Banks, finance and investment in Germany

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and

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Preface

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1 Introduction

Conventional wisdom about German banks and investment finance

Banks play a major role in the German system of finance for investment, so much so that it is often characterised as being a 'bank-based' system. This is a reflection of the fact that German banks are typically universal ones. The term 'universal bank' is normally taken to refer to a bank providing a complete range of commercial and investment banking services (see Schneider, Hellwig and Kingsman, 1978), but is sometimes extended to mean a bank which also has close links with, and influence over, non-banks (see Krummel, 1980; World Bank, 1989, p. 50). The 'bank-based' German system of finance for investment is widely regarded as having made an important contribution to the successful performance of the German economy during the 'economic miracle' following the Second World War. A representative view of the role played by German banks in the German economy in this period is the following statement by Hallett (1990, p. 83):

> The banks helped to rebuild German industry ... after 1948. Firms rely extensively on loan, as against equity, finance, and the banks exercise an important monitoring role through their representatives on the Supervisory Board ... the role of the banks tends to counter 'short-termism', and provides a mechanism for reorganising management in good time, when a company starts running into trouble.

As this quotation illustrates, the German system of finance for investment is commonly perceived to be one which has two main distinguishing features. The first is that a large part of the funds for investment are provided in the form of bank loans, while the second is that banks monitor the performance of firms closely, and restructure firms and their management where necessary. The close involvement of German banks with firms is seen as having the consequence that German banks are more willing to provide finance for long-term investment than is the case in most other economies.

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The conventional wisdom that Germany's 'bank-based' system of investment finance has been an important factor in German economic success underlies much criticism of the 'market-based' system in the UK. Carrington and Edwards (1979, p. 191) argue that the German system of finance for investment, along with that of Japan, constitutes an

> alternative western capitalist tradition ... [with] a high debt and low equity capital structure, where a major source of the new long-term company investment is bank loans ... It can hardly be doubted that the sources of industrial investment capital ... are more adequate [in Germany and Japan] than they are in the USA or the UK. It is also difficult to deny the observation that those nations with high debt ratios in the capital structure of their companies have been most successful in the economic growth league tables.

This quotation illustrates another feature of the common perception of the German system of investment finance, which is that it is essentially the same as the Japanese one. The financial systems of these two economies are taken to epitomise the 'bank-based' system which is regarded as being superior to the alternative 'market-based' system.

A more recent critical analysis of the UK system of finance for investment, which reflects the growing concern during the 1980s in both the UK and USA that hostile takeovers were harmful to economic performance in those two countries, is that of Charkham (1989). Charkham argues that comparisons with Germany and Japan provide important insights into weaknesses of the UK system of corporate governance and its relation to the stock market. As far as the supply of external finance by banks is concerned, Charkham (pp. 8–9) contrasts

> two distinctly different ways of approaching lending ... In Japan and Germany the banks take a long view *ad initio*. If it is worth lending it is worth lending long: if it is worth lending long it probably means lending more later. Taking this view the banks have set about getting to know companies and the people who run them really well, in order to assess, help and guide them. This in turn has often led to the banks having good internal information systems on which to base advice: and to extensive training so that bank staff are qualified to advise ... In the United Kingdom the banks have been most anxious not to get so involved.

However Charkham (p. 8) argues that 'it is not just the banks' role as providers of finance that is important ... but also their direct help to, and influence on, company management'. Charkham (p. 13) sees the influence of German banks on management as deriving partly from the degree of knowledge the banks have about German firms, and partly from the banks' role as monitors of management acting on behalf of shareholders: 'In West Germany ... the banks ... are often substantial shareholders in their own right, but even more important act for those who deposit shares with them.'

The perceived superiority of the 'bank-based' system of business finance in Germany by comparison with the 'market-based' system in the UK has naturally resulted in policy recommendations which are based on the view that economic performance in the UK would be improved if the UK system of investment finance were altered to be more like the German one. Carrington and Edwards (1979, p. 220) say that

> there are three main choices for the future funding of industrial investment. First, nothing or very little may change; second, there could be a higher state involvement in banking; and third, banks could provide long-term funds for industrial investment on the German or Japanese pattern.

In their view, the third choice is clearly the appropriate one for the UK to make. At the conclusion of their discussion of takeovers and short-termism in the UK, Cosh, Hughes and Singh (1990, pp. 19–20) argue, following Charkham, that

> the institutional shareholder [in the UK] should take a much more active and vigorous part in the internal governance of corporations . . . in order for such a proposal to be effective both in disciplining inefficient managements and promoting long-term investments, far reaching changes in the internal workings and behaviour of the financial institutions would be required. The financial institutions would need to pool their resources together, set up specialised departments for promoting investment and innovations – in other words behave like German banks.

It is not simply in the post-Second World War period, however, that German banks have been seen as making a major contribution to good German economic performance. German banks have also been argued to have had an important influence on the rapid industrial development of the German economy in the latter part of the nineteenth century. Gerschenkron (1968, p. 137) is only one of several authors to assign a major role to German banks in German industrialisation:

> In Germany, the various incompetencies of the individual entrepreneurs were offset by the device of splitting the entrepreneurial function: the German investment banks – a powerful invention, comparable in economic effect to that of the steam engine – were in their capital-supplying functions a substitute for the insufficiency of the previously created wealth willingly placed at the disposal of entrepreneurs. But they were also a substitute for entrepreneurial deficiencies. From their central vantage points of control, the banks participated actively in shaping the major – and sometimes even not so major – decisions of the individual enterprises. It was they who very often mapped out a firm's paths of growth, conceived far-sighted plans, decided on major technological and locational innovations, and arranged for mergers and capital increases.

Kennedy (1987, p. 130) contrasts the operation of German banks in the late nineteenth century with that of the UK banks, and argues that the failure of UK financial intermediaries to behave in the same way as German banks hampered UK economic performance in this period:

> In Germany ... banks acted to evaluate managerial performance by rewarding good results and punishing bad ones, in short acting as a very large shareholders' protection agency ... In addition the extensive commercial intelligence of large banks provided the management of client firms with information both of relevant production and investment decisions taken elsewhere and of possible investment or marketing opportunities while providing the banks with a ready measure of their clients' successes and failures ... Intermediaries did not play such a role in Britain however.

The view that useful lessons for the UK system of finance for investment could be learned from the operation of the German one was sufficiently influential in UK policy circles for the Committee on Finance and Industry (1931, p. 163) to state that

> in Germany ... the banks were driven to assist industry to obtain permanent as well as short-dated capital. Accepting these heavy responsibilities, they were obliged to keep in more intimate touch with and maintain a more continuous watch over the industries with which they had allied themselves than were the English banks

and (p. 171) to say in relation to

> the more general question of the relations between finance and industry, and in particular to the provision of long-dated capital, we believe that there is substance in the view that the British financial organisation concentrated in the City of London might with advantage be more closely co-ordinated with British industry, particularly large-scale industry, than is now the case.

To achieve this the Committee recommended (p. 172) that an industrial financing concern should be established, to perform the functions of 'Acting as financial advisers to existing industrial companies ... assisting in ... founding companies for entirely new enterprises ... and generally being free to carry out all types of financing business.'

A particularly clear summary of the view that German arrangements are superior to UK ones was made by Crafts (1992):

> there are good reasons to choose the German rather than British style of capital markets: substantial bank involvement both in long-term lending and management of industrial companies, discouragement of hostile takeovers. In practice, the effectiveness of German banks as monitors of company performance (Cable, (1985)) and the apparent ineffectiveness of the British takeover mechanism in eliminating poor performance and creating post-merger efficiency gains (Cowling et al. (1980); Meeks,

(1977); Singh, (1975)) makes the German system unambiguously superior.

Although the view that the German system of finance for investment is better than the UK one is thus widely-held, there is only rather limited evidence available to support it. Crafts, for example, refers to one empirical study, by Cable, which attempts to link the performance of German firms directly to the role played by German banks, and three empirical studies which show that firms which have been taken over in the UK are not especially unprofitable, and that profitability after takeover does not improve. On its own terms, this evidence is limited, at best. Cable's study is the only one available which provides any evidence of a relationship between firm performance and bank involvement in Germany, and even Cable's work does not definitely establish that such a link exists.[1] There are many studies other than the three referred to by Crafts which provide evidence of the relative ineffectiveness of the takeover mechanism in improving firm performance in the UK, but all of these studies, including the three mentioned by Crafts, suffer from not distinguishing between hostile and friendly takeovers. Since the theoretical arguments that suggest takeovers are a mechanism for improving firm performance apply only to hostile takeovers, and since there are reasons to expect friendly takeovers to be motivated by very different considerations – for example, the desire of the owner-manager of a profitable and successful small firm to sell his or her controlling interest – it is important to make this distinction when undertaking empirical analyses of takeovers. There are some empirical studies of takeovers in the USA which do differentiate between hostile and friendly takeovers (Mørck, Shleifer and Vishny, 1988; Ravenscraft and Scherer, 1987). These studies suggest that it is potentially misleading to draw conclusions about the effects of hostile takeovers from empirical work which does not distinguish between hostile and friendly takeovers. In particular they find some evidence that firms which are the subject of hostile takeovers have been performing poorly, in contrast to the findings of studies which do not distinguish between the two types of takeovers, although their results do not provide any evidence that performance improves after a hostile takeover. Nevertheless, in order to argue that hostile takeovers are ineffective in the UK, it is necessary to have evidence which specifically relates to hostile takeovers, and at present such evidence does not exist.

Even if the evidence provided by Cable, and by studies of takeovers in the UK, were not subject to any qualifications, such evidence would not be sufficient to establish that the German system of investment finance

[1] Cable's study is discussed in detail in Chapter 9.

was unambiguously superior. It is to some extent inevitable that only very limited evidence is available to support the widely-held view of the merits of the German system, because the question which is being addressed is a very difficult one to answer. The evidence that would be required to answer this question satisfactorily would involve a comparison of investment and growth by German firms under the actual German system of financing investment, and under a hypothetical alternative, such as the UK system. A similar comparison of investment and growth by UK firms under the actual UK system, and under a hypothetical alternative, such as the German system, would also be needed. It is clearly very difficult to assess the alternatives involved. Ideally an empirical model of economic growth in which the significance of all possible influences on relative growth performance were identified and quantified would be used. But a model of this sort does not exist, and is unlikely to do so for some time given the present state of knowledge concerning the explanation of relative growth performance. This being the case, it must be recognised that the question, say, of the contribution made by the German system of business finance to German industrialisation in the nineteenth century is one to which it would be very difficult to give an unambiguous answer, even if there were not data deficiencies. As such deficiencies do exist, it is not surprising that Lee (1991, p. 14) should write that 'the precise role of ... the banking mechanism in general on German industrial growth [during German industrialisation] must remain open'. It is also not surprising that, in general, the empirical basis for the claims made about the significant contribution of the German system of investment finance to German economic success in the post-1945 period takes the form of simple correlations – German economic performance has been superior to that of the UK, German investment as a proportion of GDP has been higher than in the UK, and the German system of finance for investment is different from that of the UK. The temptation to use such simple correlations is understandable, given the difficulty of the question that is being addressed. But since there are many other respects in which Germany differs from the UK that may be relevant for relative economic performance since 1945 – for example, in its system of education and training, or in its macroeconomic policy – it is impossible to conclude anything about the contribution of the German financial system to German economic performance on the basis of simple correlations which do not take account of other possible influences.

Because we think that it is not possible to assess how far good German economic performance in the post-1945 period was due to the German system of investment finance as compared to, say, education and training in Germany, the approach taken in this book is more modest, but as a result, we believe, more informative. We attempt to establish the extent to which the various components of the commonly-held view about the contribution of the German system of business finance to German economic success are supported by evidence for the post-1945 period. In contrast to many previous studies of the German financial system we use an analytical framework derived from modern theories of business finance and financial intermediation as the basis for our empirical work. This has the advantage of focusing attention more sharply on the issues for which it is important to have empirical evidence in order to assess the plausibility of the widely-held view of the benefits the German economy has derived from its system of investment finance.

Before proceeding with the analysis, it is useful to set out in some detail the various components of the view that the German system of finance for investment has contributed to good German economic performance. As is apparent from our discussion above, there are several different ways in which the important position of banks in the German system of business finance is seen as producing favourable outcomes for the quantity and quality of investment in the German economy. For analytical purposes, it is helpful to enumerate them systematically.

The merits of the German system of finance for investment: elements of a widely-held view

What we have called the 'widely-held view' has a number of different components, and in this section these various elements are set out. In assembling these various components, we have drawn indiscriminately on arguments expressed with reference to the pre-1914 and post-1945 period, because although we recognise that there are significant differences between the German economy in these two periods, the ways in which the German system of investment finance has been argued to benefit the economy in the two periods are very similar.[2]

A central feature of the widely-held view is that German banks are supposed to be much more closely involved with the firms to which they supply funds than are UK banks. This close relationship between banks and firms in Germany is seen as being partly the consequence of some German institutional features which are not present in the UK. One is the

[2] For example, Carrington and Edwards (1979, p. 120) in their discussion of the contribution made by banks to the economic success of West Germany since 1945 say that 'this industry-assisting role of German banks goes back to the mid-19th century', while Eatwell (1982, p. 79), another proponent of the view that German banks are an important factor in German economic success, states that 'the close relationship which exists today between industry . . . and the banks in Germany derives from institutional arrangements developed in the nineteenth century'.

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