Banking and Finance in West Germany

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Chapter 1

AN HISTORICAL INTRODUCTION AND AN OVERVIEW OF THE BOOK

I Introduction

From the viewpoint of the theory of financial intermediation, the structure and degree of sophistication of the banking and financial system in West Germany should be readily explicable: as in other advanced capitalist economies, the credit institutions in the Federal Republic serve the primary function of transferring funds from surplus to deficit units. Again, given the high degree of economic development attained in the Federal Republic, the range and complexity of its financial intermediaries should approximate to that in other similarly advanced economies. There might well be specific differences between countries in the nature of the banking and financial system with which they are equipped, but the role of financial intermediation is common to them all. While not denying the validity of this approach, however, the purpose this study is precisely to focus upon the specific features of the West Germany system.

Two reasons may be advanced immediately for doing so: first, the particular nature of financial intermediation characteristic of an individual country cannot be seen as merely due to chance, or as embodying some abstract logic. It is capable of providing information as to the paths which that country's economic development has followed and the general political and social environment within which it has proceeded. Relatedly, but perhaps even more basically, the present shape and "feel" of a financial structure, the way it performs its functions, cannot be fully understood without our having some idea of just why it has that shape and no other. For some purposes, any knowledge of its development may quite permissibly be dispensed with; but for an insight into the way it works now and the type of institutions which embody it, some grasp of the history of that development seems necessary.

Second, the way in which a particular country has sought to organise financial flows can suggest to others facing similar problems that certain types of institutions might well be implanted in them. We need only think, for example, of the influence exerted throughout Europe in the late 19th Century by the Credit Mobilier developed in France[1]; and certain features of the German system, especially the "universal banks", have exerted a similar (though lesser) attraction upon other countries up to the present day.[2]

Both reasons may therefore be advanced in justification of the approach to be followed in this introductory chapter and, to a lesser extent, throughout this study. For what would be seen as the most evident feature of the German system which distinguishes it from that in other advanced economies, especially from that in Britain and (after the New Deal banking reforms[3]) the USA, has been the dominance exerted in various fields by the "universal banks", i.e. banks which provide a full range of banking services. They "take deposits and make loans, are active in the securities business (the underwriting and issue of securities, the acceptance of securities on deposit and provision of bankers' services) and sit on the supervisory boards of non-bank corporations"[4]. This appears to provide a sharp contrast with systems in which a clear separation has been enforced between various types of banking, especially between commercial and investment banking. In turn, the predominance of the universal banks in Germany has been widely ascribed to the way in which and the period during which German industrialisation took place.

A somewhat less evident feature of the development of the German financial system, but one perhaps equally determinant of its present organisation, has been, however, the fact that on three occasions in the present century it has faced virtual collapse: after the inflation of 1922/23, the bank crisis of 1931, and the destruction of the Nazi regime in 1945. The problems of the system in 1931, though not some of its probable political consequences, and the role of the state in reorganising it, can to some extent be paralleled in other advanced economies at the same time, most obviously the USA. But the other experiences mark out the history of the German system as basically <u>sui generis</u> among economically advanced countries, and taken together they render explicable such features of it as the importance attributed by West Germans today to the autonomy of the central bank.

Other, historically specific features of the German system need only be pointed to here, since they and their consequences will be referred to in later chapters, e.g. the relative narrowness of the money and capital markets that has historically existed in Germany, and the difficulties confronted by open market operations of the traditional type; or, relatedly, the fact that until the early to mid-seventies the state was absent as a net borrower of funds from the market. In this introductory chapter, two features of the historical development of the system that have been referred to above will receive primary emphasis: the development of the universal banks and their function, and the collapse of the overall financial system on three occasions this century.

II The Universal Banks

The most famous thesis as to the origin of the universal banks and their role in German economic development is that advanced by Alexander Gerschenkron,[5] though some of their special features and functions had been pointed out long before Gerschenkron published his work. Thus Jacob Riesser in 1911 emphasised their role in providing the capital sums required by German industrial firms in their founding years, in the absence of either a supply of funds forthcoming from the general public in sufficient quantity for the purpose or a willingness on their part to accept the risk of investing their funds in industrial undertakings. Since, in Riesser's view, the private banks could not meet the capital requirements of such undertakings, which were both "new and enormous", joint-stock banks had had to be created for the purpose. But these banks in turn did not merely "leave enterprises to their fate" but retained a share in them, so as to "exercise permanent supervision over (their) management", because the banks expected the funds they had advanced to them to be repaid from the proceeds of an issue of stocks and bonds once the enterprise was sufficiently well established.[6]

What Gerschenkron did, then, was not so much to discover the role of the universal banks in German industrialisation as to provide a theoretical rationale for it. This rationale stemmed from his views as to the way in which European countries embarking upon industrialisation in the late 19th century had both developed and been forced to develop means of financing that process which the early starter, England, had solved in other ways. Thus, he argued, the industrialisation of Europe should be seen as a process that was diffused from Britain during the 19th Century. A country could then be defined as "backward" by reference to the date at which its industrialisation began, and the greater the degree of its backwardness the greater would be its variation from the British pattern of growth. Two such variations are of most importance in the present context: first, a large scale of industrial plant is involved, and primary emphasis is upon the producers' goods sector rather than that of consumers' goods; and secondly, a much greater role is played "by special institutional factors designed to increase the supply of capital to the nascent industries and, as well, provide them with less decentralized and better informed entrepreneurial guidance".[7] Germany then fits into this scheme in the following way: when Britain began to industrialize, it did so on the basis of relatively small-scale firms, whose growth could be financed by reinvesting profits and required little in the way of specialised entrepreneurial skills. When Germany began its industrialisation, the process had been rendered very much more difficult by the far greater complexity of technology and markets, and far more capital was required if the optimum scale of plant was to be installed. Similarly, entrepreneurial talent was scarce. Hence, in a formulation which, although applying to Europe as a whole, is seen as fitting the German case well, "it was the pressure of these circumstances which essentially gave rise to the divergent development in banking over large parts of Europe as compared to Britain. Continental practices in the field of industrial investment banking must be conceived of as specific instruments of industrialisation in a backward country".[8]

The argument appears initially persausive, especially since it links so closely with what contemporary observors such as Riesser emphasised as the main role of the universal banks. Subsequent criticism of it has taken two main lines, both questioning the actual significance of such banks for German economic development. The first argues that there is both a dating and a location problem involved in the thesis. Thus Cameron points out that the "heroic age" of German industrialization should be seen as falling roughly between 1834 and 1870, but the great majority of the large joint-stock banks were not formed until after 1870.[9] There is also a location problem: it was the Rhenish private bankers who were closely involved in the process, and who developed the type of industrial promotional and financing activities so firmly associated afterwards with the joint-stock "universal banks".[10]

The second line of criticism is a product of the new econometric history, and questions the efficiency of the universal banks as a system for financing German economic development. This suggests that the banks inhibited rather than stimulated German development because of the policies they followed in their allocation of credit among the various economic sectors. In particular, it has been asserted, there was a bias towards heavy industry and against light industry, and in general a degree of "allocative inefficiency serious enough to have hampered the growth of non-agricultural output" in general.[11]

Even if both these criticisms of Gerschenkron's thesis are correct, however, and some serious doubts have been raised in connection with the second,[12] they do not set aside the basic fact of a closeness of relationship between the banks and industry which does not really have a parallel in either Britain or the USA. But a more promising line of approach would be to look at the degree of influence actually exerted by such banks on the structual, growth and pricing policies of the firms upon whose supervisory boards they were so widely represented. After all, the possession of substantial shareholdings and/or seats on its supervisory board does not necessarily imply anything more than an ability to "influence" which could fall very far short of control, as the banks found to their cost when the firms with which they were involved got into difficulties during the depression of 1929/33. In this connection, the work of Böhme is important, for it shows above all that the relationship between the universal banks and "their" industrial customers underwent substantial changes as the process of industrialization continued. In particular, disputes between the banks and their industrial clientele as to concentration and pricing policy had already flared up in 1879, and the growing scale of industrial firms, especially in the basic heavy industries, meant that the initiative in determining the structural and growth policy of industry tended to pass into the hands of the firms themselves. In effect, the success of the banks in promoting concentration and suppressing competition in the interests of "market peace" had led to the creation of such large industrial undertakings that from the '90s onwards the capital sums required for further expansion began to be beyond the resources of any one of the large banks to supply, and bank consortia had increasingly to be formed for the purpose.[13] Gerschenkron in fact refers to this process when he remarks that "the sheer growth of industrial enterprises enhanced the position of individual firms to the point at which they no longer needed the banks' guidance".[14]

On the other hand, the very same factor promoted concentration among the banks themselves, so that by 1912 the eight big Berlin banks (Berliner Grossbanken) controlled 51% of all commercial banks' assets. The provincial banks continued to exist in substantial numbers, partly because the Berlin banks located as they were in the main city for the flotation of industrial and commercial securities, tended to withdraw from regular daily business and concern themselves primarily with the large securities' flotation. While, however, the provincial banks apparently maintained their independence, they became tied more and more closely to their Berlin correspondents and could easily be swallowed up by them.[15] When this is taken into account, the Berlin banks in fact controlled 83% of the total assets of all commercial banks in 1912.[16]

Finally, if Gerschenkron's thesis overstated the novelty, ubiquity and entrepreneurial role of the universal banks, it and the discussion to which it gave rise has also led to neglect of the rest of the banking system in particular by concentrating concern upon the provision of credit to large-scale industrial firms. Even before the First World War, however, a range of other financial intermediaries, especially the local savings banks and the credit cooperatives assembled and distributed funds on a scale that was considerably in excess of the joint-stock and private banks, as the following table shows. Of course, much of the credit granted by intermediaries of this type was to small borrowers, especially in the fields of agriculture and small-scale business. Yet it must be remembered that, shortly before the First World War, some 38% of the working population were still employed in the "primary" sector (predominantly agriculture).[17] Similarly, 89.8% of all enterprises were socalled "small firms" (Kleinbetriebe) employing up to 5 employees, but responsible for about one-third of all dependent employees and for the same proportion of the net product of the sector "industry and crafts (Handwerk)".[18]

III The Instability of the System

There was, however, one feature of the banking system which, at least to an observer whose experience was purely of the British system, continuously threatened danger: the way in which its main private institutions conducted their intermediary role. This was most obvious in the case of the universal banks: while the loans they granted to large-scale industrial firms were expected to be repaid in a relatively short time by the proceeds of an issue of securities by the firm, or rather by the bank on behalf of the firm, the time was of necessity considerably longer than that for which a British bank would normally extend credit to one of its borrowers. Moreover, the German procedure did appear to make the recovery of their liquidity by the banks highly vulnerable to changes in the prevailing sentiment on the stock market and hence to the reception it would give to a flotation. This was even more the case if the bank retained substantial shareholding in the firm even after it had been successfully floated. Given that the banks worked with very low liquidity ratios anyway,[20] the dangers seemed obvious, though historically they had not really eventuated. The savings banks (and the same could be said of the credit cooperatives) seemed rather less prone to such liquidity problems: the great bulk of their business remained in savings deposits, whose volume could be expected to be relatively stable and could therefore be converted, with a much higher degree of security, into long-term lending. What was to prove a source of instability for them, but not till the depression period of 1929/33, was their peculiar legal position: as bodies wholly owned and controlled by particular local government authorities, they were open to pressure from those authorities to place large proportions of the funds they had accumulated from depositors into very highly illiquid obligations issued by the local authorities themselves.[21] In both cases, however, while general economic

Table 1.1: Deposits with German Credit Institutes, 1910 and 1913[19]
(in mill. Marks)

Year	Large Berlin Banks	Provincial Banks	Total	Mortgage Banks	Savings Banks	Credit Cooper-atives
1910	4482	4241	9123	705	16781	3619
1913	5149	4493	9642	809	17882	3908

conditions remained to any degree favourable, there seemed to be little cause to worry about the possible consequences of their divergence from the British model in their intermediating behaviour.

In any case, it is difficult to believe that the particular nature of that intermediation was in any meaningful sense responsible for the enormous difficulties experienced by the German financial system in the postwar inflation.[22] Indeed, it seems reasonable to ask whether <u>any</u> financial system could have surmounted the catastrophic devaluation of its assets to which that process gave rise. For the proximate cause of that inflation is to be traced to the willingness of the Reichsbank to facilitate an enormous increase in the money supply, and that willingness in turn to factors whose origins are far more of a political than an economic nature.

Among such underlying causes of the inflation, two seem to have been of crucial significance: the deficit financing of the war and its continuance in peace-time, exacerbated by what Germans felt to be the need to finance the costs of the passive resistance to the French occupation of the Ruhr in 1922/23; and reparations. The latter was clearly political in origin; but the former as well has been traced to the inability of the central government both during and after the war either to impose and collect a level of taxation that would have been necessary to prevent the growth of government debt, or to acquire that legitimacy in the eye of the population which would have enabled it to fund its debt. The characteristic of German central government finances after 1918 especially was an enormous and accelerating rise in its floating debt, composed of central government obligations which the Reichsbank stood ready to discount without restriction and thus to enable the money supply to show an enormous increase.

Moreover, as prices rose, the demand for credit from the financial system also rose in proportion simply to finance a volume of business stable in real terms, as well as enable the purchase of real assets on which speculative gains could be made. And if such credit was not forthcoming, the result could well have been a complete collapse of industrial activity in a country still subject to revolutionary attempts to change its political constitution and to uncertainty as to its reparation burdens and even to the future shape of its political frontiers. It was possible to initiate by restrictive monetary policy a sharp business downturn in Britain and the US in 1920/21 to come to terms with the inflationary overhang from the war, but the fragility of German political institutions made it unlikely that such a sharply deflationary policy could have been followed there.[23]

Once inflation accelerated, it became virtually impossible for German financial institutions to present balance sheets with any economic meaning: the real purchasing power represented by a loan of a given nominal amount deteriorated rapidly from day to day, as did that represented by the interest and amortization payments upon it. In fact, the large banks ceased to issue balance sheets at all in 1922 and 1923.[24] While there was some shift to accounting in terms of stable currency units, especially the dollar, the principle of "Mark equals Mark" retained its dominance during the whole of the period.[25] When the mark was finally stabilized, the financial institutions were simply permitted to construct new balance sheets in terms of gold marks as of 1 January 1924; even then, the figures which appeared in them reflected simply the valuations placed on their assets and liabilities by the firms themselves. As Hardach points out, "their opening balances reflected not so much the heritage of the past but rather an evaluation of the future earnings of the bank".[26] There was some writing-up of debts to compensate for the loss of purchasing power inflicted upon them by the inflation, especially of government debts, but it was tardy and represented only a very small proportion of such losses.[27]

What the inflation had done, however, was not merely to accelerate the process of concentration in the banking system in particular, but also to bring about a substantial weakening in its balance sheet position. The figures reflecting this development are subject to substantial difficulties of interpretation, but Lüke has estimated that the banks lost up to 35.9% of their paid-in share capital and 31% of their true reserves.[28] And what was of equal significance was that there had also occurred a pronounced shift in the term structure of deposits with the banks. Thus, in the case of the large Berlin banks, deposits of from seven days to three months had constituted 29.8% of their total deposits in 1913, but 40% in 1924, and deposits of more than three months had fallen from 13.4% to only 2.5%. Similarly for the savings banks: at the end of 1913, savings deposits had accounted for 99.7% of their total deposits and current accounts (Giroeinlagen) for only 0.3%; at the end of 1924, the proportions were 48.1% and 51.9% respectively.[29]

This in itself would have been serious enough, given the potential liquidity dangers arising from the way in which German banking conducted its business, as has already been pointed out. But in addition, Germany during the 1920's appeared to be suffering from a "capital scarcity", exemplified for contemporaries by the persistently large interest rate differential that persisted between Germany and other advanced economies.[30] Faced with a persistently high level of demand for credit, in conjunction with a weakened base of own funds with which to (at least partly) meet it, the German banking system in general and the large Berlin banks in particular turned increasingly to foreign inflows of funds to fill the gap. Thus in 1928, foreign short-term deposits in German banks made up 43.4% of their total deposits.[31] Yet such foreign funds were not merely dominantly short-term in nature; even more, the willingness of their owners to retain them in Germany was highly vulnerable to both fluctuations in the level of economic activity in Germany and to more narrowly political factors, e.g. the unsettled position with reparations and political developments within Germany itself.

While the savings banks and credit cooperatives had not been so heavily involved in the inflow of short-term funds as the large commercial banks, the savings banks in particular were placed in a vulnerable position by their peculiar legal relationship to their sponsoring/owning local government authorities. In effect, they were wholly under the influence of such authorities, and with the outset of the depression the ominous features of this relationship were actualized. For the local authorities were faced with a sharp decline in their revenues from the taxation they were empowered to levy, while simultaneously they faced sharply increasing expenditures on unemployment benefits, especially since the central government sought to ease its difficulties in this field by shifting onto their shoulders an increasing proportion of its responsibility. In this situation, they turned to "their" savings banks for finance, who were thereby put into an almost totally illiquid position.[32]

When, then, outflows of foreign funds and a domestic withdrawal of deposits began in early 1931, the latter spurred by the collapse of the textile firm Nordwolle and the large Berlin bank most closely associated with it the Darmstädter and National (Danat), the banking system necessarily entered into very great difficulties. Nor could the Reichsbank