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

• 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 absorption 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))