Provincial Bank Privatization in Argentina

The Why, How, and “So What?”

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Argentina's recently privatized provincial banks generate much of their income through service contracts with the provinces, and the transition to commercial banking has been challenging. Available evidence suggests improvements in post-privatization performance, but it is uncertain whether these are sustainable. At the very least, however, a fiscal burden has been lifted from the provinces.

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Summary findings

Argentina's provinces offer a unique opportunity to study bank privatization because so many transactions took place there in so short a period in the 1990s (1994–98). As the decade started, every province owned at least one bank, performance in publicly owned provincial banks was substantially worse than in private banks, and the losses incurred imposed substantial fiscal costs on the provinces.

Politicians whose provinces were in dire fiscal straits, their banks losing money at a fast rate, were most willing to seize opportunities to privatize, even though overstuffed provincial banks were harder to privatize. Deposit loss and liquidity problems associated with the Tequila crisis made privatization more likely.

The right political situation is necessary but not sufficient to ensure good privatizations. First, one must find a buyer, and Argentina's provincial banks were the least attractive in the banking sector. So the provinces settled for purchasers that were not first-tier banks. Many of them were small wholesale banks that had to make the difficult transition to retail banking.

Three important concessions were made to purchasers: contracts to provide post-privatization services to the

provinces, portfolio guarantees, and the assumption of only "good" assets. In return, provincial politicians were granted restrictions on branch closings and layoffs of bank employees.

Both types of accommodation were costly to the purchasers and the provinces. These transactions probably could not have been completed without long-term loans from the Fondo Fiduciario.

Were the Fondo Fiduciario loan funds put to good use? Did privatization leave provincial banking on a sounder footing?

Initial indications are that the situation has improved in most provinces. And the provinces experiencing post-privatization difficulties tend not to have participated fully in the Fondo Fiduciario privatization program.

But the privatized banks rely on their service contracts with provinces to generate a big share of their income and are having trouble making the transition to commercial banking. It is uncertain whether the newly created banks are sustainable. But at least a fiscal burden has been lifted from the provinces.

This paper — a product of Regulation and Competition Policy and Finance, Development Research Group — is part of a larger effort in the group to investigate the determinants of structural change in developing countries' banking sectors. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Paulina Sintim-Aboagye, room MC3-422, telephone 202-473-8526, fax 202-522-1155, Internet address psintimaboagye@worldbank.org. Policy Research Working Papers are also posted on the Web at <http://www.worldbank.org/html/dec/Publications/Workpapers/home.html>. The authors may be contacted at gclarke@worldbank.org or rcull@worldbank.org. August 1999. (30 pages)

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PROVINCIAL BANK PRIVATIZATION IN ARGENTINA:

THE WHY, THE HOW, AND THE SO WHAT.

By

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1. INTRODUCTION

Argentina's provinces offer a unique opportunity to study bank privatization because of the large number of transactions that took place in a relatively short period (1994-98). At the beginning of the decade, all Argentine provinces owned at least one bank.¹ The performance of these publicly owned provincial banks were substantially worse than that of private banks, and the losses they incurred imposed substantial fiscal costs upon the provinces (Clarke and Cull, 1999). Beginning in 1991, when the provincial government of Corrientes passed a law authorizing the privatization of *Banco de Corrientes*, provincial governments started to consider privatizing the public banks. The trickle of provincial bank privatizations became a flood after the "Tequila Crisis" of December 1994. Of twenty-six provincial banks, over two-thirds (eighteen) had been privatized by the end of 1998.

The number of bank privatizations provides as rich a data source for one country as can be found anywhere in the world, one that we have exploited in previous research. The earlier papers focused on the first question in the title of this paper – why the provinces privatized their public banks. Clarke and Cull (1999) look at this question normatively, assessing why a social welfare maximizing policymaker would want to privatize. It quantifies the potential fiscal benefits of privatization and compares them with the short-term losses realized at the time of privatization. In contrast, Clarke and Cull (1998) look at this question positively, trying to explain why policymakers in some provinces privatized and policymakers in others did not. Rather than viewing policymakers as social welfare maximizers, it econometrically analyses how different provincial and bank characteristics affected the political costs and benefits of privatization.

The main results from these earlier papers are summarized in Section 2. In that section, we briefly describe the technical process and the roles of the main players, summarize the fiscal effect of privatization, and discuss factors that seem to have influenced privatization decisions. The primary focus of this paper, however, is to address the other two questions: the 'how' and the 'so what'. In Section 3, we describe the terms of the privatization contracts and the division of assets into the privatized banks and the residual entities. This section draws upon both the contracts and interviews that we conducted with some owners to uncover their motivations for buying a provincial bank, their long-range strategies, and the most significant difficulties that they faced during the transition period. We then use characteristics of the provinces and the banks to explain differences in contract provisions.

Finally, in Section 4, we describe the gains and losses associated with privatization beyond the effect privatization had on the provincial governments' finances. Enough time has elapsed since privatization that we can begin to analyze post-privatization performance to identify the challenges faced by the new owners of the provincial banks. We complement this with an econometric analysis of the evolution of credit market in provinces that did, and did not, privatize. The section's recurring theme is that, while there have been post-privatization

¹ Twenty provinces owned only one bank and three owned two banks.

improvements in performance, sustainability remains uncertain. The small, low quality, publicly owned banks were unable to attract large, solvent buyers, and the baggage associated with the actual buyers made the post-privatization transition process more difficult in some cases. Coming on the heels of crisis, provincial bank privatization in Argentina was mainly about making the best of a bad situation.

2. WHY?

2.1 The method of privatization.

One of the reasons that provincial bank privatization in Argentina is interesting is the institutional innovation that allowed the provinces to meet the fiscal and political costs of privatization more easily. In all but one case, the purchaser of the privatized entity did not assume ownership of all pre-privatization assets and liabilities. Although the individual cases varied, the basic strategy was to first place attractive assets in the privatized entity and then to match those assets with liabilities, up to the point that the privatized entity's net worth met Argentina's prudential standards. The remaining assets and liabilities were then transferred into a residual entity.

Residual asset recovery would have been neither quick enough, nor on such advantageous terms to liquidators, that it would have covered most residual liabilities. Consequently, provinces needed some way to meet a substantial portion of their residual obligations immediately. To address this, the Argentinean Government, the Inter-American Development Bank and the World Bank developed the Fondo Fiduciario, a part of the federal government that extends loans to provinces that have privatized their provincial banks. The provinces could then use the loan proceeds to pay off the obligations of the residual entity. In this way, some short-term obligations are converted to longer terms. From a political perspective, financing obligations in this way was presumably beneficial, as the yearly loan payments due to the Fondo are less eye-catching than short-term obligation payments would have been.² The Fondo Fiduciario, therefore, enabled provincial governments to design privatization arrangements to mitigate political objections. This is important because governments can, and often do, design the privatization program to buy off important political opponents. Boyko, Shleifer, and Vishny (1993, 1995) argue, for example, that this was central to the design of Russian privatizations.

2.2 Fiscal Benefits of Privatization: Why it makes sense to privatize.³

One feature shared by the public provincial banks was their penchant for losing money. This provided the underlying fiscal rationale for privatization. Clarke and Cull (1999, Table 1) compare the costs of re-capitalizing a typical provincial bank, based on their average loss rates

² Of course, assuming the terms of the loans are reasonable, the refinancing should make little difference from an economic (*i.e.*, present value) perspective.

³ In this sub-section, we briefly summarize the results of Clarke and Cull (1999)

from 1991-96, with the short-term cost of privatization. In practice, the loss rates are likely to be understated. The poor performance of the provincial banks meant that they had good reason to be less than forthcoming when reporting loan quality to the Central Bank of Argentina. Indeed, just before privatization these banks were subjected to external audits that revealed that their portfolios were far weaker than had been previously reported. In any event, even based on the observed loss rate, we find that the present value of the future re-capitalization required by Argentinean law exceeded the maximum short-term costs associated with privatization. As will be described below in more detail, these short-term costs come from realizing and cleaning up the past losses of the provincial banks.

As noted in the previous subsection, most purchasers did not to assume all of the assets and liabilities of the provincial banks. Low quality assets and remaining liabilities went into a residual entity for collection by the province. Based upon the experience to date, we derive a predicted residual entity.⁴ The maximum short-term costs of privatization would be the residual liabilities. These may eventually be covered by recoveries of the residual entities' assets (and by the purchase price for the privatized banks). Clarke and Cull (1999), however, simply compare them with the discounted re-capitalization costs. Under discount rates of ten and fifteen percent, the residual liabilities do not exceed the discounted re-capitalization payments and in the ten-percent case, they are substantially smaller.⁵ In other words, even if the province receives nothing for the privatized entity and recovers no residual assets, it makes sense from a fiscal perspective to privatize to avoid the large future losses of the provincial bank. Although the fiscal benefit is not likely to be the only, let alone the most important, gain from privatization, these results suggest that the fiscal gain alone justifies privatization. In Section 4, we discuss the post-privatization performance gains and the effect that privatization had on the provincial banking sectors.

2.3 The Political Economy of Privatization: Why privatization occurred.⁶

Given the fiscal benefit of privatization and the improvements in bank performance summarized in Section 4.1, a natural question is why did some provinces not privatize at all and others take so long to do so? Clarke and Cull (1998) analyze this question, studying factors that affect the costs and benefits of privatization to self-interested provincial policymakers. Politicians might decide to privatize for several reasons. For example, Shleifer and Vishny (1994) suggest that privatization is more likely when conservative governments that benefit from low taxes win out over leftist governments that favor public employees (p. 1022). Opposition from labor might make privatization especially costly when the public enterprise is overstaffed or when policymakers rely upon union support. Another factor that might affect the privatization decision is external crises. By altering the costs and benefits of public ownership, crises might make it more difficult for policymakers to continue to subsidize loss-making state-owned

⁴ Residual liabilities are set equal to .698 of pre-privatization liabilities, the share of liabilities shifted to the residual entities in the privatizations to date (Table 3).

⁵ The losses were 383 million pesos for re-capitalization (10% discount rate) and 132 million for residual liabilities (Clarke and Cull, 1999, Table 1).

⁶ This section briefly summarizes the results of Clarke and Cull (1998).

enterprises (World Bank, 1995). Finally, political ideology or affiliation might also affect the decision to privatize.

Using a semi-parametric hazard model, Clarke and Cull (1998) investigate what drove the privatization decisions for the banks in this study. The analysis includes variables to proxy for the political affiliation of policymakers, the fiscal performance of the province, the size of the bank, bank performance and the extent of overstaffing. They find that poorly performing banks were far more likely to be privatized than better performing banks. A 1% decline in net worth (divided by total liabilities) increased the estimated privatization rate by nearly 5% and a 1% increase in the percent of 'normal' (i.e., not overdue) loans decreased the estimated rate of privatization by nearly 7%. Poor performance could affect the probability of privatization in several ways. First, poorly performing banks might put greater fiscal pressure on public finances, forcing policymakers to make tough decisions. Another possibility is that the social cost of not privatizing the public banks, in terms of greater likelihood of failure or a more inefficient allocation of credit, might be higher in those provinces with the worst performing banks. If policymakers are concerned about social welfare, this might encourage them to privatize.

After controlling for these measures of bank quality, Clarke and Cull (1998) find that overstaffed banks were far less likely to be privatized. This would be consistent with the hypotheses that opposition from labor was greatest in the most over-staffed banks. Clarke and Cull (1998) also find that provinces that faced higher provincial deficits were more likely to privatize their provincial banks. One plausible explanation for this is that exogenous fiscal crises make it more difficult to finance money-losing banks. However, they note that this result was not highly robust in different model specifications.

Finally, Clarke and Cull (1998) find that when the bank was large relative to the provincial banking sector, the province was less likely to privatize the provincial bank. Since the provincial banks often dominated the sector in their province, one plausible explanation is that politicians might be unwilling to turn the sector over to a private bank that might act non-competitively. In Section 4, however, we find that there is no evidence that privatized banks behave more non-competitively than the public provincial banks did. Another explanation, therefore, is that this variable simply represents the preferences of provincial policymakers or voters. Policymakers with a strong preference for public ownership might have been both less willing to privatize, and more willing to encourage the growth of public banks, than other policymakers were. Other variables, including demographic controls, variables indicating political affiliation of provincial policymakers and measures of transfers to the province from the national government were statistically insignificant or were not robust to small variations in model specification.

3. How?

3.1 Contract Terms

Because the negotiations were principally over the level of assets and liabilities that the purchaser would assume, the prices fetched in the completed privatizations were relatively low, compared to the face value of the assets transferred (See Table 6). Table 1, therefore, focuses on

the non-price features of the privatization agreements. In the Argentine context, two important ways opponents to bank privatization were bought off were through agreements to limit the number of layoffs or compensate laid-off workers and to maintain branches in certain cities.⁷ Based upon a review of the requirements imposed on the purchasers of the privatized banks, it appears that limits on branch closings and layoffs were the rule rather than the exception (Table 1). Of the sixteen contracts summarized, half had some restriction on the number of employees that could be dismissed and another purchaser agreed to implement a job re-training program. Three of the contracts stipulated that the private purchasers maintain the existing branch network and ten permitted the closure of branches but required that the purchaser maintain service provision in all locations served at the time of privatization. These contract features strongly suggest that the political buyoffs present in other privatizations were also evident in Argentina.

As noted above, the public provincial banks were chronic money losers frequently in need of re-capitalization. To pass a substantial share of their low-quality assets onto a private purchaser while, at the same time, imposing branching and labor restrictions on that purchaser would have been difficult, if not impossible, without concessions on other dimensions. The most attractive of these were service contracts to provide banking services to the provinces and guarantees as to the quality of the acquired assets. The service contracts, which, among other things, provide income to the private owners for coordinating the payments activities of the provincial government, varied in duration from five to twenty years. Ten of the sixteen agreements provided service contracts of at least ten years. In interviews, the new private owners confirmed that these contracts are of vital importance, as an abnormally high share of the privatized banks' income is generated from services (described in more detail in Section 4).

In many cases, however, the lure of the service contract appears to have been insufficient to entice a private bank to acquire assets of dubious quality. Rather than verify the quality of each individual asset, which proved time-intensive, many provinces took to guaranteeing a substantial share of the assets transferred to the privatized entity. In six cases, the province guaranteed assets up to either a fixed dollar (peso) limit or a certain share of the total assets acquired. In two other cases, private owners were able to substitute assets from the residual entity for privatized assets during some trial period; in another, the buyer could shift low-quality assets to the residual for a period. Finally, in two cases the guarantee was set as a fraction of the residual assets recovered. Presumably, since the owner of the privatized bank was also charged with managing the residual entity, the idea was to increase incentives to recover residual assets. Only four cases did not guarantee the privatized asset portfolio at all.

⁷ The issues discussed in this paragraph are analyzed in detail in Clarke and Cull (1998, 1999).

Table 1: Terms of the Provincial Bank Privatizations

Province (Bank)	Object of Sale	Branching	Employees	Duration of Banking Service Contracts	Portfolio Guarantees
Chaco (6/94)	60% Class A shares	Maintain service	Keep at least 715 workers	20 years	None
Entre Ríos (12/94)	60% Class A shares	Maintain service, closures require approval	Up to 700 (of 1500) early voluntary retirement	7 years	Up to \$26 million maximum
Formosa (9/95)	60% Class A shares	Maintain service	--	10 years	35% recovered residual assets
Misiones (12/95)	100% Class A shares	--	No dismissals in first six months; <30% of workforce after	5 years	Up to \$16 million maximum
Río Negro* (2/96)	Determined by bidders	--	--	10 years	Up to 80% of portfolio or \$50 million
Salta (3/96)	75% Class A shares	Maintain similar geog. Coverage	--	10 years	None
Tucumán (3/96)	75% Class A shares	Maintain service	Workforce <= 200 at transfer	10 years	Up to \$32 million
San Luis (5/96)	100% Class A,B shares	Maintain service	--	10 years	\$16 million deposit from province, up to 5 years
Santiago del Estero (7/96)	95% Class A, B shares	Maintain service	Job re-training program, >= 1 yr.	10 years	None
San Juan (7/96)	75% Class A shares	Maintain similar geog. Coverage	--	10 years	None
Mendoza (7/96)	90% Class A shares	Maintain all branches	Keep at least 600 workers	5 years	Can substitute p-tized assets for residual assets, up to \$20 million
Mendoza (Prev. Social) (7/96)	90% Class A shares	Maintain all branches	Keep at least 500 workers	5 years	Can substitute p-tized assets for residual assets, up to \$10 million
Municipal de Tucuman (10/97)	100% Class A,B shares	Maintain service	Keep at least 70 workers	10 years	Can shift some assets to the residual
Jujuy** (1/98)	80% of capital	Maintain all branches	Keep at least 170 workers	10 years	Fund created w/ 35% recovered residual assets
Santa Fe (5/98)	90% of class A shares	Maintain service in all branches or through paid representatives	Keep at least 1500 workers	5 years	Up to \$43 million guaranteed by a bond
Santa Cruz (6/98)	Not available	Not available	Not available	Not available	Not available

Source: Fondo Fiduciario para el Desarrollo Provincial

*Rio Negro – Portfolio guarantees and flexibility with respect to the object of sale were modifications to original pliego. Pliegos were initial announcements by the provinces of the proposed terms of sale. ** Jujuy – The original pliego was altered to allow for a higher share of capital to be transferred to the new owner, less stringent restrictions regarding firing, and slightly more generous guarantees.

Table 1 shows a number of dimensions over which provinces and potential buyers would negotiate. The single most important, however, was the amount of residual assets to be assumed

by the purchaser. Table 2 shows the size of the privatized and residual entities for the sixteen completed privatizations that relied on Fondo Fiduciario assistance.⁸ The most striking feature of the data is the size of the residual entities. In only four of fifteen cases for which data are available did the province manage to transfer more than half of the pre-privatization assets to the purchaser and one of these (Entre Ríos) is somewhat misleading. Both Entre Ríos and Chaco had nearly finalized their privatizations before the Fondo Fiduciario became operational. A desire to provide some fiscal relief to these early privatizers enabled them to enter the program after the fact. Because most details of these two privatizations had been worked out, however, neither transaction was typical of those that followed. In particular, Entre Ríos transferred all pre-privatization assets to the purchaser, and later used Fondo Fiduciario assistance to guarantee some of them.

Table 2: Sizes of Privatized and Residual Entities

Bank	Privatized Entity		Residual Entity		% Transferred to Private Owner		Residual	
	Assets (million pesos)	Liabilities (million pesos)	Assets (million pesos)	Liabilities (million pesos)	Assets (million pesos)	Liabilities (million pesos)	Asset recovery (mil)	As % of Assets
Chaco	42.9	34.5	245.3	233.1	15%	13%	0*	0%
Entre Ríos	425.5	414.5	0.0	0.0	100%	100%	--	--
Formosa	26.5	11.5	135.7	244.9	16%	4%	5.2*	4%
Misiones	67.2	57.8	133.9	340.8	33%	14%	6.1	5%
Río Negro	59.4	47.4	379.2	402.6	14%	11%	6.0	2%
Salta	42.9	41.0	70.0	68.4	38%	37%	17.6*	25%
Tucumán	66.9	56.9	261.7	262.9	20%	18%	5.3	2%
San Luis	38.6	38.6	29.7	81.8	56%	32%	1.7	6%
Sant. Estero	43.8	43.5	199.6	227.3	18%	16%	7.5	4%
San Juan	173.9	158.9	78.6	175.3	69%	48%	2.3	3%
Mendoza ^a	335.1	326.9	666.6	666.6	33%	33%	14.3	1%
Prev. Social	62.9	41.0	292.1	292.1	18%	12%	--	--
Mun. Tucumán	38.2	32.2	38.1	25.7	50%	56%	n.a.	n.a.
Jujuy	35.7	33.7	206.9	218.7	15%	13%	n.a.	n.a.
Santa Fe	--	--	--	--	--	--	--	--
Santa Cruz	157.9	142.9	37.7	126.9	81%	53%	n.a.	n.a.

Source: Fondo Fiduciario.

* Province also refinanced some (less than ten percent) of residual assets. Refinancings are not included in the recovery figures presented here.

Table 2 also summarizes the provinces' experience with residual asset recovery. So far, results have not been impressive. In most cases, provincial governments realized that they were ill equipped to handle the recovery effort, and they therefore created incentive contracts to encourage the purchasers of the privatized entities to try to recover these assets. The provinces granted the privatized entity a higher share of the face value of recovered assets for the items that were most difficult to recover (as indicated primarily by the length of time that the asset had been deemed non-performing). While the underlying intuition may have been sound, the figures

⁸ We refer to the cases listed in Table 2 as provincial bank privatizations throughout the paper. One of the sixteen, Municipal de Tucumán, is referred to as a municipal rather than a provincial bank in Argentina. Because municipal bank privatizations were also eligible for Fondo Fiduciario assistance, we include that case in our analysis. Data for another, the Santa Fe privatization, were not yet available as of our last visit to Buenos Aires (January 1999).

in Table 2 suggest that these relatively simple incentive contracts have failed to produce substantial asset recovery.

Mendoza's experience is instructive because the residual entity created from its two provincial banks (Banco de la Provincia de Mendoza and Banco de Prevision Social) is quite large and the recovery process has been rife with hiccups. The province has, so far, recovered only one percent of its residual assets, and the owners of the privatized entity (one private bank was created from the two provincial banks) are no longer involved in the process. Provincial policy makers decided that it would be best to acquire the services of private experts skilled in bank asset recovery. That would be difficult to do, however, without providing very detailed information on the assets to be recovered – information on the delinquency of credit re-payment did not adequately describe the prospects for asset recovery.

To improve the available information, the province has employed about one hundred people (many of them ex-employees of the provincial banks) to make a complete catalogue of the residual assets. The ultimate goal is a database that can be searched by credit (or by creditor), which provides complete information on any guarantees or collateral attached. Initial interest in the residual assets has been high, with over twenty companies reviewing the existing database. Mendoza intends to award the recovery contract to the company that displays the most technical expertise. A subset of those that have reviewed the database will pay a fee for the right to make a presentation that outlines their asset recovery capability. Determining which company is best suited to recover assets appears to be as much art as science. The only certainty is that the companies will *not* bid money for the right to recover assets. Further, those that are part of the cataloguing effort expressed an interest in being hired by whatever company is awarded the recovery contract. While it is true that these people know these assets very well, one worries about their incentives in awarding the contract. After investing so much time in assembling information, it would be unfortunate to award it based on non-economic criteria – especially when the province's fiscal health could be much improved if asset recovery goes well.

Table 3, which presents a consolidated balance sheet for the privatized and residual entities created to date, provides more detail on the "anatomy" of these transactions. On the assets side of the balance sheet, 92% of the available liquid assets (which excludes public bonds) were transferred to the privatized entity. Among the public bonds, 76% of those that were publicly quoted were transferred to the privatized entity. Only 17% of those that were not publicly quoted were transferred to privatized entities. These figures should not be surprising, since private purchasers had a strong preference for liquid, easily valued assets. In contrast, they assumed only about a third of the loans and the fixed assets of the provincial banks. Presumably, the private purchasers have been able to meet their geographic service requirements (Table 1) with far fewer fixed assets than those of the old public provincial banks, an indication that the public banks had inefficient branch networks. The figures also suggest that the provinces will face an uphill battle selling many illiquid fixed assets and recovering loans of dubious quality.

Table 3: Creating Privatized and Residual Entities, Consolidated Balance Sheet for all Privatizations

Item	Privatized Entity (000s of Pesos)	Residual Entity (000s of Pesos)	% Transferred to Privatized Entity
Liquid Assets	221,241	18,353	92%
Public Bonds (Quoted) (Not Quoted)	191,301	274,398	41% (76%) (17%)
Loans (net of Provisions) (Private Sector) (Public Sector) (Financial Sector) (Interest Accrued) (Provisions)	751,548	1,864,093	29% (15%) (27%) (3%) (24%) (15%)
Credits from Fin. Intermed.	29,175	0	100%
Other Credits	23,918	0	100%
Fixed Assets	69,599	159,718	30%
Other Assets	271,266	458,517	37%
Total Assets	1,617,410	2,775,079	37%
Deposits (Private Sector) (Public Sector) (Financial Sector)	1,052,616	974,121	52% (91%) (23%) (99%)
Oblig. From Fin. Intermed. (BCRA) (Banco de la Nación) (Accrued Interest)	328,465	1,851,804	15% (6%) (0%) (15%)
Other Liabilities	42,272	420,760	9%
Provisions	10,576	120,391	8%
Total Liabilities	1,481,291	3,367,076	31%

Source: Fondo Fiduciario

On the liabilities side, provinces transferred over ninety percent of their private deposits to the privatized entity. This probably reflects a desire to maintain the confidence of depositors. Indeed, all of the owners of the privatized entities chose to keep the name of the provincial bank that they acquired. In fact, in the case of Misiones and Rio Negro, the acquirer chose to merge with the privatized bank, under the name of the provincial bank.⁹ These owners must have recognized the value of the provincial bank's name in attracting, and holding onto, deposits. Having transferred most private deposits to the privatized entities, the residual entities were left with public sector deposits and obligations to BCRA and Banco de la Nación, the two banks that provided liquidity to faltering banks during the Tequila Crisis. Over ninety percent of the BCRA/Nación obligations and almost eighty percent of the public sector deposits of the provincial banks went into residual entities.

⁹ The merged bank in the Misiones case, Banco Macro-Misiones, retains the names of both the province and the acquirer.

Table 4 presents a summary of the funds received from the Fondo Fiduciario to facilitate the individual transactions, and the type of liabilities that were retired with those funds. One potential problem with the Fondo Fiduciario program was that maximum loan amounts were determined based on the assets of the provincial bank rather than on the quality of those assets. The eight provinces that received loans of \$78-80 million had pre-privatization assets ranging from \$314 to \$523 million and shares of non-performing credits ranging from fourteen to sixty percent. Within a given asset class, therefore, the assistance received by the weakest banks might have been inadequate.

Table 4: Liabilities Retired with Fondo Fiduciario Loans

<i>Privatization</i> <i>n</i>	Total Disbursement from Fondo Fiduciario (millions)	<i>Type of Liability Retired with Loan Proceeds</i>			
		<i>Debts to BCRA</i> (millions)	<i>Debts to BNA</i> (millions)	Compensation to Personnel (millions)	Other Debts (millions)
Chaco	78.0	78.0	0.0	0.0	0.0
Entre Ríos	78.0	45.3	0.0	9.9	22.8
Formosa	80.0	32.2	37.7	0.0	10.1
Misiones	78.0	20.2	47.6	0.0	10.2
Río Negro	80.0	32.2	11.5	3.9	26.7
Salta	50.0	16.7	9.5	9.2	14.7
Tucumán	80.0	53.6	18.1	7.7	0.7
San Luis	50.0	21.0	0.0	7.4	21.7
Sant. Estero	48.0	4.7	0.0	1.3	42.1
San Juan	78.0	43.7	34.3	0.0	0.0
Mendoza*	160.0	89.7	70.3	0.0	0.0
Prev. Social	100.0	79.3	20.7	0.0	0.0
Mun. Tucumán	25.0	0.8	8.1	3.4	12.8
Jujuy	50.0	21.7	7.1	19.2	2.0
Santa Fe	160.0	19.8	0.0	16.1	124.1
Santa Cruz	80.0	0.0	0.0	0.0	80.0
Mun. Parana	20.0	15.9	0.8	2.6	0.8
Catamarca	15.0	0.0	0.0	0.0	15.0
Total	1310.0	574.8	265.7	80.7	389.3
% of Total		44%	20%	6%	30%

Table 3 indicates that residual obligations to financial intermediaries (most to BCRA and Banco de la Nación) totaled \$1.85 billion while Table 4 indicates that total Fondo Fiduciario disbursements were \$1.31 billion (\$841 million going to BCRA and Nación). This suggests that, despite the limits, provinces were able to retire a large share of these obligations with Fondo Fiduciario assistance. Further, they were able to transfer nearly all private-sector deposits to the privatized entity. This allowed them to do away with about sixty percent of the pre-privatization liabilities that they faced through the two methods (i.e., Fondo Fiduciario loans or sale of the privatized entity). Finally, although the share of Fondo Fiduciario funds devoted to personnel compensation was small (six percent), these funds may have been crucial in designing politically feasible privatizations. The next subsection presents a slightly more formal attempt to understand the tradeoffs that provinces faced – especially between concessions to labor and the size of the residual entity – in privatizing their banks.

3.2 Effect of political variables on the privatization contracts.

Table 1 and Table 2 clearly show that contract provisions and the share of assets assumed by the privatized bank differed significantly between the cases. In this sub-section, we study

characteristics of the banks and provinces that affected the outcomes of the negotiations between the private buyers and the provincial governments. Ideally, we would be interested in factors that might affect either the preferences of policymakers or the attractiveness of the bank to potential buyers. Unfortunately, the small number of observations severely limits our ability to specify a complete model, test plausible variables and control for demographic factors that might affect contract provisions.

The contract provisions studied are restrictions on layoffs, the percent of privatized assets guaranteed by the province, the percent of public bank assets taken by the privatized bank rather than put into the residual entity, the price paid relative to size of the bank and the length of the service contract. We do not look at branching restrictions because there was not enough variation to estimate a model with this as the dependent variable.¹⁰ In general, we would expect policymakers to prefer fewer layoffs, smaller residual entities, smaller guarantees and a higher price. Although it is not immediately clear that politicians would prefer shorter to longer service contracts, as noted in the last section, the new owners tended to prefer longer contracts. Since we do not observe uniformly long contracts, this suggests policymakers preferred some limits. One plausible reason for this might be that policymakers might believe they could reduce the price of these services, in the future, through competitive bidding.

The independent variables include two variables that might proxy for policymaker's preferences and three variables that might affect how attractive buyers find affect the bank. The variables that proxy for the preferences of provincial policymakers are the political affiliation of the governor and a measure of the province's fiscal deficit. Although the preferences of other policymakers might also affect contract provisions, past work has suggested that the political affiliation of the governor appears to be a reasonable proxy for preferences regarding bank privatization in Argentina.¹¹

Here we find that provinces with governors who were members of the *Partido Justicialista* (PJ) tended to allow fewer layoffs, provide smaller guarantees, have relatively smaller residual entities and grant shorter service contracts (See Table 5). These results are somewhat surprising, since they do not indicate any tradeoff between different provisions. For example, we might expect parties that rely upon the support of labor to allow fewer layoffs, but assume larger residual entities or provide larger guarantees. Further, the coefficient on this variable is positive, but insignificant, in the price equation. One possible explanation for this result is that after controlling for bank performance, PJ governors appeared more willing to privatize their province's provincial banks. Since provinces tended to become more willing to privatize the bank as its performance deteriorated, it is possible that banks privatized in provinces with opposition governors were, on average, less attractive. If this poor performance is not captured by the performance measure included in the regression (i.e., net worth of the public provincial bank before privatization), the dummy for PJ governor might be proxying for

¹⁰ That is, if we estimate a simple probit model with a dummy variable indicating branching restriction, there are only two cases with no restrictions (see Table 1). A multivariate model would go far beyond the data constraints.

¹¹ Clarke and Cull (1998) find that this variable tends to be more highly significant in determining the likelihood of privatization than the political affiliation of the provincial legislature. Further, in practice, when a single opposition party had a majority in one, or both, chambers of the legislature, the governor belonged to that party.

performance. In other words, it may be best to think of the PJ variable as a control for bank quality, and focus on other explanatory variables to describe the tradeoffs that were made to facilitate these transactions.

The size of the province's fiscal deficit might also affect the preferences of policy makers. First, provinces with large fiscal deficits might put greater emphasis on the speed with which the transaction is completed (i.e., to quickly receive privatization proceeds and reduce the drain of supporting the public bank). If this were the case, they might not be willing to walk away from negotiations that are going poorly, or to take tough bargaining positions and risk the private partner walking away. Therefore, we might expect provinces with higher deficits to achieve generally worse outcomes than other provinces (i.e., more layoffs, more guarantees, and lower prices). In addition, the fiscal deficit might also affect how policymakers weight different provisions. For example, they might be more willing to trade off restrictions on layoffs and guarantee a greater part of the loan portfolio in return for a higher price. The results in Table 5 support this second hypothesis. In general, provinces with high deficits imposed fewer restrictions on layoffs and guaranteed more assets, but received a higher price (relative to the size of the bank before privatization).¹² Interestingly, they also tended to privatize a greater share of the public banks' assets (see Column 2), although this result is not highly significant. One possible reason for this might be that the Fondo Fiduciario loan often did not cover all the liabilities of the residual entity. Provinces with large deficits might have preferred to assume fewer liabilities (and poor quality assets), that would affect provincial finances in the near term, in return for more layoffs and higher guarantees.¹³

The analysis includes three variables to proxy for the attractiveness of the bank – the net worth (relative to liabilities) of the public provincial bank before privatization, the size of the public bank relative to the size of the provincial banking sector and a dummy for whether the contract was written before the Tequila crisis occurred. It seems reasonable that potential buyers would be more interested in a public bank, if they believe that the bank was already operating relatively efficiently. For example, stronger performance might suggest that the bank's staff or assets are better quality. Consequently, this measure should be negatively correlated with allowed layoffs, positively correlated with the size of privatized bank (i.e., negatively correlated with the size of the residual entity), negatively correlated with the percent of assets guaranteed by the province and positively correlated with the price. The correlation with the length of the service contract is less clear. Although provinces might have to sweeten the deal for poorly performing banks by providing longer service contracts, they might also be less wary about

¹² We measure price relative to pre-privatization assets because that measure is a better indicator of the eventual size of the privatized entity. The privatized banks have grown very quickly since privatization (see Section 4.1) and it seems likely that they will be similar in size to the public banks once they reach equilibrium. We are presuming, therefore, that buyers' bids primarily reflected the future value of conducting a banking business in the province (while retaining the name of the provincial bank, rather than as a new entrant).

¹³ Although guarantees have the potential to affect provincial finances, politicians with short time horizons might be less worried about the potential for future problems than about the immediate problems of large residual entities. In addition, disbursement of Fondo Fiduciario funds was tied to completing the privatization process. Those provinces most in fiscal need may have been less willing to go through a lengthy asset quality verification process with potential purchasers, and thus were more willing to use guarantees to speed the transaction along.

signing long contracts with better provincial banks.¹⁴ The results in Table 5, in general, are consistent with these hypotheses, although the coefficients are statistically insignificant in four of the five regressions.¹⁵

The second variable is the size of the public bank's loan portfolio relative to the size of the provincial banking sector. As noted in Section 4, many public provincial banks were quite large relative to the provincial banking sectors – typically accounting for between 40 and 70% of total lending in the province. If large provincial banks were able to exploit significant market power, then provinces privatizing large provincial banks might have believed that they would be able to extract monopoly rents through the bidding process. For example, prices might be higher or the provinces might be able to restrict layoffs more. The market power potentially exercised by the public provincial banks that we allude to is not the type that leads to restricted output (credit) and higher prices (interest rates). Indeed, the poor performance of the public banks suggests that they were not profit-maximizing in this sense. We mean, rather, their ability to drive private competitors from the market, perhaps through issuance of credit at subsidized interest rates. In places where they had done this effectively, the private owner of the provincial bank might have anticipated little competitive threat, at least in the near term. Because provinces would no longer be able to manipulate interest rates directly (or indirectly through regulation), they may have felt most justified in extracting rents from bidders when the provincial bank dominated the sector.

In practice, the reverse seems true – provinces with dominant public banks managed to impose fewer restrictions on layoffs and had to assume a greater share of the public bank's assets and liabilities. This suggests that buyers did not see size as a positive factor. Phrased another way, the dominance of the provincial bank signaled that it was located in an unattractive banking area rather than in an area ripe for extraction of large monopoly rents. The coefficient on the length of the service contract was also positive and significant. This is consistent with the previous two results – contract provisions were more generous when the bank was relatively large. However, the last result might also be because in provinces with large provincial banks, there simply might not have been much possible competition for the service contract. Consequently, the provinces would have been less able to rely upon other banks for these services and, therefore, might gain less from competitive bidding. The coefficients on the size of the public bank relative to the provincial banking sector were insignificant in the other two equations (price and percent of the portfolio that was guaranteed). In summary, the results in this section and Section 4 suggest that the public banks were not exploiting market power to preclude entry (or, at least, that the new private owners did not think that they could do so).

Finally, the regression also includes a dummy variable indicating whether the contract was written before, or after, the Tequila Crisis.¹⁶ One reason for including this variable is that

¹⁴ The implicit assumption is higher quality public banks are more likely to become high quality privatized banks.

¹⁵ Further, the coefficient on this variable has a statistically insignificant negative sign in the equation for minimum number of workers (i.e., fewer workers need to be retained in better banks).

¹⁶ The Tequila crisis began as an exchange rate crisis, following the devaluation in Mexico in December 1994. However, the loss of confidence also affected other Latin American countries, which led to shrinkage of Argentina's domestic economy and a run on many poorly performing domestic banks.

the early privatizations were started before the Fondo Fiduciario was operational. It is not immediately clear what effect the Fondo Fiduciario would have on contract provisions. For example, it might improve contract provisions (in the view of provincial policymakers) by reducing the pressure for quick privatizations, since the province would have to worry less about the bank deteriorating while it was waiting to be privatized. However, viewing the Fondo Fiduciario as a free lunch ignores the evolving bargaining situation between the provinces and the federal government. Since many poorly performing public provincial banks lost considerable deposits during the Tequila crisis and, therefore, required liquidity injections from federal sources, provincial politicians were in no position to request many favors. Their banks were adversely affecting the province's fiscal situation, they needed immediate relief, and they would have to accept the terms on which it was offered. Indeed, Fondo Fiduciario employees worked closely with provinces to draft the terms of sale and they determined the amounts to be disbursed to each province.¹⁷ In these ways, Fondo Fiduciario involvement might have actually increased pressure on the provinces to act more quickly.

Table 5: Effect of political variables on restrictions in contract

Estimation Method	(1) Tobit	(2) Tobit	(3) Tobit	(4) Least Squares	(5) Least Squares
Dependent Variable	Minimum percent of workers that new owners must keep	Percent of assets assumed by privatized bank	Percent of portfolio guaranteed by province*	Price over pre- privatization assets	Length of service contract
Number of Observations	15	14	14	15	15
Degrees of Freedom	10	9	9	10	10
Constant (t-stat)	0.512 (1.77)	0.238 (1.54)	0.650** (2.26)	0.040 (1.82)	7.994** (3.64)
Dummy indicating PJ Governor (t-stat)	1.308*** (3.35)	0.275** (2.32)	-0.720*** (-3.44)	-0.005 (-0.27)	-5.090** (-2.93)
Net worth of public provincial bank (as % of liabilities) (t-stat)	-0.910 (-1.03)	0.480 (1.05)	-2.557* (-1.96)	0.031 (0.46)	1.442 (0.21)
Lagged Provincial deficit (over revenues) (t-stat)	-8.037*** (-3.72)	0.553 (1.77)	1.458** (2.53)	0.125** (2.65)	1.605 (0.34)
Loans by public bank (as % of loans in province) (t-stat)	-1.965** (-2.71)	-0.619** (-2.28)	-0.484 (-0.85)	-0.024 (-0.65)	10.654** (2.91)
Dummy indicating before Tequila Crisis (t-stat)	2.132*** (3.99)	0.442** (2.96)	-0.285 (-1.37)	-0.025 (-1.22)	2.449 (1.20)
R ² (pseudo R ² for Tobit regressions)	1.12	2.59	0.69	0.51	0.67

Excludes guarantees as percent of recovered residual assets (See Table 1).

The crisis itself, and the resulting deposit loss, also must have made the provincial banks less attractive to potential purchasers. The results in Table 5 suggest that the strict provisions imposed by the Fondo Fiduciario or the diminished attractiveness of the provincial banks following the crisis (or both) affected contract terms. Most provisions were better, in the view of provincial policymakers, before the crisis – fewer layoffs were allowed and more assets were transferred to the privatized bank. These results are interesting when combined with the results from Clarke and Cull (1998) on the timing of privatization. Clarke and Cull (1998) found that the external shock of the Tequila crisis and poor bank performance increased the likelihood of privatization. Here we find that the Tequila crisis, poor performance, and involvement with the

¹⁷ The terms of sale and the disbursements were also subject to World Bank approval.

Fondo Fiduciario are correlated with worse contract provisions from the viewpoint of provincial policymakers. This suggests that if policymakers wait until an external crisis or poor performance forces the province to privatize, then the outcome will be worse from their perspective. They will be able to guarantee fewer jobs, will be left with larger residual entities, and will be forced to guarantee more of the privatized bank's assets. However, the post-privatization performance data in the next section also shows that the early privatizations were among the least successful. In the end, the best privatization outcomes may only come about when political decision-makers have fewer choices.¹⁸

4. SO WHAT?

4.1 Pre- and Post-Privatization Performance

The previous discussion makes it clear that the provincial banks were not particularly attractive acquisition targets – they had been losing money over an extended period and the quality of their assets was low. In addition, these banks were small and their asset portfolios were not well diversified (at least geographically). This is likely to have influenced who was willing to take these banks over. Table 6 indicates that the purchasers were not the best performing banks in Argentina. They were small – none had over \$1.2 billion, and most had less than \$500 million, of assets at the time of the acquisition, and none held more than one percent of total banking assets in Argentina.

If the strategy were to attract large, well-functioning banks to assume the provincial banks' assets and liabilities, it is clear that it failed. The return on assets (ROA) and return on equity (ROE) figures in Table 6 show that in all cases except Mendoza, Prevision Social, Jujuy, and Santa Cruz, the provincial banks were bought by banks with ROA and ROE below the sector average (and often well below). Further, the Jujuy and Santa Cruz cases are misleading because both were bought by former provincial banks (Jujuy by Banco Macro-Misiones and Santa Cruz by Banco San Juan). Due to the transfer of bad assets to the residual entity, these two newly privatized entities tended to enjoy great initial success and, therefore, their performance, at that time, probably did not reflect their (likely) long-term performance. Table 6 also shows that the transactions varied widely in the share of total capital transferred to private owners (50.4% to 100%), and in the share of capital held by the largest private owner (34.5% to 100%). These ownership stakes might have implications for the corporate governance of the privatized entities and, therefore, affect the performance of the privatized banks. Given the short post-privatization time-series available, however, the governance-performance links that we discuss below should be interpreted with caution.

¹⁸ A more charitable interpretation would be that, in cases where a politician already recognizes the benefits of privatization, a crisis might help her win support for that position.

Table 6: Characteristics of Purchasers of Privatized Entities

Privatization	Principal Buyer	Principal Buyer Capital Share (%)	Total Capital All Private Owners (%)	Price Paid (mill. pesos)	Characteristics of Principal Buyer on Date of Purchase*			
					Assets (million pesos)	Liabilities (million pesos)	Return on Assets	Return on Equity
Chaco (94)	Patricios	34.5%	69.8%	6.3	200.9	175.8	0.3%	2.5%
Entre Ríos (94)	Institucional	54.5%	82.0%	15.1	131.7	114.7	0.5%	4.1%
Formosa (95)	Patricios	48.0%	70.0%	9.3	383.9	332.2	0.0%	0.1%
Misiones (95)	Macro	92.5%	100.0%	9.1	310.0	249.5	-0.4%	-1.3%
Río Negro (96)	Mildesa	85.0%	85.0%	10.2	145.2	103.4	0.2%	0.9%
Salta (96)	Macro	88.0%	98.0%	7.9	254.0	193.7	0.4%	1.6%
Tucumán (96)	Comafi	75.0%	80.0%	10.3	281.7	247.9	0.2%	1.7%
San Luis (96)	Exprinter	100.0%	100.0%	12.4	398.0	368.4	-0.3%	-4.5%
Sant. Estero (96)	Florencia	71.3%	100.0%	6.7	551.6	464.2	-1.6%	-9.8%
San Juan (96)	Piano	18.8%	79.5%	11.5	134.2	113.7	0.3%	1.9%
Mendoza (96)	República	97.1%	50.4%	20.1	1163.6	1019.0	1.4%	11.4%
Prev. Social (96)	República	97.1%	50.4%	8.2	1163.6	1019.0	1.4%	11.4%
Mun Tucumán (97)	Comafi	100.0%	100.0%	6.0	220.9	182.5	-0.2%	-1.6%
Jujuy (98)	Macro	90.0%	100.0%	12.3	504.9	432.9	2.0%	12.2%
Santa Fe (98)	Gn Negocio	90.0%	100.0%	57.2	644.5	533.1	0.9%	9.9%
Santa Cruz (98)	San Juan	51.0%	56.0%	10.5	319.6	298.6	2.1%	55.2%
Banking Sector:								
1994					78132.5	65745.2	—	—
1995					93560.0	79447.8	-0.0%	-0.2%
1996					108342.0	93086.9	0.6%	4.4%
1997					131935.7	115895.6	0.7%	5.9%
1998**					157618.3	140978.8	0.7%	6.1%

* Figures are for last complete quarter before purchase of the provincial bank. Source: BCRA

** Figures through July, 1998.

Table 7, which presents comparisons between the buyers and the provincial banks that they eventually acquired, provides a more detailed description of the purchasers as of the first quarter of 1995. Chaco's privatization was complete by then and a residual entity had already been created. Therefore, the size comparison between the purchaser and the provincial bank is misleading. In the other cases, however, the purchasers tended to acquire banks that were larger than they were. Excluding Jujuy and Santa Cruz (which, again, were bought by ex-provincial banks) and Municipal de Tucumán (municipal banks tended to be much smaller than provincial banks), the purchaser held fewer assets than the provincial bank in eight of eleven cases.¹⁹ In some cases, the target's assets were more than 2.5 times larger than the size of the acquirer's assets. The purchase of a provincial bank, therefore, appears to have been an important growth opportunity for the acquirers.

One reason for comparing the acquiring banks with the pre-privatization provincial banks is that it seems likely that the privatized entities will end up about the same size as the public provincial banks were. Although the large share of assets and liabilities transferred to the residual entity meant that purchasers assumed much lower assets and liabilities than these figures indicate, the privatized banks have experienced rapid growth in assets (and liabilities) following privatization. The re-equilibration process suggests that the pre-privatization figures are,

¹⁹ We consider Mendoza and Prevision Social one case here because the two were merged before their purchase by Banco República. República's \$691 million in assets in first quarter, 1995 comprised less than half of the joint assets of Mendoza and Prevision Social at that time.

therefore, the more appropriate figures for comparison – private purchasers likely understood that the privatized entity would recover to a size close to that of the old provincial bank.

Table 7: Acquisition/Purchaser Comparisons, First Quarter, 1995

Bank P'tized (Buyer)	Basic Balance Sheet (millions pesos)				Performance			Portfolio Orientation				
	Ass	Liab	L'ns	Dep	Net Wth	% Bad lms	Inc serv as % total	% pers onal	% pren das	% pub sect	% mort gage	% fin cred
Chaco Patricio	87 320	76 276	35 236	33 164	13.8 16.0	0.0 11.6	49.7 50.6	4.1 26.6	3.0 6.2	4.4 0.0	3.6 12.0	32.8 12.6
Ent Rio Institut	314 123	303 105	391 101	143 78	3.6 16.7	58.9 9.8	30.7 23.2	3.9 18.4	1.9 18.9	27.0 0.0	2.3 11.5	13.4 1.9
Frmosa Patricio	346 276	287 276	222 236	134 164	20.4 16.0	42.7 11.6	47.5 50.6	8.3 26.6	0.0 6.2	13.4 0.0	0.0 12.0	15.0 12.6
Msiones Macro	523 190	495 130	323 131	152 31	5.7 46.4	13.7 13.4	17.9 4.4	6.4 1.7	4.6 38.8	39.2 0.0	3.2 5.4	17.4 22.7
Rio Neg Mildesa	381 145	341 104	374 74	118 50	11.8 39.3	60.4 1.1	21.4 7.6	2.4 0.0	5.4 1.5	8.7 6.4	3.7 0.1	11.6 17.8
Salta Macro	141 190	114 130	448 131	42 31	23.4 46.4	91.8 13.4	7.4 4.4	2.0 1.7	2.0 38.8	5.2 0.0	0.0 5.4	31.6 22.7
Tucman Comafi	444 248	331 212	196 36	140 32	34.2 16.7	53.1 11.9	16.8 4.9	3.8 0.0	3.5 0.0	7.4 9.9	11.2 6.9	45.4 69.9
Sn Luis Exprint.	102 186	93 156	71 37	82 46	9.3 19.1	22.0 19.9	19.9 2.6	6.2 0.3	0.3 0.0	1.6 0.0	0.3 75.0	2.7 53.3
St Estro Florenc.	77 81	76 67	269 66	54 22	1.0 21.7	94.1 12.3	43.8 16.3	1.0 2.0	0.0 13.9	3.8 0.1	0.0 6.5	3.2 6.2
Sn Juan Piano	335 113	366 95	291 60	246 53	-8.4 19.3	29.9 8.0	25.2 21.7	12.0 0.1	13.7 0.0	5.2 10.2	13.1 13.5	11.2 16.3
Mendoz Republ.	1106 691	952 592	997 255	471 49	16.2 16.7	58.0 5.1	11.9 2.9	9.1 0.0	1.1 0.1	12.2 9.7	0.1 6.5	12.8 39.3
Prv Soc Republ.	629 691	555 592	519 255	302 49	13.3 16.7	28.3 5.1	19.7 2.9	25.4 0.0	0.5 0.1	9.4 9.7	13.4 6.5	10.6 39.3
Mn Tuc Comafi	59 248	39 212	58 36	26 32	51.9 16.7	30.2 11.9	28.9 4.9	5.5 0.0	8.2 0.0	54.2 9.9	6.4 6.9	0.5 69.9
Jujuy Macro	145 190	126 129	128 131	95 31	14.9 46.4	53.0 13.4	29.5 4.4	7.9 1.7	0.8 38.8	11.8 0.0	0.7 5.4	2.9 22.7
Snta Fe GenNeg	846 431	688 395	688 186	614 150	23.0 9.1	56.0 9.7	31.0 23.6	6.3 0.5	1.5 0.0	0.1 0.0	0.2 18.6	0.6 33.7
St Cruz Sn Juan	335 366	327 366	233 291	227 246	11.9 -8.4	54.9 29.9	23.4 25.2	13.9 12.0	16.1 13.7	8.8 5.2	17.5 13.1	3.6 11.2
Avg PrvBnk Buyer	367 281	323 240	328 141	180 77	15.4 22.2	46.7 11.8	26.5 15.6	7.4 5.7	3.9 11.1	13.3 3.8	4.7 12.8	13.5 28.3

Targets enjoyed even larger advantages over acquirers for loans and deposits than for assets (or liabilities), which suggests that there were disparities between the two groups not only in terms of size but also with respect to business orientation. Additional support for that proposition is found in the portfolio orientation variables in Table 7. The provincial banks tended to lend a higher share of their funds to the public sector than did their acquirers. Acquirers, by contrast, lent higher shares to mortgages, “prendas” (mostly car loans), and to the financial sector. Neither group concentrated heavily on personal lending. The database used to construct the portfolio orientation figures in Table 7 identified only the five mentioned categories of credits. If we assume that the remainder went to businesses, provincial banks were much more involved in that type of lending than their acquirers were. Acquirers channeled 38.3% of their credit outside the five categories; provincial banks directed 57.2% of their credit outside the categories. Figures in Clarke and Cull (1999), which rely on a different, more dated database, indicate that those businesses that received funds from provincial banks tended to be located in primary production and, to a lesser extent, manufacturing.

Provincial banks offered their acquirers an opportunity to grow and to break into a new line of business. Many of these banks were so-called “mayoristas,” or wholesale banks. Interviews with directors of Macro (which acquired and later merged with Misiones) and Mildesa (which acquired and later merged with Rio Negro) indicated that the wholesale banking business was drying up as foreign entry increased competition. Many needed to break into retail banking to survive, and the provincial banks offered them a useful way of doing this. This does not imply that these banks were in hopeless situations. Although Table 6 indicated that their ROA and ROE figures tended to be below the prevailing sector average, their net worth tended to be higher and their percent of bad credit much lower than the provincial banks they acquired.²⁰ The transactions, therefore, clearly placed the former provincial banks in hands that are more capable. The figures in Table 7, however, indicate that the new owners had to adapt to an entirely new type of business and, as is reflected below, that adjustment was not always smooth.

One positive adjustment for the acquirers was the increase in income from services. Table 7 indicates that the provincial banks tended to generate a higher share of income from services (27%) than their acquirers did (16%). The privatized entities continued to generate a disproportionate share of income through services due, largely, to the service contracts with the provinces (see sub-sections 3.1 and 3.2). In fact, during the period just after privatization, most privatized banks received more than 40% of their income from services (Table 8). This, no doubt, reflects the initial dislocation associated with creating a commercially oriented lending business largely from scratch. Most privatized entities have experienced gradual declines in service income shares since their inception, although the levels remain above those of the old provincial banks. The service contracts remain key to the survival of the privatized entities, and their renewal represents an important concern for the new managers.

Aside from the decline in service income share, there have been other important developments for the privatized banks. For example, in the vast majority of cases the privatized

²⁰

B.C.R.A. classifies a loan into one of six categories. Under the present guidelines loans in the bottom three categories - those with problems and deficient coverage, those with high risk of borrower insolvency and recovery difficulty, and those deemed unrecoverable -- are considered non-performing (“bad credits”).

banks have experienced rapid growth in assets, liabilities, loans, and deposits. This growth was most pronounced for the earliest privatizers (cohorts one and two in Table 8). Average asset growth for the earliest (cohort one) privatizers was 32% per year, compared to an average rate of 19.2% for the whole banking sector. The second group (cohort two) has grown at an average annual rate of 38%, compared to 19% for the system.²¹ Although the late privatizers (cohort three) have grown more slowly, this is largely due to Mendoza and Prevision Social. These banks have been involved in lengthy disputes, between the province and the private buyer, leading to delays and adjustments in the residual and privatized portfolios. For three other banks in the third cohort, Tucumán, San Luis, and San Juan, assets have grown between 28-42% per year, well above the system's 21% growth rate. A fourth, Santiago del Estero, has experienced above average growth in loans but not in assets, liabilities, or deposits.

In general, across cohorts, liabilities have grown at rates similar to assets, and deposits and loans have grown more rapidly. There was, therefore, a clear pattern of rapid growth as privatized banks regained their "natural" size. In contrast, with exception of its first year, Entre Rios, which did not create a residual entity, experienced growth rates below the contemporaneous system average. Managers of some of the privatized entities indicated that they retained the name of the provincial bank expressly to attract deposits and experience the sort of recovery described here. Signs of growing pains were, however, evident. As the equity and asset base of the new banks increased, their ROA and ROE figures tended to decline. One could argue that these were initially abnormally high due to the heavy reliance on service income and their low levels of assets and equity. Although the time-series in Table 8 is too short to yield firm conclusions, as these banks begin to generate a higher share of income from lending, it is hoped that their ROA and ROE figures will stabilize.

In most cases, net worth and portfolio quality have not deteriorated substantially since privatization. The exceptions are again instructive. Entre Rios, which failed to create a residual, started with a relatively high percentage of bad credits that it has been unable to reduce. Chaco, which also entered the Fondo Fiduciario program through the "back door" started out with no bad credits, only to see the figure jump to 22% a year later. The figure grew to 24% in the next year, which suggests that purchasers and the province did not create an ideal privatized entity. Although the "percent bad" figure later declined, the 1998 failure of its major shareholder, Patricios, and recent reports from the Central Bank that Chaco is facing potential intervention, suggest that this privatization is different from the others. Unfortunately, Patricios was the major shareholder in Formosa also, although its (Formosa's) performance statistics are not (currently) as dire as those of Chaco. One feature that characterized the Formosa and Chaco privatizations, and the Mendoza-Prevision Social transfer, was the relatively low share of capital transferred to the principal shareholders. In all four cases, moreover, the province remained an important shareholder. At the risk of reading too much into that contract feature, it may have caused serious governance problems that are now being reflected in performance.

²¹ The disparities in reported growth rates for the entire banking system are due to the slightly different periods over which each of the three cohorts have operated as private banks.

Table 8: Post Privatization Performance

Bank P'tized (Buyer)	Basic Balance Sheet (millions pesos)				Performance					Portfolio Orientation				
	Ass	Liab	L'ns	Dep	Net Wth	% Bad l'ns	roa	roe	% inc serv	% pers onal	% pren das	% pub sect	% mort gage	% fin cred
Chaco1	87	76	35	33	13.7	0.0	1.1	8.9	49.7	4.1	0.3	0.4	0.4	32.8
Chaco2	140	160	53	85	-12.4	22.1	0.4	--	38.5	7.3	0.3	0.4	0.2	34.4
Chaco3	196	181	80	129	8.6	24.0	0.7	8.2	45.5	8.0	0.1	0.8	0.1	19.6
Chaco4	298	278	156	211	7.2	7.0	0.3	3.8	32.5	8.7	4.6	4.7	0.3	19.3
EntRio1	520	482	432	288	7.8	32.8	0.5	6.3	20.5	14.1	9.1	22.1	6.2	6.5
EntRio2	656	610	450	500	7.5	26.4	0.4	5.5	25.5	10.1	8.7	22.8	10.4	3.3
EntRio3	744	687	500	583	8.2	23.3	0.3	4.6	27.3	12.9	7.3	20.0	9.8	8.0
EntRio4	750	691	406	567	8.4	27.9	0.2	2.7	31.8	14.8	8.5	16.4	12.4	8.1
%chng Cohort1	32	36	32	60										
Frmos1	100	126	17	98	-20.8	0.0	-2.7	--	16.9	15.1	0	0.0	0.0	25.5
Frmos2	141	124	71	99	13.9	2.5	0.5	3.8	9.1	18.8	0	0.2	0.0	18.2
Frmos3	133	113	49	77	17.8	6.9	0.5	3.5	46.0	45.6	3.0	0.0	9.1	26.3
Mision1	125	112	65	81	11.8	170	1.7	16.6	58.8	15.1	1.7	53.5	2.9	19.5
Mision2	170	151	112	126	12.3	71.2	1.4	13.0	53.9	19.9	0.9	18.7	2.4	10.2
Mision3	*580	*507	*442	*359	14.5	34.7	0.6	4.9	26.5	8.1	21.9	5.3	2.0	6.0
RioNg1	159	147	83	71	8.2	27.4	0.0	-0.1	51.3	0.8	2.7	9.1	12.1	21.7
RioNg2	*366	*321	*234	*205	14.1	8.9	0.0	-0.3	42.0	1.0	0.0	4.9	0.0	15.1
RioNg3	*422	*373	*266	*244	13.0	4.5	0.3	2.2	37.7	2.1	0.1	7.1	5.5	15.1
Salta1	140	132	49	85	6.0	0.1	1.0	17.8	71.1	4.3	0.0	0.0	0.0	28.1
Salta2	277	261	189	215	6.3	0.1	1.5	25.4	40.3	5.7	0.9	0.1	0.4	10.8
Salta3	328	304	213	253	8.1	0.5	0.6	7.4	46.1	9.3	0.8	0.2	1.1	10.8
%chng cohort2	38	28	131	41										
Tucmn1	120	108	54	80	11.3	0.6	1.2	11.8	60.5	0.1	0.0	60.0	0.0	20.5
Tucmn2	154	139	90	112	10.7	0.6	1.3	13.3	50.2	11.4	0.0	33.5	0.0	15.0
SnLuis1	72	125	90	97	-42.0	71.6	-0.3	--	42.7	4.6	0.1	20.1	0.4	3.3
SnLuis2	102	96	59	75	5.8	46.2	-0.1	-2.5	41.8	23.1	0.0	0.0	0.5	23.4
SntEst1	272	263	39	107	3.4	2.7	0.5	16.7	47.8	2.7	0.0	61.9	0.0	51.7
SntEst2	236	225	59	127	4.9	8.5	0.0	-0.1	47.4	16.8	0.0	37.9	0.0	32.2
Mendz1	465	429	36	322	8.4	23.6	-1.4	-17.5	53.8	14.3	0.4	1.2	5.1	32.1
Mendz2	440	422	34	337	4.1	27.0	-1.0	-24.2	40.8	21.1	0.0	0.8	0.0	31.6
PrvSoc1	374	334	50	233	11.7	21.7	-0.4	-4.1	32.4	18.7	0.2	2.9	18.1	22.6
PrvSoc2	368	318	47	244	15.7	22.5	-0.3	-2.4	25.6	18.6	0.1	0.9	0.0	22.5
SnJuan1	231	215	48	152	7.5	1.9	0.1	2.0	42.3	13.7	10.8	7.8	9.0	21.4
SnJuan2	296	274	40	195	7.8	3.6	0.5	6.6	34.9	39.7	7.6	17.6	10.5	21.4
%chng Cohort3	13	2	9	12										

* Acquirer merged with privatized entity. Figures are for the merged bank. These observations are excluded from the reported growth rates in assets, liabilities, loans, and deposits.

Among the remaining cases, however, things are more encouraging. In those cases where initial levels of bad credit levels were relatively high, there has been substantial post-privatization decline (Misiones, Rio Negro, and San Luis). In those cases where the privatized entity started with close to no bad credit, the figure has increased slightly, but not dramatically, and the ratio of net worth to total liabilities has typically improved. The slight increase in bad credit likely reflects the difficulties associated with forging a lending business. The transition from a typical provincial bank portfolio has followed a predictable pattern – in most cases, there was a substantial reduction in credit to the financial and public sectors. The largest growth category has been personal lending. Interviews with owners of the privatized banks indicate that this lending is less risky than other types, because as bankers to the province, they assumed many payments systems responsibilities, including payments to public employees. Payments for many types of personal loans are automatically deducted from the accounts of the public employees. Growth in other, less secure, types of lending is much slower. Owners indicated that it requires time to build up a solid lending clientele among businesses, especially since many of the new owners have little experience in this area. The long-term sustainability of the new banks likely depends heavily on the success of the transition, especially if the service contracts are not renewed.

4.2 Effect of Privatization on Provincial Banking Sector.

As noted in the previous section, relative to the national banking sector, most public provincial banks were small. In the first quarter of 1995, most accounted for less than 1% of national lending (see Table 9), and only *Banco de la Provincia de Buenos Aires* accounted for more than 5%. However, relative to the provincial banking sectors, they were often very large. In early 1995, many accounted for over half of provincial lending and nearly all accounted for over one quarter of lending.²² The size of the public provincial banks, relative to the size of provincial credit markets, suggests that they might have had some degree of market power. If the privatized banks become similar in size, but behave differently, this might affect market development. For example, if private banks maximize profit, while public banks maximize some broader measure of welfare, private banks might be more willing to use market power in non-competitive ways (i.e., to deter entry, or promote exit, by other banks).

In general, it will be difficult to predict the effect of privatization on the rest of the sector, unless it is clear what public managers were trying to maximize. As noted earlier, the poor performance of the public provincial banks before privatization suggests that they were not (successfully) maximizing profit.²³ However, the large losses and poor quality of their loan portfolios could be consistent with several different hypotheses. One possibility is that this size is the direct result of easy access to cheap funds, either directly from the public sector or, indirectly, through access to cheap deposits. Knowing that the provinces bore ultimate bailout responsibilities, depositors might have been willing to accept lower interest rates than they otherwise would have, allowing politicians to use these low-cost funds to reward supporters with

²² Data on bank lending by type of bank is not available at the provincial level before 1995.

²³ See Clarke and Cull (1999) for a more detailed discussion of the performance of the public provincial banks.

credit at preferential rates.²⁴ This would have made entry into provincial markets difficult for private banks. If the privatized banks do not have access to these cheap deposits, then privatization might result in growth among other private sector banks in competition with the privatized banks.

Table 9: Loans by public provincial banks in provinces where privatization was not complete.*

	% of Loans in Province	% of Loans in Nation
Formosa**	69.65%	0.47%
La Pampa	66.66%	0.59%
Santiago del Estero**	65.08%	0.46%
Santa Cruz**	56.05%	0.30%
Tierra de Fuego	55.23%	0.26%
Misiones**	52.57%	0.46%
San Juan**	49.89%	0.45%
Salta**	48.29%	0.71%
Mendoza**	45.76%	1.93%
Jujuy**	45.67%	0.19%
Cordoba	45.44%	3.47%
Catamarca	44.37%	0.13%
Rio Negro**	44.13%	0.57%
San Luis**	31.32%	0.11%
Neuquen	27.98%	0.32%
Chubut	23.37%	0.17%
Tucuman**	18.40%	0.28%
Santa Fe**	16.18%	0.98%
Buenos Aires (including federal capital district)	14.64%	9.74%

Source: Central Bank of Argentina

* Data is for first quarter of 1995. ** Privatized by the end of 1998.

However, the public provincial banks might be large for other reasons, and these could have implications for post-privatization development. For example, if these banks were actually resolving market failures in provincial credit markets, then privatizing them might mean a reduction in total provincial credit. Consequently, the main long-run effect of privatization might be to substitute a private bank with significant market power for a public bank that resolved market failures (and thus extended more credit than a private bank would have). In that case, privatization might have an ambiguous, or even negative, effect on the growth and performance of the sector.²⁵ In this section of the paper, we investigate the effect of privatization on the growth and development of the provincial banking sectors to get some preliminary answers to these questions.

²⁴ These guarantees were especially valuable because, before May 1995, there was no deposit insurance in Argentina. In several cases, depositors bore significant losses during bank failures.

²⁵ Even if we assume that the public provincial bank was large simply because it was transferring rents to supporters of provincial politicians, or merely because it was maximizing size or market share, the substitution might result in total credit reduction.

4.2.1 Correlation of Provincial Bank Size with Sector Performance.

Given their dominance of the provincial banking sectors, it is not surprising that the size of the provincial banks is highly correlated with sector concentration. The correlation between the Herfindahl index, a measure of concentration, and the size of public banks is about 0.9 (see Table 10). The correlation between the percentage of 'normal' loans for the entire provincial banking sector (i.e., loans whose payments are not overdue) and provincial bank size is negative (although statistically insignificant). This suggests that the average quality of the lending portfolio of all banks in the province is worse in those provinces with large provincial banks. However, this seems to be simply because of the poor performance of the dominant public provincial banks. Consistent with this interpretation, the presence of public banks does not seem to have a large effect on the portfolio quality of private banks in the province. The correlation between private portfolio quality and provincial bank size is almost zero.

Table 10: Correlation between size of public banks and the development of banking sector in Q1 1995*

	Loans by Provincial Banks (% of total)	Herfindahl's Index	'Normal' Loans (% of total)	'Normal' Loans for private banks (% of total)	Loans (per capita)	'Normal' Loans (per capita)
Provincial Banks' Loans (% of total)	1.0000					
Herfindahl's Index	0.8998** (0.00)	1.0000				
'Normal' Loans for whole sector (% of total loans)	-0.3187 (0.18)	-0.2185 (0.37)	1.0000			
'Normal' Loans for private banks (% of total private loans)	0.0363 (0.88)	0.0470 (0.85)	0.3605 (0.13)	1.0000		
Loans for whole sector (per capita)	-0.0239 (0.92)	-0.0905 (0.71)	0.3333 (0.16)	0.0388 (0.87)	1.0000	
'Normal' Loans for whole sector (per capita)	-0.5728** (0.01)	-0.6384** (0.00)	0.3061 (0.20)	0.1661 (0.50)	0.6568** (0.00)	1.0000

* For provinces that had not privatized their public provincial banks by the first quarter of 1995.

The size of the public bank is also not highly correlated with total lending in the province. If large provincial banks successfully used market power to keep private banks out, then its size might be negatively correlated with total per capita lending. Similarly, if public banks successfully solved market failures at the provincial level (or shamelessly pumped credit to supporters), then the correlation might be positive. In practice, it is almost zero. However, provincial bank size is negatively correlated with 'normal' loans (per capita). These results suggest that, although public provincial banks had little effect on total lending, they tended to misallocate credit more frequently than private banks. Consequently, their presence might have had little effect on total sector size, but a greater effect on sector efficiency.

4.2.2 Effect of Privatization on Provincial Banking Sector Growth.

The only province-by-province bank-level data available relates to the size (and quality) of lending portfolios from between the first quarter of 1995 and the second quarter of 1997. In this section, we look at growth of lending for the provincial bank, private banks (first excluding

then including the privatized bank) and the entire sector.²⁶ Table 11 shows the results from a simple regression of the growth rates on a dummy variable indicating the quarter when privatization took place and a dummy variable indicating that the provincial bank has been privatized (i.e., equal to one for the entire post-privatization period in a province). Using the growth rate is equivalent to eliminating fixed effects from a regression that had the natural log of assets as the dependent variable.

Table 11: Effect of privatization on growth rate of bank sector assets (OLS Regressions)

Dependent Variable	(1) Growth rate of Provincial Bank Loans	(2) Growth Rate of Loans by Private Banks (excluding privatized provincial banks)	(3) Growth Rate of Loans by Private Banks (including privatized provincial banks)	(4) Growth Rate of Bank Loans
Number of Observations	207	207	207	207
Degrees of Freedom	196	196	196	196
Time Dummies	Included	Included	Included	Included
Province Dummies	Excluded	Excluded	Excluded	Excluded
Dummy Variable indicating year of privatization ('shift dummy')	-1.5407** (-7.50)	0.0358 (1.01)	0.3902** (7.05)	-0.3407** (-7.16)
Dummy variable indicating provincial bank has been privatized. (trend dummy')	0.1868** (2.14)	-0.0396** (-2.62)	0.0111 (0.47)	0.0218 (1.08)
R-Squared	0.269	0.216	0.331	0.249

The first dummy variable can be interpreted as a shift in portfolio size at the time of privatization. It is important to include this in the regression because privatization directly affected the size of the provincial bank, the size of the private banking sector (including the provincial bank) and the size of the total banking sector. As discussed in previous sections, many non-performing loans (and some 'performing' loans of dubious value) were transferred from the public bank to a residual entity at the time of privatization. Since the transferred loans are no longer included in banking sector loans, this results in a one-time (negative) shift in provincial (and total) bank loans at the time of privatization. At the same time, privatization leads to a one-time increase in private sector loans (including loans by the privatized bank), because provincial bank loans that are transferred to the privatized bank are reclassified as loans by a private bank. The second dummy variable allows lending growth to be different before and after the privatization. Time dummies are included in all regressions to account for events (most importantly the Tequila crisis) that affected the entire banking sector. As noted below, these dummies are statistically significant in many of the regressions.

Column (1) of Table 11 shows a regression of the growth rate of provincial bank assets on the two dummies. The dependent variable is the growth rate of the loans of the provincial bank under public and private ownership (i.e., it is the growth rate of the public provincial bank's loans before privatization and the growth rate of the privatized bank's loans after privatization). The statistically significant coefficient on the shift dummy indicates that the provincial banks

²⁶ Although three provinces had more than one bank, either both banks were privatized at the same time or neither was privatized at all. In two cases, Santa Fe and Mendoza, neither bank was privatized during the sample period and in the other case, Mendoza, both were privatized at the end of 1996. Subsequently, in mid-1998, outside of the sample period, one of the two banks was privatized in Santa Fe.

lost assets at the time of privatization. This is because, as noted above, most non-performing loans were transferred to the residual entities. Consequently, the privatized bank had a substantially smaller loan portfolio than the provincial bank had had. The coefficient on the second dummy (the 'trend' dummy) is statistically significant and positive, indicating that, on average, the provincial banks' lending portfolios grew more quickly after privatization. Based upon the two coefficients, it would take the privatized banks approximately two years to reach the pre-privatization portfolio size. Unfortunately, this makes it difficult to assess whether the privatized banks will dominate the provincial sectors in the same way that the public banks did. Since most privatizations were completed in 1996, the data used in this section, which ends in mid-1997, does not allow us to see whether the banks' portfolios stop growing before, or after, they regain their former relative size. It would be interesting to know, because it would help us assess whether privatization is likely to reduce sector concentration.

Column (2) shows results from a similar regression with the growth rate of the loans by private banks, **excluding** the privatized bank (i.e., total lending by private banks other than the privatized bank). The coefficient on the shift dummy is statistically insignificant, suggesting that privatization does not have an immediate effect on other private banks. The coefficient on the trend dummy, however, is statistically significant and negative. This suggests that other private banks grew **slower** after the privatization of the provincial bank than they did before. One plausible explanation is that the privatized bank competed more directly with other private banks than the public bank had. Column (3) shows a similar regression for the growth rate of loans by private banks, including the privatized provincial bank. In this regression, before privatization, the loans by the public provincial bank are not included in the dependent variable, while after privatization loans by the privatized bank are included. The coefficient on the shift variable is positive and statistically significant due to the one-time addition of the provincial bank's assets upon privatization. However, the coefficient on the trend variable is statistically insignificant (although positive). This suggests that the decreased growth of loans by other private banks, more or less, canceled out the increased growth by the privatized bank. Column (4) presents results for total loans from all (public and private) banks.²⁷ The coefficient on the shift variable is statistically significant and negative, due to transfer of assets from the provincial bank to the residual entity. The coefficient on the trend variable is statistically insignificant and positive; suggesting that growth of total sector lending did not increase to make up for the one-time loss due to the transfer of assets to the residual entity. The time dummies are statistically significant, at a five-percent level, in the regressions for growth of loans for private banks excluding the privatized bank and growth for private banks including the privatized banks.²⁸ Although the time dummies are jointly insignificant in the regressions for the growth rate of loans by provincial banks and by the entire sector, excluding them does not affect the size or significance of results.²⁹

²⁷ Public banks located outside a province (many of them federal public banks) often extended some credit within that province. Their contributions are the difference between the dependent variables in columns (3) and (4).

²⁸ The F (8, 196) statistic is 6.48 and 2.92 including and excluding the privatized bank respectively.

²⁹ We also tried several other model specifications and the results were broadly similar. Including province dummies, to proxy for omitted variables that are (more or less) constant over time, changes the results presented in Table 13 in two ways. First, the coefficient on the 'trend dummy' in the regression on total bank loans becomes positive and statistically significant – suggesting that total sector growth increased after privatization. In addition, the coefficients tend to become larger in absolute value.

In summary, although the provincial banks grew very quickly after privatization, making up for the transfer of assets to the residual entity, this growth appears to have been, at least partially, at the expense of other private banks. Other private banks, on average, appear to have grown more slowly after the privatization of the public provincial bank. Consequently, although the privatization resulted in a one-time increase in loans by private sector banks, the rate of growth of lending by private banks (including the privatized bank) was similar to the rate of growth before the privatization. Similarly, the one-time transfer of the poorly performing loans from the public provincial banks to the residual entity resulted in reduction in total loans. After this transfer, the total growth rate appears, on average, to be about the same before and after privatization.

4.2.3 Summary of post-privatization development of provincial banking sectors.

If the public provincial banks were either using market power, or their special relationship with the provincial government, to restrict lending by other banks, we might expect faster growth of lending following privatization. In fact, the privatization of the public provincial banks, on average, did not increase the growth rate of lending by private banks. As noted, the growth rate of lending by private banks other than the privatized bank actually seemed to slow following privatization. However, fast growth of lending by the provincial bank meant that total lending by private banks including the privatized bank, grew at similar rates before and after the privatization. Hence, the results in this section do not provide strong support for the hypothesis that public provincial banks restricted credit growth more than the privatized banks have, or for the reverse hypothesis that they have restricted it less. In summary, there is no evidence that the public provincial banks used market (or political) power to restrict sector lending more, or less, effectively than the privatized banks have. This is consistent with the observation, noted in Section 4 that buyers did not appear willing to pay a premium for larger public provincial banks. A locally dominant provincial bank appears to have provided no signal to private purchasers that they could expect the same dominance, or, at least, that such dominance was an economic advantage. In fact, the province ended up assuming larger residual entities and putting fewer restrictions on layoffs in those provinces where the public provincial bank was largest.

However, given the large size of the provincial banks (see Table 9), some evidence suggests that privatization improves overall sector efficiency and the overall allocation of credit. As shown in Table 10, although provinces with large provincial banks did not, on average, have lower per capita lending, they did have lower 'normal' per capita lending. The provincial banks appear to have had a significant, negative effect on credit allocation. Although, it is possible that poorly performing privatized banks will have the same distortionary effect, there are reasons to hope that they might not. First, in the previous section, it was noted that, in most cases, portfolio quality has not deteriorated substantially since privatization. Given the large improvements in portfolio quality due to the creation of the residual entity this is quite remarkable. Second, as shown in Table 7, the banks that became the largest shareholders in the privatized banks tended

Including lagged growth rates, using an estimation method suggested in Anderson and Hsiao (1981, 1982), does not effect the results shown in Table 11. The lagged variables and province dummies are statistically insignificant in all regressions.

to have higher quality portfolios (in terms of bad loans) and higher net worth than the public provincial banks. Third, privatized banks appear to have restructured more than non-privatized banks. Table 12 shows that, on average, public provincial banks reduced their workforces by about 5.5% between July 1995 and September 1998, compared to over 30% in privatized provincial banks. Finally, the slower growth of private banks other than the privatized bank in provinces where privatization occurred strongly suggests that the privatized banks are competing with existing private banks more effectively than the public banks were. This would be consistent with the hypothesis that their lending is now based on commercial, rather than political, criteria.

Despite these generally positive results, some qualifications are necessary. First, there has only been a short period since privatization – the province-by-province bank-level data, used in this section, was only available between the first quarter of 1995 and the second quarter of 1997. As more data becomes available, it will become easier to assess medium- and long-term results. In particular, we will get a clearer picture of how large, and dominant, the privatized provincial banks will become. Second, as noted in the previous section, the provinces' experiences with privatization have not been uniform. Although, on average, privatization appears to be improving bank performance, there are some exceptions. In the same way, although the average effect on sector efficiency might be positive, it is likely that there will be some exceptions.

Table 12: Lending to the public sector and change in employment for public and privatized provincial banks (Q3 1998)

	% Public (Q3 1998)	Change in Employment (July 1995- September 1998)
Public Provincial Banks	9.43%	-5.45%**
Privatized Provincial Banks +	5.82%	-30.80%**

** Test of null hypothesis that the two means are the same is rejected at a 5% level

+ Excludes Banco de Santa FE and Banco de Santa Cruz, because post-privatization data were not available.

5. CONCLUSION

This analysis highlights the difficulties inherent in bank privatization. Although the Argentine experience has generally been a positive one, there were many impediments to overcome. For example, provincial politicians whose banks were chronic loss makers may have understood well the fiscal rationale for privatization outlined in Section 2. Acting upon that understanding, however, required the right political opportunity. We hope that by formalizing the decision process in Argentina, we offer improved understanding of when those opportunities arise. In particular, politicians whose provinces were in dire fiscal situations and whose banks were losing money at the fastest rates were most willing (or able) to seize these opportunities. The opposition they faced also entered into the calculation – overstuffed provincial banks, for example, were generally harder to privatize. Finally, the deposit loss and the liquidity problems associated with the Tequila Crisis increased the likelihood of privatization, a formalization of the intuition that crisis offers opportunity.

The right political circumstances appear to be necessary but not sufficient to ensure good privatizations. Once politicians decide to privatize, they have to attract a buyer. This was no small feat as Argentina's provincial banks were among the least attractive in the banking sector.

Beggars rather than choosers, provinces settled for purchasers that were not first-tier banks. Many were relatively small wholesale banks whose transition to retail banking at the provincial level will likely be a difficult one. The difficulties provinces had in attracting a buyer were also reflected in the details of the privatization contracts. Contracts to provide post-privatization services to the province, portfolio guarantees, and assumption of only “good” assets were three important concessions to purchasers. In return, however, provincial politicians often received restrictions on bank employee layoffs and branch closings. Accommodations to both purchaser and province were often costly, and a strong case can be made that these transactions could not have been completed without the fiscal resources (long-term loans) provided by the Fondo Fiduciario.

The ultimate question is whether these funds were put to good use. Did these transactions leave provincial banking on more sound footing? Although the post-privatization period has been short, initial indications are that the situation has improved in most provinces. Moreover, the provinces with post-privatization difficulties have tended to be those that were not fully part of the Fondo Fiduciario privatization program. It is also clear, however, that the privatized banks rely on their service contracts with the provinces to generate a high share of their income, and that the transition to commercial lending is proving difficult. Although the sustainability of the newly created banks will be uncertain for some time to come, at the very least, these transactions have lifted a fiscal burden from the provinces.

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