Earlier this month three of Japan’s largest banks -- Dai-Ichi Kangyo Bank, Fuji Bank, and the Industrial Bank of Japan -- announced their intention to join forces as part of a single holding company to create the world’s largest financial institution. The announcement came as the Japanese economy appears to be strengthening, and the news has been welcomed by most commentators. The merger plans, however, lack the sort of boldness that is needed to make Japan’s bloated financial industry more efficient and competitive.

Given Japanese bank managers’ proven resistance to meaningful reform, it is doubtful that so-called mega-mergers will help bring an end to Japan’s decade-long banking crisis. The DKB-Fuji-IBJ merger -- and any subsequent mergers, for that matter -- may prolong the lives of the banks involved. But they fail to address the fundamental problems plaguing the Japanese banking system: unprofitability and relatively minuscule return on investment.

In order to solve these problems one must first understand what went wrong in the Japanese banking sector and arrive at a realistic forecast of where the industry is headed. Since the start of the 1990s Japanese banks have been the largest in the world and about the most unprofitable. When the "bubble" economy burst, sending real estate prices tumbling, the banks were saddled with trillions of yen in bad debt, the great majority of which remains on their balance sheets to this day. Earlier this spring the government approved requests by 15 major banks (including DKB, Fuji and IBJ) for assistance totaling nearly 7.5 trillion yen ($62 billion). Last week, several large regional banks requested an additional $2 billion to recapitalize.

Overlooked in the debate over recapitalization has been any serious discussion of the future size of the banking system. As part of the package of reforms that has come to be known as the "Big Bang," Japanese financial markets are on the way to becoming almost completely liberalized. By 2001, the banks, insurance companies and securities dealers in Japan are scheduled to be able to freely compete to offer one stop financial shopping -- it is even possible that Japanese markets will be less regulated than U.S. markets. Indeed, part of the stated rationale for the formation of the holding company for DKB, Fuji and IBJ is to position these banks to better compete in the post-Big Bang environment.

But is bigger likely to be better? The completion of the Big Bang seems bound to reinforce the trend for Japanese firms to substitute capital market financing for bank financing. While this trend has not been as far reaching as it has in the U.S, where even small- and medium-sized companies are increasingly able to draw upon nonbank sources of funding, the largest Japanese corporations (particularly in manufacturing) already are about as independent of the banks as their U.S. counterparts. For these companies the banks have already been marginalized. Over the medium term there is every reason to believe that Japanese borrowing patterns for smaller firms (and even the larger firms that have been less internationally visible) will become much less bank dependent.

When weighing the prospects for the DKB-Fuji-IBJ alliance, and the other remaining Japanese banks, one key question is raised: How attractive is the traditional borrowing and lending business likely to be? More specifically, what would happen to loan demand in Japan if the rest of the Japanese firms followed the lead of the large manufacturing firms and shifted to U.S. levels of bank borrowing? According to our research, to be published later this year by the National Bureau of Economic Research, a migration in this direction would imply a massive reduction in borrowing by Japanese firms, with typical estimates centered on a 30% to 40% reduction. Even our most conservative forecast, which has all but the large Japanese manufacturing firms only moving halfway towards the U.S. benchmark, implies a 20% reduction in bank borrowing.
While there are many caveats about our calculations, most importantly that loan demand will drive the size of the banks, many different arguments point to the conclusion that Japan is over-banked. Experience shows that it is impossible for the largest firms in an industry to consistently have the lowest returns yet avoid shrinking. In the post-Big Bang financial system, where the Japanese banks will have to fight on a level playing field with most of the same firms that have been battling each other in the U.S., how long can they stay so much larger than the U.S. banks?

The observation that the Japanese banking sector looks destined to shrink puts the DKB-Fuji-IBJ merger and other policy options being discussed in Japan in a rather different light. For instance, if the industry is going to shrink by 20%, then not all of the 15 large banks that just got money are likely to be viable. Simply combining three large banks does not necessarily reduce any of the excess capacity in the industry. Fuji has long been rumored to be one of the banks with many bad assets that need to be disposed of. Pruning these assets will be one of the challenges for this new organization. Given the long tradition and track record of these institutions, a cost-cutting binge and drive to consolidate are likely to be very difficult.

Ironically, the events surrounding the formation of DKB give a very sobering picture of the change in mind-set that will be necessary for this alliance to work. DKB was originally formed almost 30 years ago through the merger of Dai-Ichi Bank and Kangyo Bank to make it the largest Japanese bank at that time. To smooth the transition, three personnel divisions were formed: one for the Dai-Ichi employees, one for the Kangyo employees and one for the new employees. But it took the bank over 20 years to integrate these functions. Along the way, the presidency of the institution was carefully rotated between Dai-Ichi men and Kangyo men.

The DKB-Fuji-IBJ deal is significantly more complex than the deal that created DKB, yet the plans for this latest deal call for the three banks to be integrated 10 times faster than it took to complete the original DKB merger. They say they have learned from the mistakes in the DKB merger, but the current merger plan still has a flavor of what Japanese call tasukigake, or crossing pattern, personnel: two of the three current presidents are to become the chairmen and the third is to become the president of the new financial holding company.

More generally, the goal of wringing out the current excess capacity in the system ought to be a central factor in deliberations over whether marginal banks are kept afloat or further mergers are encouraged. In our view, any further public money that will be used for recapitalization should be focused on the stronger banks that are likely to have a long-run future. If mergers are encouraged, they ought to be organized so that cost cutting can be encouraged and accomplished. No large Japanese banks should be planning to make high levels of profits the old-fashioned way: by simply taking deposits and making loans.

The drive to move away from traditional banking is an important part of the DKB-Fuji-IBJ tie-up. It is far too early to say whether this first Japanese mega-bank will be successful in the more profitable, nontraditional banking businesses (such as securities dealing, derivatives, and so forth). In the meantime, the form of the financial holding company could give them enough flexibility to consolidate. But, if they don't take advantage of this option to significantly reduce the duplication across the three organizations in their traditional activities, they will not have any chance at succeeding.

Unfortunately, the initial plans released by the banks do not call for much more shrinkage than the banks were individually planning. They say that they will close 150 branches, reduce employees by 6,000, and slash their expenses by 100 billion yen (about $909 million), but these numbers are about the same as the total from the individual restructuring plans that they submitted to the Financial Reconstruction Committee when they received their capital injections in March. This lack of boldness is why we are so pessimistic about the use of mergers to help put an end to the Japanese banking crisis.

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Mr. Hoshi is an associate professor at the Graduate School of International Relations and Pacific Studies, University of California at San Diego. Mr. Kashyap is a professor of economics at the University of Chicago Graduate School of Business. A Japanese version of this article appeared in the Monday edition of the Nihon Keizai Shimbun.