Chapter 3

PUBLIC SECTOR BANKS: FROM BLACK SHEEP TO GLOBAL LEADERS

"Once the black sheep of high finance, government owned banks can reassure depositors about the safety of their savings and can help maintain a focus on productive investment in a world in which effective financial regulation remains more of an aspiration than a reality."

– Centre for Economic Policy Research, VoxEU.org (January 2010)[50]

The common perception of government-owned banks is that they are less efficient, less profitable and more susceptible to political corruption than banks operated for private profit. Recent studies, however, have found the reverse. Strong public banking sectors are linked to strong, productive economies.

Public sector banking is a concept that is relatively unknown in the United States. Only one state—North Dakota—actually owns its own bank. North Dakota is also the only state to escape the recent credit crisis, sporting a budget surplus every year since 2008. It has the lowest unemployment rate in the country, the lowest credit card default rate, and no state government debt at all. But skeptics write

these achievements off to other factors, including an oil boom in the state. The common perception is that government bureaucrats are bad businessmen. To determine whether government-owned banks are assets or liabilities for economies, then, we need to look farther than our own backyard.

Removing our myopic U.S. blinders, we find that internationally, not only are publicly-owned banks quite common, but that countries with strong public banking sectors generally have strong, stable economies. According to an Inter-American Development Bank paper presented in 2005, the percentage of state ownership globally in the banking industry by the mid-1990s was over 40 percent.[51]

These public banks are largely in the BRIC countries—Brazil, Russia, India, and China—which contain nearly three billion of the world's seven billion people, or 40 percent of the global population. The BRICs have been the main locus of world economic growth in the last decade. Publicly-owned banks compose about 60 percent of the banks in Russia, 75 percent in India, 69 percent or more in China, and 45 percent in Brazil.[52]

According to *China Daily*, "Between 2000 and 2010, BRIC's GDP grew by an incredible 92.7 percent, compared to a global GDP growth of just 32 percent, with industrialized economies having a very modest 15.5 percent."[53] In 2009, when GDP dropped by 2 percent worldwide due to the banking crisis, the BRICs expanded by 4.3 percent. In 2010, BRIC GDP surged by 8.8 percent.[54] The International Monetary Fund predicts that by 2016, the GDP of the BRIC countries will total $21 trillion, out-stripping the United States. On a currency-adjusted basis, the BRICs are already larger than the U.S. and U.K. combined.[55]

All the leading banks in the BRIC half of the globe are state-owned.[56] The largest banks globally are also state-owned, including:

- The two largest banks by market capitalization (ICBC and China Construction Bank)
- The largest bank by deposits (Japan Post Bank)
- The largest bank by number of branches (State Bank of India)
- The largest bank by assets (Royal Bank of Scotland, nationalized in 2008)
- The largest development bank (China Development Bank).[57]

The world's seven *safest* banks are also publicly-owned, leading with KfW, Germany's public development bank.[58]

The term "BRIC" was introduced in 2001 by Goldman Sachs economist Jim O'Neill, in an article titled "Building Better Global Economic BRICs." He predicted that these four countries would dominate the world's economy in the future, shifting global economic power away from the developed economies toward the developing world.[59] Events since then have confirmed this prediction.

The BRIC countries have abundant labor and resources, but O'Neill notes that their growth has far outstripped predictions based on these factors alone.[60] Something else has been responsible for their "economic miracles." According to a May 2010 article in *The Economist*, the BRICs sailed through the banking crisis largely because of their strong and stable publicly-owned banks.[61] Professor Kurt von Mettenheim of the Sao Paulo Business School of Brazil observes:

> Government banks provided counter cyclical credit and policy options to counter the effects of the recent financial crisis, while realizing competitive advantage over private and foreign banks. Greater client confidence and official deposits reinforced liability base and lending capacity. The credit policies of BRIC government banks help explain why these countries experienced shorter and milder economic downturns during 2007-2008.[62]

Not-for-profits Outperform For-Profits

In a June 2011 paper titled "Alternative Banking: Competitive Advantage and Social Inclusion," Professor von Mettenheim and Olivier Butzbach show that "alternative banks"—public savings banks, cooperative banks, and public development banks—have done more than just match their private counterparts. In recent years, they have actually outperformed their for-profit rivals:

> These "alternative banks" (or ABs) . . . not only fared better than their joint-stock counterparts during the crisis and its aftermath; they have been constantly over-performing them for some time—whether we compare cost efficiency, riskiness

> or even, in some respect, profitability—a paradox as ABs are in principle not profit-maximizing entities.[63]

These results differ from those of earlier studies. An often-cited 2004 World Bank study concluded:

> Unfortunately, the performance of most public sector banks has been weak, particularly in terms of large non-performing loans (NPLs). For example, in China, recent official estimates suggest NPLs of around 24 percent in the four public sector commercial banks, equivalent to over 30 percent of GDP; estimates of private analysts are much higher.[64]

The explanation for this discrepancy could turn on the word "performance." Although the Chinese state-owned banks may have more non-performing loans than private Western banks, the Chinese economy itself is performing better than Western economies dominated by private sector banks; and this superior performance is supported by a public sector banking system that functions very well for its intended purposes. Before 1981, the Chinese government issued its own sovereign currency, paid its bills in that currency, and did not incur national debt. When it opened to Western trade, it had to make a show of conforming to Western practices. Advances of credit intended for national development were therefore re-characterized as "non-performing loans." But the Chinese government did not actually expect repayment of these funds. They were simply credits created on the banks' books for the purpose of paying for infrastructure and services. They were in the nature of "contingent grants." If they generated income, great. If not, they were written off as a cost of running an economy. They were government-issued money stimulating economic development.[65]

Western politicians call these unpaid loans "deficits," debts" and "fiscal cliffs," and they engage in endless debates over how to get rid of them. Meanwhile, China and its neighbors carry on building, growing and producing. They recognize that the government's debt is the people's credit, and that a freely-flowing national credit is the key to a flourishing national economy. How well this has worked for the Chinese is explored further in Chapter 6.

Other Surprising Findings

Neo-classical economic theory predicted that when banking was opened to competition and liberalization (the relaxing of banking rules), "alternative" banks would disappear, either through privatization or through competitive pressures. But that is not what happened. According to von Mettenheim and Butzbach:

> Savings banks and cooperative banks have . . . retained or increased their significant market shares since liberalization of the industry. Instead of convergence toward private banking, joint-stock ownership, shareholder governance and market-centered finance, public savings banks, cooperative banks and special purpose (development) banks have modernized through a rich variety of strategies to retain or expand market shares while seeking to recast their social policies and missions.

The alternative banks have merged and integrated with each other:

> Far from being condemned by more liquid financial markets or risk seeking private banks, the integration of regional and local savings banks and cooperative banks have produced competitive advantage, better performance, increased market shares and renovated institutions for social and economic policy coordination.[66]

A major competitive advantage of public, not-for-profit banks is that their costs are less:

> Government banks . . . produce more public policy for less cash. The slim central offices, low cost/income ratios and principles of profit sustainability at special purpose banks and development banks provide powerful competitive advantages over private banks and help lower the costs of public policy.

Another competitive advantage is in the governance structure of alternative banks. Decisions are made by "stakeholders"—community members, employees and creditors who have a stake in preserving the business as a viable concern—rather than by shareholders whose chief interest is in maximizing their own short-term profits.

Publicly-owned banks can do more with the government's money than the government can by spending it outright. Banks can leverage

the funds, multiplying them many times over in the form of bank credit. Von Mettenheim, et al., use the example of Brazil's government banks, particularly the Caixa Economica Federal, its government savings bank:

> Analysts often compare government bank performance unfavorably with private commercial banks. However, in terms of public policy, government banks can do more for less: Almost ten times more if one compares cash used as capital reserves by banks to other policies that require budgetary outflows. Central Bank of Brazil regulations require eleven percent (weighted) capital reserves against credit risk. *This implies that the Caixa (and other government banks) can loan almost ten times whatever profits are retained or funds may be allocated by congress.* From this perspective, . . . the Caixa appears uniquely positioned to provide social services and extend credit to those left behind during Brazilian development. *Tapping the popular credit channel may accelerate social inclusion and economic development, deepen the Brazilian financial system, and provide substance to citizenship and democracy.*[67]

A government bank can take one million dollars of its own capital and turn them into ten million in loans. Again, "capital" means the bank's own money (shareholder equity plus profits), not the money of its depositors. Deposits will be needed to back the loans; but a government savings bank will have plenty of deposits, and if the bank does not have them, it can borrow them. This sort of system has worked particularly well in Japan, which has tapped into the copious deposits in the government-owned Japan Post Bank, now the largest depository bank in the world. (See Chapter 21.)

Public Banks Spur Growth Better and Are Less Corrupt

Another study comparing public and private banks was reported in 2010 by a team of economists at the Centre for Economic Development and Institutions (CEDI) at Brunel University in the U.K.[68] They noted that the post-2008 nationalization of a number of very large banks,

including the Royal Bank of Scotland, was an excellent opportunity to reduce the political power of bankers and to carry out much needed financial reforms. The concern was whether governments could run nationalized banks efficiently. The authors observed:

> While many countries in continental Europe, including Germany and France, have had a fair amount of experience with government-owned banks, the UK and the USA have found themselves in unfamiliar territory. It is therefore perhaps not surprising that there is deeply ingrained hostility in these countries towards the notion that governments can run banks effectively. . . . Hostility towards government-owned banks reflects the hypothesis . . . that these banks are established by politicians who use them to shore up their power by instructing them to lend to political supporters and government-owned enterprises. In return, politicians receive votes and other favors. This hypothesis also postulates that politically motivated banks make bad lending decisions, resulting in non-performing loans, financial fragility and slower growth.

But that is not what the data of these researchers showed. To the contrary:

> [W]e have found that . . . countries with government-owned banks have, on average, grown faster than countries with no or little government ownership of banks. . . . This is, of course, a surprising result, especially in light of the widespread belief—typically supported by anecdotal evidence—that "bureaucrats are generally bad bankers" . . . .

The authors suggested that, contrary to popular belief, politicians may prefer that banks *not* be in the public sector:

> 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 such as complex derivatives trading.

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, if at all, 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 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.

Public banks are run by civil servants on government salaries who do not get commissions based on loan volume and have no opportunity to engage in speculation for their own account. They get paid for serving the public interest, and they get promoted for succeeding at that pursuit. That helps explain the findings of the Brunel research team, which were summarized on *VOX* as follows:

> Using data from a large number of countries for 1995-2007, we find that, other things equal, countries with high degrees of government ownership of banking have grown faster than countries with little government ownership of banks. We show that this finding is robust to a battery of econometric tests.[69]

Public Banks Foster Growth While Expanding Social Services

This fast growth is particularly evident in the BRIC countries. Looking at them individually, China's GDP has grown by nearly 10 percent almost every year since the early 1980s.[70] India has also achieved

impressive uninterrupted growth, averaging 7.8 percent for the period 2000-2010.[71]

In Russia, GDP growth averaged 6.5 percent from 2000 to 2008. It fell back in 2009 in response to the Western financial crisis and a drop in the price of oil, but it moved back up to about 4 percent of GDP in 2010 and 2011, with low inflation and low unemployment—very good by world standards. Jim O'Neill predicts that by 2030, Russia could surpass Germany to become the richest European nation.[72]

Brazil is also experiencing the greatest economic growth in its history, averaging 4.5 percent per year since 2002. In 2010, the country's GDP expanded by an estimated 7.5 percent, bringing its total GDP to almost $2.2 trillion (the highest in Latin America) and its GDP per capita to over $11,000 (the sixth-highest in Latin America). Joblessness was at an all-time low, and foreign exchange reserves had soared to the sixth-highest globally.[73]

The popular perception is that this unusual growth has been achieved through the exploitation of the poor and working classes. But the data show that, to the contrary, millions of people in these countries have been raised from poverty into the middle class. According to a September 2012 article in *The Economist* called "New Cradles to Graves," Asian countries are providing social benefits to their citizens far beyond those available in the United States.

In 2008, India expanded its job-guarantee program to every rural district, promising 100 days of minimum-wage work a year to every household that asked for it. It has also extended health insurance to about 110 million people, more than twice the number of uninsured Americans.

China's rural health-insurance scheme covered only 3 percent of the eligible population in 2003, but it now covers 97.5 percent according to official statistics. China's National Audit Office declared in August 2012 that the country's social security system was also basically in place. Statutory retirement ages in developing Asia average 59 for men and 58 for women.

Other Asian countries with strong public banking sectors are also strong on social benefits. South Korea (discussed in Chapter 22) has legislation guaranteeing a minimum income to the poor. The government subsidizes the employment of the elderly and is beginning to socialize the burden of caring for them. In 2008, South Korea

introduced insurance for long-term geriatric care. And in Indonesia, a law was passed in October 2011 pledging to provide health insurance to all of the country's 240 million citizens, making it the largest single-payer system in the world.[74]

Indonesia is not one of the BRICs, but it too has a strong public banking sector. Publicly-owned banks control over 40% of Indonesian bank assets, and all public sector entities (including about 150 state-owned enterprises) are required by law to deposit their financial assets in state-owned banks.[75] The result is a massive, captive deposit base that can be turned into credit available for public purposes.

Unfair Competition or a Better Mousetrap?

Western competitors complain that the advantages of government ownership allow publicly-owned banks to compete unfairly, and they attempt to handicap those banks with regulations. But the fact that public banks can offer more in the way of security for customers, lowered costs, and larger capital and deposit bases is not really "unfair" competition. It is simply a more competitive banking model.

Hamstringing the BRICs and other Asian competitors with international banking regulations is ultimately doomed to failure because those countries are powerful enough to step outside our system and set up their own rules, as they are doing today in the BRIC economic bloc and the ASEAN Economic Community to be established in 2015. It might be more productive to simply incorporate some portion of their safe and efficient banking models into our own. That doesn't mean adopting their political agendas; but by rigidly insisting even on the outmoded aspects of our system just because of ideology, we may find that our entire ideology—democracy and all—has been relegated to the dustbin of history.

The next three chapters will take a closer look at the BRICs, since they are the most powerful contemporary examples of efficient public banking systems. But there are other public models that are also quite instructive, going back thousands of years. That history will be the subject of Section 2, laying the groundwork for the interesting 20th century developments in Section 3.

Chapter 4

THE BRICS AS A GLOBAL POWER: BRAZIL AND RUSSIA

"Don't you find it very chic that Brazil is lending to the IMF? I spent part of my youth carrying banners against the IMF in downtown Sao Paulo."

-- Brazilian President Lula da Silva after the 2009 G20 Summit[76]

Today, the BRIC bloc is evolving into not just an economic but a political force, and undergirding it all is a strong public banking sector. Brazil and Russia, the first two countries in the BRIC acronym, are both forging bright futures with public banks as key features of their economies. Brazil is considered the most successful model among the BRICs, while Russia is expected to be the richest country in Europe by 2030.

The BRIC group has evolved into more than just a growth trend identified by an economist. It has become an international organization, an alliance of countries representing the common interests and goals of its members. Russia has been the main driving force behind this alliance. In a famous speech in Munich in February 2007, Russian President Vladimir Putin predicted the emergence of the new alliance on the ruins of the unipolar world being pursued by the United States. The first BRIC meeting, held in 2008, was called a triumph for Putin's