POLITICAL ECONOMY OF THE RELATIONSHIP BETWEEN GOVERNMENT AND BANKS IN FINANCIAL INTERMEDIATION

Marijana Badun  
Faculty of Economics, University of Zagreb  
Trg J. F. Kennedyja 6, 10 000 Zagreb, Croatia  
Phone: ++385 1 238 3136;  
Fax: ++385 1 233 5633  
E-mail: mbadjun@efzg.hr

Key words: government, banks, financial intermediation, Political economy

1. INTRODUCTION

Since the beginning of the 1990s there has been a large increase in the number of scientific papers in which the link between financial intermediation by banks and economic growth is being analyzed. The majority of them are based on econometric models and the focus of research is on investigating the direction of causality between financial intermediation and economic growth. Although significant progress has occurred in econometric estimation techniques, econometric results are still plagued by the lack of appropriate data and often not robust to inclusion of various control variables as well as to changes in the observed time period or countries in the sample. In addition, researchers have neglected political economy issues in their econometric models. This primarily refers to incentives that determine the behavior not only of bankers, but of government officials as well.

Due to the fact that banking sector determines who will use society's savings, political factors have always shaped policies directed at financial system and its functioning. Economic historians Sylla et al. (1999:1) wrote that the more historical roots and the development of modern financial system are studied, the more obvious it becomes that in most critical points when financial system changed, for better or worse, the role of government was of crucial importance. This does not surprise because government has always needed financial funds, mostly for political ambitions, of which the most important one has been war financing. Apart from needing financial funds, the government also had the power of coercion which enabled it to collect taxes. This also means that it had greater ability of borrowing and returning debts compared to the private agents. Furthermore, the government had the power to create financial institutions and markets, as well as to influence their development, through legislation.

The goal of this paper is to analyze the interaction between government and banks from the political economy point of view. It will be done by looking into financial market ad government failures. The paper will show that corruption of government officials and the influence of special interest groups can distort financial intermediation. The theoretical
findings of the paper might improve future econometric research on the role of financial intermediation by banks in economic growth.

2. FINANCIAL MARKET FAILURES

Financial markets, in comparison to other markets, have its specific characteristics which also manifest in their failures. Since one of the main roles of financial markets is collecting and processing information, one can assume that problems mostly occur in that segment. The problem of information as a public good appears on financial markets in at least two contexts (Stiglitz, 1994). The first one relates to pieces of information on the solvency of financial intermediaries, which are important for investors or depositors who want to take a loan or entrust their funds to a specific financial intermediary respectively. The second problem concerns pieces of information on management of the financial intermediaries, which influences the risk and the rate of return on investments. In both cases the problem is actually in the information asymmetries, which is especially pronounced with banks since they are less transparent than other companies. For example, in banking it is not easy to estimate the loan quality, or in other words, one can hide the true quality of the loan for a long time.

With asymmetric information, markets do not have to be in equilibrium and Pareto efficient. On the loan markets, investors who are ready to pay the most need not be the ones who can ensure the highest return. Expected return can fall as the interest rate goes up since the risk of default increases. The consequence can be credit rationing; even when there is excess demand for loans, banks will not necessarily increase interest rates. Instead, interest rates will be set on a level which maximizes banks' expected return. This situation was first described by Stiglitz and Weiss (1981). The problem is also that on financial markets private and social returns are not aligned and this is why markets can continuously avoid financing certain projects. Good projects can be forced out from the market, and the biggest part of loans can go into consumer goods and real estate.

Bank management is in charge of efficient allocation of resources, but the question is: who monitors the managers? Who supervises the supervisory board? According to Stiglitz (1994), monitoring is a public good, which means that there is insufficient supply of it: shareholders and depositors do not put enough effort in monitoring financial intermediaries. This can have damaging consequences for two reasons. The first one is that managers know that they are not being monitored which stimulates them to undertake projects with very large risks, or to use the assets of the intermediary for their personal benefit. This problem is described as moral hazard and it can be explained by the principal agent relationship: the agent has always got the incentives to make decisions which benefit him at the expense of his principal. For example, the agent (bank manager) is prone to offer high interest rates to attract depositors and then invest in risky projects with high rate of return so that he can keep a large share of net profits. From microeconomic perspective, bank managers operating as agents will lead to misallocation of resources because they will undertake risky activities that maximize their private expected return, and not the expected gain for the society as a whole (Montiel, 2003:242). The second reason for damaging consequences is that insufficient monitoring builds distrust among investors. Therefore, fewer funds will be allocated through financial intermediaries who hence will not be able to perform their functions as they otherwise could.
Apart from moral hazard, a specific characteristic of financial intermediation is adverse selection. One of the most important functions of banks is choosing between alternative projects and monitoring the use of allocated funds. With the mere fact that there are "bad" companies on the market, it is difficult for the good companies to obtain funds because potential investors (banks) do not easily distinguish these two groups of companies. Selection therefore has its consequence - cost, and besides, bad companies can "spoil" the market.

Further characteristic of financial markets is that failure of only one financial intermediary can have significant effects. A failure of one bank can disrupt the flow of loans to certain investors. Furthermore, after the bank failure investors have to decrease the volume of their business activities, which then influences their clients. The domino effect should also be taken into account: even if collapse of one intermediary does not cause financial panic, some depositors will withdraw their funds out of fear that their bank might fail, too. Banks do not take into consideration these externalities, which makes the public interest for financial intermediaries' solvency greater than private interest of owners and managers.

Important characteristic of the banking system is imperfect competition, that is, limited competition. Each bank has data on its clients in its database. If a certain client is reliable for one bank, this information is not automatically transmitted to another bank. For the other bank this client is not known and hence riskier than to the first one. Therefore, if there are ten banks on the market, this does not mean that they are all available to potential investors (Stiglitz, 1994:29). Competition can be observed as a double edge sword. On one hand, lack of competition can lead to higher interest rates, while on the other hand, high interest rate bring larger profits which enhance the strength of financial intermediaries and decrease the risk of insolvency.

Uninformed investors cannot be considered as a market failure, but they can be a justified reason for state intervention (Stiglitz, 1994:31). Banks can misuse the fact that their average clients do not understand compound interest, indexing etc, and this is why regulation should be created in a way which disables banks from abusing uniformed clients. It is questionable how far regulation should go with disclosing information, since the trading on financial markets is based on the amount of information one possesses.

3. GOVERNMENT FAILURES

State intervention on financial markets is usually justified by afore mentioned market failures and externalities. Second viewpoint by which government intervention is necessary finds its justification in basic ingredients which are required for a developed financial system (Rajan and Zingales, 2003:18): a) protection of property rights; b) accounting standards which promote transparency; c) legal system which enables inexpensive enforcement of contracts; d) regulatory infrastructure which protects consumers, encourages competition and controls excessive risk taking. Although all this might be achieved by private agreements, government has the ability to coordinate standards and use coercion. Government intervention is larger in banking sector than in other sectors because banking is generally considered vital for the economy and is an important source of fiscal revenues. Apart from intervening directly (through for example subsidies to certain industrial sector), and controlling the banking system though regulation, the government can influence financial intermediaries by monetary
and fiscal policy; e.g. inflation has significant impact on financial intermediation, as well as taxing.

Montiel (2003:2002-205) describes three types of policies by which government can enhance market efficiency: a) enabling policies; b) policies directed towards developing financial market infrastructure; and c) policies created to resolve special problems in financial sector. Enabling policies are those that improve the environment in which financial intermediaries operate. They are not directed towards financial sector exclusively. Enabling policies decrease risk and enhance the ability of financial intermediaries for monitoring. They also include avoiding large tax burden on financial intermediaries and their clients. Enabling policies have an institutional and macroeconomic dimension. Institutional policies promote financial sector development by enabling financial intermediaries to deal with credit market imperfections (which are a basis for external financing premium) in a less expensive way. These policies decrease information costs and costs of contract enforcement by imposing an adequate legal framework. The main components of an adequate legal framework are: defined property rights, accounting standards, standards on information disclosure, insider trading laws, commercial laws and bankruptcy laws which protect shareholders and creditors, and efficient judiciary. Macroeconomic dimension refers to policies which influence external financing premium.

Policies directed at infrastructure include provision of regulatory and supervision framework which promote competition in financial sector and decrease moral hazard problem by preventing excessive risk taking. Here it comes to three special functions: 1. setting up and applying standards for obtaining working licenses for banks; 2. developing market infrastructure for shares and bond trading; 3. introducing and applying anti-trust laws for banks. Policies aimed at special problems of the financial sector include preventing and dealing with bank crises and asset market bubbles.

Cameron (1972:9) wrote that in no other economic sector, apart from maybe in foreign trade, has government intervened so broadly, so consistently, and with such telling effect - usually bad. Fry (1995:371) also concludes that only in a small number of countries has government intervention been benign. Namely, government engages in correcting market imperfections under assumption that it has the ability or will to do it, but market failure does not necessarily imply government success.

According to La Porta et al. (2002) there are two approaches to government involvement in financial markets. The first one is optimistic, developmental approach which is attributed to Gerschenkron (1962). His opinion was that in some countries in the 19th century, Russia especially, economic institutions were not developed enough for private banks to have key developmental role. Banking system could not attract enough financial funds for industrialization because of large capital shortage, and besides, the level of distrust in country was enormous. In such conditions government had to take the function of industrial banks. This idea has been accepted across the world: in 1960s and in 1970s governments have nationalized existing commercial banks and founded new ones in Africa, Asia and Latin America (La Porta et al., 2002).

---

1 Gerschenkron was at that time not the only one with such attitudes about the need for government ownership of companies in strategic industrial sectors. Lewis (1950) was also in favor of government ownership over banks. According to his opinion, controlling finances would lead to development of strategic industries.
According to the second, political approach to government involvement in financial markets, government obtains control over banks and companies in order to provide employment, subsidies and other benefits to its supporters, which in return vote for a specific party, finance their campaigns or give bribes. Political control over banks is the largest in countries with undeveloped financial systems and weak protection of property rights because government does not have to compete with the financial sector for resources.

In the rest of this paper it will be shown that there are a few reasons for optimism when it comes to strong government involvement in financial intermediation, but also that consequences of total government withdrawal can be detrimental. Political approach to government involvement will be explained in more detail by looking into public governance quality. Attention will be drawn to the fact that banks can have significant influence on government and its regulatory bodies, with a consequence of misallocation of resources.

3.1. Financial repression

The fact that some government interventions are justified, does not imply that every intervention is justified. The best example of this is financial repression. Policy measures which can be characterized as financial repression are the following (Montiel, 2003:215-217; Agénor, 2000:56-57):

- Controls of capital inflows and outflows. Under financial repression, domestic residents are typically not allowed to hold foreign assets, and domestic firms are not permitted to borrow abroad. The consequences are that country is characterized by financial autarky and that foreign financial intermediaries cannot compete with the domestic financial industry.

- Restrictions on entry into the formal financial sector. Under financial repression, in the domestic financial sector there is no possibility of free entry and exit, and many banks are government owned. The consequence is that domestic financial sector does not operate under competitive conditions. Banking sector is usually dominated by a few banks, the largest of which are government owned.

- High reserve and liquidity requirements on banks. Banks are required to hold high reserve ratios on which they do not earn interest. In addition, they often have to hold liquidity ratios in the form of government securities which typically yield a return much lower than would be required for banks to choose to hold them voluntarily. This can be considered as forced allocation of assets from commercial banks to the public sector. Through both mechanisms banks indirectly pay taxes and lose freedom of allocating a large part of their assets into productive loans.

- Interest rate ceilings on bank assets and liabilities which usually lead to negative real interest rates. Ceilings on interest rates imply that banks cannot compete in price and that they cannot increase deposit interest rates in order to compete with nonblank intermediaries on the informal financial market. If there are ceilings on loan interest

---

2 Even Gerschenkron (1962:20) wrote that because of incompetence and corruption of government officials during industrialization, there was a large waste of resources. Despite that, he thought that government financing of industrialization in Russia was a great success.
rates, it means that banks cannot allocate their loans on the basis of price, and are forced to engage in nonprice rationing of credit.

- Directed credit restrictions on the composition of bank asset portfolios. Policy makers can force banks to allocate funds in certain sectors or activities which, based on their opinion, should have priority. Often these credits have to be given under preferential interest rates. This measure additionally decreases, along with high reserve requirement, funds available to financial intermediaries.

- The use of bank credit ceilings as instruments of monetary control. Monetary authorities set targets for amount of overall crediting which is then distributed among individual banks.

These policies cause distortions in financial intermediation and therefore reduce efficiency of resource allocation and negatively influence growth (Montiel, 2003: 223-225). In more detail:

- Restrictions on competition may impair allocative efficiency because banks in government ownership and protected banks do not have incentives to carefully select and monitor their borrowers.

- High reserve requirements mean that a larger part of household saving will be channelled into government spending. Investment undertaken by government will maybe not have high enough return in order to compensate for missed investment in the private sector.

- High price ceilings prevent financial system from allocating capital into the most productive uses. Informal market can be developed (which can be less efficient) or credit rationing can occur.

- Because of obligation of directing credit into certain sectors or activities, banks give credits to companies which maybe would not qualify for them under market conditions.

- Limitations on flow of capital decrease competition in financial sector and hence decrease incentives for lowering costs of intermediation.

- Reserve requirement can be observed as tax on banks which increases the cost of intermediation.

When it comes to government ownership of banks, which is still widespread around the world, there is no evidence that it can be connected with positive results (Barth, Caprio and Levine, 2004). La Porta et al. (2002) have shown that government ownership politicizes allocation of resources and decreases its efficiency. Their main result is that larger government ownership of banks is correlated with lower growth rates and lower productivity in following periods, including poor countries. Government ownership is especially pronounced in poor countries, countries with low protection of property rights, undeveloped financial systems and large government interventionism in economy as a whole. Large share

---

3 La Porta et al. (2002) have shown on a sample of 92 countries that in 1970 in an average country 59% of assets of ten largest banks was owned by government, while in 1995 share of government ownership was 42%.
of government ownership does not have to be negative if there is long and good tradition of
government ownership, which is the case in Germany, but such examples are rare.

Financial repression is usually not motivated by correcting market failures in the process of
financial intermediation and therefore there is no reason to believe that it would improve its
functioning from the aspect of financial market imperfections. The main motivation for
financial repression is fiscal (Montiel, 2003:214); the government relies on implicit taxing of
financial sector because it has difficulties in collecting taxes in conventional way.

Exemptions from the negative relationship between financial repression and economic growth
are Japan and four Asian tigers. However, financial repression in these countries was different
from others because it was moderate: there were no large negative real interest rates, banks
were trying to decrease interest spread so that larger share of savings could go into investment
and repression was carried out in conditions of financial stability (Montiel, 2003:229). Besides,
government did not direct loans in consumption. Funds were allocated for investment based on amount of exports as criterion. These countries were successful because they did not exaggerate with financial repression and because it was going on in special
conditions which are hard to copy somewhere else. When financial repression is carried out
with goals different from removing market inefficiencies, then their net effect is damaging.

3.2. Financial liberalization and bank crises

In 1970s McKinnon (1973) and Shaw (1973) criticized financial repression because it
decreases depth of financial system and efficiency of savings allocation. Their proposal was
complete liberalization. The basic idea behind liberalization was that it would be followed by
higher real interest rates which would increase savings and make more loans available.4

Financial liberalization actually represents removal of earlier mentioned restrictions on
financial intermediation. After liberalization, competition and market efficiency should ensure
adequate functioning of deregulated financial system. The key problem with this approach has
been already described in this paper: it cannot be assumed that deregulated markets will be
efficient; in totally liberalized system there is a threat of systemic misallocation of resources
and sensitivity to crashes. These crashes include bank crises (solvency problems) and bank
panics (liquidity problems). Evidence has shown that financial liberalization is usually
followed by financial crisis. In general, there is not enough evidence that after financial
liberalization efficiency of allocation of resources increases in terms that they are used in the
most productive way (Caprio, 1994:2).5

From late 1970s to 2000 there were 112 systemic banks crises in 93 countries and 51
borderline crises in 46 countries (World Bank, 2001:75). Crises are obviously numerous, but
also expensive, which is especially damaging in countries in development. Apart from
influencing growth (Gorton and Winton, 2002), they have large fiscal costs - those funds
could have been used for e.g. healthcare and education. Demirgüç-Kunt and Detragiache
(1998) found that determinants of bank crises in countries in development from 1980 to 1994

4 It has been evidenced that financial liberalization can decrease liquidity constraints and hence lead to a
temporary increase of consumption, not saving (Agénor, 2000:56-57); elasticity of saving to real interest rate is
low or equal to zero.

5 Loayza and Ranciere (2005) found that financial liberalization has a positive impact on economic growth in the
long run, while in the short run it is characterized by financial crises and low GDP growth rates or recession.
were: low GDP growth, excessively high real interest rates, high inflation and low effectiveness of legal system. It can be concluded that bank crises are usually a consequence of general economic conditions in a country for which government is mostly responsible.

Government reacts in case of bank crisis because it does not want public to think that it will come to a financial system collapse or because it does not want that citizens suffer a loss. However, if government intervenes in the case of financial collapse, then expectations are formed that government will always bear the cost of financial crises by "saving" banks and protecting depositors. Since banks are expecting rescue, they will be less careful in giving loans, i.e. when assessing applications for loans. In other words, banks will take larger risks than they would if there was no government backup. Furthermore, as long as a single bank behaves like other banks, the probability of government rescue grows. As a prevention of bank crisis governments usually introduce safety nets like deposit insurance but it can lead to moral hazard by banks.

Barth, Caprio and Levine (1999) found negative correlation between quality of public governance and probability of bank crises. In general, it has been shown that effects of financial liberalization depend on institutional structure of the economy, that is, quality of public governance (Arestis and Demetriades, 1997). Furthermore, before liberalization macroeconomic stability and adequate prudential supervision and regulation of banks are necessary - this is usually not the case. Liberalization without appropriate regulatory framework has disappointing results which was obvious in the case of Latin American countries. Even though it could be claimed that financial liberalization should not be described in the context of government failures, this paragraph should prove otherwise.

3.3. Quality of public governance

Cameron (1972:19) wrote that if it wants to be achieved that banking system effectively contributes to formation of capital, then government has to provide minimal conditions of financial and political order and refrain from random and ad hoc interferences that increase uncertainty for long-range investment planning. If banking system is distorted by bad regulation and policy measures, it can thwart country's economic growth. It could be said that Cameron stressed the importance of public governance quality, i.e. the way in which government uses its authority in managing country's institutional environment.

Normative literature presumes existence of a benevolent dictator, but that "species" is all too rare in the real world of economic policy making (Grossman and Helpman, 2001). Recently, economists have developed a new approach to analysing policy influence on the economy, treating policy makers as agents who want to maximize their personal benefit, and not like benevolent social planners. This approach is known as "new political economy" (Pagano and Volpin, 2001:503). By applying political economy to finance it can be understood why financial regulation often has flaws and why it hinders market development instead of promoting it. In other words, it helps to understand why some countries have poorly designed financial institutions and regulation.

Most policy measures directed at financial system implicitly assume that government will strive to common good, but such attitude neglects incentives with which policy makers are faced and political structure within which they operate. For example, in World Bank publication (World Bank, 2001:130) it is stated that banks will contribute to economic growth if there is a large enough number of well motivated regulatory bodies for financial
intermediaries. However, when it comes to regulation, there is the problem of incentives: in "real" world regulators often earn less than those who they should regulate. Because of this, there is often a lack of quality staff in regulatory agencies or widespread corruption. Even if there is no corruption, every kind of monitoring is fallible; there should be agencies for monitoring monitory agencies.\footnote{A possible problem is that regulators often become employees of companies they used to regulate.}

The main problem is the following: how can policy makers remove market inefficiencies if they are working in their own interest? Furthermore: what is the probability that good financial policy will be adopted if it is opposite to interests of policy makers currently in power? Too often personal interest of policy makers created and sustained distorted incentives in financial sectors which led to crisis or allocation of bank resources in government ownership for political or personal causes (Haggard and Lee, 1993). Since government action is necessary for financial development, the key question is when and where there is political will to carry out those policies. Who can force government to hold on to its commitments? It has been shown that the will to form a good regulatory framework is more important than the ability to regulate (Haggard and Lee, 1993). It should also be taken into account that political and institutional obstacles to financial sector development slowly change. Path dependency exists: initial laws shaped the differences between financial systems.

Even when role for government is initially justified, it can lead to rent seeking. Rent can be defined in several ways (Buchanan, 1980:4): a) part of the payment to an owner of resources over and above that which those resources could command in any alternative use; b) receipt in excess of opportunity cost; c) allocatively unnecessary payment not required to attract resources to the particular employment. Just like rent, rent seeking can be described in several ways: a) socially expensive search for wealth transfers (Tollison, 1997:506); b) process by which an individual, organization or company tries to obtain benefit by manipulating economic environment instead of trading and producing added value (Wikipedia, 2006); c) description of behavior in institutional environment where individual efforts to maximize value result in waste of social resources, rather than social surplus (Buchanan, 1980:4).

On an individual level, behavior is not different from profit seeking in market interactions. Rent seeking is rational behavior but it decreases the amount of resources available to the society. "The unintended consequences of individual value maximization shift from those that may be classified as 'good' to those that seem clearly to be 'bad', not because individuals become different moral beings and modify their actions accordingly, but because institutional structure changes. The setting within which individual choices are made is transformed. As institutions have moved away from ordered markets toward the near chaos of direct political allocation, rent-seeking has emerged as a significant social phenomenon." (Buchanan, 1980:4)

Public governance can be categorized as bad if it results with institutions which stimulate rent seeking and consumption instead of production and saving (Hall and Jones, 1999). If culture of rent seeking prevails, individuals believe that influence over political allocation is the main source of personal benefit. In order to get rich and improve their private position, individuals focus their activities on obtaining favorable government decisions. Namely, rent is received when a third party, usually the government, makes it impossible for one party to have access to otherwise available transaction possibilities, by which a nominally consensual transaction between two parties becomes an opportunity for rent collection for one party. Furthermore, if somebody gets a monopoly right, others will not patiently observe it. They will instead invest
effort, time and other productive activities to win over policy makers' favor which would bring them personal benefit.

Buchanan (1980:12-14) identified three types of expenditures of rent seeking which can be wasteful from the aspect of the society: 1. efforts and expenditures of potential monopolists (lobbying etc.); 2. efforts of state officials in order to obtain or react to expenditures of potential monopolists (e.g. bribes); 3. distortions caused to third parties by monopolists or government as a result of rent seeking activities (efforts of others to receive subsidies or at least form an oligopoly). The main point is that those resources could have been used in a more productive way. If a company can calculate the cost of lobbying, bribing or any other way of obtaining favorable regulation from the state, than this cost can be compared to the cost necessary to obtain similar benefit within the market by investment or increased productivity. If buying favorable regulatory environment is cheaper than increasing efficiency of production, than it will lead to suboptimal allocation of resources (money spent on lobbying instead on improving production) and productivity growth slowdown.

Usually in theory the notion of rent seeking refers to rents from regulation, monopoly or tariffs. Rent seeking can be observed as a two phase game. In the first phase, agents are competing for control over the political apparatus which creates and distributes rents through legislation. In the second phase, agents are competing for rents which stem from monopoly and regulation (Tollison, 1997:519). Instead of looking at private companies as government victims, they could be observed as government's accomplices in forming institutions (laws, acts, regulations) which create rent seeking opportunities for both parties. Rents are shared between government officials and companies through government interventions and distribution of legal and regulatory advantages to some companies.

Political economy does not take regulation as given. Instead, it is trying to understand it - when and why it changes and develops, taking into account demand and supply factors. From the demand side, it is dealing with pressure of interest groups on legislators and regulators in order to promote policies for their own private interest, and not to contribute to social welfare. In some environments regulators can be a special interest group (Kroszner, 1998). Regulatory equilibrium in financial markets is influenced by technological, economics and legal shocks (Kroszner, 1998), or it can come to a crisis which changes distribution of power among existing interest groups. Traditional approach of economists to regulation is that it exists in order to correct market imperfections and hence maximize social welfare. This is the public interest theory.

Economic theory of regulation (e.g. Stigler, 1971; Peltzman, 1976; Becker, 1983), or private interest theory, is based on assumption that regulatory process is characterized by competitions of interest groups which use government's power to obtain rents at the expense of other groups. These interest groups can be so strong that they can capture regulators. For this reason, this theory is also called capture theory. Continuous existing of a dysfunctional regulatory framework can be partially explained with politicians and regulators being captured by those they should be regulating. In these cases regulatory policy works in private interest and not in interest of general public. Even if regulation seems strict, there can be loopholes in the law.

Banking regulation is an area in which political factors can have a significant role - Kroszner and Strahan (1999) have shown that the timing of interstate branch banking regulations in USA since the 1970s has been determined by relative power of interest powers which would
be influenced by reform. Deregulation happened earlier in states with a lesser number of small banks, states in which small banks were financially weaker and states with more small companies dependent on banks. In the next section more will be written about banks as an interest group.

3.4. Interest groups

Hellman, Jones and Kaufmann (2003) focused in their research on two concepts: state capture and state influence. State capture refers to payments by private companies to state officials in order to have impact on the rules of the game (institutions), and state influence has the same goal but without paying to state officials. This kind of corruption cannot be considered as extortion since it is based on voluntary companies' decisions. Authors conducted their research on a sample of 22 transition countries (Eastern Europe and former Soviet Union) in order to stress that after only a decade of transition fear of government as leviathan has been replaced with a new reason to worry: powerful oligarchs who manipulate politicians and shape institutions in order to advance and protect their empires at the expense of social interests (Hellman, Jones and Kaufmann, 2003:752).

The authors have shown that influential companies are usually large, state owned, privatized and have close formal and informal ties with the state. Their influence is legacy of the past. On the other hand, companies which capture the state are newly founded private companies with weaker government ties. The authors have found out that both groups of companies grew faster than other companies and that social costs of capture and influence for other companies (especially small) have been significant. There are two groups of countries: countries with high state capture and countries with low state capture. In the first group of countries regulatory framework is distorted for the benefit of a few powerful companies. In the second group of countries companies maybe want to capture the state, but there are limitations which prevent government officials from abuse of power.

Participation of interest groups in policy making is not specific for transition countries only; it can be generally stated that politics is a battle between numerous competing interests. Unfortunately, Hellman, Jones and Kaufmann (2003) did not include banks in their survey, but banks can be a strong interest group. Interest group can be formed more easily if the number of potential members is small (Mueller, 2003:473) and banking sector is characterized by monopolistic competition, i.e. a small number of participants.

Animosity is often felt towards banks; it is believed that banks control everything, that they are above everything and that they are a symbol of power of the rich. The following quotes are in favour of this (World Newsstand, 2006):

- "History records that the money changers have used every form of abuse, intrigue, deceit, and violent means possible to maintain their control over governments by controlling money and its issuance." (James Madison)

- "What is the crime of robbing a bank compared with the crime of founding one." (Bertolt Brecht)

- "I believe that banking institutions are more dangerous to our liberties than standing armies." (Thomas Jefferson)
"The bank is something more than men, I tell you. It's the monster. Men made it, but they can't control it." (John Steinbeck)

"Give me the power to issue a nation's money, then I do not care who makes the law." (Anselm Rothschild)

James (2002:118) wrote for banks that they do not operate in some neutral, antiseptic environment; they are a part of a larger financial and social system in which government plays the leading role, and government is susceptible to many economics and political influences. When Willie Sutton, a famous bank robber, was asked why he robbed banks, he replied: Because that's where the money is. Connection between politics and special interests can be very close if for nothing else, then because banks are the ones in which the money is.

Bankers have always enjoyed close relationships with political power, most often as advisors to politicians (Cassis, 2002) because they had good technical knowledge about finance. That relationship was enhanced with the fact that government officials often had leading manager positions in banks. Banks were through influence on politics interested in defending their own interests (e.g. stopping competitors from entering the market) as well as in keeping independence from government interference. Naturally, influence of bankers on politicians has not everywhere and always been the same. For example, in Great Britain at the end of the 19th century bankers enjoyed better social status from bankers in Germany, i.e. they were better integrated in higher classes. In general, British bankers have been very successful in defending their own interests until 1946 when Bank of England was nationalized, but even then government authorities over banking stayed limited. Interests of the financial community were successfully presented as interests of the whole society. Cassis (2002) has shown that banks have throughout history quickly learned how to avoid the main purpose of different types of regulation. Influence of bankers on government officials has depended on how successful they were compared to other interest groups.

David Landes (1958) gives many historical examples of various types of close relationship between rulers and bankers. For banking in Europe in the 18th century he wrote: "...one may be sure that much influence with governments was bought – tactfully, through gratuities and accommodations, and crudely, by bribes". According to his findings, corruption was definitely a tool of banking policy.

Along with bribes, nowadays influence can be made through lobbying and financing of political campaigns, which are also forms of rent seeking (Mueller, 2003:498). It is interesting that in the USA in 1999 financial and real estate industry had the largest share in federal lobbying expenditures (Grossman and Helpman, 2001). Lobbying is a one direction transfer of information from interest group to government (Mueller, 2003:494). The way in which lobbyists function is that they help legislators in forming new laws. Their advantage is that they have access to information; legislators cannot master all technical and very complex questions in all fields and this is why they need resources and expertise of lobbyists. Another way of influence is campaign financing. Even if it is regulated by strict laws (and usually it is not, except in highly developed countries), interest groups find a way to circumvent them. With contributions interest groups buy influence: a loophole can be created, amendment not put forward etc. All this affects composition of laws, which then influences policy outcomes: "the link between a contribution and a legislator's action need not be made explicit, but nonetheless, influence is there: candidates know where their money is coming from" (Grossman and Helpman, 2001:12-13).
Often corruption and lobbying are thought to be very similar. However, lobbying is usually focused on changing existing laws, and corruption on avoiding enforcement of existing laws and regulations. It is interesting to mention that technically bribe is not a rent seeking cost. Bribe is a transfer and as such represents a method of influence on government's behaviour and that does not include explicit costs of rent seeking (consumption of expensive resources in order to get a transfer). Hiring a lawyer or lobbying to get a favourable law is rent seeking; bribing a legislator for the same purpose is not (Tollison, 1997:508).

Even though literature on lobbying is growing, there is almost no empirical research. Empirical papers are usually limited to developed countries and concentrate on characteristics of companies as determinants of lobbying (within one country) or differences in GDP in cross-country comparisons. Campos and Giovannoni (2006) conducted their research on a sample of around 4000 companies in 25 transition countries using BEEPS (World Bank, 1999) data for year 1999. By using tobit econometric analysis they have found out that lobbying and corruption work as substitutes and that lobbying is a more efficient instrument for influencing policy makers in rule than corruption, even in poor, less developed transition countries. This especially refers to highly positioned government officials. The notion "substitutes" in this context means that lobbying is an important alternative instrument to corruption in influencing policy makers in transition countries.

Their analysis also suggests that there is a larger probability for lobbying to occur in countries which have parliamentary systems (more players with veto rights) and high level of political stability. In addition, size of companies has significant influence on whether they will become lobby members, and probability of membership increases with the share of foreign ownership in a company as well as with the size of GDP (e.g. in Hungary and in Slovenia 77% and 67% companies stated they are lobby members respectively). Furthermore, in countries in which corruption is decreasing, the influence of lobbying is growing.

Nature of state interventionism in the field of finance depends on the type of relationship between government and financial elite. Financial elite can be connected with political elite only, or it can together with political and industrial elite form a single elite as it was the case in France in the last couple of decades (Cassis, 2002:13). The question is if bankers are a special interest group or connected with somebody. Morck et al. (2005) think that powerful families are those who control both banks and the political system.

According to Morck et al. (2005) business elites (majority owners, often powerful families) manage to transform their business power in political influence. They use this influence to, with the help of policy makers, create policies which would protect them from competition and enable subsidies for their business operations. In countries in which corporate ownership is highly concentrated, probability of influencing policy measures in a way which would stimulate rent seeking and stifle growth is large. Growth can also be hindered through direct influence of business elites on other companies and banks. Groups of influential companies often own banks as members of these groups. Caprio, Laeven and Levine (2003) analysed 10 largest banks in each of the forty-four countries in the sample and discovered that half of shareholders with controlling package of banks' shares are rich families.

It is important to point out that in cases when politicians followed interests of bankers, it was not necessary at the expense of others - e.g. financial stability is in interest of others, too. Furthermore, relative power of interest groups changes over time. Question that should be
asked is why in some time periods it was considered that influence of bankers on government is large, i.e. that government was captured by bankers. It is not impossible that government officials in some cases wanted to blame financial community for their own mistakes.

It is often assumed that influence of foreign banks is not as pronounced as influence of domestic banks can be. However, Landes (1958:65) gives as an example speech of Sir William Clay, which he held in 1864 in front of shareholders of Ottoman Bank (bank which came to existence by joining a couple of banks from the West and from the East). This is how he explained why it was worthwhile to build relations with Turkish banks: "...there were many financial operations connected with the government, others with municipal bodies, and other again with individuals, in which local experience, knowledge, and connections of the native bankers and capitalists of Constantinople made them the most fitting instruments". The "problem" with strong presence of foreign banks is that they can decrease control of government over the economy.

The ability of interest groups to achieve their goals depends on the interest of politicians and structure of state institutions (Haggard and Lee, 1993). In countries in which banks are faced with regulation full of flaws, corruption and frequent preferential measures, they are in better position to get central bank policies which suit them better (Haggard and Lee, 1993). The scope of influence of sector interests over politicians depends on political rules within which they operate, and maybe even on social norms.

4. CONCLUDING REMARKS

Government has powers which private sector does not, but it is susceptible to limitations which make it less efficient than private sector. On one hand, government should correct market failures, but on the other hand it is under influence of interest groups and election results. Government officials who will, if not prevented by law, try to maximize their personal wealth and not social welfare are on one side. They are open to cooperation with all interest groups if it will benefit them. On the other side are the bankers, fundamentally pragmatic interest group (also ready for cooperation with whoever it takes) which will try to maximize their own profit independent from influence on aggregate economic activity. It also possible that there are other interest groups which control both government and banks.

Government has the power to regulate the banking sector (which it does very intensively), but banks have the power to capture regulators. Along with all this, one should have in mind that the relationship between government and banks is not static: regulation causes market reaction which usually requires a new reply from the government. Policy makers are usually aware that their country needs good institutions, but they do not develop because with them interest groups would be at loss (Rajan and Zingales, 2003). Furthermore, the most basic requirement which government should provide is the rule of law (good protection of property rights, accounting standards and efficient judiciary), but this is exactly where the government most often fails (Bernstein, 2004). It is questionable what is more harmful: market or government failures. Laissez faire is not a good solution but strong state intervention has been successful only in East Asia. In other countries it resulted with corruption and other unwanted consequences.
These complexities in the government-bank relationship should be taken into account when doing empirical research on financial intermediation by banks and economic growth. Without it, research is greatly simplified and may lead to misleading results on the importance of banks for economic growth.

**BIBLIOGRAPHY**


APPENDIX: OVERVIEW OF SELECTED INDICATORS FOR TRANSITION COUNTRIES

<table>
<thead>
<tr>
<th>Country</th>
<th>Private sector share of GDP – mid 2006 (%)</th>
<th>Corruption Perceptions Index (CPI)</th>
<th>Member of a trade association or a lobby group (%)</th>
<th>Capture economy index and capture classification</th>
<th>Domestic credit to private sector</th>
<th>Net interest margin (NIM)</th>
<th>Gross wages in financial intermediation/total gross wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>75</td>
<td>2.6</td>
<td>28.4</td>
<td>16 – low</td>
<td>10.3</td>
<td>5.2</td>
<td>-</td>
</tr>
<tr>
<td>Armenia</td>
<td>75</td>
<td>2.9</td>
<td>19.2</td>
<td>7 – low</td>
<td>8.0</td>
<td>6.2</td>
<td>-</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>60</td>
<td>-</td>
<td>5.8</td>
<td>41 – high</td>
<td>9.5</td>
<td>8.5</td>
<td>-</td>
</tr>
<tr>
<td>Belarus</td>
<td>25</td>
<td>2.1</td>
<td>12.9</td>
<td>8 – low</td>
<td>16.2</td>
<td>4.9</td>
<td>-</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>55</td>
<td>2.9</td>
<td>21.3</td>
<td>-</td>
<td>22.6</td>
<td>7.3</td>
<td>-</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>75</td>
<td>4.0</td>
<td>26.2</td>
<td>28 – high</td>
<td>44.5</td>
<td>5.1</td>
<td>2.4</td>
</tr>
<tr>
<td>Croatia</td>
<td>60</td>
<td>3.4</td>
<td>55.1</td>
<td>27 – high</td>
<td>55.6</td>
<td>4.0</td>
<td>1.6</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>80</td>
<td>4.8</td>
<td>19.5</td>
<td>11 – low</td>
<td>37.6</td>
<td>3.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>80</td>
<td>6.7</td>
<td>35.6</td>
<td>10 – low</td>
<td>60.0</td>
<td>3.0</td>
<td>-</td>
</tr>
<tr>
<td>FYR Macedonia</td>
<td>65</td>
<td>2.7</td>
<td>20.6</td>
<td>-</td>
<td>18.6</td>
<td>5.7</td>
<td>2.1</td>
</tr>
<tr>
<td>Georgia</td>
<td>70</td>
<td>2.8</td>
<td>9.3</td>
<td>24 – high</td>
<td>9.5</td>
<td>8.8</td>
<td>-</td>
</tr>
<tr>
<td>Hungary</td>
<td>80</td>
<td>5.2</td>
<td>76.9</td>
<td>7 – low</td>
<td>51.7</td>
<td>3.4</td>
<td>2.2</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>65</td>
<td>2.6</td>
<td>15.6</td>
<td>12 – low</td>
<td>26.7</td>
<td>4.2</td>
<td>-</td>
</tr>
<tr>
<td>Kyrgyz Republic</td>
<td>75</td>
<td>2.2</td>
<td>7.6</td>
<td>29 – high</td>
<td>8.0</td>
<td>3.0</td>
<td>-</td>
</tr>
<tr>
<td>Latvia</td>
<td>70</td>
<td>4.7</td>
<td>48.8</td>
<td>30 – high</td>
<td>60.7</td>
<td>3.0</td>
<td>-</td>
</tr>
<tr>
<td>Lithuania</td>
<td>75</td>
<td>4.8</td>
<td>8.0</td>
<td>11 – low</td>
<td>34.0</td>
<td>2.2</td>
<td>-</td>
</tr>
<tr>
<td>Moldova</td>
<td>65</td>
<td>3.2</td>
<td>15.1</td>
<td>37 – high</td>
<td>21.2</td>
<td>6.4</td>
<td>-</td>
</tr>
<tr>
<td>Mongolia</td>
<td>70</td>
<td>2.8</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Poland</td>
<td>75</td>
<td>3.7</td>
<td>25.2</td>
<td>12 – low</td>
<td>27.8</td>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>Romania</td>
<td>70</td>
<td>3.1</td>
<td>16.8</td>
<td>21 – high</td>
<td>11.3</td>
<td>4.0</td>
<td>2.2</td>
</tr>
<tr>
<td>Russia</td>
<td>65</td>
<td>2.5</td>
<td>16.3</td>
<td>32 – high</td>
<td>25.7</td>
<td>6.1</td>
<td>2.6</td>
</tr>
<tr>
<td>Serbia</td>
<td>55</td>
<td>3.0</td>
<td>13.8</td>
<td>-</td>
<td>7.8</td>
<td>2.2</td>
<td>-</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>80</td>
<td>4.7</td>
<td>15.2</td>
<td>24 – high</td>
<td>36.2</td>
<td>2.5</td>
<td>2.0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>65</td>
<td>6.4</td>
<td>66.4</td>
<td>7 – low</td>
<td>53.8</td>
<td>2.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>55</td>
<td>2.2</td>
<td>-</td>
<td>-</td>
<td>17.1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>25</td>
<td>2.2</td>
<td>-</td>
<td>-</td>
<td>1.4</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Ukraine</td>
<td>65</td>
<td>2.8</td>
<td>15.4</td>
<td>32 – high</td>
<td>31.2</td>
<td>4.4</td>
<td>1.9</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>45</td>
<td>2.1</td>
<td>21.4</td>
<td>6 – low</td>
<td>20.4</td>
<td>9.6</td>
<td>-</td>
</tr>
</tbody>
</table>

1 The share includes income generated from the formal activities of registered private companies as well as informal activities where reliable information is available. Source: EBRD (2006).
2 CPI score relates to perceptions of the degree of corruption as seen by business people and country analysts, and ranges between 10 (highly clean) and 0 (highly corrupt). This score is for year 2006. Source: Transparency International (2007).
4 Percentage of firms affected by capture. State capture is defined as the efforts of firms to shape the formation of the basic rules of the game (i.e. laws, rules, decrees and regulations) through illicit and non-transparent private payments to public officials. In the bargain between politicians and firms the politician uses political power to provide rents to firms in return for private economic gains, which further his political or economic objectives. Data are from year 1999. Source: Hellman et al. (2003).
6 Net interest margin is accounting value of bank's net interest revenue as a share of its interest-bearing (total earning) assets. Data are for year 2005 except of Slovenia and Kyrgyz Republic (data are for 2004). Source: World Bank (2007).
This indicator shows how many times monthly gross wages in financial intermediation are larger than total monthly gross wages. Data are for year 2005. Source: Author's calculations based on WIIW (2006).

For the majority of transition countries, government involvement is still larger than in highly developed countries. This need not be a problem per se, but transition countries are characterized by widespread corruption, weak legal framework, and most of them have high state capture, sometimes accompanied by strong lobby groups. Problems occur in their banking systems as well; large majority of transition countries went through a bank crisis. Since then banks have improved their performance and although the share of domestic credit to private sector is growing, it is still smaller than in EU-15 countries where average is around 80%. Furthermore, the cost of financial intermediation (net interest margin as a proxy) by banks is relatively large compared to EU-15 countries where NIM is on average 2%. According to these two indicators, financial intermediation by banks in transition economies is relatively inefficient compared to more developed EU countries. At the same time, gross monthly wages in the financial intermediation sector are approximately two times larger than total gross monthly wages in transition countries. Taking all this into account, it would be interesting to investigate how the relationship between banks and government influences the impact of banks on economic growth in transition countries because of possible rent-sharing between government and banks.