Republic and Poland, when the governments maintained relatively large ownership stakes, with the second, when the governments divested more or all of its shares. In Poland’s initial round of privatization the Polish Treasury retained a 30% stake, employees purchased up to 20% of the shares on preferential terms, and the remaining shares were divided between a large and small investor tranche (Bonin et al. (2003b)). Performance improved somewhat, but the subsequent divestiture of all government shares led to unambiguous performance gains (compare Poland I and Poland II in Table 2). The Czech Republic distributed shares for vouchers in the first round of sales and most voucher shares were invested in funds, many of the largest created by banks. These investment funds acquired large stakes in both financial and non-financial firms which resulted in interlocking ownership between the banks and their clients. The state also retained substantial influence over the banks’ operations. The banks’ soft-lending practices for many of their large voucher-privatized clients eventually resulted in a deterioration of bank performance; government bail-outs were required before foreign
investors could be attracted to the second round of bank privatization (Bonin et al. 2003b; Cull et al. 2002). Again performance improved in the second round (Czech II in Table 2) although because the time series since the second privatization episode is not long, we do not place it far to the right of Table 2.

Comparing banks within Brazil and Nigeria leads to a similar conclusion: government ownership is associated with weaker bank performance. Brazil fully divested some banks and retained complete control of others that it attempted to restructure. Performance improved in Brazil’s fully privatized banks but remained unchanged in the state restructured banks (Beck, Crivelli, and Summerhill 2003). Nigeria maintained a minority interest in some of its privatized banks. There was some improvement in profitability and portfolio quality in those Nigerian banks where the government fully divested its shareholdings, but where the government retained minority shareholdings performance was substantially worse than in the fully privatized banks, nearly as bad as that of the state-controlled banks for some measures of profitability (Beck, Cull, and Jerome 2003). In short, the Nigerian case highlights the negative performance effects of even minority ownership by government, while the Brazilian case offers reasons to be skeptical of state restructuring of government-controlled banks.

Cross-country analysis also indicates that bank privatization outcomes are best when government fully divests its ownership stake. Using a sample of twenty-one share issue privatizations from nine developing countries (Croatia, Egypt, Hungary, India,  

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5 Berger et al. (2003) also illustrates the negative effects of state control of banks for Argentina. We do not reflect this in Table 2, because our focus is not static government control of banks, but changes in state control or organization. In the Brazilian case, there were presumably organizational changes associated with state restructuring. In Nigeria, minority ownership is interesting because the state had already relinquished control (if not full).

6 One might be worried that selection effects are driving these results. However, the pre-privatization performance of those banks where the government fully relinquished its shareholdings was worse than that of the restructured banks in Brazil and the minority government owned banks in Nigeria.
Jamaica, Kenya, Morocco, the Philippines, and Poland), Otchere (2003) finds that, privatization announcements led to abnormally negative returns for rival banks: a sign of enhanced competition. Nevertheless, the shares of the privatized banks under-performed the market and there was no statistically significant improvement in their operating performance. Empirical tests indicate that the proportion of ownership retained by the government significantly explains the under-performance of the privatized banks.

The Hungarian case is further evidence that fully privatized banks perform better than state owned banks, but it also supports the more sobering conclusion of the broader privatization literature: privatized enterprises often do not perform as well as de novo private firms. The de novo foreign banks in Hungary have long out-performed the state banks sold to foreign buyers. The de novo banks are much smaller, to be sure, but their stronger performance provides further evidence that changing the performance of weak, formerly public banks is difficult, often more difficult than setting up a good performer from scratch.

2. Strategic Investors or Share Offerings?

The cases suggest that in weak institutional environments direct sales are preferable to share issue privatizations (SIPs). Red (and rose) letters in Table 2 red indicate that the majority of bank sales were to strategic investors and green (and lime) indicate the majority were sold though share issues in the stock market, while blue signals that it was mixed: no one method predominated. Most of the SIP (green) entries are on the left side of the table, the region of no performance improvement, while the sales to strategic investors (red) are on the right side. The only case where sales to strategic investors are not associated with performance improvements is Romania, which
largely results from its very late start on bank privatization. Over time performance of their newly privatized banks could improve.

The most notable exception to this general pattern is the SIP privatization in Australia (based on a case study of the privatization of Commonwealth Bank of Australia by Otchere and Chan 2003). Australia’s privatized bank out-performed a control group of existing private banks on multiple financial ratios and share price. The announcement of the privatization had adverse effects on rivals’ share prices, and these adverse effects were most pronounced with the announcement that the government would cede its entire shareholding in the bank. Aside from further illustrating the importance of full divestiture of government holdings, the Australian case also suggests that SIPs can successfully spur performance improvement, but only in an environment where the stock market and the associated market monitoring by informed investors are well developed.

By contrast, SIPs in less developed countries (Czech I, Egypt, Poland I, Nigeria II) were less successful. Only in the Nigerian and Polish cases did the banks show even meager performance improvements. In Poland and Czech Republic the first privatizations used share issues and the second, more successful episodes used direct sales (Bonin et al. 2003b). Fully disentangling the cause of performance differences between the first and second privatization episodes in Poland and the Czech Republic is difficult, however, since the governments, as we discussed also maintained sizeable shareholdings in the privatized banks in the first round; they also largely precluded foreign participation in the initial privatizations.

Cross country analysis in Otchere (2003) also shows few or no performance gains in banks sold through SIP. The strong association between SIP and large government
ownership in Table 2 could lead one to argue that SIP is used to ensure that private owners do not fully control the bank. Considering the strong performance improvement after SIP in Australia, it seems more likely that SIP is problematic in weak institutional environments, perhaps because it disperses ownership widely to poorly informed investors who have even less than the usual limited power of minority shareholders to resolve agency problems.

3. *Foreign Ownership*

Foreign ownership is associated with greater performance improvement in our cases. In Czech Republic, Mexico, and Poland the government prohibited or tacitly discouraged foreign ownership in the initial round of privatization, as indicated by the lighter shading in Table 2 (rose and lime). In none of these cases did the initial privatization produce performance benefits. Performance did improve after a subsequent round of privatization in which foreign ownership participation was permitted, although in all three cases the post-privatization time series is not long.

Again we cannot ascribe poor performance solely to restrictions on foreign ownership. As we know in Poland and Czech Republic the governments also used SIPS and retained relatively large shareholdings in these banks. Bonin et al. (2003b) does suggest strongly that foreign ownership produced a much more stable banking sector in these two countries, at least compared to their experiences just after their initial bank privatizations. In addition, those authors point to the positive post-privatization performance of banks in Hungary, the first country in the region to embrace foreign ownership.
Mexico’s banks were initially privatized unsuccessfully to locals, renationalized after a systemic crisis, and then sold to outside investors, many of them foreign (Haber and Kantor 2003). Mexico I stands out in Table 2 as the only case in which the government relinquished all shareholding and sold to strategic investors, yet privatization produced no performance benefits. To the contrary, the banking system went into crisis shortly after the privatizations. Foreign investors in the second Mexican privatization episode helped created a more stable and efficient banking sector, albeit one that has responded to the failure of Mexico’s legal system to enforce banks’ property rights by making few loans and charging high margins. Mexico I’s poor performance cannot be wholly attributed to the prohibition on foreign ownership; Haber and Kantor (2003) argue that Mexico’s initial privatization program was fundamentally flawed because of Mexico’s political economy, a topic that we develop in the next sub-section.

Cross country evidence from transitional economies also suggests that the type of buyer has an important effect on post privatization performance. While privately owned banks are unambiguously more efficient than government banks in a study of 11 transitional economies (Bulgaria, Czech Republic, Estonia, Croatia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia, Slovakia), foreign owned banks outperformed other private banks within their own country (Bonin, Hasan and Wachtel 2003a). Foreign bank entry has generated more competitive and efficient banking systems in these countries and this is associated with higher GDP growth as well. Not all foreign investors produce these benefits: participation of international institutional investors, such as EBRD or IFC, in a bank’s ownership is associated with higher returns on assets and
more profits but not greater cost efficiency than their counterparts, which may reflect the selection preference of these investors.

B. Political Economy

The privatization literature summarized in section II documents how political incentives and institutions determined the design and outcomes of privatizations. For a sector often intimately connected with government finance, it comes as little surprise that political factors also played a decisive role in the nature and timing of the bank privatizations studied here, and in their eventual success or failure.

World Bank 1995 suggests that politicians usually privatize a firm when the political benefits of privatization – increased revenues for spending on constituents, elimination of a poorly performing SOE that has become a political liability – outweigh the political costs – layoffs of constituents, price increases, an end to services or subsidies for favored groups. The political economy of privatization is more complicated than this simple equation suggests since the design is also affected by a country’s political institutions, for example, by electoral laws that determine politicians’ time horizon and the strength of political parties or by constitutional provisions that determine the number of political actors who can veto the privatization policy or the likelihood that the policy will be sustained through changes in leadership. Nevertheless, case studies of bank privatization do suggest certain regularities in the interplay between privatization and politics.

Detailed evidence on how political factors affect bank privatization comes from the hazard models estimated for Argentina in Clarke and Cull (2002). Poor performance of Argentina’s provincial banks was associated with greater likelihood of privatization, as
was also the case in Croatia (Bonin et al. 2003b) and Nigeria (Beck, Cull, and Jerome 2003). Large, overstaffed banks in provinces with high levels of both unemployment and public sector employment were less likely to be privatized. Despite the difficulties in assembling reliable cross-country data on the extent of privatization over a long time horizon, Boehmer, Nash, and Netter (2003) find somewhat similar results for a sample of 101 countries over twenty years. In non-OECD countries, bank privatization is more likely the lower the quality of the nation’s banking sector, the more fiscally conservative the government, and the more accountable the government. While not directly comparable to the results for Argentine provinces, one could argue that overstaffing and a high level of public employment are signs that a government is not responsible to the full electorate, but only to a narrow set of favored constituents. There is also weak evidence that provinces with governors from the more fiscally conservative of Argentina’s two major political parties (Partido Justicialista) were more likely to privatize than those with governors from the other major party (Unión Cívica Radical).7

Political factors also affected the design of the privatization contract in Argentina: provinces with high fiscal deficits were willing to accept layoffs and to guarantee a larger part of the privatized bank’s portfolio in return for a higher price. Exogenous factors sometimes stimulated political reactions as well. In particular, the Tequila Crisis and the associated fiscal costs caused politicians to agree to protect fewer jobs and retain a higher share of public banks’ non-performing assets in a residual entity.

7 Note that Beck, Crivell, and Summerhill (2003) have run preliminary ordered probit models that describe the privatization and/or restructuring choices made by state governments in Brazil using political and macroeconomic variables. If they can finalize those results and make them available to us soon, we could describe them here.
Since most banks effectively ceased operations during Argentina’s latest crisis, it is not possible to test directly whether specific features in the privatization contract had adverse effects on bank performance, but there are suggestive regularities. Berger et al. (2003) find that the privatized provincial banks improved profitability, profit efficiency and portfolio quality, while showing no improvement in terms of cost efficiency or the ratio of operating costs to assets. These results suggest that the contract provisions that protected workers and limited branch closures made it more difficult for the privatized banks to reduce their costs.

Indirect evidence on the effects of timing, and in particular the costs of delay, comes from comparisons of transition countries. Early in the 1990s, Hungary moved decisively to privatize its banks, and permit greater de novo foreign entry. As noted, the strategy paid substantial dividends, providing the country with a strong, stable banking system long before its neighbors. However, speed in bank privatization is not sufficient to ensure success. The Czech government was quick to sell some of its ownership stakes in the four large banks that dominated the financial system, but as we have seen they also chose to retain a sizable, and in some cases a controlling, interest in these banks (Bonin et al., 2003) and Cull, Matesova, and Shirley (2001). Performance improvements did not materialize, as the banks maintained their old links with their most influential former clients, who were often borrowing to channel funds into their private uses or to prop up unproductive firms. As noted above, it was not until a second round of bank privatization reduced government’s stake in the banks in the late 1990s that performance improved. In the Polish case, the authorities moved much more slowly than in the Czech Republic, but they avoided the near-crisis situation faced by the Czechs.
The Mexico case study shows most clearly the decisive effects that political factors can have on the success of bank privatization. Until 1997, Mexico’s government was a one party political system dominated by the PRI (Partido Revolucionario Institucional) with few constraints on the authority and discretion of the government. The lack of constraint had three important consequences: (i) high expropriation risk; (ii) distortion of privatization policy to serve PRI political needs; and, (iii) weak mechanisms to enforce contractual rights. These three characteristics of Mexico’s political economy led to fundamental flaws in the design of the privatization program according to Haber and Kantor (2003).

The risk of expropriation was real. PRI-controlled governments expropriated Mexico’s bankers twice in the twentieth century, in 1915-16 and in 1982, and also carried out de facto expropriations through drastic increases in the money supply or draconian regulation of interest rates. Potential buyers of privatizing banks would not bid unless they were compensated for the risk of expropriation with the promise of high rates of return secured by protection from competition.

The second feature, the political distortion of privatization policy, became evident when President Carlos Salinas de Gortari (1988-94) decided to sell the nationalized banks and other SOEs. The government had strong political incentives to sell the banks for the highest price possible. Salinas faced a fiscal crisis fed by years of deficit spending and the Mexican government’s lack of administrative capacity to raise taxes effectively. At the same time, the future survival of the PRI required social spending programs to shore up political support in the face of rising political competition -- Salinas’ electoral victory had been won by the smallest margin in the history of the PRI.
Four features of the privatization program seem designed to maximize revenues from sales. First, the government did not break up Mexico’s highly concentrated banking system but sold the banks as is with 70% of assets controlled by four firms. Second, the banks were auctioned sequentially, which led to increased competition for banks in later rounds and pushed up the bid to book ratio in every round. Third, entry into the banking industry required permission of the Secretary of the Treasury who could decline a charter for any reason, thereby raising the charter value of the privatized banks. Finally, foreign banks were not allowed to bid and the NAFTA agreement was structured so that only the smallest banks could be foreign owned. These four features of the privatization program signaled to bidders that they were buying the secure oligopoly they needed to compensate for the expropriation risk, contributing to much higher than expected prices for the banks. On average Mexico’s banks sold for over 3 times book value, compared to the 1.7 to 1.8 bid to book ratio typical in most less developed countries.

The new owners of the privatized banks proceeded to lend aggressively and open new branches in order to quickly reap high returns before a new round of expropriation might occur. The total stock of lending doubled in real terms from 1990 to 1994. Many of these loans were poor choices, reflecting Mexico’s lack of creditor information. The proportion of non-performing loans expanded rapidly, from 2 percent in 1990 to 9 percent in 1994 to 13 percent in 1995. Since Mexico’s accounting standards grossly underestimated the size of non-performing assets, the real numbers were probably much worse. At the same time the banks were undercapitalized – the capital ratio was probably only 6.5 percent during this period – while operating costs stayed high, averaging about 7.5 percent per loan.
As the bad debt of the banks began to mount the third characteristic of Mexico’s political economy, the weakness of mechanisms to protect contractual rights, became important. Delays and obstructions in Mexico’s legal system meant that banks could not repossess collateral on their bad loans. Bankers turned to relational loans to family and network members, but these did not prove any easier to collect. There were no checks on bad banking. Unlimited deposit insurance gave bankers little incentive to re-create the strong networks that bankers had once used to monitor each other’s behavior. Instead the prospect of a bailout motivated bankers to increase lending to family and friends with the expectation of default.

Mexico’s political economy had created a fragile banking system poised for collapse. The devaluation in December 1994, which led the Central Bank to raise interest rates, exposed the unsustainable situation of the banks. As the banks faltered, the 100% deposit insurance system bailed out depositors and the government took over insolvent banks. To recapitalize the banks, Mexico turned to foreign capital: the government removed all restrictions on foreign bank ownership in Mexico. The privatization to foreign banks in 1996 drove down operating costs (to 1.8 percent per loan), raised the rate of return on assets, and increased the capital/asset ratio to 11 percent. The government assumed all the bad debts, and Mexico’s banks now follow much more prudential policies. Since contracts are still difficult to enforce, banks make far fewer loans: bank lending averages only 15% of Mexico’s GDP compared to 150% in the U.S., 200% in Japan, and 25% in Mexico in 1910.

The remaining case studies offer some indications of the importance of political economic factors for bank privatization outcomes, although this is not the focus of those
studies. For example Beck, Cull, and Jerome (2003) discuss the preponderance of ex-military officials and politicians who were and are owners of Nigeria banks. They also argue that the government’s multiple exchange rate regime created arbitrage opportunities for financial institutions that had privileged access to foreign exchange, fostering a banking sector focused on rent seeking rather than financial intermediation. These incentives continue to influence the behavior of the privatized banks. Bonin et al. (2003b) describe how the unstable macroeconomic situation made privatization infeasible in Bulgaria and Romania until the late 1990s. By that time, the state banks had suffered such large losses that substantial re-capitalization was necessary to make the banks attractive to investors, especially foreign investors.

A. Competitive Environment

The cross-country results suggest that privatization has pro-competitive effects, perhaps even in instances when the performance of the privatized banks is below market standards. In the event studies for Australia (Otchere and Chan 2003) and across countries (Otchere 2003) privatization announcements resulted in abnormally negative returns for rival banks. In the Australian case this is not surprising since the privatized bank was large, and its performance improvements substantial. More surprisingly, rivals also exhibited negative abnormal returns in the cross-country analysis despite little evidence of performance improvement on the part of the privatized banks.

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8 Although less widely studied, privatization of banks may also have positive effects on related industrial firms. Djankov, Jindra and Klapper (2003) find that the sale of banks to foreign buyers is associated with a premium in the value of related firms over the long run because of the value investors put on the effects of foreign capital and expertise. Conversely, the Czech Republic’s initial failure to privatize majority control over its banks may explain the poor performance of its larger privatized firms that were the banks’ preferred customers (Cull, Matesova and Shirley 2002).
Just as bank privatization affected the competitive environment, the competitive environment shaped bank privatization, which we can see indirectly in the Nigerian and Argentine cases. The second round of privatization in Nigeria suggests that privatization can have a positive effect on performance even in an inhospitable macroeconomic and regulatory environment, and even when the banks being sold are the weakest ones. Although the bank-level data are probably somewhat less reliable for Nigeria than for the other countries, there is still significant and robust evidence that privatization was associated with a significant increase in return on equity and a significant decrease in non-performing loans. But Nigeria II also shows how an adverse macroeconomic and regulatory environment limits privatization’s positive effects: privatized banks improved in the first year, but made no subsequent gains; the performance of non-privatized banks was not improved by the stimulus from privatization; and banks that focused on retail lending performed worse than banks investing in government bonds and other non-lending activities.

The contrast between Nigeria’s privatized banks and those in Argentina’s provinces is instructive. In both cases, profitability and loan portfolio quality improved. Unlike in Nigeria, however, Argentina’s improvements were reflected only in measures of profit efficiency; cost efficiency did not improve (Berger et al. 2003). Argentina is also the only case study which documents the changes in lending strategy associated with these efficiency improvements. In particular, privatized banks reduced overall lending and lending in local currency, both signs of greater prudence. There were also substantial initial reductions in mortgage lending and agricultural lending. Subsequently, loans to both of these sectors increased, but their quality was much higher than in the pre-
privatization period, presumably because screening of potential borrowers had improved. The design of the privatization, including restrictions on firing and branch closing, and perhaps changes in lending strategy made it difficult for the provincial banks to lower their costs, but this was more than offset by increases in revenue.

IV. Conclusions

The cases studies and the cross-country analyses strongly support the conclusion that privatization improves performance over continued state ownership, even the privatization of relatively poorly performing banks. As we can see graphically in Table 2, several policies reduce the benefits:

1. Continued state ownership, even of minority shares, harms the performance of privatized banks;
2. In weak institutional environments share offerings produce lower performance gains than direct sales to strategic investors;
3. Prohibiting foreigners from participating in privatizations reduces the gains from both direct sales and SIP.

There is evidence that foreign banks tend to be more prudent, which may result in less lending in weak regulatory environments. This is an appropriate response to the true hazards, but it may be politically problematic. The best solution to lack of credit in risky environments is not to sell banks to risk-loving owners, or to increase government subsidies or bail outs or extend World Bank loans for small borrowers, but to put in place better safeguards against expropriation, protection of lenders’ property rights, and creditor information.
While some of these reforms may have to await a change in a country’s political economy, others – such as creditor information – are amenable to short term reform.

Privatization improves performance even in poor regulatory environments as we have seen in Nigeria, although poor regulation reduces the gains. This suggests that it is better to privatize even with weak regulation, rather than await reforms that may be a long time coming. Selling to foreigners may be especially important in a poor regulatory environment since they face regulation in their home country that may curb their opportunism as evidenced by the bias towards prudence that they showed in our cases. They may also lobby more for regulatory improvements and legal reforms if they cannot take full advantage of regulatory or judicial lacunae. More research is needed to determine whether foreign-owned banks indeed behave less opportunistically and have a stronger preference for better regulation than domestically owned banks in weak regulatory environments.

The Mexico and Argentine cases also suggest some political economy lessons. Mexico’s experience in particular illustrates that politicians who are motivated to maximize revenues will design privatization programs that will raise the risk of crisis, especially if prudential regulations are weak and there is deposit insurance. Seeking to maximize revenues from sales is short sighted since the cost may greatly outweigh the revenue gains in medium term. Politicians with a short time horizon may not be disposed to heed this advice; their preferences for revenues should not be encouraged by outside advisors who are also sometimes focused on short-term public deficits rather than long-term efficiency gains. Making privatization politically palatable can be risky, as we can see in Argentina’s
provincial bank privatizations. The restrictions on bank closures and firings there reduced cost efficiency.
References


Dyck, Alexander. 1999. “Privatization and Corporate Governance.” Draft. NEED TO UPDATE THIS CITE


Table 1: Share of Banking Sector Assets in Majority State Controlled Banks

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n.a. – not available
## PERFORMANCE IMPROVEMENTS

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<th>Majority</th>
<th>No Improvement</th>
<th>Some Improvement</th>
<th>Notable Improvement</th>
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<tr>
<td>Brazil Restructuring (Beck et al. 2003)</td>
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<td>X-country (Otchere 2003)</td>
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<td>Czech I, Romania (Bonin et al. 2003)</td>
<td>Poland I (Bonin et al. 2003)</td>
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<td>Egypt (Omran 2003)</td>
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<th>Govt. Ownership</th>
<th>Minority Post- Privatization</th>
<th>No Improvement</th>
<th>Some Improvement</th>
<th>Notable Improvement</th>
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<td>Bulgaria, Croatia, Czech II (Bonin et al. 2003)</td>
<td>Pakistan (Bonaccorsi di Patti Hardy 2003)</td>
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<td>Argentina (Berger et al. 2003)</td>
<td>Brazil Privatization (Beck et al. 2003; Weintraub Nakane 2003)</td>
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<td>Mexico II (Haber Kantor 2003)</td>
<td>Hungary, Poland II (Bonin et al. 2003)</td>
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- **Red** - Direct Sale to Strategic Investor
- **Rose** - Direct Sale, Foreign Ownership Not Permitted (or at least discouraged)
- **Green** - Sale via Share Offering
- **Lime** - Share Offering, Foreign Ownership Not Permitted
- **Blue** - Mixed, Some Privatization Via Both Share Issues and Direct Sale to Strategic Investors
- **Black** - No Actual Privatization
Figure 1 Assets Held by Govt. Controlled Banks, 1999

Figure 2 Change in Assets Held by Govt. Controlled Banks, 1999-2002

Figure 3 Assets Held by State-Controlled Banks, 1999

Figure 4 Changes in Assets Held by Govt. Controlled Banks, 1999-2002

Figure 5 Assets Held by Govt. Controlled Banks, 1999

Figure 6 Change in Assets Held by Govt. Controlled Banks, 1999-2002