Institution: University of Leicester

Unit of Assessment: Economics and Econometrics

Title of case study: Research on bank nationalisation contributes to management of banking crises

1. Summary of the impact

Since the financial crisis of 2007-8, many failing banks have had to be rescued. Rescue has taken different forms, including acquisition by rivals, public subsidies, and nationalisation.

Research at University of Leicester contributed to the changing of perceptions on the relative merits of these options, by showing that the cost of bank nationalisation had previously been over-estimated. This work paved the way for a wave of bank nationalisations that occurred during the financial crisis of 2007-8. **Demetriades** directly applied the findings of his research in the rescue of the crisis-hit Cypriot banking sector, following his appointment as Governor of the Central Bank of Cyprus and member of the European Central Bank governing council in 2012.

2. Underpinning research

The privatisation of banks has long been a key ingredient of the so called “Washington consensus” – a set of policies promoted by the World Bank and the IMF around the world as key to economic development and success.

The main works that allegedly backed this claim are La Porta *et al* (2002) and Sapienza (2004). In particular, La Porta *et al* provide empirical evidence that the degree of government ownership in the banking system is negatively correlated to subsequent financial development and economic growth, and positively correlated with financial instability. The estimated effects were quite large: a 10 percentage points rise in the share of government ownership of banks would reduce the growth rate by approximately 0.25% per annum.

Research carried out by **Andrianova**, **Demetriades** and Shortland has challenged the views underlying the Washington consensus both theoretically and empirically. It has highlighted that while the Washington consensus posits a causal relationship between government ownership of banks and financial development, all that La Porta *et al* demonstrate is just a statistical correlation, which can be interpreted in different ways. Furthermore, even the statistical correlation is not very robust.

In particular, in [Ref 1] Andrianova, Demetriades and Shortland develop a theoretical model in which public ownership of a bank depends on the quality of institutions and financial development rather than causing them. The model provides a rationale for government ownership of banks, and shows that publicly owned banks may be especially important as a means to prevent contagion in a financial crisis.

[Ref 1] also provides empirical evidence that supports a different interpretation of the observed correlation: government ownership of banks, that is to say, does not cause financial under-development and instability, but is caused by them. This suggests that state banks will die a natural death when they are no longer useful, but may be crucial while financial instability is a key concern.

Follow-on research (see [Ref 2], [Ref 3] and [Ref 4]) suggests that the concern that governments may be unable to run nationalised banks efficiently may also have been exaggerated. In particular, [Ref 4] shows that the results in La Porta *et al* (2002) are fragile to inclusion of more fundamental determinants of growth. It also reveals that during the period 1995-2007, government ownership of banks was robustly associated with higher, not lower growth rates.

In sum, this research strongly suggests that the costs of bank nationalisation had been over-estimated. The implications for policy are evident. When a bank has to be rescued, and policy-makers must choose among different forms of intervention, they must explicitly or implicitly make a comparison between the costs of different policy options. By showing that bank nationalisation is not as costly as previously thought, this research laid the intellectual foundation for the wave of bank nationalisations that occurred during the financial crisis of 2007-8 and the on-going Euro crisis.

The research was carried out by Panicos Demetriades (University of Leicester since 2000) and Svetlana Andrianova (University of Leicester since 2003) in collaboration with Anja Shortland (Brunel University) and Chenggang Xu (University of Hong Kong).

3. References to the research

1. S. Andrianova, P. Demetriades and A. Shortland “Government ownership of banks, institutions and financial development”, *Journal of Development Economics* 85 (2008), 218-252. (published online 4 October 2006).

2. S. Andrianova and P. Demetriades "Finance and Growth: What We Know and What We Need to Know”, in C.A.E. Goodhart (ed.), *Financial Development and Growth: Explaining the Links,* Palgrave Macmillan, 2004, 38-65.

3. S. Andrianova, P. Demetriades and C. Xu "Political Economy Origins of Financial Development in Europe and Asia", *World Development*, Vol. 39 (2011), 686-699.

4. S. Andrianova, P. Demetriades and A. Shortland "Government Ownership of Banks, Institutions and Economic Growth" *Economica* 2011, doi: 10.1111./j.1468-0335.2011.00904.x.

4. Details of the impact

In demonstrating that bank nationalisation is not as costly as had been thought, research by **Andrianova** and **Demetriades** went against previous orthodoxy promoted by the World Bank and the IMF. Their new research was presented at numerous academic conferences and seminars in the UK and around the world, including Australia, Austria, China, France, Germany, New Zealand and the Unites States, and in a series of papers, the first of which was published in the *Journal of Development Economics* on line in 2006 (in 2008 on paper).

Their ideas spread across both the academic and practitioner communities, and were taken up by the media and policy commentators. For example, *Handelsblatt*, Germany’s leading financial newspaper, ran a feature on 15 February 2010 (“Are state banks better than their reputation?”) comparing the findings of the anti-nationalisation La Porta et al (2002) with those of Andrianova *et al* (2008, 2011). The newspaper concluded that the findings of La Porta *et al* were ideologically driven ([Source 1]). The research was also cited by the media during the debate on proposals to privatise Sberbank, Russia’s largest savings bank. In addition, an article warning against the risks of early de-nationalisation, citing the research, was posted in February 2010 on *VOX EU*, the leading economic policy portal in Europe.

The research played a crucial role in changing the academic and policy climate, laying the intellectual foundation for the wave of bank nationalisations that started in 2007 at the outset of the financial crisis. Many bank nationalisations that have taken place since have been directly or indirectly influenced by the research described above. The impact of the research is most evident in two cases. These are the nationalisation of Northern Rock in 2007-8, and the reform of Cyprus’ banking system in 2012-3.

Northern Rock is perhaps the first important episode in the great financial crisis in the UK. The bank applied for, and was offered, liquidity support on 17 September 2007. It was then fully nationalised on 22 February 2008. The *Journal of Economic Development* paper mentioned above was presented at a seminar at HM Treasury on 14 September 2007 ([Source 2]). The seminar was attended by a large number of government economists and officials. Many of these were directly involved in the policy decisions that eventually led to the nationalisation of Northern Rock. The bank's successful nationalisation in early 2008 paved the way for further nationalisations in the autumn of the same year, both in the UK and overseas.

Partly as a result of his influential research on bank ownership, in May 2012 **Demetriades** was appointed as governor of the Central Bank of Cyprus and member of the European Central Bank's governing council. When he took charge, the Cypriot banking sector was already in a critical situation, having suffered huge losses because of the Greek bonds crisis. Since January 2012, Cyprus had been relying on an emergency loan from Russia to re-finance its maturing debt. On 13 March 2012, credit rating agency Moody's slashed Cyprus's rating to the lowest "junk" status.

On 30 June 2012, a month after Demetriades' appointment, the Cypriot government recapitalised the country's second-largest bank, Cyprus Popular Bank (also known as Laiki Bank). As a result, the government acquired 84% of the bank's equity – a *de facto* nationalisation.

In the spring of 2013, after long and complex negotiations between the Cypriot Government, the Central Bank of Cyprus, the European Commission, the European Central Bank and the IMF, Cyprus Popular Bank was shut down. The bank's bad assets are being liquidated, and any remaining good assets will be transferred to the country's other bank, the Bank of Cyprus. A substantial fraction of the Bank of Cyprus' equity is therefore to be owned by the government.

It is therefore evident that government's acquisitions played a major role in the solution to the crisis of the Cypriot banking sector. Although the entire process has been controversial, many commentators argue that the solution achieves financial stability while avoiding issues of moral hazard, by putting the burden of future bank restructuring onto creditors and depositors rather than taxpayers in general. (Cyprus Popular Bank's shareholder capital has been written off, and the uninsured deposits - along with other creditor claims - will be largely lost).

In any case, the Cypriot banking sector has been stabilised, preserving the viability of the Euro system. Given the risks of financial contagion, failure to solve the Cyprus crisis might have had catastrophic consequences for a number of Southern European countries.

In his capacity as Governor of the Central Bank of Cyprus, **Demetriades** has actively contributed to the rescue of the Cypriot banking sector ([Source 3], [Source [4]). In doing so, he has implemented the ideas developed in his academic research at Leicester, to manage one of the world's most complex banking crises.

5. Sources to corroborate the impact

1. *Handelsblatt* feature, 15 February 2010.
2. Correspondence related to the seminar held at HM Treasury on 14 September 2007.
3. Statement by the Governor of the Central Bank of Cyprus.
4. Statement by a senior director and member of the monetary policy committee of the Central Bank of Greece.