

A Strategy to Prevent Future Crises: Safely Shrink the Banking Sector

Adam S. Posen¹

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Satisfying some of our everyday needs involves a certain amount of risk. We have a large and daily demand for personal transportation, for example, and predominantly rely upon automobiles to satisfy that need. Our reliance on that particular technology results in numerous accidents and deaths. There is a long history of policymakers attempting to reduce the number of traffic fatalities in the U.S., without significantly curtailing the amount of transportation services provided. Essentially, there were two basic strategies undertaken: There was the strategy of building safer cars and there was the strategy of enforcing rules to improve driving behavior. These both are legitimate means to reduce fatalities, once one takes automobile usage as given. And so airbags and crumple zones have been introduced to make cars safer, and stricter enforcement of regulations against drunk driving and of those requiring seatbelt usage, and the like, have been undertaken to improve driving.

But there is a third strategy to reduce the number of fatalities which is to reduce the number of drivers. If you have fewer drivers, you have smaller accidents and fewer fatalities. This would involve decreasing the share of transportation demand being met by automobiles, and increasing the share met by alternative technology such as public

¹ Senior Fellow, Institute for International Economics, contact: aposen@iie.com. An earlier version was presented as the closing address at the Conference on "Financial Crises: Japan's Experience and Implications for Latin America and the Caribbean," IDB-JCIF Conference, June 11-12, 2001. I am grateful to Sukru Binay, Samantha Davis, Pietro Masci, Peter Sinclair, and two anonymous reviewers for helpful comments. ©Institute for International Economics, 2002

transportation. Clearly, such a policy decision would require support for development of substitute technologies, as well as provision of incentives for individuals to switch their mode of transport. It should not be lost, however, that the costs involved would be partially compensated for by the reduction in *ex post* resources allocated to the judgmental monitoring of driving behavior (i.e., traffic police) and to the clean up of damage from accidents (including health care costs). One need not ban autos, and the degree to which this strategy of accident reduction should be pursued might well depend upon the particular circumstances of the country involved. For example, the U.S., which relies excessively on the private auto and which has very large areas of roads making driving behavior difficult to monitor, the case for moving in this direction might make particular sense.

As with transportation, we have a large and daily demand for both corporate and household financial services, and we incur a certain amount of risk of financial crisis in meeting this demand. Like traffic fatalities, financial crises are bad, so the fewer, the better. When we examine the historical record of financial crises, it becomes clear that most severe of the financial crises are in large part banking crises. Yet, just as North Americans love depend upon their autos for transportation, in most countries (particularly developing countries) customers rely heavily on banks to provide financial services. Therefore, there is a long history of policymakers attempting to reduce financial fragility by improving bank safety. So as with traffic, governments can try to build a safer banking sector by installing deposit insurance and capital adequacy minimums, and so on. Governments can also try to enforce better banking practice through enhancing bank supervision standards and instilling appropriate market discipline.

I am going to suggest that there is a third strategy available to prevent future financial crises which has been underutilized to date: reducing the number of banks. If traditional deposit-taking, long-lending banks were to play a reduced role in the supply of financial services for most economies, and therefore the amount of damage bank failures could do was limited, both the incidence and severity of financial crises would be decreased. This would involve reducing the share of corporate financing and savings allocation being met by banks, and increasing the relative shares of those met by alternative financial technologies such as securities markets and mutual funds. For developing economies, which rely excessively on the banking sector, and for whom monitoring of the imperfect information in the sector is expensive and difficult, moving in this direction makes particular sense².

Of course, utilizing this third strategy of financial fragility reduction raises the two questions of what economies sacrifice when the number of banks is reduced, and how feasible or likely it is for governments to reduce the number of banks. I will argue on the first point that even developing economies do not give up all that much by reducing the number of banks, that many of the arguments for the distinctive benefits of bank-centered systems are refuted by the evidence, and that, due to technological progress, other financial services increasingly can replace banks for both borrowers and depositors. On the second point, I will suggest that the trends in corporate finance, global

² Reasoning by analogy can be controversial in economic discussion, even though (as Krugman and others remind us) all economic models are by their nature consciously chosen analogies. In this case, the analogy I draw between banks in financial services and autos in transportation is meant to highlight four commonalities between the two from a public policy perspective: 1) the relationship between changing technology and the relative substitutability of differing forms of financial/transportation service provision; 2) the dependence of the net public costs and benefits upon the initial relative reliance upon banks/autos; 3) the heavy requirements of *ex post* monitoring and costly clean-up distinctive to these technologies as opposed to the alternatives; and 4) the tight link between regulation and the level of demand for autos/banks. While meant to be thought-provoking, it is not mere provocation.

integration, and technology are so strongly against profitability from traditional banking, that the public policy issue is how to assure a sufficient number of safe exits of banking firms – feasibility of inducing exit is not a difficulty.

1. What Makes Banks Dangerous -

The first issue is: why? Why should we be shrinking the banking sector? There are two essential reasons we have banks. First, on the deposit-taking side, small depositors supposedly need these institutions in order to conduct their day-to-day transactions and to have a safe place to put their money. Second, on the lending side, as grows out of the work of Fama (1985) and Stiglitz (1993), banks are a response to imperfect information in financial markets. There are certain smaller businesses, or risky businesses, that cannot go directly to capital markets to get their financing, so they have to go to an intermediary. When they go to an intermediary, these businesses must put up some asset as collateral, because only then does the intermediary have the incentive to look through the imperfect information about the firm, make a judgment, and spend a lot of time monitoring the loan.

Neither side of that argument is as valid now as it used to be due to trends in information technology and financial sophistication, But even if these arguments held, it is still necessary to weigh them against the vulnerabilities and costs of banking. It is banks, more than any other actor in the financial system, that have a maturities mismatch. Any financial sector business can have a mismatch at some point, but banks inherently have liabilities of deposits to be repaid upon demand, and inherently have a large share of

assets in illiquid long-term loans³. Because banks in emerging markets tend to lend in nominal terms in domestic currency, and because during investment booms they borrow in foreign currency in international markets to meet the need for loanable funds, they tend to have currency as well as maturity mismatches⁴. Again, individual corporations can have currency mismatches as well, but the proclivity and the systemic implications are greater for banks. The safety net of deposit insurance, now nearly universal, makes these mismatches a public problem⁵. There is perverse incentive from the deposit insurance system when banks' capital dips too low: for bankers with weak balance sheets, once having lost as much shareholder capital as can be lost, there are still loanable funds to gamble with, because depositors do not withdraw their money.

Meanwhile, banks inherently have to deal with proprietary information. We hear a lot about transparency, but, as Fama (1985) observes, the reason you have banks is that they lend on the basis of information that cannot be easily or credibly traded, monitored, and/or disclosed. Without that proprietary information, there is no reason a borrower cannot take its business plan and instead go directly to financial markets. It is banks whose assets are not securitized, it is banks whose ultimate claim on borrowers is illiquid

³ This is not to say that all banks are equally caught by this mismatch, or even that in all cases such collateralized long-term lending makes up the majority of bank assets. The point, however, is that it is this mismatch which is the source of any putative special benefits from banks, as well as of their vulnerability. If a so-called bank is overwhelmingly investing in self-liquidating short-term loans, then that institution is not providing services with regards to imperfect information that cannot be met by other non-bank means.

⁴ The presumption is that developing economies have greater investment opportunities than their capital stock allows them to take advantage of, and those economies' access to capital markets tends to vary over time.

⁵ For documentation of the spread of deposit insurance and of the costs it tends to incur, see Demirguc-Kunt and Sobaci (2001) and the references therein, as well as Schmukler's contribution to this volume.

collateral (like real estate, which in a financial crisis normally becomes illiquid). So banks remain vulnerable in a way that very few other financial institutions do⁶.

This conforms with economists' good understanding of the contributing role of banking fragility to financial crises⁷. Combine imperfect information, regulatory forbearance, connected lending, illiquid collateral, untransparent accounting, deposit insurance not fully creditable, add a macroeconomic shock, and presto – a banking crisis. This is why regulators can call for research and monitoring programs meant to aid in crisis prediction⁸, and the result are systems which attempt to provide early warning.⁹ Yet, early warning does not seem to work well as a predictor, or, more importantly, as a spur to action even in the infrequent instance when the signs of oncoming financial crisis are obvious¹⁰. We have been aware of the dangerous aspects of banking systems for some time, both in principle and in specific instances, and we are constantly improving our forecasting, but as the Argentine and the Japanese experiences of recent years demonstrate, the core problem is not so much receiving adequate warning as acting on the warnings even when they are self-evident.

Thus, at issue is not whether there is time enough to react to financial crisis indicators, but instead, what banks and regulators systematically do in practice if they have too much time to react. The basic danger is that when an economy has undercapitalized regulated (deposit-protected) banks, they are subject to a moral hazard, which results in adverse selection in the financial markets. The resulting rolling over and

⁶ As World Bank (2001, p. 11) put it, “If finance is fragile, banking is its most fragile part.” See also the papers by Krivoy and by Sato in this volume for discussions of the difficulties of the supervising vulnerable banks.

⁷ For summaries of the current thinking, see Goldstein (1998) and Mishkin (1997).

⁸ See the papers by Okubo and Roberts for this conference.

⁹ See Goldstein, Kaminsky, and Reinhart (2001) for the best recent attempt at an early warning system.

¹⁰ Eichengreen (2002) gives a sympathetic but thorough critique of crisis prediction and prevention efforts.

accumulation of bad loans is an enormous drag on growth. Governments are then faced with the choice to either suffer the burden of recapitalizing the banks quickly at a large cost in terms of real output as well as political criticism (which was repeatedly the case in Latin America), or to spread out the costs over time by wasting a lot of capital, foregoing growth, and eventually paying a larger bill (which is a major part of the stagnation in Japan over the last ten years). And all of these serious costs are repeatedly incurred when it is already well known both that bank crises are costly and where they were in the process of occurring.

That leads to my second reason for leaning more on the strategy of shrinking the banking sector, and less on trying to supervise bank behavior: learning, unfortunately, does not seem to overcome the incentives underlying bank crises. Consider U.S.-Japan foreign economic relations, specifically financial relations, over the last 20 years.¹¹ What is very interesting is that, going through the history, the amount of transpacific and international exchange in the professional community of bank supervisors was already quite great by the late 1980s. Yet, we still had the U.S. Savings and Loan crisis, and prior to that we had the U.K. land bubble and crash, and immediately following that we had the Nordic banking crises, and then we have had the ongoing Japanese financial crisis. This lists *only* some of the instances in *only* wealthy countries, just to remind everyone this is a universal dynamic¹². So even with the best of intentions, real public oversight, state-of-the-art training and technology, and, assumedly, mostly non-corrupt civil servants, bank supervisors learning about financial fragility does not seem to prevent bad outcomes. The U.S. savings and loan crisis ended when there was a political demand

¹¹ Discussed in Posen (2002).

ex post; we are hoping at present (October 2002) that the Japanese banking will be ending now that there is a political demand ten years *ex post*; all this despite a flood of advice or warning to Tokyo from Washington, Basle, London, and elsewhere in the bank supervisory community by the early 1990s.

There are reasons why banks rollover bad loans and why bureaucrats engage in regulatory forbearance, and it is very difficult to get beyond those fundamental economic and political incentives¹³. One need not be an experienced political cynic, however, to model these processes. As so often in economic regulation, one is caught between the choice of either removing discretion totally (which seems self-defeating since the whole point of the bank supervisory exercise is the judgmental assessment of imperfect information), or leaving regulators the discretion to engage in regulatory forbearance (which is sometimes euphemized as “prompt corrective action”). And regulators have repeatedly show a proclivity to such forbearance, preferring not to interfere with banks, and in so doing avoiding making bad news public on their watch. The proclivity is particularly compelling if there is still hope that an increase in macroeconomic growth will bail the banks, and thus the regulators, out from making hard choices. Thus, there does not seem to be any easy consistent way to keep banks from falling into crisis if their capital is short once bad times start. We can make a useful attempt to box in bank lending behavior, but there does not seem to be any way to fundamentally remove this difficulty with bank regulators. So banks are inherently fragile, and their supervision is inherently inadequate, making dependence upon banks dangerous.

¹² Barth, Caprio, and Levine (2001) count over 130 countries that have had costly banking problems since 1980.

¹³ Friedman (2000) and Glauber (2000) explain how in the U.S. context these discretionary abuses were endemic, even though they still only lasted a few years in the S&L crisis compared to Japan.

2. The Increasing Substitutability For Banks -

Now, these vulnerabilities and their potential costs to the public could of course be outweighed if banks provided unique and special services. The question is, at the margin, or even pretty far away from the margin, do they still do that? Looking back, the first argument that is often made is that banks play a special role in development. Political scientists and development officials perhaps more than economists still find inspiration in Gerschenkron's (1967) historical argument about German industrial development relying on *Hausbanken* to create capital-intensive heavy industries such as machine tools, chemicals, and steel. Aoki and Patrick (1990) offer a more theoretically-grounded but ultimately similar argument for the Japanese main bank system's role in postwar Japanese economic growth. And the ill-timed World Bank (1996) report, *The East Asian Miracle*, suggested intertwined bank-industry-government relationships played a role in the Asian NIC's success. For political reasons, there are lobbying interest groups, not least in the U.S., that have picked up these arguments to back claims about small businesses being both critical to economic growth and critically dependent upon bank financing.

The reality is that most of these claims about a special role for banks and economic development do not hold up very well to econometric analysis. The bottom line from a long series of cross-national studies conducted by the World Bank, the OECD, and other institutions, is that while financial depth is positively correlated with (and probably contributes causally to) economic growth, it does not have to be banks to

provide those services¹⁴. In the cross-national evidence, what matters is the amount of credit being disbursed, the amount of private-sector investment, and the rates of return, not the institutional structure of financial firms per se. Also, at higher levels of income and development, there tends to be less relative reliance on banks, and given the persistence of underdevelopment, it is difficult to interpret this as evidence of banks being “appropriate” for less developed economies. Moreover, as is becoming clear after the Asian crisis, when you have banks, especially in developing societies, there is a tendency towards politicization of lending – either there is government pressure on the banks to make loans for specific purposes as a fiscal tool, which would be more difficult to do in a more arms-length marketized framework, or there are insiders’ clubs, industrial networks and other relationships, that are very hard for new firms to break into for funding.

There are now a number of economists who reconsidered Japan’s postwar economic history, and suggested Japan grew *despite* the main-bank relations in the postwar era, not because of them (David Weinstein and his co-authors made the taboo-breaking initial contributions)¹⁵. Takeo Hoshi and Anil Kashyap’s (2001) *Corporate Financing and Governance in Japan* develops very clearly with persuasive evidence the idea that the *Kereitsu*-type financing which scholars had made so much of in Japan was largely an artificial post-war construction that does not really reflect the mainstream of Japanese economic development. And in fact, in Utsumi’s opening chapter in this volume, he cites the example of Japanese banks in the early postwar era who had the

¹⁴ There is a vast literature on this topic, with much of the best work done by Gerald Caprio, Ross Levine, and their colleagues at the World Bank, though a number of economists have contributed. See World Bank (2001) and the references therein, as well as Levine (2001), and Beck and Levine (2001, 2002).

foresight to lend on the basis of no collateral to what became Sony and Honda as we know them today¹⁶. In those days, however, they were not acting as banks, they were acting as venture capital funds in so doing; these were not set loans, these were investments in return for equity stakes. Japan corporate finance, once upon a time, had a venture capital culture, even if you would not know it now, and it was replaced by a commercial bank culture.

Now, in addition to this backwards-looking long-term view, minimizing the uniqueness of the role of banks in development, there are also some trends that are gaining strength right now that are very important to reassessing the distinctive benefits of banks. We are moving towards a world where there is less need for banks in corporate finance – This is true even in the advanced economies, which already have relatively less reliance on bank loans in finance. If you think about the fact that historically banks made their profits by arbitraging information imperfections, there is reason to doubt such a large role in today's world where there is superior accounting, improved computerization, better disclosure and training, and the accumulation of financial innovation. Taken together, it is easier and easier across the world for firms to go directly to markets for their financing. This is a worldwide trend, albeit less so in emerging markets than in Japan, and less so in Japan than in the U.S.

We should also acknowledge that international capital mobility is increasing, granted with major interruptions, but still resulting in sufficiently deep global financial markets such that we are no longer in the Feldstein-Horioka world – that is, we are no

¹⁵ See in particular Hall and Weinstein (1996), Weinstein and Yafeh (1998), and the discussion in Posen (1998, ch. 6), among others.

¹⁶ See also Posen (2001b) for a discussion of financing and technological development in Japan despite the financial system.

longer in the world where the amount of capital available for investment is the amount of savings that happens to be available in a given country at given time. And the further we move away from that, the less we need a depositor base in every country to aggregate savings for investment. Consider the U.S. experience of the last 15 years, when domestic private sector savings declined, but the economy still managed to get investment funding. For emerging markets, saying “be like the U.S. with easy access to capital markets” is, of course, facetious, but the basic point as illustrated by Chile, China, Korea, and Israel remains¹⁷: with deeper financial markets, with better information flows, with advanced technology, with lower transaction costs, with new financial instruments, with better trained financial professionals and regulators, and with more people in the world exposed to financial concepts, the need for financial intermediation goes down, and the ability of firms and even households to go directly to markets goes up.

How do we know this? There is a worldwide secular trend of banks becoming less profitable as competition and technology reduce the cost of intermediation. Fukao’s contribution to this volume demonstrates the declining long-term profitability of Japanese banks and uses that as a major explanation of the resulting Japanese financial problems. Many of us recognize this basic story told of the Japanese financial crisis¹⁸: first came partial financial deregulation in Japan in the mid 1980s; then the best firms, the large non-financial corporations on which Japanese banks were making high margins with little risk, left their bank relationships to go directly to financial markets; as a result, the margins for what was left of the banks’ business with those firms shrinks; the newly

¹⁷ This does not address the current controversy over whether the first three of these countries benefitted from various controls they placed on capital flows, nor does it dismiss the costs of Israel’s security situation overwhelming investment incentives. It simply illustrates that for a non-negligible number of countries with some fundamental qualities, investment funds beyond their domestic savings were available.

unprofitable banks were not allowed to exit because exit was seen by Japanese regulators as market instability; this left those banks with a captive body of deposits to keep lending out; and so the hardest hit banks, particularly the long term credit banks that formerly had the big corporate accounts, switched to real estate based lending to riskier SMEs, and increased risks while earning no profits. And this has gone on for years.

Even in the U.S., which liberalized its financial markets earlier and more extensively, there arguably still is a great deal of over-banking. For Japan, it is very frightening to look at Table 1 in Okubo's paper for this volume, which shows how many banks there are in Japan, and the number is almost completely unchanged in any part of the banking sector, despite the fact of zero profitability for five, six, or seven years. Of course, the slow growth of the Japanese economy, and particularly the deflation of the last four-plus years, have played a role. But traditional banking has been of declining profitability around the world, except where government guarantees and interventions distort market results. One can see this in the current straits of the Germany banking system, excepting the government protected Sparkassen, or in the ongoing consolidations and sales to foreigners of U.K. banks.

3. Four Steps To Safely Shrink the Banking Sector -

First we have discussed why banks may be bad public risks given their association with costly financial crisis, why they are inherently so vulnerable, and why there seem to be insuperable incentives for regulators and bankers to be unresponsive to that vulnerability. Then we have considered the evidence that banks are not as uniquely helpful as some would purport they are, and that technological trends are further

¹⁸ See Mikitani and Posen (2000), notably the chapter by Shimizu.

increasing the ability to substitute for them, so that their benefits are increasingly outweighed by their risks. Yet, exit of individual banks, even from a situation of overcapacity, remains a difficult process to manage with potentially systemic effects – especially if savers have a reluctance to shift their investments elsewhere. How can policymakers safely shrink the banking system? Neither legal abolition nor raising of capital adequacy standards to prohibitive levels which would force shutdowns are viable. These hypothetical extreme measures, however, do indicate just how banks do owe their very existence to regulatory sufferance. Therefore, it is within a government’s power to broadly determine the banking sector’s number and scope in its economy

I advocate that policymakers should take advantage of certain of these major long-term trends against traditional banking that are already in place and encourage them. By policymakers, I am referring to the elected legislators, the financial regulators, the central bankers and people working at the IFIs. While there remains a real role for efforts to improve supervision, there is at least as great a role for encouraging the decline of traditional banking, especially since this strategy for stability has been little utilized so far and because banks will grow increasingly fragile and difficult to supervise as current trends continue.

I offer four more specific suggestions on how to undertake a strategy to safely shrink the banking sector: First, as called for in many of the papers in this volume, emerging markets or even developed small open economies should import foreign financial services. This may sound opportunistic, because obviously a great beneficiary of this process would be U.S. financial firms, recent scandals and reversals notwithstanding. But, it is important to realize that foreign direct investment [FDI] in the

financial sector, just like in every other sector, tends to transfer skills, technology, management techniques, as well as putting constructive competitive pressure on incumbent banks, and these knowledge transfers are embodied in the actual investment. Moreover, as we have seen in country after country, including Japan, when financial sector FDI comes in, investing firms do need to hire local people to implement their portfolio allocation and product marketing in a local context, even if their top management and financial principles come out of the world's financial centers.

Furthermore, except for the possibility of systemic risk—and is addressed in my second suggestion—there is no special reason to think that protection of the banking sector is any more necessary or efficiency enhancing than protection of any other industry¹⁹. There is direct evidence to this effect, but the relevant thought experiment is to imagine a U.S. auto industry that starting in the late 1970s managed to successfully persuade the US Government (even more than it did), “Okay, no company or plant needs to exit, competition would short-change our customers, workers, and shareholders, so the U.S. should not accept any FDI from Japan into the auto industry, nor import any production or management techniques from there.” How uncompetitive those firms would be, how backwards their production techniques would be, how under-performing the whole U.S. economy would be. It is very clear now in the auto sector that the intellectual battle has been won through openness to FDI; yes, there is still a GM and Ford, but there is also a *Daimler-Chrysler*, and all the big auto firms basically follow Japanese techniques of production, shop-floor teamwork, and inventory management, and they were prompted to do so by Japanese FDI and competition.

There are two additional reasons why the import of financial services, particularly through FDI, are good as a practical measure in emerging markets or all small economies: For one thing, such FDI allows the smaller economy to do some free-riding on the more diversified portfolios and better supervision of the home country banks. As we know, Latin America, especially the major countries therein in terms of size, has been in the forefront of taking in foreign investment in the banking sector. Argentina staved off crisis perhaps as long as it did, despite its self-destructive currency board and poor fiscal trends, in part because of a very strong financial system, and that financial system strength was in significant part the result of foreign investment.

The second important advantage of the importation of financial services is that it is a useful constraint on government behavior. It is well documented that banks, under regulatory control or as semi-public institutions, can be arm-twisted into doing things for the government²⁰. Not everything in the world should be privatized, but I think we would all agree that anything that is not should be on the public books in a transparent and accountable fashion. Admitting foreign financial firms, and having competition force domestic banks into greater independence from government, tends to weaken the ability of politicians to exert hidden pressure for the allocation of investment.

The second suggestion of how policymakers should bandwagon on the transition to a world with fewer traditional banks would be to extend securitization and transparency of financial transactions. In the U.S., one of the great success stories is Fannie Mae, Freddy Mac, and all the other semi-private institutions that securitize vast

¹⁹ Graham (2001) goes through this argument in detail. A series of recent empirical studies by B. Gerard Dages and Linda Goldberg, of the Federal Reserve Bank of New York, focussing on Latin America, support the view that foreign banks in emerging markets behave at least as well as domestic banks.

²⁰ See Sapienza (2002) and the references therein.

numbers of otherwise illiquid long-term bank-based loans (home mortgages, student loans) to individuals. There are efforts to do this outside of the U.S, but the general point is that securitization allows markets and regulators to work together. It increases market signals, it allows you to set very straightforward performance requirements, and, should there be a financial crisis, it helps unload what financial firms have in terms of distressed assets. A pointed way to make the comparison is to combine my previous point of concerns about government influence over lending behavior with the uses of securitization: where the Japanese Fiscal and Investment and Loan Program (FILP) takes savings directly to government uses and yields low or negative returns, Fannie Mae adds liquidity to lending, but holds few specific loans and makes few choices about allocation of funds. I think you would rather have Fannie Mae.

The other advantage of substituting transparent securities markets for banks insofar as practical are the advantages it offers to markets and savers over trying to make sense of what is a reasonably profitable bank and what is not. Remember, not just in Japan, but everywhere traditional banks are becoming less and less profitable, but more and more opaque in their regulation and in their books —that is, banks who have not diversified their activities out of traditional deposit taking and lending long are losing margins and should be going out of business. The increasing use of derivatives, and the coming shift to banks' self-designed Value-at-Risk models makes ascertaining the true exposure of banks to risk ever more challenging, leaving more prospect of surprise bankruptcies. Now the usual answer by regulators to a process of decreasing bank profitability, once they get beyond forbearance, is to encourage consolidation, mergers and acquisitions, either forced or voluntary. Unfortunately, in practice, this tends to be

much like regulatory forbearance. It tends to be a way of just keeping banks – and their less than competent managements, and their unduly protected shareholders - afloat.

So, for example, there is a system now in Japan where twelve of the top thirteen banks have merged into four new megabanks in groups of three, and each of these megabanks has supposedly gained in capital and in capabilities by garnering economies of scale and scope. These economies have not accrued in reality yet because these banks' announced to date reductions in labor force and in branch networks are miniscule. In any merger of two city banks in Japan, both would start out with national branch networks and with tens of thousands of employees. Meanwhile, each bank prior to the merger had major efficiency gains available to it by reducing their own staff and by replacing branches with ATMs and electronic banking, in line with global trends. Even before the merger, these megabanks needed movement into new services, and some investment in new IT, and new products with which they can compete—they certainly do not need to double their total staff, and they certainly do not need branches across the street from one another throughout Japan.

The third trend against traditional banking on which policymakers should piggyback comes on the deposit side. We can tell a story about the hypothetical Argentinean grandmother who is more financially sophisticated than the average American bank teller, given what instability she has had to cope with in protecting her savings over the years. Savers who get burnt enough times will put their money offshore, or will realize that other forms of investment impose not much more risk than bank accounts vulnerable to political forces and inflation²¹. We can expect there will be a very rapid tipping point at which the demand for standard branch-based time- or demand-

deposit services is going to go away. It is better to promote the shrinking of banks beforehand than to have a bloodbath of called in loans and foreclosed assets when that disintermediation occurs.

But also making reference to the more timid Japanese-type of grandmothers, let us ask what then happens to the depositors and consider bank runs. For a U.S. citizen, the movie *It's a Wonderful Life* is the fixed but removed image of what a bank run looks like – citizens of much of Latin America know from experience what a real bank run looks like. But, as was demonstrated in Martinez-Peria and Schmuckler (2001), there does not seem to be true market discipline or full credibility in *any* deposit insurance system²². Even in Japan in recent years, for example in 1997-98, when the crisis was at its most overt (so far), though there was explicitly unlimited deposit insurance through government guarantees, people still moved a significant portion of their savings out of private banks into the postal savings system, or into foreign Citibank accounts, or into cash in their home safes – and that is in Japan²³. Two factors are at work: one, deposit insurance does not provide much in the way of stability, except for a very limited subset of small depositors, especially given the perverse incentives it induces raising the risk of crisis; and two, most private individuals do seem inclined to react and take preemptive action on their own (whether or not this constitutes full self-insurance).

Every policymaker wants to protect small, unsophisticated depositors, or at least has no political choice but to do so. There is, however, an alternative path to that goal. It

²¹ The exception is Japan, but even this is changing – see Posen (2001a, 2002).

²² Barth, Caprio, and Levine (2001) and Demirguc-Kunt and Sobaci (2001) discuss the evidence for this point.

²³ See the evidence for a credit crunch in Japan due to low bank capital, despite blanket deposit insurance, in the analysis in Kuttner and Posen (2001). This process repeated itself in Japan in the first quarter of 2002, although the Koizumi government has made it clear that caps on deposit insurance would not be imposed beyond time deposits.

is time to revive an old idea of “narrow banking.” Narrow banking was the idea that the government could create a financial institution whose job was solely to provide simple financial services (secure small deposits, checking accounts for individuals and small businesses), which would invest in very safe (usually government) assets, and which would charge a very transparent fixed price (in the form of a fixed fee deducted from market returns) for providing these services. So, for example, the government could take the Postal Savings System in Japan, commit to their holding a wide portfolio of short-term government bonds, and use that as the investment assets of a narrow banking system. Unlike the current Postal Savings, however, the narrow bank version would buy the government bonds in the secondary market and not therefore not give the Ministry of Finance a discretionary off-budget pool of funds for lending. The narrow banking version of Postal Savings would also offer *lower* returns on investments than private vehicles, in return for the safety and convenience it offered, rather than using its government subsidy and guarantee to compete for deposits with private banks (as Japan’s Postal Savings System now does, distorting markets along the way).

The creation of such an institution has the beneficial side effect of adding depth in the secondary market for government bonds in any country you choose.

The fourth and final aspect of the secular trend in technology and profitability against traditional banking which policymakers should use to shrink the banking sector regards the payments system. Private commerce is moving more and more towards use of real time gross settlement for financial transactions, and to where even private non-financial entities are able to settle their books very quickly without services of a financial intermediary, or to off-load payments risk through derivatives and other means. There is

even some movement towards outright privatization of many forms of payment²⁴. This movement in payments of course also removes still one more steady source of easy income from banks.

Such a trend does tend to shift the risk onto the specific counterparties involved in any given transaction and limit the exposure of the broader financial system to interbank payment problems that might spill over. In a system that is largely securitized, if there are fewer banks, with fewer mismatches, and wider use of more real-time settlement, the *Herstatt* and related kinds of risks tend to decrease. On the side of the individual depositor, increasing numbers of individuals, even in emerging markets, are utilizing credit cards, e-money, pre-paid purchase/debit cards, frequent flyer miles, internet barter programs, and so on. While this trend is not yet anywhere close to replacing all checking accounts, it is plausible to project that a citizen of Ecuador or perhaps Argentina might someday soon think: “Gee, do I need to go through my country’s banking system, with the risks that opens me up to, to get a means of payment, or can I buy a value card from Citibank or Banco Santander, or a non-bank, like Wal-Mart or Microsoft? Yes, there is corporate risk, but this money is on the card for only a month and then I use it and I’m fine, and I shed some payment or bank-run risk. In fact, these multinational companies might be even more stable or protected from inflation or government expropriation than my domestic banking system.” Policymakers can change regulations and support pilot projects to encourage such developments as a form of additional safe exit from the banking system.

²⁴ See Friedman (1999). An important but separate macroeconomic issue this trend raises is whether such shrinkage of the banking system, and particular of the banks’ and the central bank’s role in the payments

4. Conclusion: Monetary Policy is No Substitute for Bank Exit -

So there are four very practical, reasonable steps policymakers can take to safely shrink the banking sector that take advantage of ongoing financial and technological trends in order to increase efficiency and reduce vulnerability. These by no means replace bank supervision, and by no means replace the need to keep banks adequately capitalized, so far as banks remain open. But if governments do not deliberately shrink the banking sector, their economies only remain unduly vulnerable to financial crisis, the frequency of crisis will increase over time as bank profitability continues to erode faster than safety-net and regulatory forbearance protected banks shed deposits or exit. It is therefore both feasible and preemptive for emerging markets to: encourage FDI and imports in the financial sector; to promote securitization and transparency; to create public narrow banks thereby shifting depositors either into accounts without systemic risk, or into risk-based assets; and to privatize payments systems as far as reasonable.

Is there any role for monetary policy in this bottom line? One striking aspect of the papers in this volume is that there has been very little said about macroeconomic and monetary policy. But, looking forward, to what extent is monetary policy either a cause of or a fix for the pressures on bank profitability and for regulators' repeatedly lagging responses to mounting financial crises? What Japan has demonstrated in the last several years (the case intended as the baseline for this volume) is that the effect of monetary policy is very asymmetric. Unduly deflationary monetary policy can cause great harm, although actively inflationary monetary policy may not do you very much good²⁵. In other words, the reason for the Bank of Japan to print yen, and buy JGBs or dollars or

system, might erode the effectiveness of monetary policy.

non-conventional assets, is not because inflation will fix the Japanese economy or even just the financial system. Rather, the reason the Bank of Japan should have been creating inflation in the last five years is because doing so would remove the additional drag on the economy and the corrosion of the financial system inflicted by deflation. A hammer may not be the correct tool for every kind of repair, but it is still worthwhile to stop repeatedly hitting yourself in the head with one.

But what about the supposed connection between loose money and crises? That illustrates another way that shrinking the banking system reduces vulnerability. Monetary policy that targets asset prices does not seem to work very well²⁶. Central banks want to err on the side of caution, meaning they do not want to commit to tackling issues beyond their control. A central bank can be very confident in its capabilities to be lender of last resort for one bank. A central bank can generally presume that if it raises interest rates a lot, it can probably make asset prices decline, but only by being unsure when, or for how long or how much, with extremely uncertain effects. And no central bank can be sure how much real effect there will be from increasing money in the banking system once the banking system is already broken. So, rather than being distracted by monetary policy from the main matter of banking stability at the structural level, it is best to simply acknowledge that economies do not benefit from high inflation, and obviously are harmed by deflation, and leave it at that. Avoiding extreme deviations from price stability, however, is not the fix for financial crises, nor is it likely to prevent them.

²⁵ See Mikitani and Posen (2000), particularly the chapters by Bernanke, Blanchard, Jinushi, et al, and Posen.

²⁶ Admittedly, this is still an open debate in economics. Two of our most brilliant macroeconomists, Ben Bernanke (2000) and Olivier Blanchard (2000), come down on opposite sides of this question.

Of course, monetary policy also has a role in stabilizing the real economy, and in particular in responding to the recessions that follow financial crises and burst bubbles. In this light, it is worth considering what used to happen in the late 1990s when Japanese government officials would pose the question, “What’s going to happen when the U.S. stock market bubble bursts?” I would reply, and I believe most mainstream macroeconomists felt much the same, “I think I agree with you, the U.S. stock valuations are a bubble, that’s why I didn’t invest in them myself. But I do not think the real effects will be the as long-lasting or as deep in the U.S. as in Japan because we are not as bank dominated, we are much more securitized, our collateral is more varied, and our real estate markets are much more liquid.” Certain visitors would hear this, start gnashing their teeth, and would reply, “You’ll see, you’ll see.”

Well, without wanting to sound overconfident, by September 2002 we have by now seen. The U.S. technology stocks have deservedly crashed, the trend U.S. productivity growth indeed was somewhat inflated by how much was attributable to the cyclical upswing, and there may be lingering effects of the corporate financing scandals. But there has been nothing of the transmission mechanism, of the financial fragility, of the devastating effects on growth we saw in Japan from the asset bubble there. That, of course, is an argument against too much reliance banks, which is where this essay began.

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