# It Never Really Worked:
# Universal Banking in Germany and Japan

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# Remember the Model?

- Fifteen years ago, ‘patient capital’ with ‘long-time horizons’ was supposed to be a source of competitive advantage in Germany and Japan
- High savings rate with conservative households
- ‘Mixed Claims’ (equity and debt) improving corporate governance
- Interlocking boards going beyond this quarter’s liquidity problem for investment
- Universal banking creating diversification and competition
- Supervision centralized and streamlined

….*At least that was the theory*

# Connections, Connections,

- Instead, universal banking in Germany and Japan proved to be anti-competitive
  - Bank consolidation was abysmally slow in Japan, and has not happened yet in Germany
    - Only partly a question of public banks/Postal Savings
  - Mixed claims led to mutually entrenched management of banks and non-financial firms
    - Value destroying from the start (e.g., Weinstein and Yafeh (1995; 1998); Hoshi and Kashyap (2001))
  - Over-lending to uncompetitive small- and medium-enterprises/the Mittelstand seems to be inherent
    - The best firms go to capital markets, the worst firms get loans rolled over (e.g., Posen (2003); Shimizu (2000))
  - Insurance companies are treated as money pots

# Was connected lending inevitable for universal banking?

- The starting points were very different from each other and from the US in 1999
  - Long German tradition of universal banking
  - Japan starts postwar with US-style separations
  - Neither country had well-developed securities markets or risk-tolerance among investors
- Still, the gains for financial managers from pursuing the protected course far outweigh those from arms-length transactions
  - The issue is probably shrinking/replacing the banking system rather than allowing it to diversify (Posen (2001), unless the goal is to keep the banks afloat

# An Ugly Record on Supervision

- A great deal of faith is put into supervision, but it cannot escape its political imperatives
  - German Buba shadows supervisors, but will not be held accountable, and got trumped in 2003
  - Japanese FSA retains revolving door
  - Despite lack of regulatory competition, local bank-politician relationships are powerful
  - Desires for national champions have so far defeated any efforts at true internationalization
  - If judgment is involved, the incentives for forebearance are overwhelming; if rules are involved,why any better than the market? Premium on diminished transparency
  - Hidden reserves aren’t just for Fannie and Freddie

# Macroeconomic Implications are Procyclical not Stabilizing

- There is some cross-national evidence on average growth rates that says financial/banking system does not matter either way
  - Caprio, et al; Levine, et al; OECD (Leahy, et al)
- Time-series evidence on cyclical persistence and on volatility is more negative about performance
  - Financial accelerator effect deepens with shareholdings
  - Regulatory forebearance increases with central bank regulator and cyclical bank capital (Posen (1993))
  - Shock absorbtion impedes reallocation across sectors (Kuttner and Posen (2001), Caballero, Hoshi, and Kashyap (2003), Posen (2003)) and may amplify transmission of equity market shocks
- No evidence of greater macro stability payoff for universal banking), and some indications of deeper crises when they hit (Posen (2001))