

The state should exit Europe's banking sector

By Wolfgang Munchau

Published: November 20 2006 02:00 | Last updated: November 20 2006 02:00

When I recently asked a well-known Swedish economist about the lessons of Sweden's economic success for the rest of Europe, he answered: "Don't copy our social model. Have a financial crisis instead." He was referring to the early 1990s, when Sweden experienced severe financial turmoil that precipitated deep structural changes in the banking industry and the economy at large.

The exact reasons for sudden improvement in a country's economic performance are difficult to ascertain. Policymakers often have only a single shot at reform. Gerhard Schröder, the former German chancellor, chose to reform welfare entitlements. Dominique de Villepin, the current French prime minister, tried, and failed, to reform the labour market for young people.

My own priority for France and Germany would be neither of the above. I would start with the banking system. Follow the money. A Schumpeterian Swedish-style financial crisis might do the job but it is not going to happen. Back in the real world, reform is the best alternative.

Of course, the problems are not identical across European countries. In both France and Germany, the banking market is dominated by non-private financial institutions. The problem is perhaps most acute in Germany, where in 2005 commercial banks accounted for a mere 26.5 per cent of the assets of the entire banking system, a figure hardly changed since 1990. The biggest force in the German banking system is the public sector and co-operative banks. The result is a pathological co-existence between the public and private sectors, under which the private sector has been driven out of large parts of the retail market.

There are instructive parallels with Italy. A comparative study of the two systems by academics from the Bank of Italy, the Bundesbank and various European universities found that Italy is in some respects a role model. In 1990, Italy had a similar bank structure to Germany's. Between 1990 and 2005, the asset share of the public sector banks declined from 70 per cent to about 9 per cent. The research found that technological progress was the main cause of the increase in total factor productivity in both countries but in Italy, privatisation also contributed to the rise in TFP.*

Why has Italy reformed, while Germany has not? The Italians realised they needed a modern banking sector in time for monetary union in the late 1990s. The Germans, by contrast, actually believed in their multi-pillar system. It served them well, especially in the period of postwar reconstruction. Attitudes are changing but only slowly. As a senior German official noted, the prevailing attitude today is more defensive: if it ain't broke, don't fix it.

Last week, the Bundesbank co-sponsored a conference on the future of public sector banking in Germany. The remarkable fact about this event is that it could not have taken place 10 years ago.

Academic research has consistently shown a negative relationship between the prevalence of public sector banking and a country's growth rate. This has been known for some time. Ross Levine, professor of finance at Brown University, argued that public sector banks are even unsuited to serving the goals they were originally set up to pursue: poverty reduction; financial development assistance; giving people access to capital they would otherwise not get; and overcoming the lack of credit history for small companies. The conclusion from the academic literature is that state-owned banks are mostly political banks that serve sectarian interests within society, but not society at large. To put it another way: they can be tools of corruption.

A study of state-owned banks in India, for example, has shown that their credit volume is 5-10 per cent higher in an election year. A similar study in Japan concluded that prefectures represented by influential members of the governing Liberal Democratic party received more public-bank loans. The situation is not fundamentally different in Europe. In Germany, the public sector banking system was often used by politicians at all levels of the federal system to prop up companies that would otherwise not exist in a purely competitive environment. While bail-outs are politically popular, their long-term economic effect is negative.

They impede structural change. If Germany had a purely commercial banking system, I would not be surprised if the share of manufacturing in the economy were smaller than it is today. The public-sector banking system is geared heavily towards the manufacturing sector.

So what are the chances of reform? A few years ago, after the collapse of the dotcom bubble, it looked for a while as though Germany might suffer a Swedish-style financial shock. But profit margins have since recovered. My prediction is that the combined force of European competition policy and further European financial integration will eventually lead to the long-overdue modernisation of the banking sector across the eurozone. It should be a priority for economic reformers to prepare the ground for change.

*Productivity Change, Consolidation and Privatization in Italian and German Banking Markets, de Vincenzo et al, conference paper, November 2006

[Copyright](#) The Financial Times Limited 2006